IPO Report

2020

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2020 IPO Report – What's Inside

REVIEW

The IPO market produced 157 IPOs in 2019, a total that marked a 14% decline from the 183 IPOs in 2018 but stands only 4% shy of the annual average of 163 IPOs between 2013 and 2017.

Total gross proceeds for the year were $45.32 billion—4% above the $43.75 billion reached in 2018 and the second-highest annual figure since 2000, trailing only the $74.39 billion achieved in 2014.

As in 2018, IPOs by emerging growth companies (EGCs) in 2019 accounted for 92% of the annual total, surpassing the 87% overall market share held by EGCs between 2012—when the JOBS Act was enacted—and 2017.

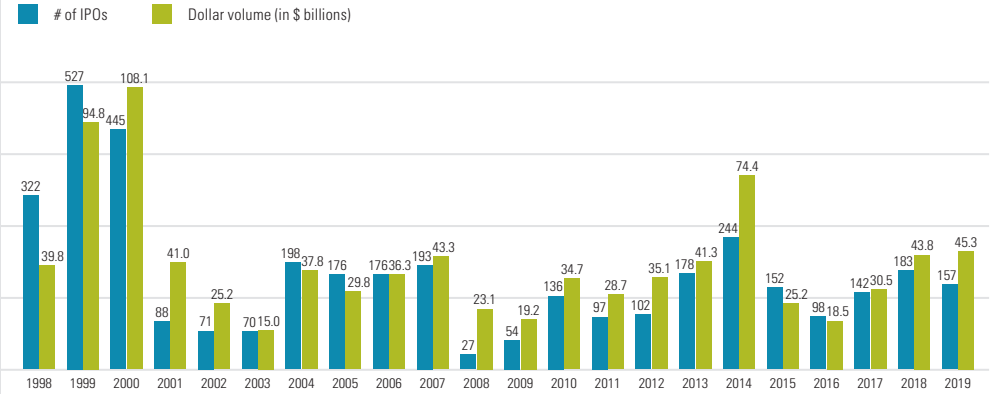
The median offering size for all 2019 IPOs was $106.7 million, down from the $108.0 million median for 2018 but 7% higher than the $100.1 million median that prevailed during the five-year period between 2013 and 2017.

The median offering size for life sciences IPOs in 2019 was $82.5 million, 3% below the $85.3 million median in 2018 but 25% higher than the $66.0 million median for the five-year period from 2013 to 2017. By contrast, the median offering size for non–life sciences IPOs in 2019 was $167.7 million—up 4% from the $161.0 million median in 2018 and 14% higher than the $147.1 million median for the five-year period preceding 2018.

In 2019, the median offering size for IPOs by EGCs was $96.9 million, 4% lower than the $101.3 million median in 2018 but 8% higher than the $90.0 million median that prevailed from the passage of the JOBS Act through 2017. The median non-EGC offering size declined 26%, from $731.5 million in 2018 (the highest annual level since 2012) to $544.4 million in 2019, a figure still 23% higher than the $444.0 million median between 2013 and 2017.

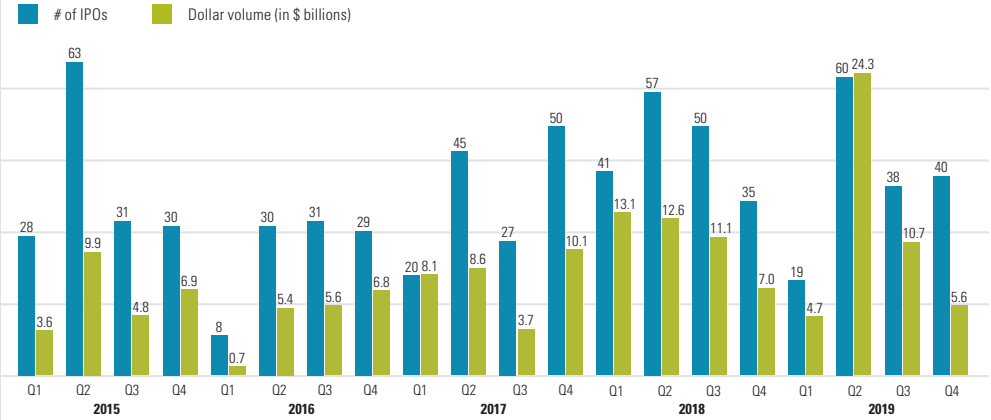
The median annual revenue of all IPO companies in 2019 was $85.0 million, 25% higher than the $68.2 million figure for 2018 and 21% above the $70.2 million figure that prevailed over the five-year period preceding 2018.

US IPOs by Year – 1998 to 2019



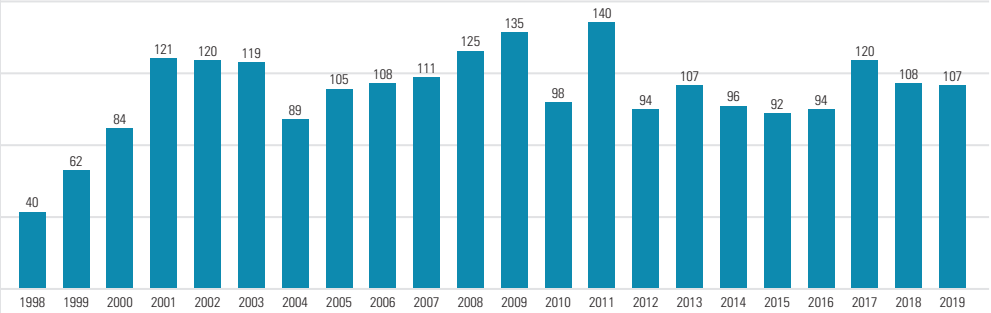
Source: SEC filings

US IPOs by Quarter – 2015 to 2019



Source: SEC filings

Median IPO Offering Size – 1998 to 2019



Source: SEC filings

In 2019, 43% of life sciences IPO companies had revenue, matching the percentage in 2018 but trailing the 59% median for the five-year period from 2013 to 2017.

The median non–life sciences IPO company in 2019 had annual revenue of $147.1 million, 27% below the $201.6 million median for 2018 and 31% below the $212.8 million median for the two-year period from 2016 to 2017, but only 4% below the $154.0 million median that prevailed during the five-year period from 2011 to 2015.

In 2019, EGC IPO companies had median annual revenue of $75.5 million, compared to the $2.57 billion median for non-EGC IPO companies. The median annual revenue for non–life sciences EGC IPO companies in 2019 was $125.3 million, representing a 25% decline from the $167.3 million median in 2018 but still 8% above the $116.1 median that prevailed from the enactment of the JOBS Act through 2017.

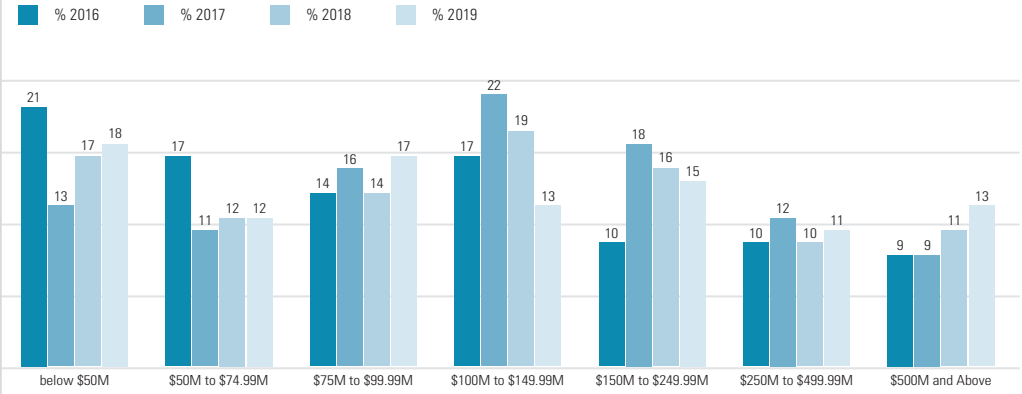
The percentage of profitable IPO companies increased to 32% in 2019 from 28% in 2018 but trailed the 36% average that prevailed for the five-year period between 2013 and 2017. Only five life sciences IPO companies in 2019, or 7% of the year's total, were profitable, up from the 4% in 2018 but lower than the 10% average over the five-year period from 2013 to 2017. In 2019, 48% of non–life sciences IPO companies were profitable, up from 44% in 2018 but down slightly from the 52% average during the five-year period preceding 2018.

In 2019, IPOs produced an average first-day gain of 19%, compared to 16% in 2018 and 14% in 2017. The 2019 first-day gain was the second-highest annual figure since 2000, behind only the 21% first-day gain in 2013.

In 2019, the average first-day gain for life sciences IPO companies was slightly larger than that of non–life sciences IPO companies, reversing the result in 2018, when the 14% average first-day gain for life sciences IPO companies trailed the 18% average for non–life sciences IPO companies.

