IPO Report

2019

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2019 IPO Report – What's Inside

REVIEW

The IPO market produced 183 IPOs in 2018, an increase of 29% from the 142 IPOs in 2017. The year's tally represented the second-highest annual figure since 2007, trailing only the 244 IPOs in 2014.

Total gross proceeds for the year were $43.75 billion—43% above the $30.51 billion figure for 2017.

IPOs by emerging growth companies (EGCs) accounted for 92% of the year's IPOs, compared to 87% in 2017—a figure that matched the overall market share for EGCs since enactment of the JOBS Act in 2012.

The median offering size for all 2018 IPOs was $108.0 million, a 10% decline from the $120.0 million median for 2017 but 10% higher than the $98.0 million median for the five-year period from 2012 to 2016.

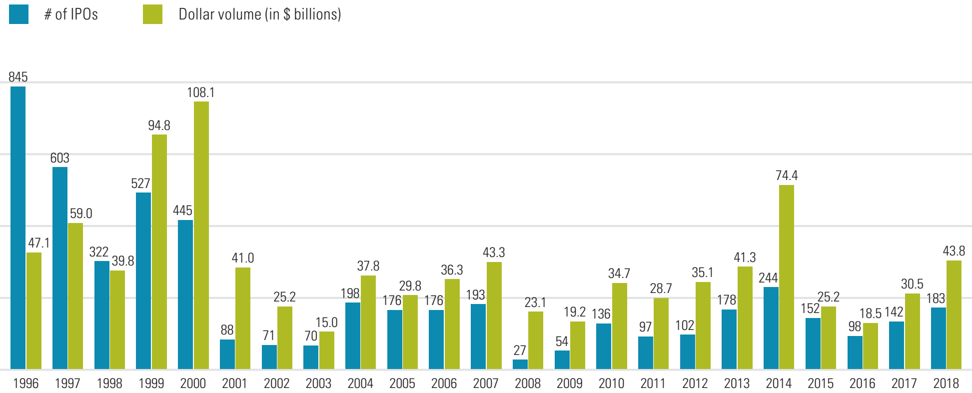
The median offering size for life sciences IPOs in 2018 was $85.3 million, 8% above the $79.1 million median in 2017 and 31% higher than the $65.0 million median for the five-year period from 2012 to 2016. By contrast, the median offering size for non–life sciences IPOs in 2018 was $161.0 million—up 7% from the $151.0 million median in 2017 and 23% above the $130.8 million median for the five-year period preceding 2017.

In 2018, the median offering size for IPOs by EGCs was $101.3 million, a decrease of 5% from the $106.5 million median in 2017 but 18% above the $85.9 million median that prevailed from enactment of the JOBS Act through 2016. The median non-EGC offering size in 2018 was $731.5 million, a 55% increase from the $472.0 million median for 2017, representing the highest annual level since 2012.

The median annual revenue of all IPO companies in 2018 was $68.2 million, almost one-third below the $101.4 million figure for 2017 but 20% above the $57.0 million figure that prevailed from 2014 to 2016.

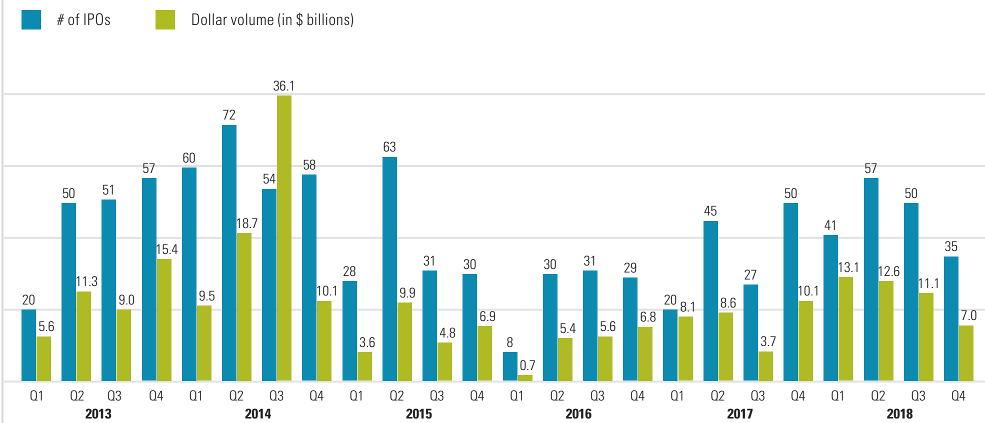
In 2018, only 43% of life sciences IPO companies had revenue, up from 34% in 2017 but below the 64% of life sciences IPO companies that had revenue during

US IPOs by Year – 1996 to 2018



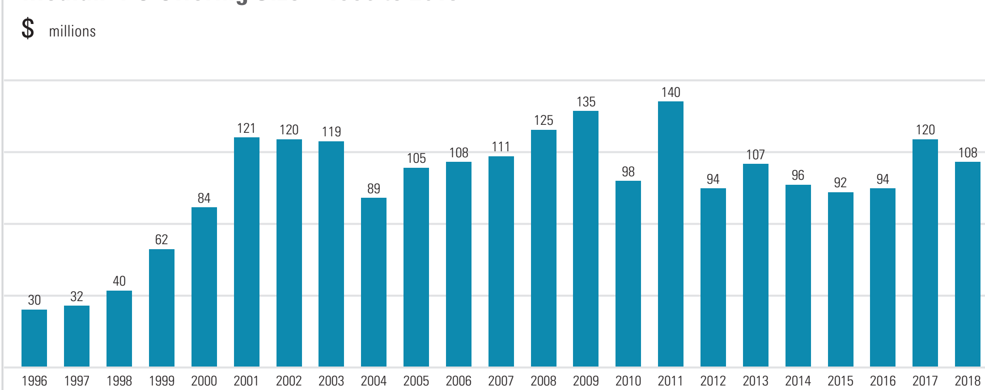
Source: SEC filings

US IPOs by Quarter – 2013 to 2018



Source: SEC filings

Median IPO Offering Size – 1996 to 2018



Source: SEC filings

the five-year period from 2012 to 2016. The median non–life sciences IPO company in 2018 had annual revenue of $201.6 million, 5% below the $212.8 million median for 2017 and 2% below the $205.8 million median for 2016, but 31% above the $154.0 million median that prevailed during the five-year period from 2011 to 2015.

EGC IPO companies in 2018 had median annual revenue of $50.8 million, compared to $1.69 billion for non-EGC IPO companies. The median annual revenue for non–life sciences EGC IPO companies in 2018 was $167.3 million, an increase of 10% from the $152.1 million median for 2017 and 55% above the $108.2 median that prevailed from the enactment of the JOBS Act through 2016.

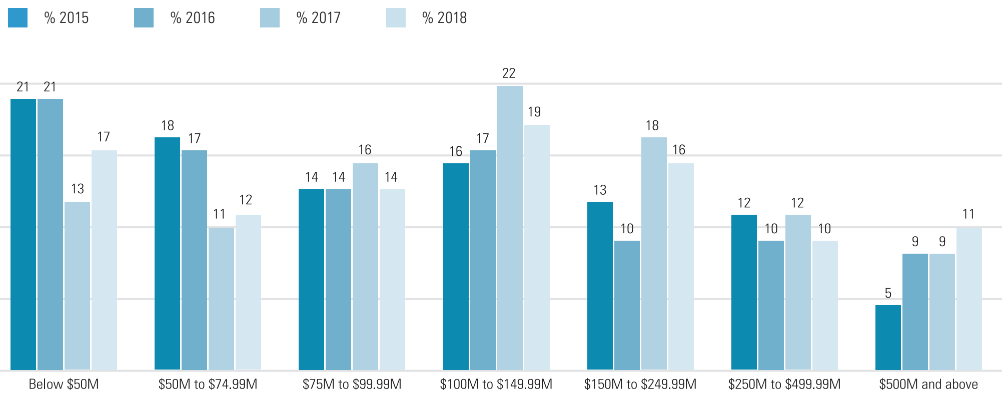
The percentage of profitable IPO companies declined to 28% in 2018 from 34% in 2017 and 36% in 2016. Only three life sciences IPO companies in 2018, or 4% of the year's total, were profitable, compared to 10% over the five-year period from 2013 to 2017. In 2018, 44% of non–life sciences IPO companies were profitable, down from 52% for the preceding five-year period.

In 2018, the average IPO produced a first-day gain of 16%, compared to 14% for the average IPO in 2017 and 12% in 2016. The average 2018 first-day gain was the second-highest annual figure since 2000, behind only the 21% first-day gain in 2013.

The average life sciences IPO company gained 14% in first-day trading in 2018, compared to 18% for the year's non–life sciences IPO companies. First-day trading results in 2018 were similar to 2017, when the average life sciences IPO company gained 13% in first-day trading, compared to 14% for non–life sciences IPO companies. In 2016, by contrast, the average life sciences company rose only 6% on its first trading day—less than half the 16% gain achieved by non–life sciences IPO companies.

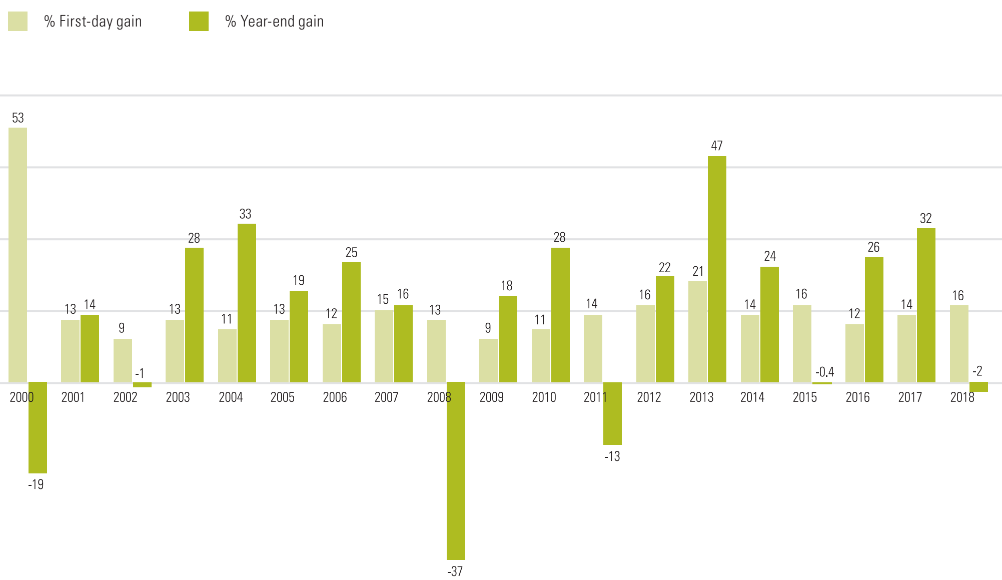
There were a pair of "moonshots" (IPOs that double in price on their opening day) in 2018, up from one each in 2016 and 2017 but down from an annual average of six moonshots between 2013 and 2015—a three-year period that stands out as an aberration when compared to

Distribution of IPO Offering Size – 2015 to 2018



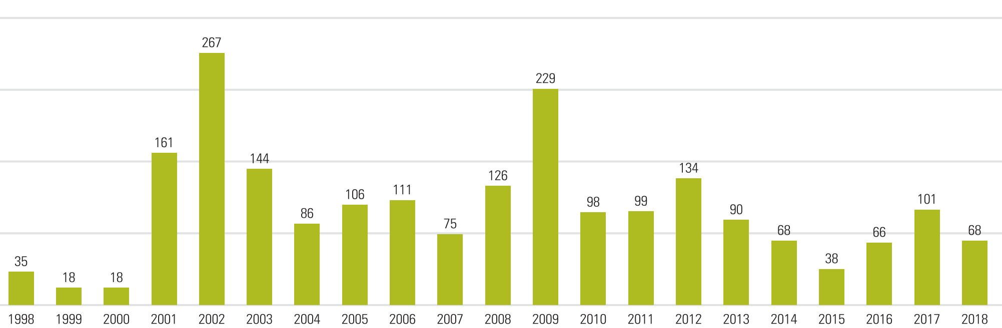
Source: SEC filings

Average IPO First-Day and Year-End Gain by Year – 2000 to 2018



Median Annual Revenue of IPO Companies – 1998 to 2018

$ millions



Source: SEC filings and IPO Vital Signs the incidence of moonshots for all other years following the dot-com boom.

In 2018, 24% of IPOs were “broken” (IPOs whose stock closes below the offering price on their first trading day), up from 20% in 2017 but equal to the percentage over the five-year period from 2012 to 2016. In 2018, 28% of life sciences company IPOs were broken, compared to 21% of non–life sciences company IPOs.

Overall, the average 2018 IPO company ended the year 2% below its offering price—only the third time in the last ten years that the average IPO has failed to produce a gain by year-end.

The year’s best-performing IPO was Tilray (trading 315% above its offering price at year-end), followed by Allakos (up 190%), Inspire Medical Systems (up 164%) and Goosehead Insurance (up 163%).

At the end of 2018, 61% of the year’s IPO companies were trading below their offering price—life sciences companies faring better than their non–life sciences counterparts, with 55% trading below their offering price compared to 64% for non–life sciences IPO companies.

Individual components of the IPO market fared as follows in 2018:

— ***VC-Backed IPOs***: The number of IPOs by venture capital–backed US issuers increased by 52%, from 50 in 2017 to 76 in 2018. The percentage of all US-issuer IPOs accounted for by VC-backed companies increased from 48% in 2017 to 61% in 2018. The median offering size for US VC-backed IPOs increased by 5%, from $96.8 million in 2017 to $101.3 million in 2018. The median deal size for non–VC-backed companies was $142.8 million in 2018, down 8% from $156.0 million in 2017. The average 2018 US-issuer VC-backed IPO gained 8% from its offering price through year-end.

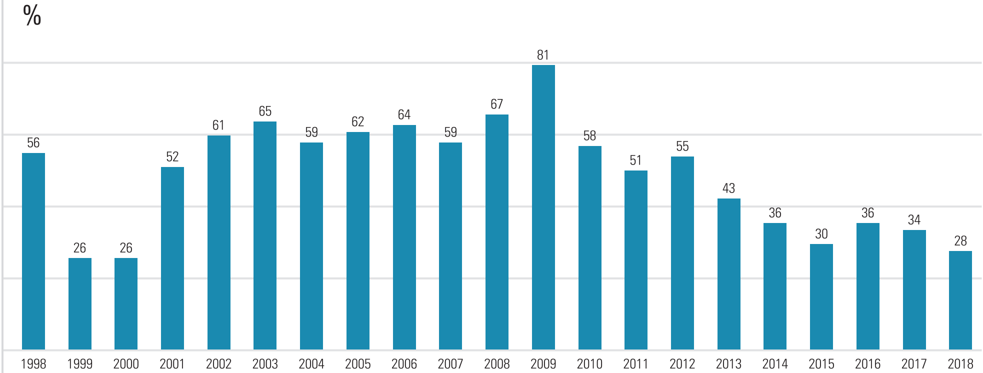
— ***PE-Backed IPOs***: Private equity–backed IPOs by US issuers declined by 23%, from 26 in 2017 to 20 in 2018. Overall, PE-backed issuers accounted for 16% of all US-issuer IPOs in 2018, compared to 25% in 2017. The median deal size for PE-backed IPOs in 2018 was $288.0 million, compared to $100.2 million for all other IPOs. The average PE-backed IPO in 2018 ended the year 9% below its offering price.