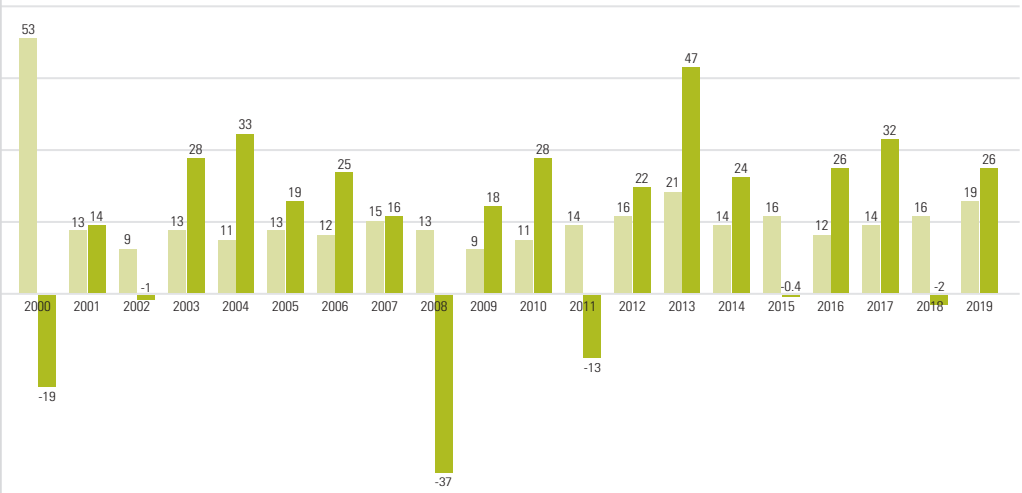
There were three "moonshots" (IPOs that double in price on their opening day)

Distribution of IPO Offering Size – 2016 to 2019

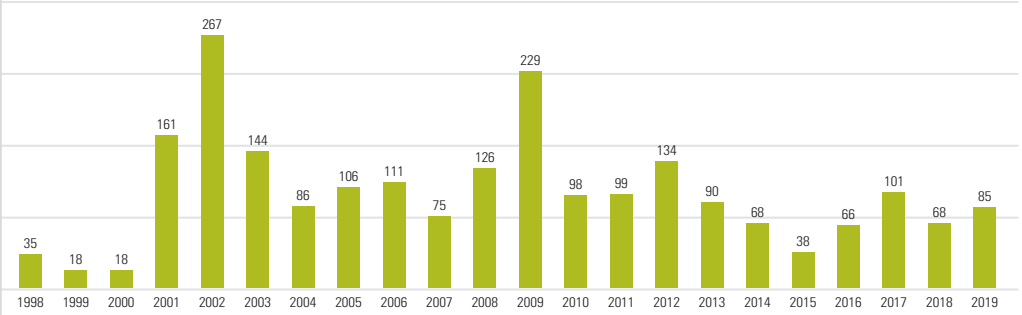


Source: SEC filings

Average IPO First-Day and Year-End Gain by Year – 2000 to 2019



Median Annual Revenue of IPO Companies – 1998 to 2019



Source: SEC filings and IPO Vital Signs

in 2019, up from two in 2018 and one each in 2016 and 2017, but down from the annual average of six moonshots from 2013 to 2015—a three-year period that stands out as an anomaly when compared to the incidence of moonshots over the past 20 years.

In 2019, 31% of IPOs were "broken" (IPOs whose stock closes below the offering price on their first trading day)—the second-highest annual percentage in the last 20 years, behind only the 63% figure in 2008. In 2019, 33% of life sciences company IPOs were broken, compared to 29% of non–life sciences company IPOs, continuing a pattern that held steady over the five-year period from 2014 to 2018, when an average 30% of life sciences company IPOs were broken, compared to 21% for all other companies.

On average, IPO companies in 2019 ended the year 26% above their offering price, with life sciences companies up 48% and non–life sciences companies up 10%.

The year's best-performing IPO was Karuna Therapeutics (trading 371% above its offering price at year-end), followed by NextCure (up 276%), LMP Automotive Holdings (up 257%), Turning Point Therapeutics (up 246%) and Palomar Holdings (up 237%).

At the end of 2019, 57% of the year's IPO companies were trading above their offering price. Life sciences IPO companies fared better than their non–life sciences counterparts, with 67% trading above their offering price, compared to 51% of other companies.

Individual components of the IPO market fared as follows in 2019:

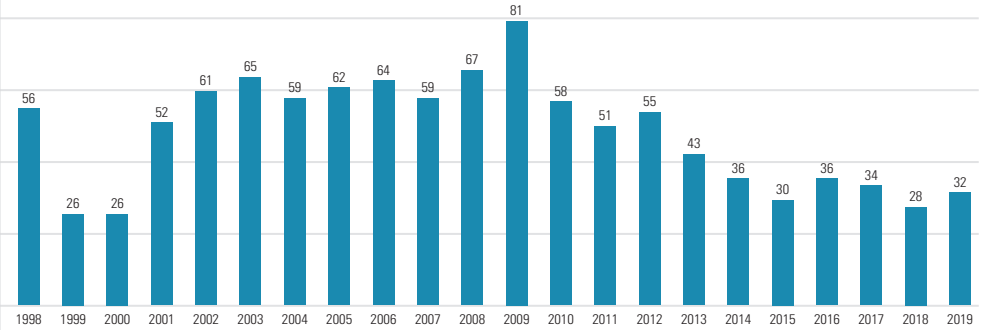
— *VC-Backed IPOs*: The number of IPOs by venture capital–backed US issuers decreased by 4%, from 75 in 2018 to 72 in 2019, although the market share for this segment increased from 60% in 2018 to 65% in 2019. The median offering size for US VC-backed IPOs increased by 8%, from $102.0 million in 2018 to $110.5 million in 2019. The median deal size for non–VC-backed companies declined for the second consecutive year, falling 26% from $141.4 million in 2018 to $105.1 million in 2019. As a result, for the first time since 2000, the median offering size for US VC-backed IPO companies in 2019 was larger than the median for all other IPO companies. On average, US issuer VC-backed IPO companies gained 46% from their offering price through year-end.

— *PE-Backed IPOs*: The number of private equity–backed IPOs by US issuers declined by 20%, from 20 in 2018 to 16 in 2019. Overall, PE-backed issuers accounted for 14% of all US-issuer IPOs in 2019, compared to 16% in 2018. The median deal size for PE-backed IPOs in 2019 was $236.4 million, compared to $101.7 million for all other IPOs. PE-backed IPO companies ended the year up an average of 28% from their offering price.

— *Life Sciences IPOs*: There were 63 life sciences company IPOs in 2019, a decrease of 15% from the 74 in 2018. The portion of the IPO market accounted for by life sciences companies remained steady between 2018 and 2019, at 40%. On average, life sciences IPO companies gained 48% from their offering price through year-end.

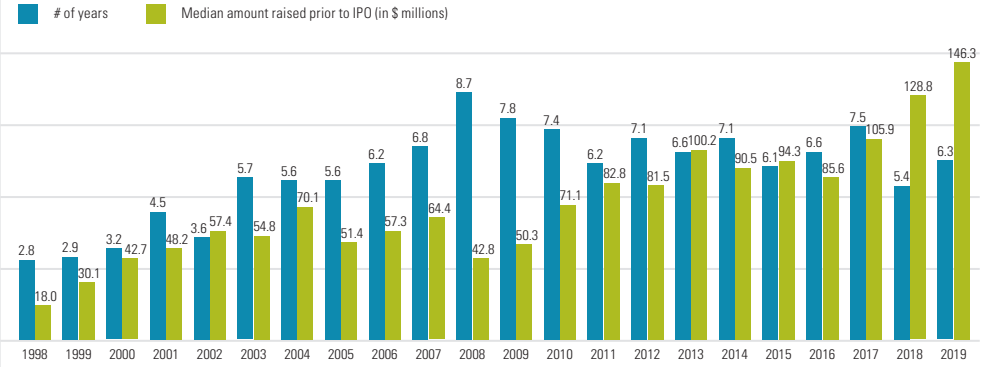
— *Tech IPOs*: Deal flow in the technology sector increased by 4%, from 57 IPOs in 2018 to 59 IPOs in 2019. The tech sector's share of the US IPO market increased to 38%, up from 31% in both 2017 and 2018. Tech IPO companies ended the year up an average of 5% from their offering price.

Percentage of Profitable IPO Companies – 1998 to 2019



Source: SEC filings and IPO Vital Signs

Median Time to IPO and Median Amount Raised Prior to IPO – 1998 to 2019



Source: Dow Jones VentureSource and SEC filings

— *Foreign-Issuer IPOs*: The number of US IPOs by foreign issuers declined by 21%, from 58 in 2018 (32% of the market) to 46 in 2019 (29% of the market). Among foreign issuers, Chinese companies led the year with 23 IPOs (down from 32 in 2018), followed by companies from Israel (four IPOs), Brazil and Germany (each with three IPOs). On average, foreign-issuer IPO companies ended the year down 6% from their offering price.

In 2019, 50 companies based in the eastern United States (east of the Mississippi River) completed IPOs, compared to 61 for western US–based issuers. California led the state rankings with 48 IPOs, followed by Massachusetts (13 IPOs), New York (11 IPOs) and Texas (six IPOs).

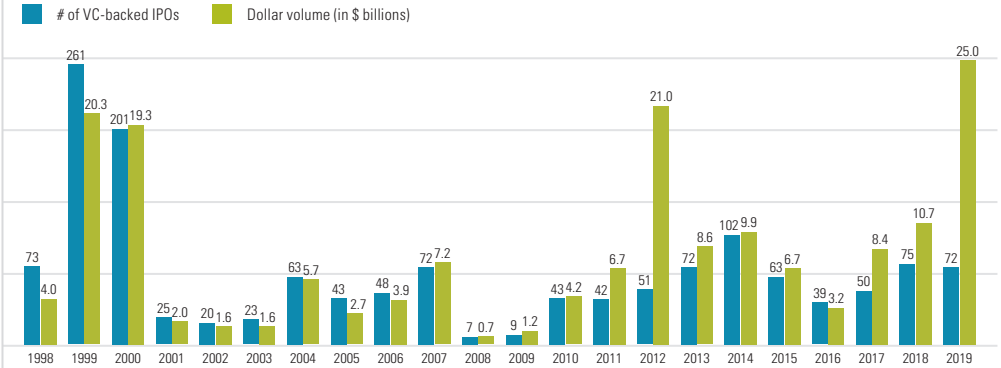
OUTLOOK

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

— *Economic Growth*: Heading into the new year, the US economy was in its eleventh year of expansion, the unemployment rate was at a 50-year low and the Federal Reserve had cut interest rates by a quarter point for the third time in 12 months. These macroeconomic factors boded well for the IPO market until the coronavirus arrived, inflicting an unprecedented shock on the economy, stalling growth and pushing the unemployment rate to its highest level since the Great Depression. Despite massive government stimulus efforts, the likely pace of economic recovery as stay-at-home orders are lifted and non-essential businesses are allowed to re-open is unclear. The economic outlook is further clouded by rising international trade tensions and the unfolding consequences of a messy Brexit.

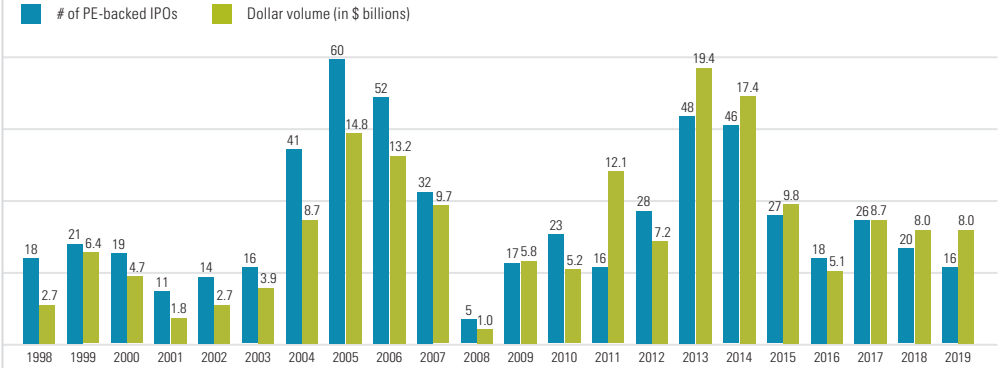
— *Capital Market Conditions*: The major US stock indices posted solid gains in 2019, with the Dow Jones Industrial Average up 22%, the Nasdaq Composite Index up 35% and the S&P 500 up 29%—the second-best annual gain in the last ten years for each index. As the economic consequences of the COVID-19 pandemic unfolded in the first quarter of 2020, many of these gains were erased. Although the major US stock indices began to recover in late March, weak capital markets—particularly if coupled with the kind of the extreme volatility exhibited in recent months—would create additional headwinds for the IPO market.

Venture Capital–Backed IPOs – 1998 to 2019



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

Private Equity–Backed IPOs – 1998 to 2019



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

— *Venture Capital Pipeline*: The pool of IPO candidates is large and vibrant, including more than 200 "unicorns" (private companies with valuations exceeding $1 billion) in the United States and 400 worldwide. With 2019 yielding more than 200 venture financing rounds that raised at least $100 million, however, most VC-backed companies can continue to opt for private financing and delay their public debuts. For VC-backed companies pursuing liquidity, the poor aftermarket performance of some of last year's largest VC-backed IPOs, combined with the possibility of market pressure on valuations, may make sales more appealing than IPOs in the current climate.

— *Private Equity Impact*: With private equity fundraising near record levels in 2019, PE firms have substantial capital for new acquisitions. The huge sums flowing into private equity continue to raise the specter of asset price inflation, making it harder for firms to allocate investment profitably. At the same time, PE firms face pressure to exit investments—via IPOs or sales of portfolio companies—and return capital to investors.

The first quarter of 2020 produced 26 IPOs, before deal flow dwindled to a trickle of offerings—most by life sciences companies. How long the IPO market remains in a holding pattern is uncertain. What is clear, however, is that there will be a deep and diverse pool of IPO candidates once market conditions become more conducive. ■

CALIFORNIA

California produced 48 IPOs in 2019, reaching its highest annual IPO count since the 54 recorded in 2014. Climbing 12% from its 2018 total of 43 IPOs, the 2019 tally also marked the state's third consecutive year of IPO market growth.

Boasting three of the five largest US IPOs of the year and 38% of all US IPOs raising at least $500 million, the state saw its gross proceeds nearly triple, from $7.20 billion in 2018 to a record $20.94 billion in 2019.

The largest California IPO in 2019 came from Uber ($8.10 billion), followed by offerings from Lyft ($2.34 billion), Pinterest ($1.43 billion) and Zoom ($751 million).

With an uptick in IPOs by consumer goods and financial services companies, technology and life sciences companies accounted for 81% of the state's total in 2019, down from the 90% figure that prevailed over the five-year period from 2014 to 2018.

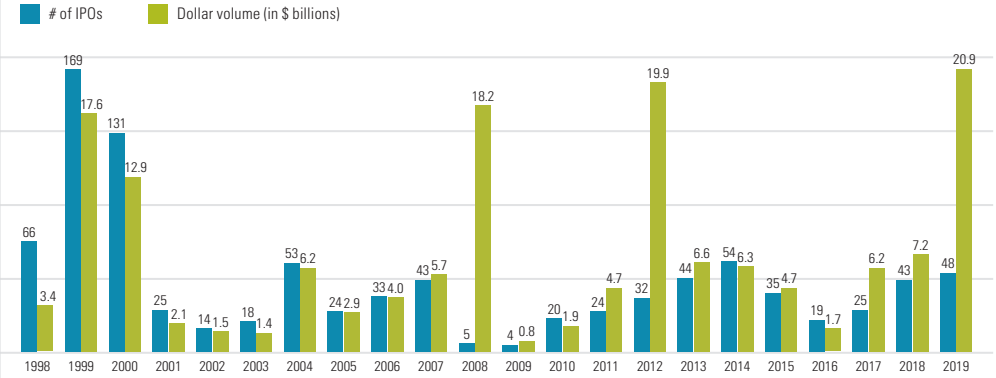
The number of venture-backed California IPOs increased by 9%, from 33 in 2018 to 36 in 2019. California accounted for 50% of all US-issuer VC-backed IPOs in 2019, up from 44% in 2018 and representing the state's largest annual share since the 53% figure for 2012.

California IPOs produced an average first-day gain of 33% in 2019. The state's top performers were Beyond Meat (up 163% in first-day trading), Cortexyme (up 93%) and Revolve Group (up 89%). At year-end, 66% of California's 2019 IPOs were trading above their offering price, with an average gain of 44%.

The best-performing California IPO of the year was Turning Point Therapeutics (up 246% at year-end), followed by Palomar Holdings (up 237%), Cortexyme (up 230%) and Beyond Meat (up 202%).

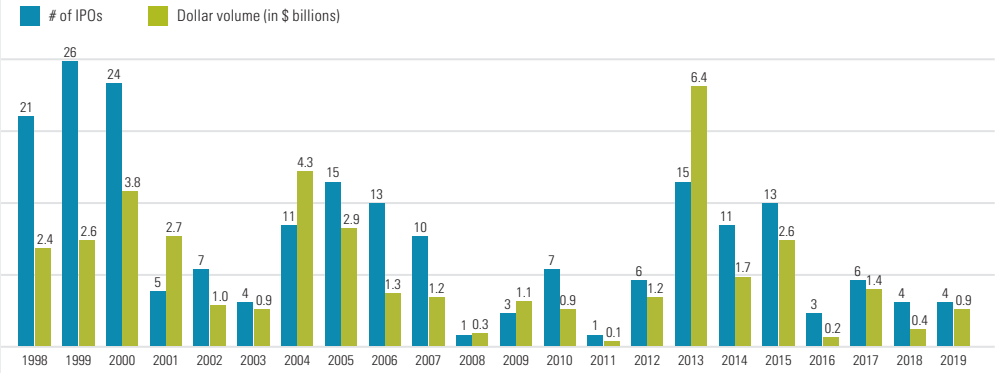
With the largest pool of venture capital–backed companies in the United States and a wealth of entrepreneurial talent, California should remain a major source of attractive IPO candidates in the coming year, particularly from the technology and life sciences sectors.

California IPOs – 1998 to 2019



Source: SEC filings

Mid-Atlantic IPOs – 1998 to 2019



Source: SEC filings

MID-ATLANTIC

The mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia produced four IPOs in 2019, equaling its 2018 tally but falling well short of the annual double-digit count that prevailed from 2013 to 2015.

Maryland produced two IPOs in 2019 and North Carolina and Virginia each contributed one, matching the composition of the region's IPOs in 2018.

Gross proceeds in the mid-Atlantic region more than doubled, from $364 million in 2018 to $851 million in 2019. The largest mid-Atlantic IPOs of 2019 came from Virginia-based Parsons Corporation ($500 million—which was twice the size of the region's largest 2018 IPO) and Maryland-based Viela Bio ($150 million).

Mid-Atlantic IPOs produced an average first-day gain of 19% in 2019, led by NextCure (up 33% in first-day trading) and Viela Bio (up 23%).

At year-end, the mid-Atlantic region's 2019 IPOs were trading up by an average of 90% from their offering price, with only one IPO trading below. The region's top performers were NextCure (up 276% at year-end) and Parsons Corporation (up 53%).

Although venture capital activity in the mid-Atlantic region did not meet historical norms in 2019, deal activity should pick up when market conditions regain their footing.

NEW ENGLAND

The number of New England IPOs dropped from 24 in 2018 to 15 in 2019. Massachusetts accounted for 13 of the region's IPOs—the second-highest state total in the country, trailing only California—and Connecticut contributed the other two.

Gross proceeds in the region declined by 47%, from $3.43 billion in 2018 to $1.81 billion in 2019.

The largest New England IPO in 2019 was by Dynatrace ($570 million)—the region's sole non–life sciences company IPO—followed by SpringWorks Therapeutics ($162 million) and Stoke Therapeutics ($142 million).

The region's 14 life sciences company IPOs in 2019 represented 26% of all life sciences IPOs in the country by US issuers, down from 33% in 2018 but equal to the region's share over the five-year period from 2013 to 2017.