— ***Life Sciences IPOs***: There were 74 life sciences company IPOs in 2018, an increase of 68% from the 44 in 2017. The portion of the IPO market accounted for by life sciences companies increased from 31% in 2017 to 40% in 2018. While the 2018 figure lags behind the sector’s 43% market share in the three-year period from 2014 to 2016, it is more than double the 17% that prevailed over the five-year period preceding 2014. The average life sciences IPO company in 2018 ended the year down 1% from its offering price, compared to a 3% year-end decline for non–life sciences IPO companies.

— ***Tech IPOs***: Deal flow in the technology sector increased by 30%, from 44 IPOs in 2017 to 57 IPOs in 2018. The tech sector’s share of the US IPO market remained steady between 2017 and 2018, at 31%, up from recent lows of 27% in 2016 and 23% in 2015, but well below the 45% that prevailed over the three-year period from 2010 to 2012. The average tech IPO ended the year 1% above its offering price, compared to a 3% loss for non-tech IPOs.

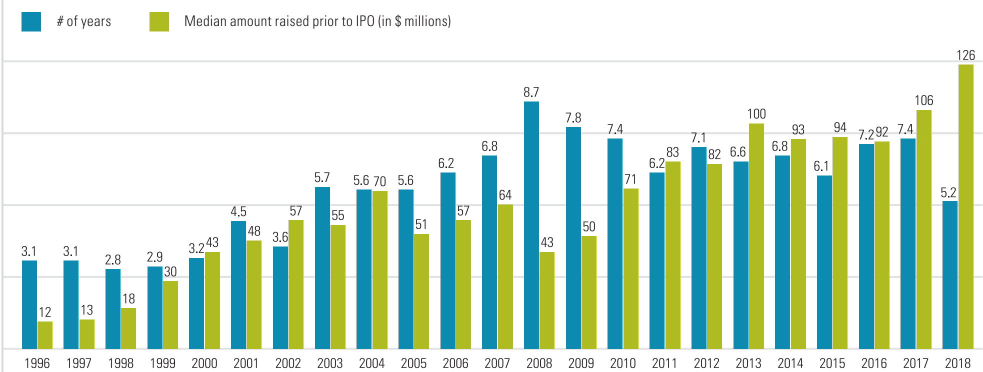
— ***Foreign-Issuer IPOs***: The number of US IPOs by foreign issuers increased by 53%, from 38 in 2017 (27% of the market) to 58 in 2018 (32% of the market). Among foreign issuers, Chinese companies led the year with 32 IPOs (the highest annual number of IPOs from China since 2010), followed by companies from the United Kingdom (eight IPOs) and Brazil and Israel (each with three IPOs). The average

Percentage of Profitable IPO Companies – 1998 to 2018



Source: SEC filings and IPO Vital Signs

Median Time to IPO and Median Amount Raised Prior to IPO – 1996 to 2018



Source: Dow Jones VentureSource and SEC filings foreign-issuer IPO company ended the year down 5% from its offering price.

In 2018, 58 companies based in the eastern United States (east of the Mississippi River) completed IPOs, compared to 67 for western US–based issuers. California led the state rankings with 43 IPOs, followed by Massachusetts (20 IPOs), Texas (10 IPOs), New York (six IPOs), and Pennsylvania and Washington (four IPOs each).

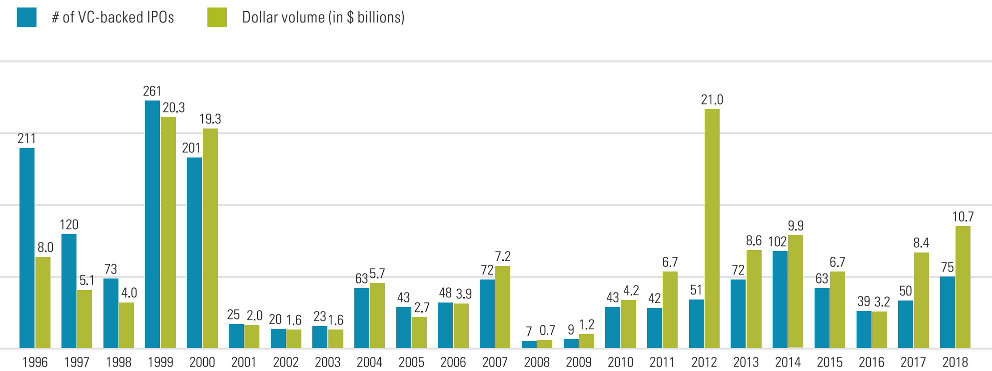
OUTLOOK

IPO market activity in the coming year will depend on a number of factors, including the following:

— ***Economic Growth***: US economic growth slowed over the course of 2018, with the fourth quarter posting a 2.2% increase, down from 3.4% in the third quarter and 4.2% in the second quarter. Despite the slowdown, the GDP growth rate for the year was among the highest in over a decade, job growth has remained consistently strong and the unemployment rate is at its lowest level in nearly 50 years. The residual effect of the US corporate and individual income tax rates enacted in late 2017, coupled with the continuation of low interest rates, should continue to support economic growth in the coming year, although geopolitical concerns—including rising international trade tensions and the growing likelihood of a messy Brexit—could dampen economic growth in the United States and overseas.

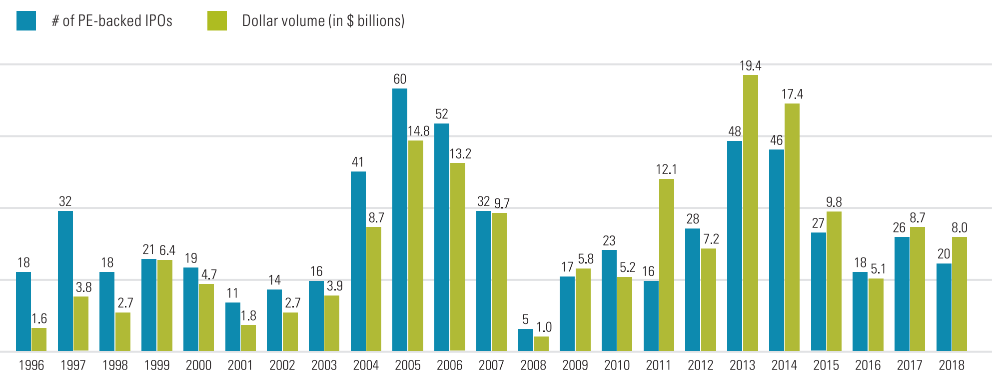
— ***Capital Market Conditions***: The major US stock market indices all posted solid gains through the first three quarters of 2018, before heading sharply lower in the fourth quarter. In what ended up as the worst year for stocks since 2008, the Dow Jones Industrial Average fell 5.6%, the Nasdaq Composite Index declined 3.9% and the S&P 500 dropped 6.2%. This bleak year-end 2018 performance was more than erased in the first quarter of 2019, as the Dow, Nasdaq and S&P 500 posted gains of 11.2%, 16.5% and 13.1%, respectively, but a return of this kind of volatility in the capital markets could create headwinds for the IPO market.

Venture Capital–Backed IPOs – 1996 to 2018



Source: Dow Jones VentureSource and SEC filings
Based on US IPOs by VC-backed US issuers.

Private Equity–Backed IPOs – 1996 to 2018



Source: Thomson Reuters and SEC filings
Based on US IPOs by PE-backed US issuers.

— ***Venture Capital Pipeline***: The pool of IPO candidates remains large and vibrant, including more than 300 "unicorns" (private companies with valuations exceeding $1 billion). With 2018 yielding more than 175 venture financing rounds that raised at least $100 million—an increase of almost two-thirds from 2017—it is clear that many VC-backed companies continue to be able to raise private "IPO-sized" rounds and delay their public debuts. However, investor demand for cash returns, coupled with the attractive valuations and comparatively favorable aftermarket performance of VC-backed IPOs in 2018, should prompt additional VC-backed companies to go public in 2019.

— ***Private Equity Impact***: Although private equity fundraising in 2018 declined by one-quarter from the record-setting level of 2017, PE firms are eager to put their unspent capital to work in new acquisitions. At the same time, PE firms face pressure to exit investments—via IPOs or sales of portfolio companies—and return capital to investors.

The US government shutdown at the start of 2019 contributed to a tepid start for the 2019 IPO market, with only 18 IPOs in the first quarter, but deal flow has since picked up, with 16 offerings in April. The long-awaited IPOs of Lyft, Pinterest, Uber and Zoom—and the likely arrival of additional unicorn IPOs—should help build further momentum as the year progresses. ■

CALIFORNIA

Posting its second consecutive year of strong growth, the California IPO market produced 43 IPOs in 2018, an increase of 72% from the 25 in 2017 and the highest annual total since the 54 IPOs in 2014. Gross proceeds grew by 16%, from $6.22 billion in 2017 to $7.20 billion in 2018—the third-highest annual level since 2000.

The largest California IPO in 2018 came from Dropbox ($756 million), followed by offerings from DocuSign ($629 million) and Pivotal Software ($555 million).

The California IPO market continues to be dominated by technology and life sciences companies, which together accounted for all but three of the state's offerings in 2018, or 93% of the year's total (up from the 86% that prevailed over the five-year period from 2013 to 2017), compared to an average of 60% for the rest of the country.

The number of venture-backed California IPOs increased by 83%, from 18 in 2017 to 33 in 2018. California's tally represents 43% of all US-issuer VC-backed IPOs in 2018, up from the 34% recorded over the prior two years but below the 47% that prevailed during the five-year period preceding 2016.

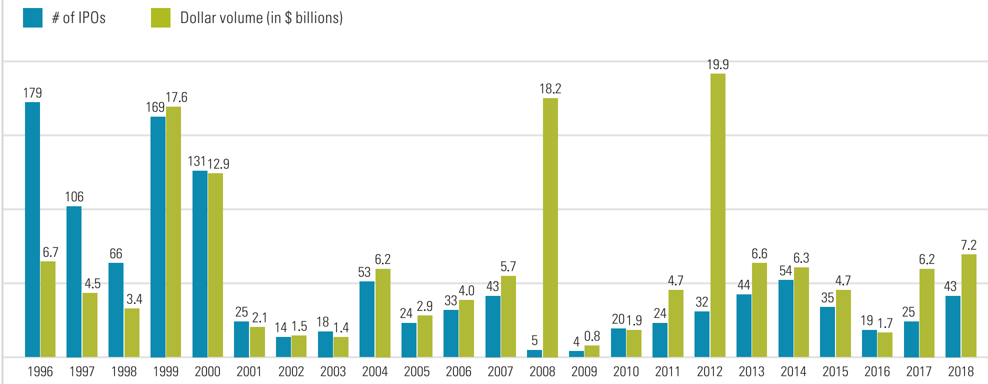
The average 2018 California IPO produced a first-day gain of 29%. The state's top performers were Zscaler (up 106% in first-day trading), Elastic (up 94%) and Principia Biopharma (up 92%).

At year-end, 53% of the state's 2018 IPOs were trading above their offering price, with the average California IPO up 17% from its offering price.

The best-performing California IPO of the year was Allakos (up 190% at year-end), followed by Zscaler (up 145%), Elastic (up 99%) and Guardant Health (up 98%).

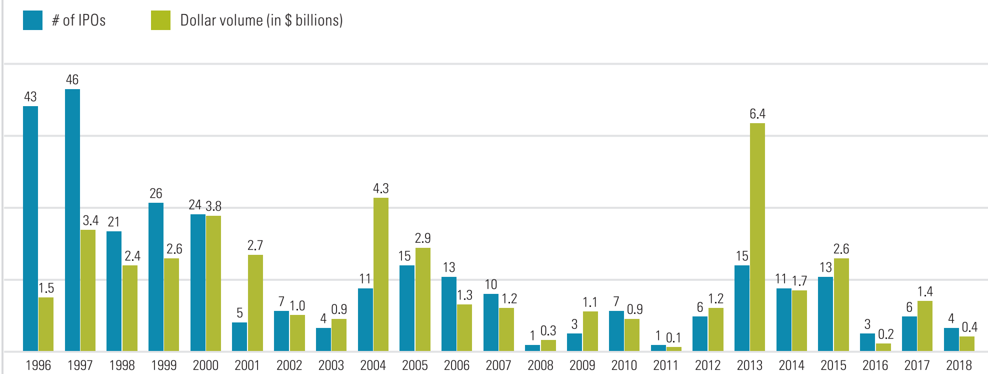
With the largest pool of venture capital–backed companies in the United States and a wealth of entrepreneurial talent, California should remain a major source of attractive IPO candidates in the coming year, particularly from the technology and life sciences sectors.

California IPOs – 1996 to 2018



Source: SEC filings

Mid-Atlantic IPOs – 1996 to 2018



Source: SEC filings

MID-ATLANTIC

The mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia produced four IPOs in 2018, down from six in 2017 and well below the annual double-digit count that prevailed from 2013 to 2015.

Maryland produced two of the region's IPOs in 2018 (doubling its tally from 2017). North Carolina contributed one (down from four in 2017), as did Virginia (matching its 2017 count).

Gross proceeds in the mid-Atlantic region were $364 million in 2018, down sharply from the $1.40 billion generated in 2017. For only the second time since 2011, the region did not produce an IPO with at least $500 million in proceeds. The largest mid-Atlantic IPO of 2018 came from Maryland-based Tenable Holdings ($251 million), followed by North Carolina–based Liquidia Technologies ($50 million).

The average 2018 mid-Atlantic IPO produced a first-day gain of 9%, largely due to the first-day gain of Tenable Holdings (up 32% in first-day trading).

At year-end, Liquidia Technologies (up 97% from its offering) was the only mid-Atlantic IPO trading above its offering price.

Despite 2018's contraction in deal flow, the region should see some recovery in IPO activity in the coming year if market conditions are conducive, with offerings from the life sciences, technology and financial services sectors.

NEW ENGLAND

The number of New England IPOs increased for the second consecutive year, from 17 in 2017 to 24 in 2018—the second-highest annual count since 2000, trailing only the 32 IPOs in 2014.

Massachusetts accounted for 20 of the region's IPOs in 2018—the state's tally was the second-highest state total in the country, behind California. Connecticut added three IPOs and New Hampshire produced the remaining one.

Gross proceeds in the region more than doubled, from $1.67 billion in 2017 to $3.43 billion in 2018.

The largest New England IPO in 2018 was by BJ's Wholesale Club Holdings ($638 million), followed by Moderna ($604 million) and Rubius Therapeutics ($241 million).

Life sciences companies accounted for 20 of the region's IPOs in 2018 (or 83% of the total), representing one-third of all life sciences US-issuer IPOs in the country.