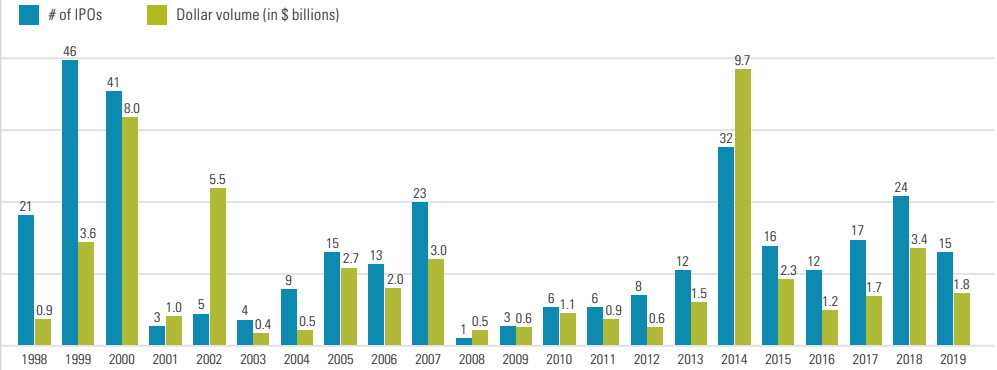
The number of venture-backed New England IPOs decreased from 21 in 2018 to 14 in 2019. The region accounted for 19% of all US-issuer VC-backed IPOs in 2019, down from 28% in both 2017 and 2018, but commensurate with its share of the US VC-backed IPO market over the five-year period from 2012 to 2016.

New England IPOs produced an average first-day gain of 10% in 2019. The region's top performer was Dynatrace (up 49% from its offering price), followed by Stoke Therapeutics (up 42%) and TransMedics Group (up 40%).

At year-end, New England's 2019 IPOs were up by an average of 45% from their offering price, led by life sciences companies Karuna Therapeutics (up 371% at year-end), Aprea Therapeutics (up 206%) and SpringWorks Therapeutics (up 114%).

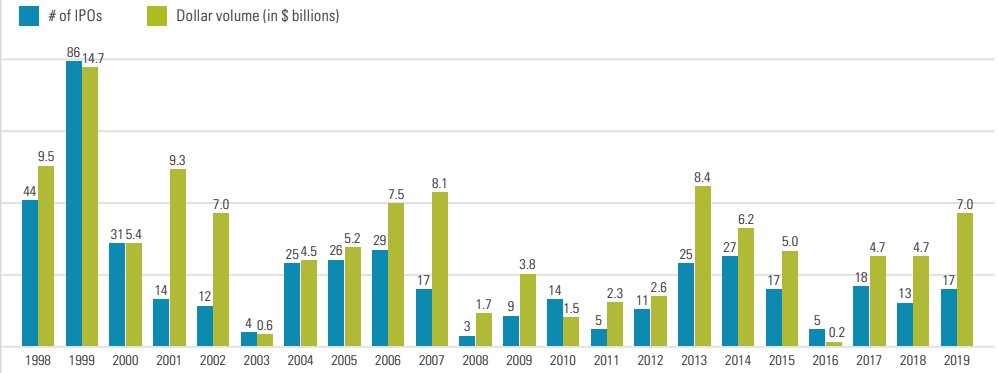
With the region's world-renowned universities and research institutions serving as incubators for emerging tech and life sciences companies, and with strong levels of venture capital investment, New England should continue to generate attractive IPO candidates in the coming year.

New England IPOs – 1998 to 2019



Source: SEC filings

Tri-State IPOs – 1998 to 2019



Source: SEC filings

TRI-STATE

The tri-state region of New York, New Jersey and Pennsylvania increased its IPO count by 31% in 2019, with 17 deals, up from 13 in 2018.

New York produced 11 of the region's 2019 IPOs, with Pennsylvania accounting for four and New Jersey contributing the remaining two.

Boosted by three billion-dollar offerings, gross proceeds from tri-state IPOs saw a 50% increase, jumping from $4.69 billion in 2018 to $7.03 billion in 2019. The region's largest IPOs were by Avantor ($2.90 billion—the nation's second-largest IPO), Peloton ($1.16 billion) and Tradeweb Markets ($1.08 billion).

The tri-state region produced 11 venture-backed IPOs in 2019—the second-highest annual figure since 2000—up from seven in 2018.

Tri-state IPOs produced an average first-day gain of 11% in 2019. The region's top performers were Hoth Therapeutics (up 52% from its offering price) and Datadog and Phreesia (each up 39%).

At year-end, 2019 tri-state IPOs were up by an average of 26% from their offering price. The region's best-performing IPO was Applied Therapeutics (up 173% at year-end), followed by Progyny (up 111%) and Oyster Point Pharma (up 53%).

With venture capital activity trailing only that of California, the tri-state region should continue to produce attractive IPO candidates, including 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 from 2017 through 2019.

Percentage of IPO companies qualifying as EGCs under JOBS Act	91%
Median offering size	$110.0 million (16% below $50 million and 11% above $500 million)
Median annual revenue of IPO companies	$81.0 million (43% below $50 million and 16% above $500 million)
Percentage of IPO companies that are profitable	31%
State of incorporation of IPO companies	Delaware—88% No other state over 3%
Percentage of IPOs including selling stockholders, and median percentage of offering represented by those shares	Percentage of IPOs—22% Median percentage of offering—33%
Percentage of IPOs including directed share programs, and median percentage of offering represented by those shares	Percentage of IPOs—43% Median percentage of offering—5%
Percentage of IPO companies disclosing adoption of ESPP	57%
Percentage of IPO companies using a "Big 4" accounting firm	72%
Stock exchange on which the company's common stock is listed	Nasdaq—73% NYSE—27%
Median underwriting discount	7%
Number of SEC comments contained in initial comment letter	Median—17 25th percentile—13 75th percentile—24
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	Median—76 calendar days 25th percentile—59 calendar days 75th percentile—112 calendar days
Time elapsed from initial confidential submission or initial public filing to effectiveness of Form S-1	Median—112 calendar days 25th percentile—89 calendar days 75th percentile—172 calendar days
Median offering expenses	Legal—$1,500,000 Accounting—$921,500 Total—$3,500,000

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 (in 2017, a similar process became available to all companies going public). 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 50% from 2017 to 2019. Between these periods, the percentage of technology companies electing the extended transition period spiked from 12% to 62%, while among life sciences companies the percentage increased from 10% to 45%. This change in behavior appears to have been 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.

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 2019, 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	91%	47%	69%
Deferred application of new or revised accounting standards	24%	32%	27%
Omission of CD&A	100%	99%	97%

Keeping Your DSP Company-Friendly

OVERVIEW

In a directed share program (DSP)—often called a "friends and family" program—an IPO company requests that the managing underwriters reserve a portion of the IPO for sale to persons designated by the company, such as employees, customers, vendors or other persons having a business relationship with the company. Along with an employee stock purchase plan and a stock incentive plan, a DSP can also provide a means for employees to invest in the company.

DSPs reached their zenith in the Internet-company mania of the late 1990s, when many IPO stocks shot up in price. The popularity of DSPs has since waned, but a DSP can still be used to reward friends of the company by providing an opportunity to purchase shares at the IPO price in advance of anticipated price appreciation, and to strengthen the company's important business relationships by encouraging investments in the company. A properly structured DSP should have minimal impact on the offering.

POTENTIAL RISKS

A DSP does, however, pose several potential risks:

- A DSP can be a distraction to the company's management at a time when it should be focused on other IPO issues. Even if the participation criteria are predetermined and rigid, management inevitably will field requests and complaints.
- If employees are eligible to participate, ill will and financial hardship can result if the market price declines below the IPO price. Legal requirements may force foreign employees to be excluded from the DSP, potentially alienating a portion of the company's workforce.
- The company's relationships with customers, vendors or other business participants could be harmed, rather than enhanced, if the stock performs poorly following the IPO.
- If the trading price immediately declines, participants could default on their purchase commitments. The underwriting agreement will require the company to indemnify the underwriters against any damages or liabilities resulting from DSP purchase defaults.
- If purchasers are not required to sign lockup agreements, resales of shares acquired under the DSP could create downward pricing pressure in the aftermarket, when nearly all other insider shares are locked up.
- A poorly executed DSP could result in securities law violations, delaying the IPO while the company makes a rescission offer to the program participants.

TIPS TO MINIMIZE THE RISKS

If a company wishes to include a DSP as part of its IPO, the following steps should help minimize the associated risks and keep the plan "friendly" for the company:

- The DSP should be administered by one of the managing underwriters or a dealer in the selling group, rather than by the company. The DSP administrator must be equipped to handle the logistics of a DSP, which can involve anywhere from dozens to hundreds of participants, and must be familiar with the legal rules governing the related communications.
- The DSP administrator should require all participants to open brokerage accounts with it in order to facilitate the purchase of IPO shares and compliance with broker-dealer regulations.
- The size of the DSP should be reasonable. Although DSPs sometimes represent as much as 10% of an offering, a DSP's typical size is 5%.
- By establishing and adhering to objective standards for participation in the DSP, the company can avoid or reduce the chaos that often results from allocating shares with unfettered discretion. In assessing eligibility, the company should focus on the constituencies that matter most to the company's success.
- If employees are allowed to participate in the DSP, the company should consider using an evenhanded and simple formula with a modest cap. When employee demand is expected to exceed the program size, consideration should be given to excluding officers and directors. Unless the company is willing to incur the expense of complying with all local securities law requirements, foreign employees should be excluded.
- Lockup agreements should be required from all participants, unless the managing underwriters believe the immediate aftermarket can absorb the shares. FINRA rules require that lockup agreements with directors and officers also cover shares purchased in a DSP.
- The company may provide participants in the DSP with only very limited procedural information—not including share allocations—prior to the availability of a preliminary prospectus containing a price range (which will not occur until the road show begins). Before distribution to participants, written (including email) materials for the DSP must be reviewed by counsel, the managing underwriters and the DSP administrator. ■

PREVALENCE AND SIZE OF DSPs IN IPOs

YEAR	IPOs WITH DSP	DSP SIZE		
		MEDIAN	LESS THAN 5%	GREATER THAN 5%
2019	43%	5%	21%	13%
2018	46%	5%	20%	21%
2017	39%	5%	20%	30%
2016	36%	5%	19%	22%
2015	47%	5%	11%	17%
2015–2019	43%	5%	18%	20%

Source: SEC filings

OVERVIEW

An employee stock purchase plan (ESPP) permits employees of a public company to purchase shares of common stock at a discount from the market price, with favorable tax treatment. If structured correctly, an ESPP can be particularly beneficial in conjunction with an IPO.

Among other requirements, Section 423 of the Internal Revenue Code:

- requires that substantially all employees (excluding 5% stockholders) be allowed to participate in the ESPP;
- imposes an annual limit of $25,000 per employee on the value of the stock purchased under the plan;
- requires the company's stockholders to approve the ESPP; and
- sets the minimum purchase price at 85% of the lesser of the fair market value of the stock at the beginning of the offering period and the fair market value of the stock on the purchase date.

Accounting rules (ASC Topic 718) require companies to recognize compensation expense over the requisite service period for stock grants made under an ESPP, unless the discount is 5% or less and there is no "lookback" feature allowing the discount to be taken from the market price at the beginning of the offering period.

The incidence of ESPPs among IPO companies has grown in recent years, with ESPPs generally including a 15% discount and a lookback feature despite the resultant compensation charges. For example, the percentage of all IPO companies adopting an ESPP increased from 23% in 2009 to 68% in 2019. All but one of the ESPPs adopted by companies going public in 2019 had a 15% discount, and all had a lookback feature.

The pros and cons of an ESPP are summarized below:

PROS

- An ESPP can encourage broad-based employee ownership of company stock.
- Through the use of payroll deductions, purchases under an ESPP are convenient and avoid brokers' commissions.
- Although not a perfect substitute for a directed share program (DSP), an ESPP may help reduce employee disappointment if the company decides not to make IPO shares available to employees in a DSP. (DSPs are discussed further on page 10.)
- Participants can acquire shares at a discount from the market price. With proper structuring, an ESPP can even be used as a means to permit employees to invest at a discount from the IPO price.
- If the ESPP complies with Section 423, participants receive favorable tax treatment for the shares purchased under the ESPP, including deferral of any tax on the discount until the shares are sold, and the possibility of long-term capital gains treatment for further appreciation if applicable holding periods are met.
- If other employers with whom the company regularly competes for employees offer ESPPs and the company does not, it may be at a competitive disadvantage in hiring.

CONS

- In practice, many employees immediately sell the shares received under an ESPP, defeating the goal of encouraging employee stock ownership in the company.
- Unless the ESPP is structured with a discount of 5% or less and there is no lookback feature, the company will incur stock-based compensation charges, which will reduce its GAAP income (less important to companies that report EBITDA measures from which stock-based compensation charges have been removed).
- If the ESPP is structured to avoid compensation charges, the attractiveness of the plan to employees is substantially reduced.
- Legal requirements may force foreign employees to be excluded from the ESPP, potentially alienating a portion of the company's workforce.
- To the extent employees hold the stock acquired under the ESPP and the market price declines below the purchase price, ill will and disappointment among employees may result.
- The ESPP creates administrative obligations for the company, including annual IRS reporting requirements.
- Special arrangements are required if the company desires to have the first offering period commence upon effectiveness of the Form S-1 at the IPO price. The company may enroll employees in the ESPP prior to the effectiveness of the Form S-8 (pursuant to which the shares will be registered) only if no money is collected before effectiveness and if the initial deemed election for all participants is set at the highest permitted level. ■

PREVALENCE AND TERMS OF ESPPs IN IPOs

YEAR	COMPANIES WITH ESPP	ESPP DISCOUNT EQUALS 15%	ESPP INCLUDES LOOKBACK FEATURE	INITIAL ESPP OFFERING PERIOD COMMENCES UPON IPO
2019	68%	99%	100%	15%
2018	59%	96%	96%	22%
2017	41%	98%	95%	24%
2016	47%	94%	94%	31%
2015	48%	96%	96%	30%
2015–2019	53%	97%	97%	23%

"Testing the Waters" to Find IPO Investors

Companies contemplating an IPO often would like to get investor feedback—both in advance of the formal IPO process, to validate the company's decision to go public and begin to familiarize potential investors with the company, and after commencement of the formal IPO process, to educate target investors about the company and get some sense of the company's potential valuation. Although not commonplace, this feedback historically was sought through "non-deal" road shows held at least 30 days prior to the initial Form S-1 filing (in reliance on the Rule 163A safe harbor from quiet-period violations) and preliminary road shows conducted after the initial Form S-1 filing. Before the enactment of the JOBS Act, there was no clear legal basis for other forms of IPO pre-marketing in the United States.

"TEST-THE-WATERS" COMMUNICATIONS

In a substantial departure from decades of securities law, the JOBS Act permits "emerging growth companies" (EGCs) and their authorized representatives to engage in oral or written "test-the-waters" communications with eligible institutional investors at any time prior to or following the submission or filing of the Form S-1, to determine their investment interest in a contemplated IPO. Potential investors eligible for "test-the-waters" communications consist of "qualified institutional buyers" (as defined in Rule 144A) and institutions that are "accredited investors" (as defined in Regulation D).

"Test-the-waters" communications can be brief and casual (such as a single conversation), or extensive and formal (such as a series of investor meetings). These communications can be used proactively to pre-market an offering, or as a defensive measure to exempt a communication that would otherwise constitute an unlawful offer of securities. The proposed IPO may be discussed during "test-the-waters" meetings, and prospective underwriters may attend.

In late 2019, the SEC adopted Rule 163B to permit any company (and its authorized representatives), regardless of the company's EGC status, to engage in "test-the-waters" communications in connection with any registered securities offering.

PROCEDURES AND CAUTIONS

Before engaging in "test-the-waters" communications, underwriters generally will require written authorization from the company. The company and underwriters should also agree in advance on the form and content of any materials that will be used in "test-the-waters" communications. Questionnaires or certifications can be used to confirm that all recipients of "test-the-waters" communications qualify as eligible institutional investors, although as a practical matter underwriters ordinarily know whether the investors to be approached are eligible. The company should not authorize anyone other than its underwriters to engage in "test-the-waters" communications.

A company should exercise caution with respect to "test-the-waters" communications. Under the federal securities laws and underwriting agreement, the company will face potential liability for these communications. The company should also assume that the SEC staff, as part of its review of the Form S-1, will request copies of any written "test-the-waters" communications and presentation slides even if copies are not provided to potential investors. The staff may raise questions if the "test-the-waters" communications disclose material information that is not included in the Form S-1.

MARKET PRACTICES

In many sectors, particularly life sciences and technology, "test-the-waters" meetings have become routine. In other industries, these meetings are less common, although interest continues to grow among IPO candidates.

As "test-the-waters" meetings become more commonplace, institutional investors are likely to become increasingly selective as to which meetings they are willing to take in advance of the road show. In addition, some institutional investors may be unwilling to participate in "test-the-waters" meetings prior to the public filing of the Form S-1.

"Test-the-waters" communications generally should stop before the road show commences, and many underwriters insist on a buffer (one week is typical) between the last "test-the-waters" meeting and the beginning of the road show. In addition, most underwriters do not allow research analysts to attend "test-the-waters" meetings and impose a limit on the number of investors (typically in the range of 20 to 40) with whom the company may hold "test-the-waters" meetings. ■

GUIDELINES FOR "TEST-THE-WATERS" COMMUNICATIONS

Once selected, the lead underwriter is likely to have detailed procedures for "test-the-waters" communications. Typical procedures for these communications can be summarized as follows:

- Communications may only be with qualified institutional buyers and/or institutions that are accredited investors.
- Presentations should not disclose material information that will not be included in the Form S-1 for the offering, and must be factual, balanced and not misleading. Appropriate explanatory statements and disclaimers should be included.
- If presentation slides are used, they should be reviewed in advance by counsel, and copies should not be provided to attendees.
- No written materials should be provided to attendees.
- Information should not be included in presentation materials that the company is unwilling to include in the Form S-1 if so requested by the staff following its review.
- Historical financial information is permitted, but projections should be avoided.
- General valuation concepts may be discussed, but binding indications of interest may not be solicited.
- Q&A is permitted, as long as responses are provided orally.
- Presentations should not be recorded.
- Follow-up information should not be provided by email or otherwise in writing.

On March 18, 2020, in a landmark ruling in *Salzberg v. Sciabacucchi*, the Delaware Supreme Court upheld the facial validity of a "federal forum provision" included in a Delaware corporation's certificate of incorporation that requires stockholders of that corporation to sue in federal court, rather than state court, over alleged violations of the Securities Act of 1933. The holding in *Salzberg* is an important victory for Delaware corporations grappling with a marked increase in state court litigation of Securities Act claims, particularly claims brought in the wake of IPOs, although it leaves several significant questions unanswered.

WHAT WE KNOW

The *Salzberg* decision confirmed the facial validity of federal forum provisions in certificates of incorporation of Delaware corporations. However, the decision makes clear that plaintiffs may still challenge the application of such a provision in particular cases.

The decision provides a new tool to avoid duplicative litigation filings and steer cases to federal courts more accustomed to hearing federal securities claims. Thus, if a plaintiff brings state court Securities Act claims against a Delaware corporation that has a federal forum provision, that corporation can move to dismiss on the ground that plaintiffs are bound by the provision and must sue in federal court.