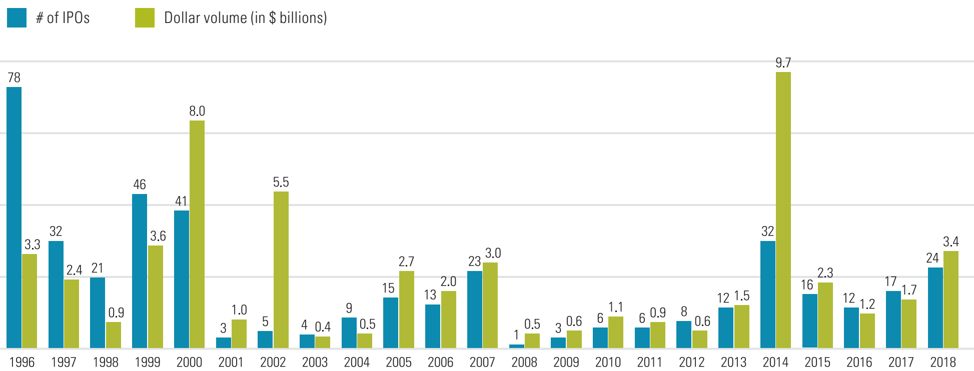
The number of venture-backed New England IPOs increased by 50%, from 14 in 2017 to 21 in 2018. The region accounted for 28% of all US-issuer VC-backed IPOs in 2018—the same percentage as in 2017 and the highest figure in at least 20 years.

The average 2018 New England IPO produced a first-day gain of 7%. The region's top performer in first-day trading was AVROBIO (up 64% from its offering price), followed by The LoveSac Company (up 50%) and Solid Biosciences (up 41%).

At year-end, only 29% of New England IPOs were trading above their offering price—led by Solid Biosciences (up 68% at year-end) and Scholar Rock Holding (up 64%)—and the region's average IPO was down 22%.

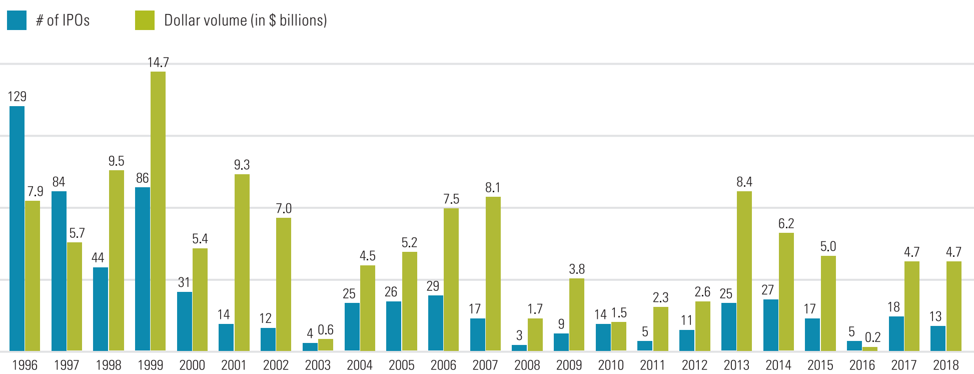
With the region's world-renowned universities and research institutions serving as incubators for emerging tech and life sciences companies, and with strong levels of venture capital investment, New England should continue to generate attractive IPO candidates in the coming year.

New England IPOs – 1996 to 2018



Source: SEC filings

Tri-State IPOs – 1996 to 2018



Source: SEC filings

TRI-STATE

The number of IPOs in the tri-state region of New York, New Jersey and Pennsylvania declined from 18 in 2017 to 13 in 2018.

New York produced six of the region's 2018 IPOs, with Pennsylvania accounting for four and New Jersey producing the remaining three.

Gross proceeds from tri-state IPOs in 2018 were $4.69 billion, just below the $4.72 billion figure for 2017, led by the AXA Equitable Holdings offering, which generated $2.75 billion in proceeds—the nation's largest IPO of the year.

The next-largest tri-state IPOs of 2018 came from Focus Financial Partners ($535 million), BrightView Holdings ($469 million) and Livent ($340 million).

The average 2018 tri-state IPO produced a first-day gain of 15%. The region's top performers in first-day trading were Neuronetics (up 63% from its offering price), Y-mAbs Therapeutics (up 50%) and Electrocore (up 32%).

At year-end, only 23% of the region's IPOs were trading above their offering price, with the average tri-state IPO down 31%. The best-performing tri-state IPOs were from Y-mAbs Therapeutics and Neuronetics, up 27% and 14%, respectively, from their offering price at year-end.

With the level of venture capital activity in the tri-state region trailing only that of California, the coming year should see IPO deal flow from both emerging life sciences and technology companies and larger, private equity–backed companies. ■

PROFILE OF SUCCESSFUL IPO CANDIDATES

What does it really take to go public? There is no single profile of a successful IPO company, but in general the most attractive candidates have the following attributes:

- *Outstanding Management*: An investment truism is that investors invest in people, and this is even truer for companies going public. Every company going public needs experienced and talented management with high integrity, a vision for the future, lots of energy to withstand the rigors of the IPO process and a proven ability to execute. An IPO is not the best time for a fledgling CEO or CFO to cut his or her teeth.
- *Market Differentiation*: IPO candidates need a superior technology, product or service in a large and growing market. Ideally, they are viewed as market leaders. Appropriate intellectual property protection is expected of technology companies, and in some sectors patents are *de rigueur.*
- *Substantial Revenue*: With some exceptions, substantial revenue is expected—at least $50 million to $75 million annually—in order to provide a platform for attractive levels of profitability and market capitalization.
- *Revenue Growth*: Consistent and strong revenue growth—25% or more annually—is usually needed, unless the company has other compelling features. The company should be able to anticipate continued and predictable expansion to avoid the market punishment that accompanies revenue and earnings surprises.
- *Profitability*: Strong IPO candidates generally have track records of earnings and a demonstrated ability to enhance margins over time, although IPO investors often appear to value growth more highly than near-term profitability.
- *Market Capitalization*: The company's potential market capitalization should be at least $200 million to $250 million, in order to facilitate development of a liquid trading market. If a large portion of the company will be owned by insiders following the IPO, a larger market cap may be needed to provide ample float.

HOW DO YOU COMPARE?

Set forth below are selected metrics about the IPO market, based on combined data for all US IPOs in the three-year period from 2016 through 2018.

Percentage of IPO companies qualifying as EGCs under JOBS Act	88%
Median offering size	$107.2 million (17% below $50 million and 10% above $500 million)
Median annual revenue of IPO companies	$78.3 million (44% below $50 million and 19% above $500 million)
Percentage of IPO companies that are profitable	32%
State of incorporation of IPO companies	Delaware—88% No other state over 2%
Percentage of IPOs including selling stockholders, and median percentage of offering represented by those shares	Percentage of IPOs—23% Median percentage of offering—33%
Percentage of IPOs including directed share programs, and median percentage of offering represented by those shares	Percentage of IPOs—41% Median percentage of offering—5%
Percentage of IPO companies disclosing adoption of ESPP	50%
Percentage of IPO companies using a "Big 4" accounting firm	73%
Stock exchange on which the company's common stock is listed	Nasdaq—71% NYSE—29%
Median underwriting discount	7%
Number of SEC comments contained in initial comment letter	Median—19 25th percentile—14 75th percentile—28
Median number of Form S-1 amendments (excluding exhibits-only amendments) filed before effectiveness	Five
Time elapsed from initial confidential submission to initial public filing of Form S-1 (EGCs only)	Median—84 calendar days 25th percentile—57 calendar days 75th percentile—146 calendar days
Time elapsed from initial confidential submission (if EGC) or initial public filing to effectiveness of the Form S-1	Median—121 calendar days 25th percentile—94 calendar days 75th percentile—227 calendar days
Median offering expenses	Legal—$1,500,000 Accounting—$900,000 Total—$3,410,000

Other factors can vary based on a company's industry and size. For example, many life sciences companies will have much smaller revenue and not be profitable. More mature companies are likely to have greater revenue and market caps, but slower growth rates. High-growth companies are likely to be smaller, and usually have a shorter history of profitability.

Beyond these objective measures, IPO candidates need to be ready for public ownership in a range of other areas, including accounting preparation; corporate governance; financial and disclosure controls and procedures; external communications; legal and regulatory compliance; and a variety of corporate housekeeping tasks. ■

The cornerstone of the JOBS Act is the creation of an "IPO on ramp" that provides "emerging growth companies" (EGCs) with a phase-in period, which can continue until the last day of the fiscal year following the fifth anniversary of an IPO, to come into full compliance with certain disclosure and accounting requirements. Although the overwhelming majority of all IPO candidates qualify as EGCs, different items of EGC relief are being adopted at different rates, with some additional variation among types of IPO companies.

CONFIDENTIAL SUBMISSION OF FORM S-1

An EGC is able to submit a draft Form S-1 registration statement to the SEC for confidential review instead of filing it publicly on the SEC's EDGAR system. A Form S-1 that is confidentially submitted must be substantially complete, including all required financial statements and signed audit reports. The SEC review process for a confidential submission is the same as for a public filing. A confidentially submitted Form S-1 must be filed publicly no later than 15 days before the road show commences.

Confidential submission enables an EGC to maintain its IPO plans in secrecy and delay disclosure of sensitive information to competitors and employees until much later in the process, although it also delays any perceived benefits of public filing. Depending on the timing, confidential review also means that the EGC can abandon its IPO plans without any public disclosure at all if, for example, the SEC raises disclosure issues that the EGC does not want made public or market conditions preclude an offering. Confidential submission has been widely adopted by EGCs.

REDUCED FINANCIAL DISCLOSURE

EGCs must provide only two years of audited financial statements (instead of three years), plus unaudited interim financial statements, and need not present selected financial data for any period prior to the earliest audited period (instead of five years). Similarly, an EGC is only required to include MD&A for the periods presented in the required financial statements.

Life sciences companies, for which older financial information is often irrelevant, have overwhelmingly embraced the option of providing only two years of audited financial statements and two years of selected financial data. Technology companies, which generally have substantial revenue and often have profitable operations, are more likely than life sciences companies to provide three years of audited financial statements and at least three years of selected financial data, although the percentage of technology companies doing so has declined significantly over the past three years.

ACCOUNTING AND AUDITING RELIEF

EGCs may choose not to be subject to any accounting standards that are adopted or revised on or after April 5, 2012, until these standards are required to be applied to nonpublic companies. Through 2016, the vast majority of EGCs opted out of the extended transition period, but a dramatic shift has since occurred. The percentage of EGCs adopting the extended transition period jumped from 11% through 2016 to 42% in 2017 and 2018. Between these periods, the percentage of technology companies electing the extended transition period spiked from 12% to 58%, while among life sciences companies the percentage increased from 10% to 35%. The change in behavior appears to be motivated by the desire of many EGCs to delay the application of the new accounting standards for revenue recognition (ASC 606) and lease accounting (ASC Topic 842) or, at a minimum, to take more time to evaluate the effects of the new standards before adopting them.

EGCs are automatically exempt from any future mandatory audit firm rotation requirement and any rules requiring that auditors supplement their audit reports with additional information about the audit or financial statements of the company—such as the requirement to make disclosure about critical audit matters (CAMs) under new auditing standard AS 3101. Any other new auditing standards will not apply to audits of EGCs unless the SEC determines that application of the new rules to audits of EGCs is necessary or appropriate in the public interest. To date, the SEC has applied all new auditing standards to audits of EGCs.

REDUCED EXECUTIVE COMPENSATION DISCLOSURE

An EGC need not provide Compensation Discussion and Analysis (CD&A); compensation information is required only for three named executive officers (including the CEO); and only three of the seven compensation tables otherwise required must be provided. The use of these reduced compensation disclosures is almost universal practice among EGCs, without apparent investor pushback.

SECTION 404(B) EXEMPTION

EGCs are exempt from the requirement under Section 404(b) of the Sarbanes-Oxley Act that an independent registered public accounting firm audit and report on the effectiveness of a company's internal control over financial reporting (ICFR), beginning with the company's second Form 10-K. Most EGCs adopt this exemption at the time it becomes applicable to them. ■

EGC ELECTIONS

Based on IPOs initiated after enactment of the JOBS Act and completed by EGCs through 2018, below are the rates of adoption with respect to several key items of EGC relief:

ITEM	LIFE SCIENCES COMPANIES	TECH COMPANIES	OTHER COMPANIES
Confidential submission of Form S-1	97%	97%	91%
Two years of audited financial statements	90%	43%	67%
Deferred application of new or revised accounting standards	18%	26%	21%
Omission of CD&A	100%	99%	96%

Special Issues for Special Issuers

For some companies, the IPO journey takes a road less traveled. Although non-traditional IPOs and alternative paths to capital and public trading share many features with conventional IPOs, these transactions have special requirements and attributes.

SPIN-OFF IPOs

The term "spin-off IPO" refers to the sale of an ownership position in a subsidiary to the public, with the parent company selling some of its shares in the subsidiary and/or the subsidiary issuing new shares. A spin-off IPO is sometimes combined with the parent's distribution of its remaining shares in the subsidiary to the parent's stockholders.

A spin-off IPO usually requires more extensive preparations than a conventional IPO. In addition to customary planning for the subsidiary's IPO and public company life, a spin-off IPO involves a number of other elements:

— *Transaction Planning*: A transaction structure must be developed to achieve the desired operating, tax and financial objectives.

— *Establishment of Subsidiary*: The business to be spun off must be segregated into a separate subsidiary, holding the correct assets, liabilities and employees, and the infrastructure of a separate company must be created.

— *Parent-Subsidiary Relationship*: The parent and subsidiary need to determine their post-IPO relationship, including the terms of inter-company agreements and transition services agreements. The parent also may wish to implement mechanisms to retain control of the subsidiary.

— *Controlled Company Rules*: If the parent holds a majority of the voting power for the election of the subsidiary's directors, the subsidiary will be a "controlled company" and entitled to exemptions from some corporate governance requirements under Nasdaq and NYSE rules.

— *Additional Disclosure*: The Form S-1 requires various disclosures that are ordinarily not necessary for other types of IPOs, such as a description of the transaction structure and its tax and accounting consequences, and a summary of the agreements between the parent and the subsidiary.

Spin-off IPOs are a staple of the market. Recent prominent examples include SecureWorks (from Dell) in 2016 and Elanco Animal Health (from Eli Lilly) in 2018.

FORM 10 IPOs

In a "Form 10 IPO," a private company sells securities in a private placement under Regulation D and, in connection with the private placement, agrees to file a Form 10 registration statement to become a reporting company under the Exchange Act and to file a Form S-1 registration statement registering for resale the shares sold in the private placement. Typically, a Form 10 IPO company will arrange to have its stock quoted on an over-the-counter market and later seek to have its shares listed on a national securities exchange once it satisfies the applicable listing standards.

The traditional IPO route can be difficult, especially for smaller companies without significant revenue in high-risk industries, such as life sciences. Given the length of time it takes to complete the overall IPO process, there is significant risk that market conditions will change between the time a company begins the process and the time it is ready to market and price the offering. In response, the Form 10 IPO has emerged.

The principal advantage of a Form 10 IPO is that it can provide a company with significant capital more quickly than a conventional IPO. The following aspects of the Form 10 IPO process contribute to its advantages:

— the price at which the company raises capital is negotiated up front with the investors in the private placement;

— SEC review does not occur until after the sale of the securities;

— institutional investors that ordinarily invest only in public companies may be willing to invest in a Form 10 IPO private placement; and

— much of the time, cost and expense associated with public company preparations can be deferred until after the company has received the capital.