The decision is most significant with respect to class action litigation relating to a company's IPO. The decision does not affect securities fraud cases under the Securities Exchange Act of 1934, which were already limited to federal court. Further, although the decision technically applies to any Securities Act class action, follow-on offerings are rarely challenged under the Securities Act because it is hard to prove that shares purchased in the open market were shares sold in the offering.

WHAT REMAINS OPEN

The *Salzberg* decision leaves several significant questions unanswered:

— *What happens to claims against underwriters?* IPO underwriters are often named as defendants in securities class actions, but it is not clear that a federal forum provision could govern a claim against an underwriter. While the Delaware Supreme Court found that at least some Securities Act claims were "intra-corporate," it did not address claims against underwriters. This uncertainty poses a practical problem for companies engaged in offerings because underwriters uniformly demand contractual indemnity rights. Plaintiffs likely will continue to sue underwriters of IPO offerings in state courts, thus creating a practical dilemma for issuers who have the ability to shift claims against the issuers to federal court, but possibly not claims against underwriters that also, through indemnity obligations, create exposure for issuers. The practical reality may be that dual-forum litigation continues to be common.

— *Can a federal forum provision appear in the bylaws?* The *Salzberg* decision by its terms only pertains to certificates of incorporation. While there is considerable logic in the belief that the decision would apply to bylaws, it technically remains an open question. Amendments to the certificate of incorporation require stockholder approval but amendments to the bylaws generally do not. In pre-IPO companies, stockholder approval generally can be obtained easily and quickly, and a federal forum provision typically is included in the certificate of incorporation. By contrast, existing public companies adopting a federal forum provision are more likely to include it in the bylaws—in doing so, a company can avoid stockholder approval but must consider the expected reaction from investors and proxy advisory firms, which could result in votes against the directors at the next annual meeting. It is also not entirely clear whether a federal forum provision appearing in the certificate of incorporation—thus bearing stockholder approval—is more likely to be enforced than a bylaw provision adopted without stockholder approval, particularly as applied to stockholders who acquired their shares prior to the adoption of the bylaw provision.

— *Will there be issues of enforceability?* The *Salzberg* decision dealt with a "facial challenge" to a federal forum provision; a facial challenge asks only whether there is any possible scenario in which the provision could be permissible. The court recognized that there could be circumstances in which the application of a federal forum provision to a specific matter is unenforceable. In addition, the attempt by a Delaware corporation to enforce its federal forum provision in another state will be subject to that state's policy considerations in determining whether the provision is enforceable.

— *Will other states follow suit?* The *Salzberg* decision applies only to Delaware corporations and it is unknown whether other states will allow federal forum provisions. The Model Business Corporation Act, on which many states base their corporation statute, includes language analogous to the provision in the Delaware General Corporation Law on which the court relied. Accordingly, other states may find the decision persuasive when deciding whether to uphold similar federal forum provisions enacted by corporations incorporated outside of Delaware.

WHERE WE GO FROM HERE

For all Delaware corporations, a federal forum provision can provide much-needed flexibility and discretion to manage Securities Act litigation more efficiently.

Federal forum provisions are likely to become part of the standard toolkit for private companies going public. For existing public companies, the question of whether to adopt a federal forum provision is more complicated, and requires consideration of the value of such provision outside of the IPO context, whether such provision should be included in the certificate of incorporation (with stockholder approval) or the bylaws (without stockholder approval), the consequences of adopting such provision without stockholder approval, and the extent to which corporations can rely on the enforceability of such provision if adopted without stockholder approval. ■

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

SCHRÖDINGER	Constellation Pharmaceuticals	TCR² Therapeutics	Akamai	Apellis	kala Pharmaceuticals	Medtronic	Stealth BioTherapeutics	Akebia Therapeutics
Initial Public Offering of Common Stock	*Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Rule 144A Placement of Convertible Senior Notes*	*Rule 144A Placement of Convertible Senior Notes*	*Public Offering of Common Stock*	*Public Offerings of Senior Notes*	*Initial Public Offering of American Depositary Shares*	*Public Offering of Common Stock*
$232,300,000	$257,887,500	$86,250,000	$1,150,000,000	$220,000,000	$133,967,250	€12,000,000,000	$85,058,750	$151,800,000
Counsel to Issuer	Counsel to Issuer	Counsel to Underwriters	Counsel to Issuer	*Public Offering of Common Stock* $404,225,000 Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer
February 2020	December 2019	February 2019	August 2019	September 2019 and January 2020	March 2020	March and June 2019	February 2019	May 2020

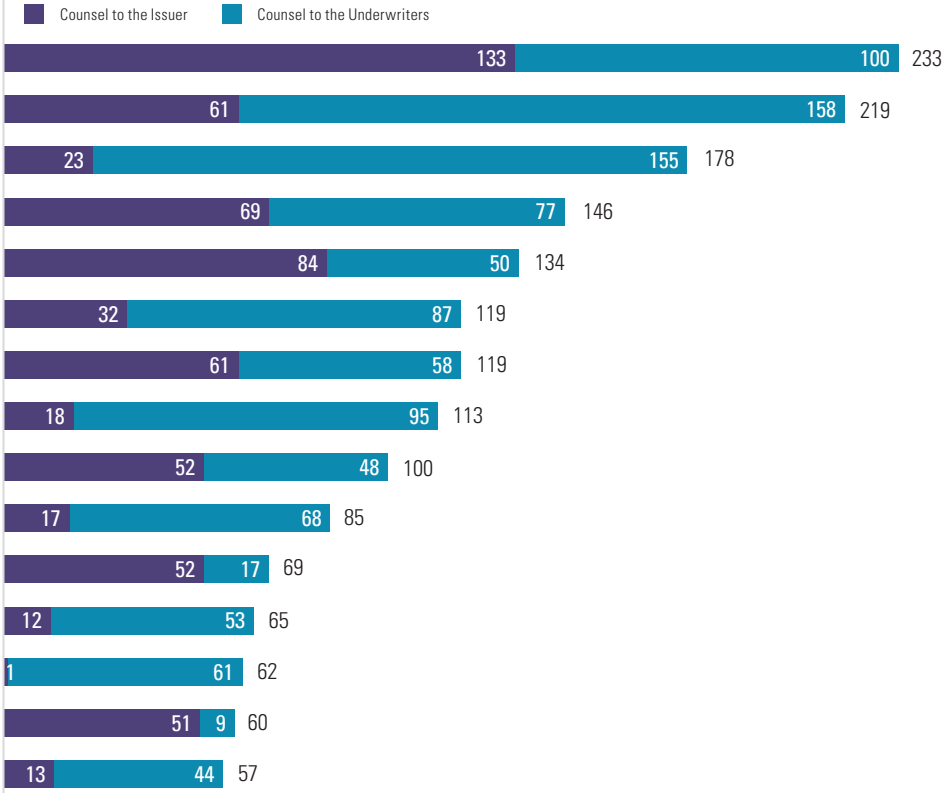
casella waste systems, inc.	ThermoFisher Scientific	Translate Bio	CoNCERT	Fulcrum Therapeutics	dynatrace	Discovery Communications	ADMA Biologics	State Street	Huntington Ingalls Industries
Public Offering of Common Stock	*Public Offerings of Senior Notes*	*Public Offering of Common Stock*	*Public Offering of Common Stock and Warrants*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offering of Senior Notes*	*Public Offering of Common Stock*	*Public Offerings of Notes*	*Rule 144A Placement of Senior Notes*
$105,167,500	$2,200,000,000 and €1,200,000,000	$90,000,000	$74,748,250	$72,000,000	$655,216,850	$2,000,000,000	$94,587,500	$2,250,000,000	$1,000,000,000
Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Underwriters	Counsel to Issuer	*Public Offerings of Common Stock* $2,852,718,750 Counsel to Underwriters	Counsel to Issuer	Counsel to Underwriters	*Rule 144A Placement of Senior Notes* $1,750,000,000 Counsel to Issuer	Counsel to Issuer
January 2019	March and April 2020	September 2019	January 2020	July 2019	August 2019–June 2020	May 2020	February 2020	November 2019–March 2020	March 2020

agios	imara	trevi Therapeutics	Voyager Therapeutics	Danaher	Karyopharm Therapeutics	Milestone Pharmaceuticals	Analog Devices	S&P Global	
Public Offering of Common Stock	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offering of Common Stock*	*Public Offerings of Senior Notes*	*Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offering of Senior Notes*	*Public Offering of Senior Notes*	
$294,112,500	$86,480,000	$55,000,000	$100,000,000	€2,500,000,000 *Mandatory Convertible Preferred Stock* $1,717,500,000 *Common Stock* $1,782,500,000	$172,500,000	$94,875,000	$400,000,000	$1,100,000,000	
Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Underwriters	Counsel to Issuer	Counsel to Issuer	
November 2019	March 2020	May 2019	December 2019	March–May 2020	March 2020	May 2019	April 2020	November 2019	

Fortive	Ocular Therapeutix	iVERIC bio	Arvinas	PTC Therapeutics	genpact Transformation Happens Here	PerkinElmer For the Better	xeris Pharmaceuticals
Rule 144A Placement of Convertible Senior Notes	*Public Offering of Common Stock*	*Public Offering of Common Stock*	*Public Offering of Common Stock*	*Public Offerings of Common Stock*	*Public Offering of Common Stock*	*Public Offering of Senior Notes*	*Public Offering of Common Stock*
$1,437,500,000	$51,750,000	$46,000,000	$115,000,000	$302,944,000	$616,462,000	$850,000,000	$42,744,000
Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	Counsel to Underwriters
February 2019	May 2020	December 2019	November 2019	January and September 2019	November 2019	September 2019	February 2020