There are also several disadvantages to a Form 10 IPO, including the following:

— it may be difficult for a smaller company to comply with its public reporting obligations under the Exchange Act, which become applicable as soon as the Form 10 becomes effective;

— the company may encounter difficulty in satisfying the public float and round-lot stockholder requirements for stock exchange listing;

— the elapsed time from the sale of the securities to trading on a stock exchange—the ultimate goal in a Form 10 IPO—may be no shorter than in a traditional IPO;

— if the company's stock trades below $5.00 per share and is not listed on a national securities exchange, the company will be subject to the SEC's "penny stock" rules, which could make it more difficult for broker-dealers to execute trades in the stock;

— the aggregate legal and accounting expenses incurred in connection with a Form 10 IPO will likely be as much, if not more, than those associated with a traditional IPO;

— the placement agent's fees may be based on a higher percentage of the financing proceeds than the percentage underwriting discount in a conventional IPO, and the company may also need to issue warrants to the placement agent as additional compensation;

— research coverage may be more difficult, and perhaps impossible, to obtain;

— major investment banks may be less likely to underwrite the company's follow-on offerings because they did not have the opportunity to become familiar with the company during a conventional IPO process;

- the intangible benefits of enhanced prestige and credibility provided by a conventional IPO will be delayed, or not present at all; and
- aspects of the relief otherwise available to an EGC under the JOBS Act are not available to an EGC filing a registration statement on Form 10 (rather than a Form S-1), including the ability to provide reduced financial disclosure.

To date, only about a dozen companies have completed Form 10 IPOs. Interest in IPO alternatives, such as Form 10 IPOs, tends to decline when the IPO market is receptive to companies lacking some of the attributes of traditional IPO candidates and to increase when market conditions become less conducive to IPOs by smaller, less seasoned companies. In these circumstances, a Form 10 IPO should remain a possibility for private companies that seek public investor capital but are looking to avoid the market fluctuation and pricing risks associated with raising money through a traditional IPO.

RULE 144A IPOs

A "Rule 144A IPO" consists of a Rule 144A placement by a private company, coupled with an agreement to register the securities for public resale or a commitment to register as a reporting company under the Exchange Act following completion of the placement.

The principal advantage of a Rule 144A IPO is that it can provide the company with as much capital as a conventional IPO—but much more rapidly because SEC review is bypassed. Other advantages include greater flexibility in the disclosure and offering process and the company's corporate governance arrangements, and the potential ability to delay compliance with public company obligations.

Compared to a conventional IPO, a Rule 144A IPO has several disadvantages:

- the Rule 144A IPO market is concentrated in a few sectors and limited to more mature companies than the market for conventional IPOs, effectively excluding many prototypical IPO candidates;
- the stock is priced with an illiquidity discount;
- the investor pool is limited to "qualified institutional buyers" and purchasers in offshore transactions under Regulation S;
- it may be difficult to satisfy the public float and round-lot stockholder requirements for stock exchange listing;
- unless the stock is exchange-listed, the offering does not create a market for employee equity incentives or liquid stock currency for acquisitions;
- research coverage may be more difficult, if not impossible, to obtain; and
- since a Rule 144A IPO is a "stealth" IPO, the intangible benefits of enhanced prestige and credibility provided by a conventional IPO will not be present.

Moreover, the benefit of avoiding public company obligations may be temporary, since the company usually agrees to register the Rule 144A securities for public resale or register as a reporting company, typically within one year after the placement.

Rule 144A IPOs have been reported as far back as the early 1990s, but the market has not lived up to the promise it showed between 2005 and 2007, when approximately 40 transactions were completed. Since then, only one Rule 144A IPO has been completed in the United States—by Oaktree Capital Group in 2012, following a Rule 144A placement in 2007.

DIRECT LISTINGS

With the rise of very large, well-capitalized private companies boasting valuations well in excess of $1 billion, the concept of a "direct listing" has emerged. In a direct listing, the company files a registration statement to become a reporting company under the Exchange Act and concurrently lists its shares on a stock exchange, without underwriters and without a concurrent public offering of newly issued shares.

Key aspects of the direct listing process include the following:

- *Registration*: In a direct listing, the company files a Form 10 to register its common stock under the Exchange Act. The Form 10 requires disclosure of substantially the same information required in a Form S-1 for a traditional IPO, except for the omission of offering-related items. Alternatively, the company may file a Form S-1 to register the resale of some or all of its outstanding shares. In the absence of a resale Form S-1, public resales must be made in reliance on Rule 144, which is not available for resales by affiliates until 90 days after Exchange Act registration and in any event may not provide sufficient liquidity for an active trading market to develop. If the company qualifies as an EGC, the use of Form S-1 permits the company to take advantage of the reduced financial statement and MD&A disclosure requirements available to an EGC, which is not permitted with the use of Form 10. A Form S-1 is eligible for confidential staff review, while the similar nonpublic review process is available for a Form 10. Other aspects of EGC relief are available with respect to the filing of either Form S-1 or Form 10.
- *Resale Considerations*: Apart from liquidity and EGC considerations, the rules of the exchange on which the company is listing its common stock may require the company to file a resale Form S-1 in conjunction with the listing, or the SEC staff may require a resale Form S-1 if it views the transaction as constituting a distribution of securities for which the exemption for "ordinary trading" is not available. A Form S-1, if filed, can be terminated 90 days after effectiveness (at which point Rule 144 becomes available for resales) in order to eliminate potential Section 11 liability for further sales under the Form S-1. If a resale Form S-1 is filed, the company may register its common stock under the Exchange Act by filing a Form 8-A instead of a Form 10 (a Form 8-A is much shorter and simpler than a Form 10).
- *SEC Review*: The Form 10 or Form S-1 undergoes the same type of staff review as in a traditional IPO. The company is permitted to submit a draft Form 10 or Form S-1 for confidential or nonpublic

review but must publicly file the Form 10 or Form S-1 (and amendments thereto) at least 15 days before it becomes effective. A Form S-1 can be declared effective upon completion of staff review, while a Form 10 automatically becomes effective 60 days after filing, unless withdrawn and refiled due to ongoing staff review. Upon effectiveness of the Form 10 or Form S-1, stock exchange listing can be completed and trading can commence. (Because underwriters are not involved in a direct listing, FINRA review and clearance is not required.)

— *Exchange Listing*: Nasdaq and NYSE both permit the listing of eligible securities registered under the Exchange Act without a concurrent public offering of newly issued shares, as long as applicable listing requirements are satisfied. The overall listing process is similar to the listing process in a traditional IPO, although aspects of the process are more difficult in the absence of a concurrent public offering and require ongoing dialogue and coordination with the exchange. In a direct listing, the company does not engage investment banking firms to act as underwriters but may need to retain investment bankers to provide assistance and advice with respect to the registration and listing process.

— *Investor Engagement*: A direct listing does not include a traditional road show, although the company may wish to undertake similar activities to familiarize investors with the company in conjunction with listing. For example, if the company qualifies as an EGC, it may hold "test-the-waters" meetings with eligible institutional investors. An "investor day" or "non-deal" road show is also possible if conducted in accordance with SEC rules.

— *Public Reporting*: Following a direct listing, the company becomes subject to the normal public reporting and other requirements of the Exchange Act. If eligible, the company can take advantage of the reduced disclosure requirements and exemptions available to EGCs following an IPO. The company must also comply with the corporate governance requirements and other rules of the stock exchange on which its common stock is listed.

A direct listing offers the potential for a faster and less expensive path to public trading than a traditional IPO. Despite the success of Spotify's direct listing in April 2018, in which Spotify achieved an initial market capitalization in excess of $25 billion, the technique remains largely unproven. As a practical matter, a direct listing is a good fit for relatively few private companies—those that do not require an immediate capital infusion, and are of sufficient value and investor interest to qualify for stock exchange listing and enjoy meaningful trading liquidity without the aftermarket support provided by underwriters (or the stabilizing influence of lockup agreements for the first 180 days) in a traditional IPO. The pending direct listing of Slack Technologies would be the second direct listing on a national securities exchange.

REVERSE-MERGER IPOs

A "reverse-merger IPO" is a mechanism for a private company to become a public company. In a typical reverse merger, a private company with an operating business merges into a public shell company without an operating business, and the private company's stockholders receive a majority of the stock of the surviving company.

Reverse mergers involving public shell companies often result in a company that bears the burdens and expense of being public but has unsatisfactory trading liquidity, cannot list its stock on a national securities exchange, does not have meaningful access to the public capital markets, has no research analyst coverage or market maker support, cannot attract institutional investors, is subject to the SEC's penny stock trading rules, and has its deal-making prospects tainted by its origins.

More recently, a new breed of reverse mergers has emerged in the life sciences sector, without the negative connotations typically associated with reverse-merger transactions involving public shell companies. In these transactions, an early-stage life sciences company whose clinical research program fails after completing an IPO is acquired in a reverse merger by a private company seeking access to the target's cash reserves to finance the acquirer's operations.

The reverse-merger route to public ownership presents several special challenges, particularly when the public target is a shell company:

— *Merger Agreement*: The transaction begins with a merger agreement defining the terms and conditions of the transaction. Every issue present in any business combination—ownership, management and integration, to list just a few—must be resolved.

— *Due Diligence*: The surviving company is responsible for the liabilities incurred and actions taken by the public target before the merger. The private company merging into the public target must carefully examine the target's corporate history and pre-merger activities to make sure it is not inheriting unexpected liabilities.

— *SEC Filing and Review*: A reverse-merger transaction usually requires a merger proxy statement or a Form S-4 registration statement. These filings typically are more complicated and time-intensive to prepare than a Form S-1 for a conventional IPO. SEC review usually takes longer than review of a Form S-1 for an IPO or a public-public merger proxy statement because of the complexity of the reverse-merger transaction and, if the public target is a shell company, the scrutiny that its origins draws.

— *Blue Sky Laws*: If the public target's shares are not listed on a national securities exchange (which typically is the case with a shell company), the target's issuance of shares in the merger transaction will not be exempt from state securities "blue sky" laws. As a result, the public target will be forced to comply with additional filing and disclosure requirements in all applicable states, and to justify the substantive fairness of the exchange in states that impose "merit review" requirements.

In most cases, it is puzzling why a private company that aspires to become a substantial public company would pursue a reverse merger with a shell company. The transaction is often more difficult and expensive than a traditional IPO, and the results are usually less satisfactory. By contrast, reverse-merger transactions involving public life sciences companies are likely to continue to grow in popularity in light of the large number of IPOs in recent years by early-stage life sciences companies—a portion of which will inevitably suffer failed clinical research programs, making them attractive reverse-merger candidates, particularly for acquirers who lack some of the attributes of traditional IPO companies.

TRACKING STOCK IPOs

In a “tracking stock IPO,” a parent company creates a new class of stock to “track” the economic performance of a specific subsidiary, division or other business unit of the parent, and issues shares of the stock to the public. Investors in tracking stock do not actually receive an ownership position in the specific business being tracked, and that business unit is not actually separated from the parent. A tracking stock is intended to function in a manner similar to a spin-off, by allowing the tracked business to be separately highlighted and valued in the public market, while preserving ownership and control for the parent.

From an investor’s perspective, there are several downsides to a tracking stock structure:

— the tracked business usually lacks the kind of corporate governance arrangements that would be present in a freestanding company;

— the investor has no direct voting rights with respect to the tracked business;

— potential conflicts exist between the interests of the parent and the tracked business;

— an investment in a tracked stock is subject to risks associated with all of the parent’s businesses, assets and liabilities;

— a tracking stock usually can be redeemed by the parent; and

— a tracking stock is immune from unsolicited acquisition bids and any accompanying takeover premium.

A tracking stock IPO is not as complex as a spin-off IPO, primarily because most of the separation arrangements involved with a spin-off are not required. The parent usually creates new equity incentive plans for the management and employees of the tracked business, but few other indicia of independent operations. Perhaps the biggest challenge in a tracking stock IPO is to accurately describe and delimit the tracked business in a manner that permits separate financial statements for it to be prepared and audited. The Form S-1 needs to describe the investors’ rights in the tracked business and the potential conflicts of interest.

Tracking stock IPOs have never represented a large segment of the market, and have now all but disappeared in favor of structures that afford more transparency and investor protections. The most recent firm-commitment underwritten tracking stock IPO was in 2002, when Loews Corporation issued a new class of common stock to track the performance of its Lorillard subsidiary. In 2014–2015, Fantex completed six tracking stock IPOs (underwritten on a “best-efforts” basis through the website of its broker-dealer affiliate) tied to the economic performance of brand contracts between Fantex and professional athletes. More recently, in 2016, Liberty Media created a tracking stock to reflect the separate economic performance of the Atlanta Braves and its new baseball stadium.

POST-BANKRUPTCY IPOs

Occasionally, a company that has emerged from bankruptcy proceedings subsequently pursues an IPO. A company in these circumstances is likely to have been a public company that deregistered in conjunction with its bankruptcy proceedings. The subsequent IPO could be prompted by registration rights given to creditors or stockholders in the bankruptcy, or could be desired by the company for its own reasons.

A post-bankruptcy IPO presents several noteworthy issues:

— *Fresh-Start Accounting*: Upon emerging from bankruptcy, the company will adopt “fresh-start” accounting. Although both pre- and post-bankruptcy results and financial statements must be presented in the Form S-1, these results will not be directly comparable, and the company may find it difficult to go public until it has several post-bankruptcy periods that can be compared.

— *Bankruptcy Disclosures*: The company will need to discuss its past financial difficulties and will be unable to focus exclusively on its “new” strategies, management, capital structure and prospects. Disclosure will also be required if any director or executive officer of the company was a director or executive officer of the company at the time of (or within two years before) the company’s bankruptcy and the bankruptcy occurred in the preceding ten years.

— *Offering Limitations*: A company that has been subject to a bankruptcy petition within the prior three years is not permitted to use an electronic road show, and its use of free writing prospectuses is limited to a description of the terms of the securities and the offering. Also, if a creditor who owns at least 10% of the voting securities of the company sells shares in the IPO, the SEC may request disclosure concerning the creditor’s underwriter status.

— *Exchange Listing*: Although Nasdaq and the NYSE do not preclude the listing of companies that previously filed for bankruptcy, a past bankruptcy could affect an exchange’s subjective judgment of the merits of the application.