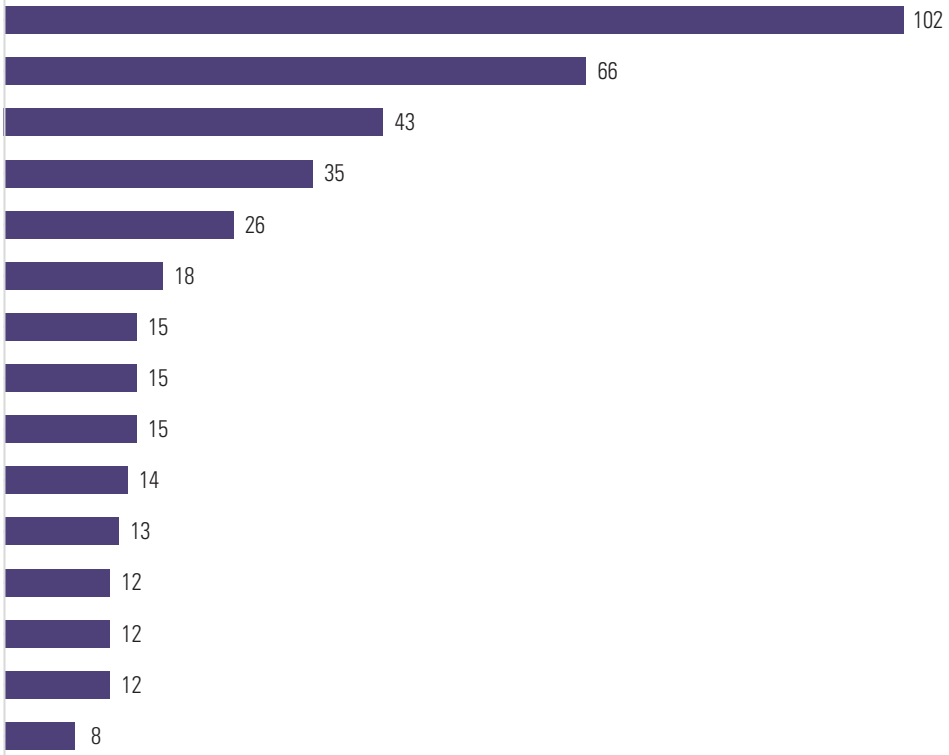
WilmerHale

Eastern US IPOs – 1996 to 2019



Source: SEC filings

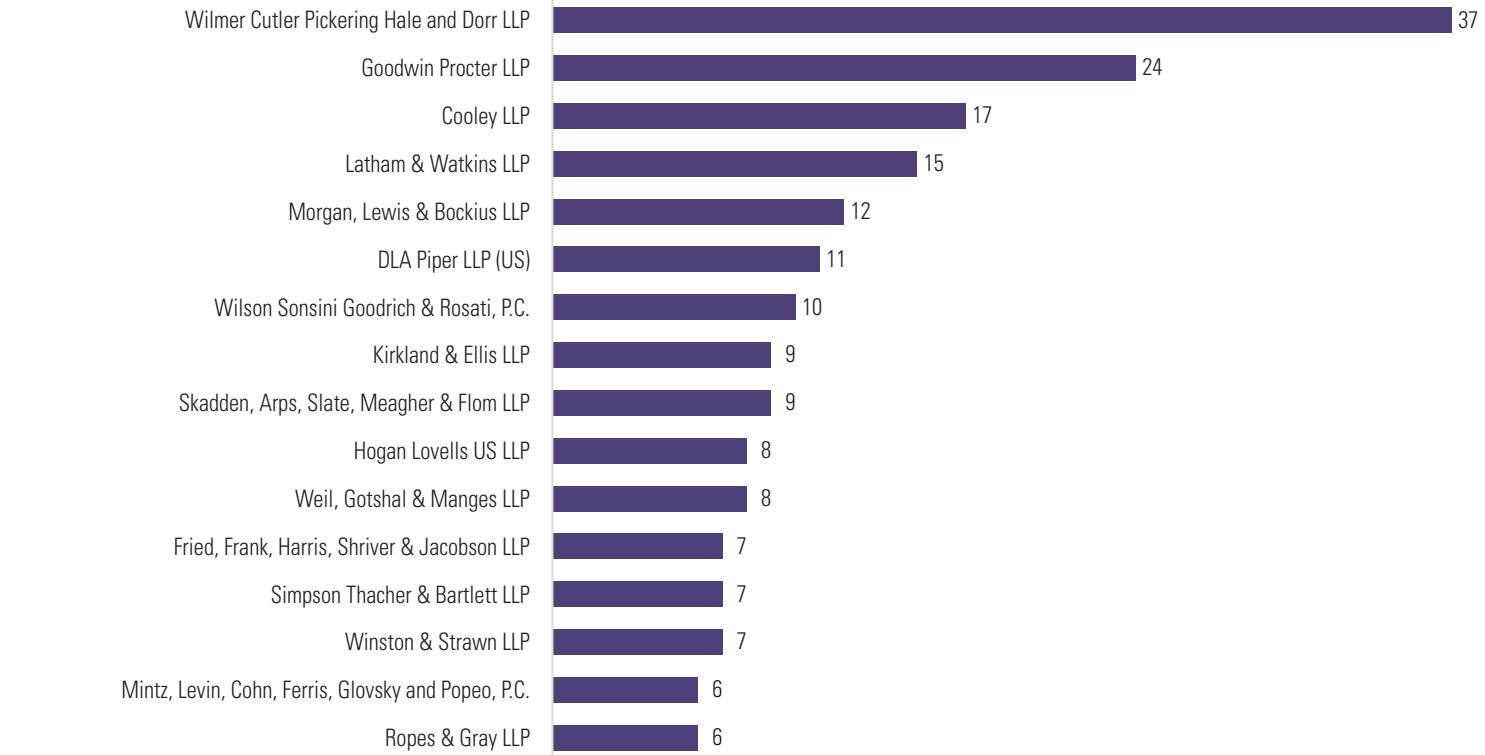
Company Counsel in Eastern US VC-Backed IPOs – 1996 to 2019



Source: Dow Jones VentureSource and SEC filings

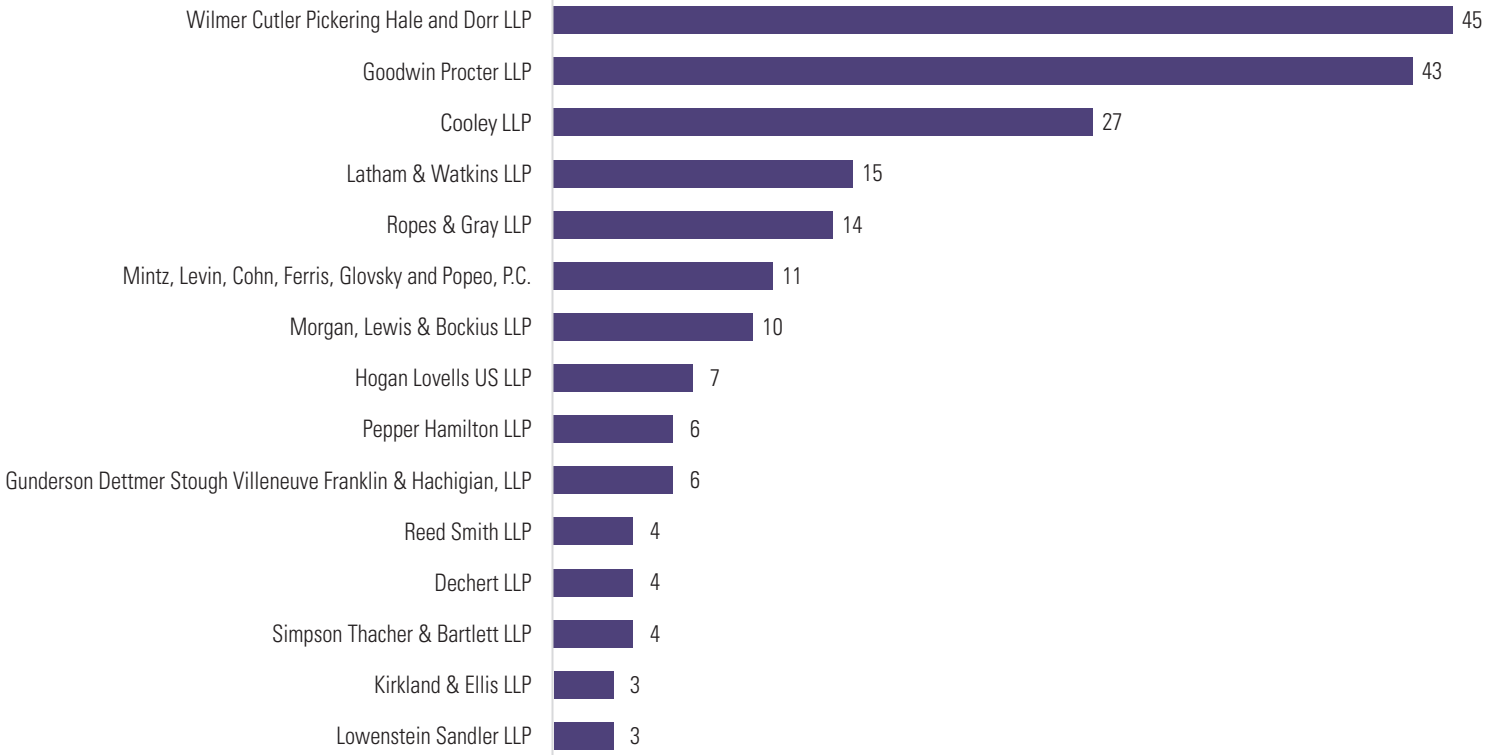
The above charts are based on companies located east of the Mississippi River.

Company Counsel in IPOs of Eastern US Technology Companies – 2000 to 2019



Source: Dow Jones VentureSource and SEC filings

Company Counsel in IPOs of Eastern US Life Sciences Companies – 2004 to 2019



Source: Dow Jones VentureSource and SEC filings

The above charts are based on companies located east of the Mississippi River.