Some public companies inevitably fail, due to excessive debt or other factors. As the financial cycle plays out, some of these companies eventually return to the public market with IPOs. The most prominent post-bankruptcy IPO of recent years was that of General Motors, whose 2010 IPO consisted of a $15.8 billion common stock offering by selling stockholders (former creditors) and a concurrent $4.35 billion preferred stock offering by GM. ■

Counsel of Choice for Public Offerings

Serving industry leaders in technology, life sciences, cleantech, financial services, communications and beyond

EverQuote	*Initial Public Offering of Common Stock*	$84,375,000	Counsel to Issuer	July 2018
Arvinas	*Initial Public Offering of Common Stock*	$123,207,750	Counsel to Issuer	October 2018
TCR² Therapeutics	*Initial Public Offering of Common Stock*	$86,250,000	Counsel to Underwriters	February 2019
Akamai	*Rule 144A Placement of Convertible Senior Notes*	$1,150,000,000	Counsel to Issuer	May 2018
agios	*Public Offering of Common Stock*	$546,250,000	Counsel to Issuer	January 2018
MacroGenics	*Public Offering of Common Stock*	$126,500,000	Counsel to Underwriters	February 2019
trevi Therapeutics	*Initial Public Offering of Common Stock*	$55,000,000	Counsel to Issuer	May 2019
Stealth Biotherapeutics	*Initial Public Offering of American Depositary Shares*	$85,058,750	Counsel to Issuer	February 2019
casella waste systems, inc.	*Public Offering of Common Stock*	$105,167,500	Counsel to Issuer	January 2019
ThermoFisher Scientific	*Public Offering of Senior Notes*	€600,000,000	Counsel to Issuer	August 2018
Translate Bio	*Initial Public Offering of Common Stock*	$126,286,750	Counsel to Issuer	July 2018
Circor	*Public Offering of Common Stock*	$145,291,500	Counsel to Issuer	June 2018
genpact	*Public Offering of Common Stock*	$324,000,000	Counsel to Issuer	February 2019
Epizyme	*Public Offering of Common Stock*	$86,250,000	Counsel to Issuer	October 2018
Entasis Therapeutics	*Initial Public Offering of Common Stock*	$75,000,000	Counsel to Underwriters	September 2018
Spark Therapeutics	*Public Offering of Common Stock*	$402,500,000	Counsel to Issuer	August 2017
CarGurus	*Initial Public Offering of Common Stock*	$172,960,000	Counsel to Underwriters	October 2017
Fortive	*Rule 144A Placement of Convertible Senior Notes*	$1,437,500,000	Counsel to Issuer	February 2019
nightstar Therapeutics	*Public Offering of Ordinary Shares*	$82,800,000	Counsel to Underwriters	October 2018
Karyopharm Therapeutics	*Rule 144A Placement of Convertible Senior Notes*	$172,500,000	Counsel to Issuer	October 2018
Constellation Pharmaceuticals	*Initial Public Offering of Common Stock*	$60,000,000	Counsel to Issuer	July 2018
PTC Therapeutics	*Public Offering of Common Stock*	$202,944,000	Counsel to Issuer	January 2019
Kala Pharmaceuticals	*Public Offering of Common Stock*	$71,156,250	Counsel to Issuer	October 2018
PerkinElmer	*Public Offering of Senior Notes*	€300,000,000	Counsel to Issuer	April 2018
State Street	*Public Offering of Common Stock*	$1,151,324,500	Counsel to Issuer	July 2018
Apellis	*Public Offering of Common Stock*	$117,300,000	Counsel to Issuer	March 2019
Syros	*Public Offering of Common Stock, Preferred Stock and Warrants*	$70,000,000	Counsel to Issuer	April 2019
Nabriva	*Public Offering of Ordinary Shares*	$50,000,000	Counsel to Issuer	July 2018
xeris Pharmaceuticals	*Initial Public Offering of Common Stock*	$98,325,000	Counsel to Underwriters	June 2018
Blue Apron	*Initial Public Offering of Common Stock*	$300,000,000	Counsel to Issuer	July 2017
Ocular Therapeutix	*Public Offering of Common Stock*	$50,000,000	Counsel to Issuer	April 2019
Danaher	*Public Offerings of Common Stock* $1,488,300,000 and *Mandatory Convertible Preferred Stock*	$1,650,000,000	Counsel to Issuer	March 2019
Analog Devices	*Public Offering of Senior Notes*	$750,000,000	Counsel to Issuer	March 2018
casa systems	*Public Offering of Common Stock*	$183,750,000	Counsel to Issuer	April 2018

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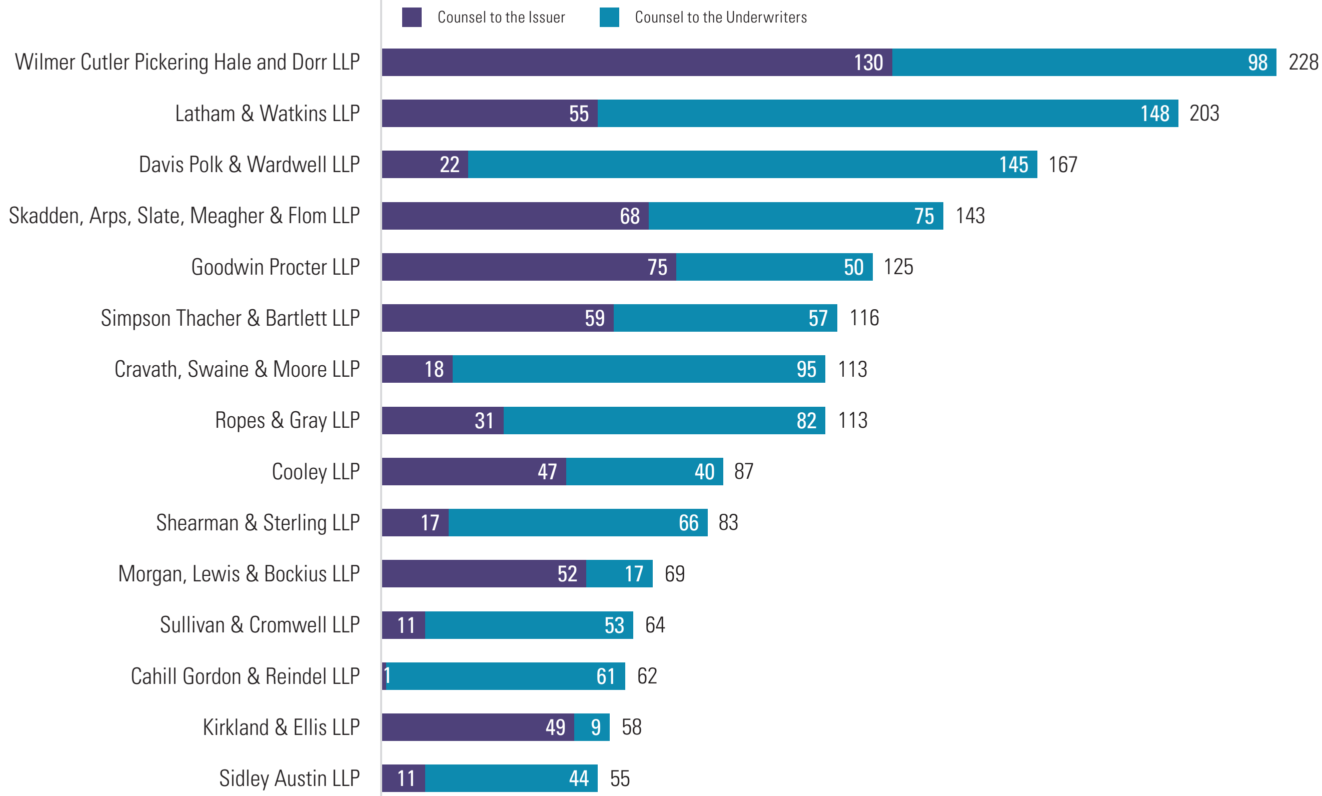
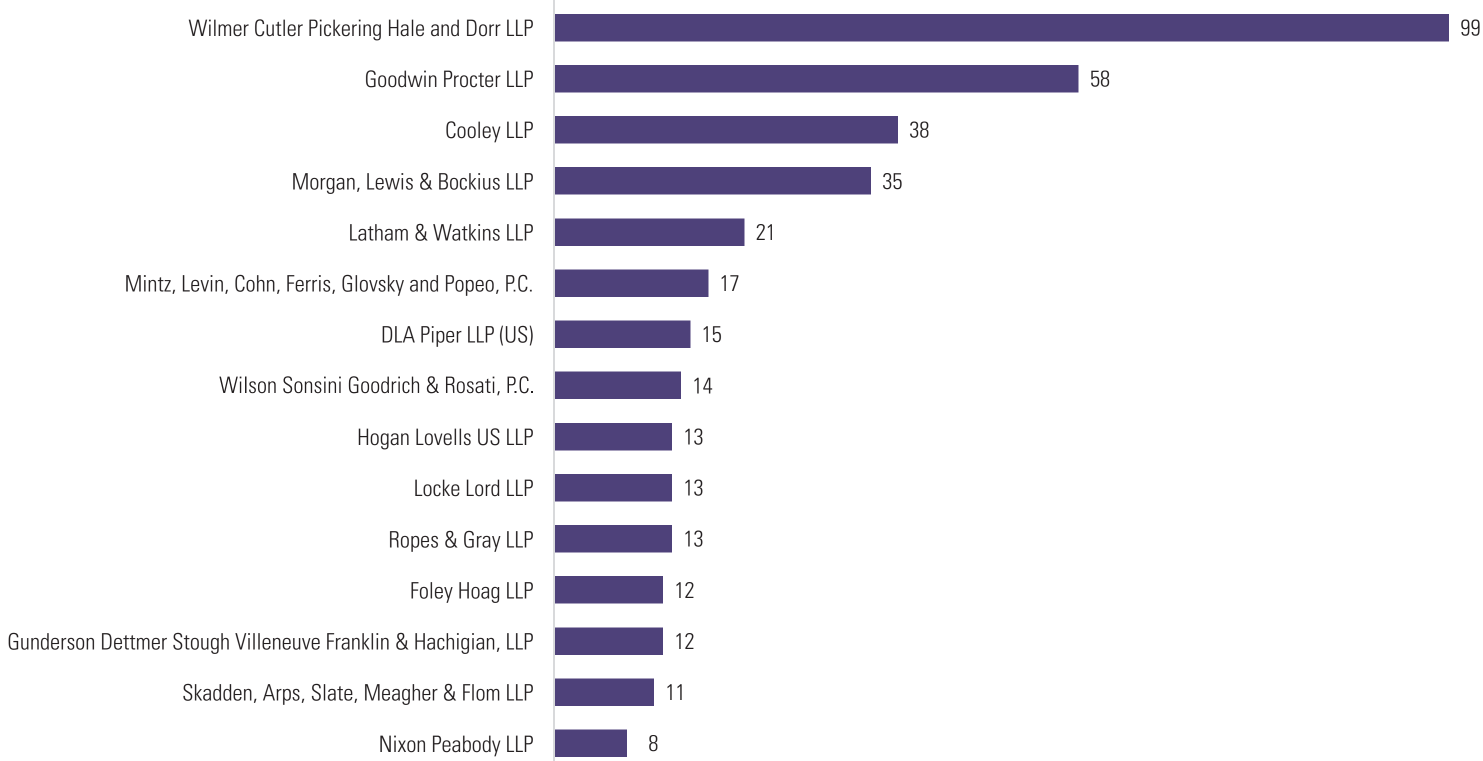
Eastern US IPOs – 1996 to 2018



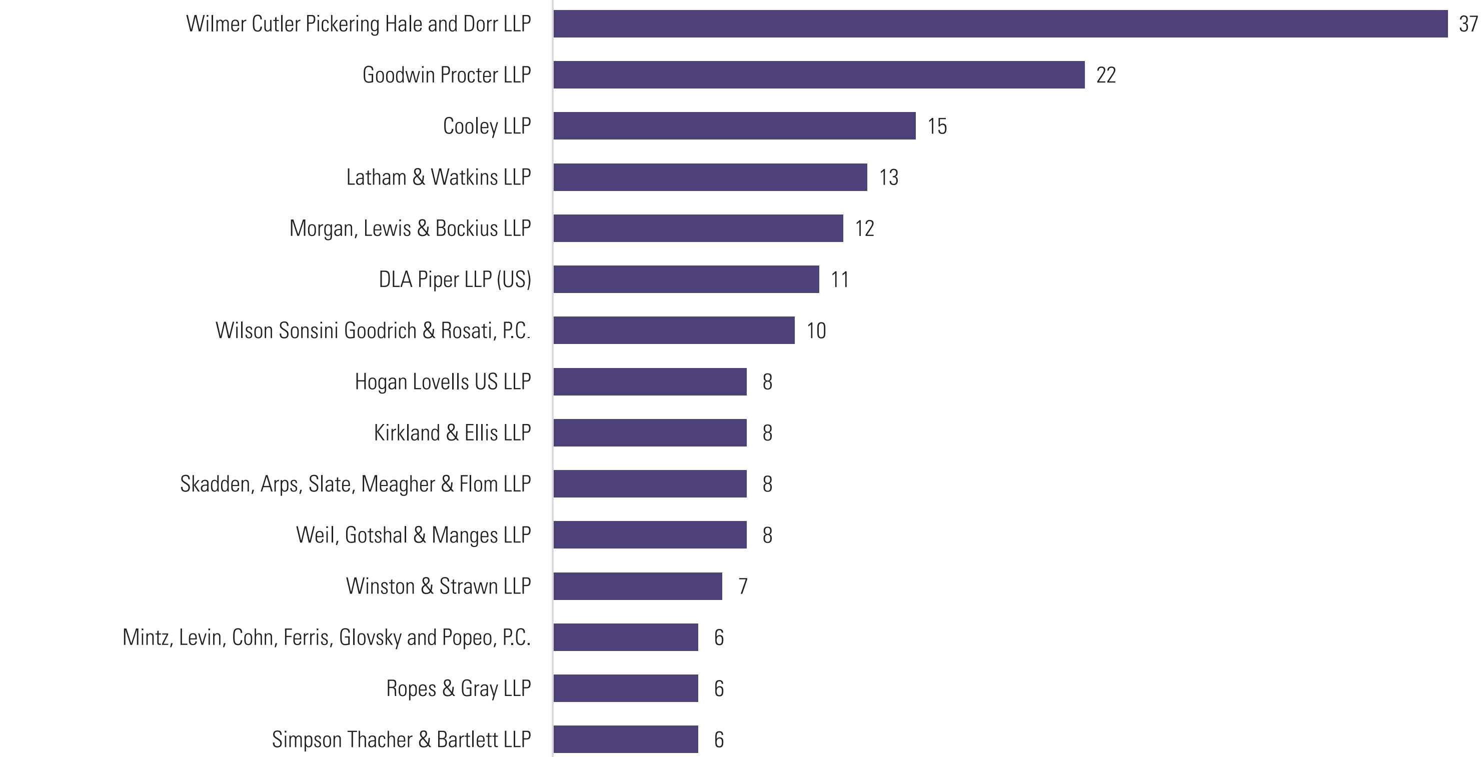
Source: SEC filings

Company Counsel in Eastern US VC-Backed IPOs – 1996 to 2018



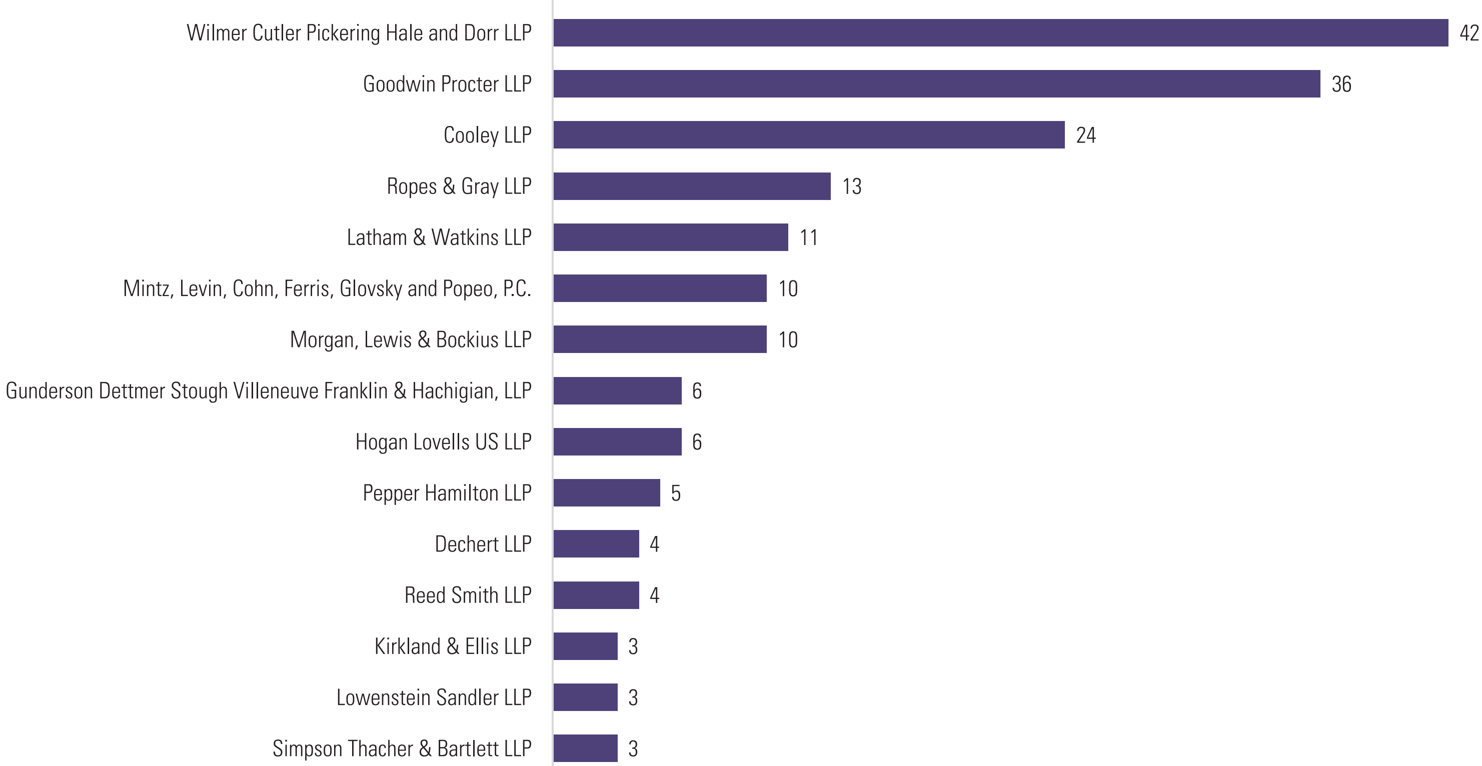
Source: Dow Jones VentureSource and SEC filings
The above charts are based on companies located east of the Missisipi River.

Company Counsel in IPOs of Eastern US Technology Companies – 2000 to 2018



Source: SEC filings

Company Counsel in IPOs of Eastern US Life Sciences Companies – 2004 to 2018



Source: SEC filings
The above charts are based on companies located east of the Mississipi River.

SEC Policies and Practices Continue to Encourage Public Offerings

The JOBS Act of 2012 was intended to spur job creation and economic growth by improving access to the capital markets for startup and emerging companies. Over the past two years, the SEC has taken additional steps—often through changes in staff policies and practices rather than formal rules—to encourage IPOs and follow-on offerings by all companies.

NONPUBLIC REVIEW OF REGISTRATION STATEMENTS

In July 2017, the staff changed its review procedures to allow any company, regardless of its status as an EGC, to submit a draft registration statement for "nonpublic review." The nonpublic review process is similar to the confidential submission process for EGCs but is available for a wider range of offerings and registration statements.

OMISSION OF CERTAIN FINANCIAL STATEMENTS

In January 2016, the FAST Act amended the JOBS Act to permit an EGC to omit from its Form S-1 financial information that relates to a historical period that the company reasonably believes will not be required to be included in the Form S-1 at the time of the contemplated offering, as long as the company adds all required financial information to the Form S-1 before distributing a preliminary prospectus to investors.

A non-EGC is not eligible for this FAST Act relief. However, under a staff policy announced in August 2017, a non-EGC may omit from its draft registration statements submitted for nonpublic review annual and interim financial information that it reasonably believes it will not be required to present separately at the time that it publicly files its registration statement.

TESTING THE WATERS

The JOBS Act permits EGCs to engage in "test-the-waters" communications with eligible institutional investors to determine their investment interest in a contemplated IPO, either prior to or following the filing of the Form S-1. In February 2019, the SEC proposed rule amendments to permit any company to engage in "test-the-waters" communications with eligible institutional investors in connection with any registered securities offering.

REGULATION A

Regulation A—historically available only to private companies—permits securities offerings of up to $50 million with less extensive disclosure than registered public offerings. Effective January 31, 2019, the SEC made Regulation A available for follow-on offerings by public companies.

MANDATORY ARBITRATION PROVISIONS

Public companies historically have not sought to impose mandatory arbitration for stockholder claims, and an attempt to do so in connection with a 2012 IPO was abandoned after it encountered significant opposition from the SEC staff and investor criticism. On several subsequent occasions, the staff allowed public companies to exclude stockholder proposals seeking to mandate the adoption of mandatory arbitration bylaw provisions, noting (but not explicitly concurring) that "there appears to be some basis for [the] view that implementation of the proposal would cause the company to violate the federal securities laws."

In public comments made in July 2017, one SEC commissioner expressed support for permitting IPO companies to include mandatory arbitration provisions in their corporate charters. Since then, SEC Chair Clayton has consistently stated that the question of whether public companies can require stockholders to arbitrate claims against them arising under the federal securities laws is not appropriate for resolution at the staff level but rather should be addressed by the SEC in a measured and deliberative manner. However, he has remained non-committal on the questions of if, when and how the SEC might consider the issue.

In February 2019, the staff permitted a public company incorporated in New Jersey to omit from its proxy statement a stockholder proposal for the adoption of a bylaw provision requiring mandatory arbitration of stockholder claims, based on the submission of an opinion from the Attorney General of New Jersey that implementation of the proposal would violate state law. In response, the proponent of the stockholder proposal filed a lawsuit seeking to compel the company to include the proposal in its proxy statement. The permissibility of mandatory arbitration provisions remains uncertain and may ultimately be resolved in the courts.

STAFF REVIEW OF REGISTRATION STATEMENTS

Reflecting the staff's focus on the most significant issues presented by a company's business and Form S-1 disclosures, the typical number of comments in the first comment letter has dropped from 30–40 several years ago to 15–25 today. The staff typically does not review registration statements for follow-on offerings, but a proposed follow-on offering generally cannot proceed until the staff confirms it will not review the registration statement. Staff "no-review" decisions are now being communicated faster, sometimes within one day after filing. ■

ENCOURAGEMENT OF FURTHER RELIEF

Rule 3-13 under Regulation S-X has long permitted companies to seek SEC relief to permit the omission of required financial statements or the substitution of "appropriate statements of comparable character" if the relief is "consistent with the protection of investors." Such requests can be bolstered by demonstrating that satisfaction of the requirement would involve "unreasonable effort or expense," the general standard contained in Rule 409 under the Securities Act for relief from SEC disclosure requirements.

On numerous occasions over the past two years, senior staff members have expressed an increased willingness to consider requests for modifications. In public commentary, SEC Chair Clayton acknowledged that in some circumstances the SEC's reporting rules may require disclosures that are burdensome to generate but may not be material to the total mix of information available to investors. He encouraged companies to consider whether modifications to their financial reporting requirements in these situations may be helpful in connection with capital-raising activities and indicated that the staff is placing a high priority on responding with timely guidance to such requests.

The requirement to file material contracts as exhibits to an IPO registration statement often provokes anxiety over the potential disclosure of competitively sensitive information. Fortunately, SEC rules have long permitted a company to redact confidential information that is not material and that would cause the company competitive harm if publicly disclosed.

Even better, rule changes approved by the SEC in March 2019 significantly simplify the process for redacting confidential information. Although the confidential treatment process has been made easier, the substantive rules regarding when confidential information may be redacted have not changed and companies still need to exercise judgment to determine what information may be redacted.

HISTORICAL PRACTICE

In the past, in order to obtain confidential treatment, a company going public was required to file an application—often termed a confidential treatment request or "CTR"—with the SEC and demonstrate that:

— the information sought to be protected falls within one of the permitted categories under the Freedom of Information Act (FOIA), most frequently exemption 4, which covers "trade secrets and commercial or financial information" that is "privileged or confidential";

— public disclosure of the information would likely cause competitive harm to the company; and

— the information is not material to investors.

The CTR was filed in paper form with the SEC and included the full text of the contract, including the portions for which confidential treatment was sought, and a detailed analysis, citing relevant authority, of why confidential treatment was appropriate under established FOIA standards. The CTR would be reviewed by the SEC staff, usually by the same legal examiner reviewing the rest of the filing. If the examiner believed the request was too broad or the applicable standards were not met, there would be back-and-forth until the examiner and the company reached a resolution.

REVISED RULES

— *CTR Not Required for Material Contracts*: Companies are no longer required to submit a CTR when they redact information from material contracts filed as exhibits under Item 601(b)(10) of Regulation S-K, if the information redacted is not material and would likely cause competitive harm to the company if publicly disclosed. A similar provision applies to plans of acquisition, reorganization, arrangement, liquidation or succession. In each case, the revised rules require the company to:

- mark the exhibit index to indicate that portions of the exhibit have been omitted;
- include a prominent statement on the first page of the redacted exhibit that certain identified information has been excluded from the exhibit because it is not material and would likely cause competitive harm to the company if publicly disclosed; and
- indicate with brackets where the information has been omitted from the version of the exhibit that is publicly filed.

— *Omission of Schedules*: Companies are allowed to omit entire schedules and similar attachments, provided the omitted schedules and attachments do not contain information material to an investment or voting decision and the omitted information is not otherwise disclosed. The filed exhibit must identify the contents of any omitted schedules and attachments. Upon request, the company must furnish a supplemental copy of any omitted schedule or attachment to the SEC.

— *Omission of Personally Identifiable Information*: Companies are allowed to eliminate personally identifiable information, such as bank account numbers, social security numbers, home addresses and similar information, from required exhibits without submitting a CTR. This new rule codifies existing SEC staff practice.

IMPLEMENTATION OF REVISED RULES

— *Scope of Redactions*: While it remains to be seen how much scrutiny the staff will apply to the review of redacted exhibits, companies should continue to focus on redacting only the specific words or numbers necessary to be kept confidential in order to prevent competitive harm—the "Swiss cheese" approach—and should continue to follow the relevant guidance set forth in Staff Legal Bulletin No. 1. As is currently the case, companies may not redact material information or information that is specifically required by SEC disclosure rules.

— *Staff Review*: If a redacted exhibit is going to be reviewed, the SEC staff will send a letter to request a copy of the unredacted exhibit marked to highlight the confidential information. Following its review, the staff may or may not ask for an analysis of why the redacted information is not material and would likely cause competitive harm if publicly disclosed. If a company's analysis does not support the redactions, the staff can require the company to file a pre-effective amendment that includes additional information disclosed in the exhibit.

— *Impact on Timing*: The SEC staff will continue to ask companies to resolve any pending confidential treatment comments relating to redacted exhibits before submitting a request for acceleration of the effective date. As a result, companies may sometimes be forced, as is currently the case, to choose between abandoning their efforts to redact certain information and delaying the IPO during the time it takes to resolve open SEC comments.

— *Scope of Revised Rules*: The new relief from the requirement to file a CTR applies only to exhibits filed under Items 601(b)(2) and 601(b)(10) of Regulation S-K and not to the other exhibits required to be filed under S-K 601, although confidential treatment typically is not sought for other types of exhibits. The other rule changes apply more broadly. ■

Assembling Your IPO Team

As part of its IPO preparations, every company hoping to go public must assemble the group of employees, board members, outside professionals and advisors who are needed for the IPO journey and subsequent life as a public company. The principal members of the IPO team are described below.

MANAGEMENT AND EMPLOYEES

The CEO and CFO are essential to the success of the company's IPO. If the incumbents do not possess the combination of experience, knowledge, communications skills, vision and integrity needed to lead the company through the IPO process, woo investors on the road show and tend to public company obligations after the closing—all while managing the company's operations—the board will need to consider deferring the IPO or changing the company's leadership. For example, it is not unusual for a company going public to seek a more seasoned CFO, even if the existing CFO has been perfectly adequate for the company's needs while it was privately held.

Most companies add other capabilities as part of their IPO preparations:

— *Controller*: An IPO company should have a controller on board before completing the IPO, and preferably six to twelve months before the organizational meeting—particularly if the CFO has more of a finance than an accounting background. The controller should be well grounded in accounting and public company reporting.

— *Finance and Accounting Staff*: Additional finance and accounting employees will be needed to assist with various public company responsibilities, including preparation for Section 404 of the Sarbanes-Oxley Act and public reporting matters. Generally, some new finance and accounting employees—such as a director of external reporting—are hired during the IPO process and others are added as the company's needs develop over time.

— *General Counsel*: A general counsel can make significant contributions to the IPO process, particularly if hired at least six to twelve months before the organizational meeting—in time to become familiar with the company's business, contracts and corporate affairs, and to participate with outside company counsel in public company preparations.

— *Investor Relations Personnel*: Most private companies rely on the CEO or CFO to handle any stockholder relations matters that come up. Following an IPO, additional resources (internal or external) must be devoted to investor relations. Before the IPO is closed, the company should have plans in place to fill this function.

— *Stock Plan Administrator*: An IPO company must hire a qualified transfer agent to handle stock transfers and record keeping. Most public companies also need an internal stock plan administrator, who usually resides within the human resources or finance group.

— *Internal Auditor*: Although not required by SEC rules, an internal audit function is required by NYSE listing requirements, subject to a one-year transition period for IPO companies. Nasdaq does not currently require its listed companies to establish and maintain an internal audit function.

BOARD OF DIRECTORS

An IPO presents both a need and an opportunity to reset a company's board. As IPO planning progresses, the company should evaluate the post-IPO composition of its board of directors and board committees, for several reasons:

— *Independence Requirements*: The board will need to satisfy independence standards under SEC and applicable stock exchange rules, including the enhanced standards for membership on the audit and compensation committees.

— *Audit Committee Financial Expert*: The audit committee should have at least one "audit committee financial expert," as defined by SEC rules.

— *Compensation Committee Considerations*: There is a securities law advantage if each compensation committee member qualifies as a "non-employee director" for purposes of Section 16 of the Exchange Act.

— *Public Company Experience*: It may be necessary or desirable to add board members with public company experience.

— *Allocation of Committee Duties*: Additional independent directors may be useful to share the burden of the board's three principal committees—generally, at least five independent directors are needed to enable a reasonable allocation of committee duties.

— *Departure of VC and PE Directors*: Directors appointed by venture capital or private equity investors often depart after the IPO lockup period ends and their funds' shareholdings are distributed to their limited partners.

Although phase-in rules apply to the director independence standards and there is no technical deadline for most of the other requirements summarized above, the board should begin discussing potential changes in board composition six to twelve months before the IPO.

COMPANY COUNSEL

Company counsel is a central player in the IPO working group. In selecting a law firm to serve as IPO counsel, a company should consider:

— *IPO and Public Company Experience*: Experience in handling IPOs and advising public companies on their ongoing reporting obligations, preferably for companies in the same or a similar industry, is essential.

— *Issuer and Underwriter Experience*: Both issuer and underwriter IPO experience is relevant, since an understanding of the priorities and expectations of underwriters will facilitate the offering process on the company's side.

— *Prior SEC Work Experience*: Former SEC staff members within a firm can often draw on prior working knowledge to expedite the resolution of issues or identify the appropriate decision maker within the SEC.

— *Team Members*: The company should assess the experience and capabilities of the individual lawyers who will handle the IPO, including the more junior lawyers on the team—the "second chair" on the offering may well be the company's principal point of contact for many parts of the IPO process.

— *Firm Capabilities*: The firm's full-service capabilities should be considered, as the company will inevitably have legal needs in a wide range of areas, both during and after the IPO process.

INDEPENDENT ACCOUNTANTS

Although an IPO company does not need to hire a "Big 4" or other national accounting firm to go public, most do. The Big 4 plus the next three largest audit firms account for more than 80% of all US IPOs, for several reasons:

— *SEC Experience*: Every independent registered public accounting firm will be familiar with Regulation S-X, GAAP and PCAOB auditing standards, but national accounting firms can tap into a wellspring of institutional experience concerning the SEC and IPOs.

— *Bench Strength*: With large staffs in many or most major metropolitan areas in the United States, national accounting firms have the bandwidth to meet the demanding schedule of an IPO and can service the audit needs of companies with widely dispersed operations.

— *Additional Services*: National accounting firms offer a variety of tax and advisory services in addition to traditional audit services, often enabling companies to benefit from "one-stop shopping" (subject to limitations on non-audit services imposed by the Sarbanes-Oxley Act).

— *Brand Name*: Underwriters and investors often draw comfort from the inclusion of a national accounting firm audit opinion in an IPO prospectus.

IPO candidates that are not using a national audit firm often switch to an audit firm with more IPO and public company experience. If a new audit firm is engaged, previously audited financial statements may need to be re-audited. To avoid potential offering delays, a switch in auditors generally should be made six to twelve months before beginning the IPO process. A change in auditor during the company's two most recent fiscal years or any subsequent interim period must be disclosed in the registration statement for the IPO.

MANAGING UNDERWRITERS

The selection of managing underwriters—in particular, the lead managing underwriters—is perhaps the single most important decision the company will make as part of the IPO process. The following criteria are generally considered relevant in choosing from among competing investment banks:

— *Track Record*: An investment bank's prior experience and success is arguably the most germane factor, and has three dimensions: overall track record, IPO experience and familiarity with the company's industry.

— *Team Members*: The company should evaluate each underwriter's entire team, including the investment banking personnel, research analysts, and equity capital markets and syndicate group.

— *Commitment to the Company*: The company should be sure that the managing underwriters it chooses are committed to the company and that the deal teams have sufficient capacity to devote to the company.

— *Distribution Capabilities*: The managing underwriters collectively must have sufficient distribution clout to sell the entire IPO and the ability to achieve the target mix of institutional, retail, domestic and international investors.

— *Aftermarket Support*: An IPO can quickly sour if an active trading market does not develop or the stock underperforms the market after closing, and securities litigation often follows a sudden drop in the stock price.

— *Prestige*: Perceptions of underwriter prestige are largely subjective and can vary across industries, but few directors or institutional investors would have difficulty identifying those potential managing underwriters they consider to be more (or less) prestigious than others.

— *Economic Factors*: If the company anticipates a large IPO and hopes to negotiate a discount below the generally prevailing 7% rate, the topic should be discussed when banks are competing for the engagement.

— *Financial Strength*: An investment banking firm's financial resources will determine the amount of capital it can commit to aftermarket trading support and will affect its potential ability to make credit available to the company for acquisitions or other corporate purposes.

— *Other Capabilities*: The company should assess each potential underwriter's strengths in the areas of the company's likely future needs, including follow-on public offerings, M&A engagements, assistance in takeover defenses and other capital markets matters. If the company contemplates a "dual track" process, it should also consider the underwriter's M&A capabilities and track record for this process.

UNDERWRITERS' COUNSEL

The lead managing underwriters will select an outside law firm to serve as underwriters' counsel. In addition to experience with IPOs and the company's industry, familiarity with the company will make underwriters' counsel more effective and contribute to a smooth offering process. Many law firms are qualified to act as underwriters' counsel, and the underwriters will often give considerable weight to the company's views on the choice of firm.

OTHER ADVISORS AND VENDORS

Companies going public regularly retain additional consultants and advisors, such as a compensation consultant, investor relations firm and accounting consultant. An IPO company also needs to line up several vendors as part of the IPO process, including a financial printer, transfer agent and virtual data room provider (typically the financial printer). ■

As part of its review of the Form S-1, the SEC staff scrutinizes a company's pre-IPO grants of options and other compensatory equity awards to assess whether they were properly valued. If the staff determines that the company underestimated the fair market value of its common stock in accounting for equity grants—commonly referred to as having issued "cheap stock"—the company will be required to recognize additional compensation expense.

Accounting for compensatory equity awards has long been a focus of staff review. Although the accounting consequences of a cheap stock finding often are not as severe as in the days prior to the mandatory adoption of ASC Topic 718 (the accounting standard requiring companies to record compensation expense for employee equity grants), the resultant changes to the company's audited financial statements can trigger a restatement. Perhaps more importantly, the time required to achieve closure with the staff on cheap stock issues can delay an IPO, particularly since the topic typically cannot be resolved until the estimated price range for the offering becomes available shortly before commencing the road show.

COMMON STOCK VALUATION

The starting point of proper accounting for compensatory equity awards—and a cheap stock analysis—is the fair market value of the company's common stock. Valuation practices for common stock of pre-IPO companies have become less subjective and more formal over the years, for several reasons.

— *Section 409A*: Under Section 409A of the Internal Revenue Code, if a stock option is granted with an exercise price that is below the fair market value of the common stock on the date of grant and does not otherwise comply with the provisions of Section 409A, the recipient is required to pay—as the option vests and regardless of whether it is exercised—ordinary income tax based on the difference between the exercise price and the fair market value in the year of vesting, plus in each such year a 20% penalty tax and possibly interest and penalties. This tax treatment will continue on an annual basis with respect to any post-vesting appreciation in the stock until the option is exercised or expires.

IRS regulations provide that the fair market value of private company stock must be determined by the reasonable application of a reasonable valuation method that considers all relevant facts and circumstances and specifies the factors that should be considered in this process. The regulations also contain two safe harbors that, if followed, will be presumed to result in a reasonable valuation. The first safe harbor is for a valuation performed by an independent third party. The second safe harbor, which is much less commonly utilized, permits an internal valuation under limited circumstances.

— *AICPA Practice Aid*: The SEC staff applies the recommendations contained in an AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, in assessing the basis on which a company has estimated the fair market value of its stock. The Practice Aid identifies three acceptable valuation methodologies—market-based, income-based (such as discounted cash flow) and asset-based—and states that the preferred approach is a valuation at the time of grant by an unrelated valuation specialist. Use of rules of thumb—such as informal discounts from the anticipated IPO price range—is not permitted, and there is no predictable pattern as to the timing and amount of the discount from the IPO range that the staff will find acceptable. The staff generally focuses on the application of the Practice Aid to grants made in the 12-month period prior to the initial filing or submission of the Form S-1, although it may examine earlier grants as well.

The confluence of the SEC's emphasis on the Practice Aid, the onerous Section 409A tax consequences of granting discounted stock options and the difficulty of valuing private company stock—the "perfect storm" of cheap stock—has driven almost all pre-IPO companies to obtain independent valuations of their common stock for equity granting purposes. These valuations vary in quality and price, based in part on the size and nature of the valuation firm. The company's independent auditor cannot perform the valuation without losing its independence from the company.

Whenever the company obtains an independent valuation of its common stock, it should confirm in advance that the valuation will be Section 409A–compliant for tax purposes and consistent with ASC Topic 718 for accounting purposes. The company should also confirm that the valuation firm and methodology will be acceptable to the company's independent auditor and then work with its auditor to review the draft valuation report before issuance. Methodologies that include more than one valuation approach are more likely to pass muster with the company's auditor and the SEC staff.

The Section 409A regulations permit an independent valuation to be used for up to 12 months as long as its continued use is not grossly unreasonable. However, it is advisable to obtain an updated valuation contemporaneously with each significant grant date and following each significant company development affecting valuation, such as closing a new round of financing, substantially exceeding the company's revenue plan, achieving positive cash flow or profitability, commercially launching an important new product, commencing discussions to be acquired, or beginning the IPO process. Similarly, significant reversals in the company's fortunes may merit a reduction in the common stock valuation.

STRATEGIES TO MINIMIZE CHEAP STOCK ISSUES

The following strategies can be incorporated into pre-IPO planning and equity granting practices to minimize the likelihood and severity of cheap stock issues during SEC review:

— *Use of Independent Valuations*: For the period of 12 to 18 months preceding the initial Form S-1 filing or submission, the company should price all options, and recognize compensation expense for all stock-based awards, based on independent, contemporaneous valuations and should procure updated valuations quarterly, or more frequently if warranted by significant company developments. Under the Practice Aid, a contemporaneous valuation considers conditions and expectations that exist at the valuation date and is not biased by hindsight. Independent, contemporaneous valuations that are compliant with the Practice Aid and Section 409A will not preclude the SEC staff from raising cheap stock issues, but they will present strong evidence to counter any challenges by the staff.

— *Grant Approval Process*: All option grants beginning 12 to 18 months before the initial Form S-1 filing or submission should be made only at meetings of the board and not pursuant to written consents. Options must have an exercise price that is at least equal to the fair market value of the common stock on the date of grant, and board determinations of fair market value of private company stock cannot, as a practical matter, be made by written consent. Also, since a written consent is not legally effective until the last required signature is obtained, any delay in obtaining all required signatures can lead to assertions that the fair market value of the common stock has increased in the interim. If the company had previously authorized the CEO to make option grants to new employees, new-hire grants should now be made only at board meetings to avoid similar issues (the board can choose to begin vesting with the date of hire, instead of the grant date, so that the delay in grant has no effect on vesting).

— *Prospectus Disclosure*: In the initial Form S-1 filing or submission, the company should include stock compensation disclosure in accordance with SEC staff guidance. In general, a description of a company's historical valuation methodology, and how that methodology will change post-IPO, is now sufficient. Under prior staff guidance, much more extensive disclosure regarding pre-IPO stock-based compensation was required.

The staff will generally permit the company to state that it obtained third-party valuations (without naming the valuation firm) as data points to support the company's determinations of fair market value and the associated accounting charges. The staff will ask companies to explain the reasons for valuations that appear unusual (such as unusually steep increases in the fair market value of the underlying shares leading up to the IPO) but has indicated that these comments are intended to assist the staff in confirming the appropriate accounting for the stock-based compensation and are not for the purpose of requesting changes to the disclosure in the prospectus.

— *Cheap Stock Submission*: Because the SEC staff cannot assess the company's cheap stock situation until it knows the estimated offering price range, which ordinarily is not included in the Form S-1 until the last amendment prior to printing preliminary prospectuses and commencing the road show, the company should consider supplementally providing to the SEC examiner—or may be asked by the examiner to provide—a preliminary estimate of the anticipated price range (often referred to as a "cheap stock submission").

If provided, a cheap stock submission typically discusses the factors contributing to the difference between the midpoint of the estimated price range and the fair market value of the common stock, determined as of the date of the company's most recent equity grant (and sometimes other recent grants). In a cheap stock submission, the company may prefer or need to use a wider price range than the $2.00 spread that is customary in the preliminary prospectus—sometimes as large as $3.00 to $4.00 per share. A cheap stock submission typically is made one to two weeks before the road show is expected to commence. Confidential treatment is usually sought, since the submission will otherwise become publicly available following the completion of the staff's review of the Form S-1.

Cheap stock submissions are no longer universally requested by the SEC staff, and practices vary across examiners. If a cheap stock submission is not requested by the examiner, some companies voluntarily make a submission to avoid the potential offering delay that could result if the staff raises concerns when the price range is publicly disclosed shortly before the road show is scheduled to begin, while other companies with unremarkable patterns of valuation determinations in the months approaching the IPO, and with appropriate prospectus disclosures regarding valuation methodologies consistent with staff guidance, conclude there is no need to make a cheap stock submission. ■

EQUITY GRANTS DURING IPO PROCESS

Between Org Meeting and Initial Filing or Submission: The company should consider forgoing all equity grants as the initial Form S-1 filing or submission approaches, because the fair market value of the common stock used to establish option exercise prices or to determine the accounting treatment of other equity grants during this period—even when based on independent, contemporaneous valuations—will be the most vulnerable to second-guessing once the estimated offering range is known. If it is impracticable to stop making grants during this period, the company should ensure that the valuation firm knows about the company's IPO plans and uses an appropriate valuation methodology in light of the company's near-term liquidity.

After Initial Filing or Submission: After the initial filing or submission of the Form S-1, the fair market value used to establish option exercise prices or to determine the accounting treatment of other equity grants should continue to be based on independent, contemporaneous valuations. Ideally, the fair market value used for these purposes should be within the estimated offering range, and it may be desirable to stop making grants as the road show draws near, to avoid raising new cheap stock issues. An alternative approach is to use the IPO price as the fair market value for equity grants after the initial filing or submission and to make the grants effective concurrently with the execution of the IPO underwriting agreement, as long as the IPO occurs by a specified date. This strategy should be immune from cheap stock challenges, but will leave a recipient with nothing if the company is acquired instead of going public.

Selling Stockholders: The Basics

Selling stockholders are pre-IPO stockholders of a company who sell some of their shares to the public as part of the company's IPO. Pre-IPO investors often have contractual registration rights permitting them to include shares in the offering. Selling stockholders achieve immediate liquidity for the shares sold but face several tradeoffs, as discussed below.

BACKGROUND

Investors in private companies routinely negotiate two types of registration rights:

- "Demand" registration rights permitting investors to require the company to file a registration statement with the SEC and register their shares for public sale, usually after passage of a minimum period of time and subject to a minimum offering size. Such rights typically cannot be invoked to "demand" an IPO.
- "Piggyback" registration rights enabling investors to include a portion of their shares in a public offering initiated by the company (sometimes excluding the IPO). Piggyback rights generally allow the managing underwriters to cut back, or exclude entirely, selling stockholder shares if such a step is deemed necessary due to market conditions.

Registration rights agreements usually contain detailed provisions to address, among other topics, eligibility, notices, registration procedures, lockup requirements, expenses, waivers and indemnification obligations.

NATURE AND PREVALENCE OF SELLING STOCKHOLDERS

Most frequently, selling stockholders are pre-IPO investors with piggyback registration rights. Company management without registration rights may also be permitted to sell shares in an IPO. Management sales in an IPO can create the perception that insiders lack confidence in the company, and are usually limited to a small percentage of their holdings (typically 5% to 10%), if permitted at all. Employees can also be allowed to sell shares in an IPO, but widespread employee participation significantly complicates the offering logistics.

The prevalence of selling stockholders in IPOs varies widely. Selling stockholders are less common in weak offerings, because underwriters may be leery of introducing any negative factor into the mix. In strong offerings, selling stockholders appear more frequently, sometimes including management as well as pre-IPO investors.

ADVANTAGES AND DISADVANTAGES

For stockholders, the principal advantage of including shares in the IPO is the opportunity to receive liquidity for the shares that are sold without waiting for the expiration of the lockup agreement, and the ability to sell at the IPO price without the risk of a subsequent market decline. For large stockholders that are considered "affiliates" of the company, selling in the IPO also avoids the Rule 144 volume limitations that would otherwise constrain the rate at which pre-IPO shares can be sold without registration once the lockup agreement expires. Disadvantages include the following:

- *Loss of Upside*: The flip side of receiving the IPO price for their shares is that selling stockholders forgo any subsequent market appreciation in the value of the shares sold. This factor is difficult to assess, since no one knows for certain how any particular company's stock will perform following its IPO.
- *Potential Liability*: Selling stockholders face potential liability to all IPO investors for material misstatements or omissions in the Form S-1. In addition, under the underwriting agreement, selling stockholders are required to indemnify the underwriters against liabilities to the extent attributable to information supplied by the selling stockholders for inclusion in the Form S-1. For investors, these potential liabilities are usually mitigated by the company's obligation to indemnify the investors against liabilities resulting from misstatements or omissions in the Form S-1, except to the extent attributable to information supplied by the investors. The managing underwriters often seek more extensive representations and indemnification from selling stockholders who are members of management, and management selling stockholders often are not parties to any agreement obligating the company to indemnify them for information in the Form S-1. Nonetheless, in the absence of deliberate misbehavior, the practical risk of liability for management selling stockholders should be small.
- *Uncertain Terms*: Although assured of receiving the IPO price for their shares, selling stockholders usually must cede authority to the company to negotiate the final offering price and the exact number of their shares to be included in the IPO. In theory, selling stockholders can condition inclusion of their shares in the IPO on receiving a specified minimum IPO price or being allowed to sell a minimum number of shares, but such conditions can greatly complicate IPO pricing and thus are generally resisted by both companies and underwriters.
- *Higher Sales Commission*: Selling stockholders must pay the same underwriting discount on the sale of their shares as paid by the company—typically 7% in an IPO. If the shares were sold in the open market following

PREVALENCE OF SELLING STOCKHOLDERS

Among all US IPOs completed from 2016 through 2018:

- 23% included selling stockholders.
- The selling stockholders consisted solely of investors in 65% of these deals, solely of management in 12%, and of both in the remaining 23%.
- Of the IPOs with selling stockholders, 30% included the shares only as part of the firm-commitment portion of the offering, 17% included the shares only as part of the over-allotment option, and 52% included the shares in both.
- In the IPOs in which selling stockholders participated in the firm-commitment portion of the offering, the median percentage of the firm-commitment portion represented by selling stockholder shares was 33%.

the IPO and the expiration of the lockup agreement, the brokerage commission would be lower.

- *Other Expenses*: Most registration rights agreements require the company to pay the reasonable fees and expenses of one law firm to represent all selling stockholders in the IPO (often with a fee cap). If selling stockholders need to retain additional counsel to review the Form S-1 or to render legal opinions to the underwriters at closing, the expense typically must be borne by the selling stockholders.

SELLING STOCKHOLDER DOCUMENTS

The principal documents to be provided by each selling stockholder consist of:

- *Questionnaires and FinCEN Certifications*: Each selling stockholder typically is required to complete questionnaires to elicit the information required to be disclosed in the Form S-1 and to obtain information required by FINRA rules. In addition, each selling stockholder that is a legal entity is required to provide a beneficial ownership certification form and identifying documentation in compliance with the rules of the Financial Crimes Enforcement Network (FinCEN) within the US Department of the Treasury.
- *Power of Attorney*: The power of attorney irrevocably authorizes attorneys-in-fact—typically designated officers of the company—to sign the underwriting agreement on behalf of the selling stockholder for the sale of the selling stockholder's shares and to take any other actions necessary to complete the sale. If the selling stockholder is selling shares to be received upon exercise of an option or warrant, the power of attorney also authorizes the attorneys-in-fact to exercise the option or warrant prior to or simultaneously with the execution of the underwriting agreement.
- *Custody Agreement*: The custody agreement, which is accompanied by a stock certificate for the shares being sold in the IPO and an executed stock power, authorizes a custodian, typically the company, to deliver the stock certificate and stock power to the managing underwriters at the closing of the IPO. If the selling stockholder is exercising an option or warrant and selling the underlying common stock in the IPO, the applicable option or warrant agreement and notice of exercise will be placed in custody in lieu of stock certificates.
- *Stock Power and Medallion Guarantee*: The stock power is used to convey the shares to the underwriters at the closing. The selling stockholder's signature on the stock power will need to be guaranteed by an eligible financial institution, such as a bank or stockbroker, that participates in an approved signature guarantee "medallion program" under SEC rules.
- *IRS Form W-9*: Each selling stockholder also needs to complete and submit to the company an IRS Form W-9 (Form W-8BEN for non-US persons) for federal tax withholding purposes.

The purpose of these documents is to make the sale of the selling stockholder shares as turnkey as possible and to eliminate the need for selling stockholders to make any further decisions or sign any additional documents in order to complete their sales. Any deviation from this approach—such as minimum price or share requirements—can cause logistical complications.

SEC FILING OBLIGATIONS

Depending on the circumstances, selling stockholders may have SEC filing obligations in connection with the sale of shares in the IPO. For example, a Section 16 insider selling shares in the IPO must file a Form 4 to report the transaction by the end of the second business day after the closing of the IPO. Also, although typically inapplicable due to the large share and dollar thresholds, selling stockholders must consider their "large trader" filing obligations pursuant to Rule 13h-1 under the Exchange Act.

DISCLOSURE OBLIGATIONS

In general, the IPO prospectus must identify each selling stockholder, indicate the nature of any position, office or other material relationship that the selling stockholder has had with the company within the past three years, and disclose the stock ownership of the selling stockholder prior to the IPO, the amount offered in the IPO, and the amount and percentage (if 1% or more) to be owned after completion of the offering. If a selling stockholder is not a natural person, the prospectus must also identify its controlling persons and provide similar information about them.

Disclosure complications can arise if a selling stockholder is not willing to sign a customary power of attorney authorizing the company to determine the IPO price and number of shares to be sold. Similarly, last-minute changes in the composition of the selling stockholders or the number of shares being sold can precipitate the need to update the prospectus.

FOREIGN SELLING STOCKHOLDERS

The inclusion of selling stockholders who reside in foreign jurisdictions in a US IPO can present various procedural and administrative challenges, such as the following:

- The underwriters may need to impose intrusive and time-consuming documentary requirements on foreign selling stockholders in order to comply with applicable anti–money laundering and "know your client" obligations.
- Transfer agent requirements may be more burdensome for foreign selling stockholders, particularly if they reside in tax haven jurisdictions. In foreign countries, for example, it generally is not possible to obtain a medallion guarantee, so selling stockholders are required to make alternative arrangements for authentication of signatures.
- Notarization of documents, if required, is more difficult and time-consuming in foreign countries than in the United States.
- Depending on the jurisdictions of the selling stockholders, foreign tax concerns may need to be addressed. ■

Disclosure and Reporting Obligations—One Size Does Not Fit All

At one time, most US companies going public underwent the same IPO process and were subject to the same disclosure standards, auditing requirements and post-IPO reporting obligations. Nowadays, significant variations exist.

— *Accelerated Filers and Large Accelerated Filers*: In 2003, the SEC introduced an "accelerated filer" reporting classification based on a company's public float (at least $75 million) and tenure as a public company (a company that has been subject to the Exchange Act for at least 12 calendar months and has filed at least one Form 10-K). In 2005, the SEC added a "large accelerated filer" classification for companies with a larger public float (at least $700 million). Accelerated filers and large accelerated filers are subject to earlier filing deadlines for Form 10-Qs and Form 10-Ks and must comply with several disclosure obligations and auditing requirements from which non-accelerated filers are exempt—most notably, the requirement under Section 404(b) of the Sarbanes-Oxley Act to obtain an annual independent audit report on the effectiveness of the company's internal control over financial reporting.

— *Well-Known Seasoned Issuers*: Also in 2005, the SEC created another new classification, consisting of large, mature public companies known as "well-known seasoned issuers" (WKSIs) that are eligible for substantial flexibility in the registration process for follow-on public offerings. A WKSI is a US public company that is Form S-3–eligible and has a public float of at least $700 million or has issued at least $1 billion of debt securities in registered transactions in the preceding three years. To be eligible for Form S-3, a company must have been subject to the Exchange Act for at least 12 calendar months and timely filed all reports on Form 10-K, Form 10-Q and Form 8-K (with limited exceptions) required to be filed during the 12 calendar months and any portion of a month immediately preceding the filing of the Form S-3.

— *Smaller Reporting Companies*: In 2008, the SEC introduced another new reporting category consisting of "smaller reporting companies" (SRCs) that satisfy public float or revenue tests. SRCs can take advantage of relaxed disclosure standards in a Form S-1 and as a public company. In June 2018, the SEC amended the definition of an SRC to significantly expand the pool of eligible companies. Under the amended definition, an SRC must have a public float of less than $250 million, or annual revenues of less than $100 million in its most recent fiscal year and either no public float or a public float of less than $700 million. As a result of the amendments, some SRCs may also be categorized as accelerated filers or large accelerated filers and thus obligated to obtain Section 404(b) audit reports. In May 2019, the SEC proposed to exclude from the accelerated and large accelerated filer definitions any SRC that had annual revenues of less than $100 million in its most recent fiscal year.

— *Emerging Growth Companies*: In 2012, the JOBS Act created the "emerging growth company" (EGC) classification. An EGC is a company that had total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year. EGCs enjoy substantial disclosure and reporting relief and the ability to submit a draft Form S-1 for confidential SEC review during the IPO process.

— *Testing the Waters*: The JOBS Act permits EGCs to engage in "test-the-waters" communications with eligible institutional investors to determine their investment interest in a contemplated IPO, either prior to or following the filing of the Form S-1. In February 2019, the SEC proposed rule amendments to permit any company to engage in "test-the-waters" communications in connection with any registered securities offering.

— *Expansion of Regulation A*: Effective in January 2019, the SEC amended Regulation A—which provides an exemption from registration for public offerings by private companies—to make Regulation A available for follow-on offerings by public companies. Offerings under Regulation A require less extensive disclosure than registered public offerings.

— *Staff Policies and Practices*: Over the past two years, the SEC staff has modified several policies and practices to facilitate IPOs and follow-on offerings.

- In 2017, the staff changed its review procedures to allow any company, regardless of EGC status, to submit a draft registration statement for nonpublic review and made that process available for a wider range of offerings and registration statements.
- Under a staff policy announced in 2017, any company is permitted to omit from a draft registration statement annual and interim financial information that the company reasonably believes will not be required in the registration statement when it is publicly filed.
- The staff has encouraged companies to request relief from SEC reporting rules requiring disclosures that are burdensome to generate but may not be material to the total mix of information available to investors.

Further regulatory and legislative efforts to streamline capital formation, encourage IPOs and reduce compliance burdens on public companies, particularly for the benefit of smaller companies, can be expected. For example:

— In May 2019, the SEC proposed amendments to Regulation S-X to update and ease the financial disclosure requirements in connection with acquisitions and dispositions of businesses.

— Bills have been introduced in Congress that would, among other things: extend the period of time during which EGCs are exempt from the auditor attestation requirement under Section 404(b) of the Sarbanes-Oxley Act; reduce the minimum public float for WKSI status; permit more companies to use Form S-3; exempt all EGCs and other smaller companies from the requirement to provide financial statements in XBRL format in SEC filings; pare back the requirement for say-on-pay votes and eliminate the requirement for say-on-frequency votes; and repeal the statutory authority for SEC rules on hedging and pay ratio disclosure. ■

The IPO process has its own vocabulary, which is often new and confusing to IPO participants. Below are definitions of some key terms.

Analyst Day. Event held for research analysts employed by the managing underwriters at which the company makes in-depth presentations and entertains questions about the company's financial model and internal projections.

Bookrunner. The lead managing underwriter primarily responsible for organizing and conducting the road show, building the order "book" and agreeing with the company on the price and size of the IPO. Many IPOs have joint bookrunners.

Box. The prospectus summary, which customarily is framed in a page border.

CD&A. Compensation Discussion and Analysis, a narrative overview of the company's executive compensation objectives and policies (which EGCs are not required to provide).

Comfort letter. A letter from the company's auditor that confirms certain financial and other information relating to the IPO and the auditor's status.

Comment letter. A letter from the SEC staff containing legal and accounting comments on the Form S-1.

Confidential submission. Submission by an EGC of draft Form S-1 for confidential staff review. Under staff policy, a non-EGC can submit a draft Form S-1 for similar "nonpublic review."

Corp Fin. Division of Corporation Finance, the SEC division responsible for reviewing Form S-1 filings for IPOs.

DSP. Directed share program, a portion of an IPO (typically 5%) reserved for sale to persons designated by the company.

EDGAR. The SEC's system for electronic submission of, and public access to, nearly all SEC filings.

EGC. Emerging growth company, a company that had total annual gross revenues of less than $1.07 billion during its most recently completed fiscal year.

ESPP. Employee stock purchase plan, pursuant to which employees may purchase shares of the company's common stock, typically at a small discount from the market price, through the use of payroll withholdings.

Evergreen. Provisions in a stock incentive plan or ESPP pursuant to which the number of plan shares is subject to automatic annual increases for a stated number of years.

FINRA. Financial Industry Regulatory Authority, the principal self-regulatory organization for securities firms doing business in the United States.

Form S-1. Registration statement filed with the SEC by a US issuer for an IPO in the United States. Foreign issuers file a Form F-1.

FWP. Free writing prospectus, a written communication that constitutes an offer of securities but is not a statutory prospectus.

Green shoe. An option granted by the company and/or selling stockholders that permits the underwriters to purchase additional shares (up to 15% of the offering) within 30 days after pricing. Formally called an "over-allotment option."

Gun-jumping. A public communication that constitutes an impermissible "offer" of securities prior to the public filing of the Form S-1, in violation of the quiet period.

JOBS Act. Federal legislation, enacted in 2012, intended to spur job creation and economic growth by improving access to the capital markets for startup and emerging companies.

KPIs. Key performance indicators, a common term for the key metrics used by management to monitor and assess the company's operations and performance.

Lockup. Agreement prohibiting a stockholder from selling shares acquired prior to the IPO for a specified period of time following the IPO (typically 180 days).

MD&A. Management's Discussion and Analysis of Financial Condition and Results of Operations, a narrative discussion of the company's financial statements that is a principal focus of Form S-1 preparation and SEC staff review.

Non-GAAP financial measure. A numerical measure of financial performance, financial position or cash flows that excludes amounts included in the most comparable GAAP measure or that includes amounts excluded from the most comparable GAAP measure.

Org meeting. Organizational meeting generally attended by all members of the working group to formally commence the IPO process.

PCAOB. Public Company Accounting Oversight Board, a nonprofit corporation established by Congress to oversee the audits of public companies.

Primary/Secondary offering. The portion of an IPO consisting of shares offered by the company for its own account (primary offering) or the portion of an IPO consisting of shares offered by existing stockholders of a company (secondary offering).

Quiet period. The period during which offering and publicity restrictions apply to a company in the process of going public. Generally begins when the company selects managing underwriters and lasts until 25 days after the IPO.

Red herring. Version of the preliminary prospectus circulated to make written offers, which must include a bona fide estimate of the offering price range and the number of shares to be offered.

Road show. The series of meetings held by company management with prospective investors to market shares in an IPO.

Selling stockholders. Company stockholders that sell shares in an IPO.

Staff. Employees of the SEC, including lawyers, accountants and financial analysts.

Test-the-waters ("TTW") communications. Oral or written communications with eligible institutional investors to determine their investment interest in a contemplated IPO, either prior to or following the filing of a Form S-1. ■

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