Although an insider trading policy is not technically required, every company going public should adopt one. An insider trading policy is intended to help:

- prevent violations of the insider trading laws;
- avoid embarrassing proxy disclosure of reporting violations by persons subject to Section 16 of the Securities Exchange Act of 1934;
- avoid the appearance of impropriety on the part of those employed by or associated with the company;
- minimize the company's risk of incurring "controlling person liability" for insider trading violations by directors, officers and employees; and
- protect the reputations of the company, its directors and its employees.

Reasonable people can differ on many of the underlying policies and threshold decisions that shape an insider trading policy. Each company must select the package of provisions that reflects its own circumstances, achieves its policy goals, and is workable. The terms of the policy do not need to be publicly disclosed.

KEY ELEMENTS

The key elements of a typical insider trading policy are:

- prohibitions, rooted in the federal securities laws, against trading in the company's securities while aware of material nonpublic information concerning the company and "tipping" such information to others;
- prohibitions on trading in the company's securities during designated "blackout" periods, regardless of whether a person is actually aware of material nonpublic information;
- prohibitions on short sales of company securities and on purchases or sales of puts, calls or other derivative securities based on the company's securities, and other limitations on pledging or hedging of the company's securities;
- requirements to pre-clear proposed transactions in company securities with a designated company representative, such as the company's CFO or general counsel, and, for Section 16 reporting persons, to promptly report completed transactions to the company representative; and
- the company's commitment to provide ongoing education and assistance regarding compliance with the policy and insider trading laws.

BLACKOUT PERIODS

As part of their insider trading policies, virtually all public companies establish blackout periods in order to prevent transactions from taking place during periods when there is a high risk that someone is aware of material nonpublic information. Companies generally have regularly scheduled quarterly blackout periods that commence at some point during the final month of each fiscal quarter and end one or two trading days after the company has publicly announced its earnings for the quarter. Some companies extend the end of their quarterly blackout period until one or two trading days after the applicable periodic report is filed with the SEC. Pre-commercial life sciences companies often use a shorter blackout period in light of the immateriality of quarterly financial results.

Companies typically reserve the right to impose special blackout periods in connection with potential or pending corporate developments (such as merger discussions) that constitute material nonpublic information. In addition, certain trades by directors and executive officers typically are precluded during any "pension fund blackout period" imposed by Regulation BTR if the company has a 401(k) plan that permits investments in company stock.

All directors, officers, employees, family members and controlled entities are subject to the prohibitions on trading in the company's securities while aware of material nonpublic information concerning the company and on "tipping" such information to others, given that those restrictions are required by law.

The company must, however, determine the universe of employees who will be subject to the regularly scheduled quarterly blackout periods, as those periods are not mandated by law.

Companies that have a relatively small number of employees or that have a corporate culture of broadly sharing information often apply these blackout periods to all employees. Many young public companies adopt this approach, particularly if they have only one principal facility and their employees have fairly open access to company information. More established companies with large numbers of employees, multiple facilities and more restricted access to sensitive information typically apply blackout periods only to designated employees, such as management, finance, accounting and legal staff. Similarly, the company must decide which employees will be subject to the other provisions of the policy.

OTHER POLICY CHOICES

Crafting a suitable insider trading policy also requires the company to make additional decisions, which means answering questions such as the following:

- *Blackout or Window Periods*: What time period will be covered by the company's regular quarterly blackouts? Alternatively, should the company adopt a more restrictive "window" approach that permits insider transactions only during a short period following the filing of a quarterly or annual periodic report with the SEC (assuming a special blackout period is not in effect)?
- *Treatment of Option Exercises*: On what conditions may stock options be exercised during blackout periods? May an option be exercised if it is not otherwise going to expire? Will any form of "cashless" exercise or share withholding with the company be permitted?
- *Rule 10b5-1 Trading Plans*: May purchases and sales be made during blackout periods pursuant to Rule 10b5-1 trading plans? Will the company encourage—or perhaps mandate—that all market purchases and sales by directors and

officers be effected only pursuant to Rule 10b5-1 trading plans? Will the company specify minimum requirements for Rule 10b5-1 trading plans that go beyond what is technically required by the rule, such as a minimum waiting period between when a plan is adopted and sales under the plan may begin? (Rule 10b5-1 trading plans are discussed further on pages 20-21.)

— *Gifts and Charitable Donations*: Will gifts and charitable donations be restricted in the same manner as purchases and sales? What restrictions will be imposed on the recipients of these shares?

— *Stock Pledges and Loans*: Will the policy restrict the use of company securities as collateral for loans (including securities in margin accounts) and the purchase of company securities using borrowed funds?

— *Hedging Company Securities*: Will the policy limit the ability of employees and directors to hedge against losses in value of company securities they hold? Available hedging techniques include prepaid variable forward contracts, equity swaps, collars and exchange funds. An SEC rule adopted pursuant to the Dodd-Frank Act requires proxy disclosure of any practices or policies a company has adopted regarding the ability of employees or directors to purchase financial instruments or otherwise engage in transactions that hedge or offset any decrease in market value of company securities, including those of any parent, subsidiary or sister company.

— *Application to Controlled or Affiliated Entities*: How will the policy apply to entities controlled by the company's directors, officers and employees? How will the policy apply to transactions in company securities by a venture capital or private equity fund that has an affiliate on the board of directors, including distributions to the fund's partners? One approach is to apply the company's insider trading policy unless the controlled or affiliated entity has implemented appropriate policies and procedures to prevent the insider from influencing trades by the entity.

MARKET PRACTICES

The National Association of Stock Plan Professionals periodically conducts surveys of insider trading compliance practices among public companies. The survey set generally includes between 400 and 600 public companies of various sizes and across industries, with most of the companies headquartered in the United States. The three most recent surveys, co-sponsored by Deloitte Consulting LLP, were conducted in 2011, 2014 and 2017 (2020 survey results are not yet available).

In addition to the survey results presented in the table below:

— 85% of the respondents in the 2017 survey require insiders to clear all stock transactions in advance, including option exercises, down from the 89% reported in the 2014 survey and the 90% reported in the 2011 survey;

— 16% of the respondents in the 2017 survey do not permit the use of Rule 10b5-1 trading plans, unchanged from both the 2014 survey and the 2011 survey;

— 7% of the respondents in the 2017 survey require officers and directors to use Rule 10b5-1 trading plans, down slightly from the 8% reported in the 2014 survey but up slightly from the 6% reported in the 2011 survey; and

— public companies typically prohibit open market purchases and sales during blackout periods, except pursuant to Rule 10b5-1 trading plans. ■

PERSONS SUBJECT TO REGULARLY SCHEDULED QUARTERLY BLACKOUT PERIODS

CATEGORY	2011 SURVEY	2014 SURVEY	2017 SURVEY
Section 16 insiders	96%	96%	96%
Other senior management	90%	93%	92%
Middle management	59%	65%	64%
Other exempt employees	48%	51%	49%
Employees with access to financial or material nonpublic information	89%	91%	91%
Non-exempt (hourly) employees	38%	39%	39%
Outside directors	92%	95%	91%
Contractors, consultants and temporary employees	30%	35%	32%

TRANSACTIONS PROHIBITED DURING REGULARLY SCHEDULED QUARTERLY BLACKOUT PERIODS

CATEGORY	2011 SURVEY	2014 SURVEY	2017 SURVEY
Broker-assisted cashless option exercises	92%	90%	89%
Stock-for-stock option exercises	62%	61%	63%
Share withholding upon option exercises	53%	58%	54%
Cash option exercises	49%	50%	55%
Share withholding upon restricted stock/RSU awards	33%	35%	36%
Pledges	37%	43%	42%
Gifts	37%	38%	40%

Rule 10b-5 under the Securities Exchange Act of 1934 prohibits fraudulent statements or actions in connection with the purchase or sale of securities. The practical effect of Rule 10b-5 is to prohibit any insider with material nonpublic information about the company from buying or selling the company's securities until the company has publicly disclosed the information and the market has had an opportunity to absorb it. The result is that executives of public companies have limited opportunities to buy or sell company stock.

Violations of Rule 10b-5 can result in administrative, civil or criminal penalties and may also be the subject of private lawsuits. Any of these consequences, or even an SEC investigation that does not result in a formal proceeding or prosecution, can also tarnish an executive's reputation and cause irreparable career damage, including a bar from serving as an officer or director of any public company. The SEC and federal prosecutors vigorously pursue alleged violations of the insider trading laws, even in cases where the amounts involved are small.

SEC rules provide some relief to executives facing this quandary. Rule 10b5-1 can help protect a person from Rule 10b-5 liability for trading while aware of material nonpublic information concerning the company if the purchase or sale was made pursuant to a binding contract, specific instruction or written plan that the person put into place while unaware of material nonpublic information. These plans are commonly referred to as "Rule 10b5-1 trading plans" or "pre-arranged trading plans."

WHAT IS MATERIAL NONPUBLIC INFORMATION?

Information is "nonpublic" if it has not been disseminated in a manner making it available to investors generally.

In general, courts have held that information is "material" if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision with respect to the company's securities. Stated another way, there must be a substantial likelihood that a reasonable investor would view the information as having significantly altered the "total mix" of information available about the company.

Material information can include positive or negative information about the company. Prospective developments, such as a possible acquisition, can be material if the anticipated magnitude of the event, discounted by the likelihood of its occurrence, is something that a reasonable investor would consider important.

REQUIREMENTS

Rule 10b5-1 trading plans generally must specify the number of shares to be purchased or sold, the timing of the transactions, and the price or prices at which the trades will be effected. These variables may be expressed as specific numbers, dates and dollar amounts, or described in ranges or formulas that are automatically applied. Rule 10b5-1 trading plans may be used for either purchases or sales, but when used by executives typically cover sales. Rule 10b5-1 is also available for company transactions, and companies often rely on the rule to structure open market stock repurchases.

In order to rely on the rule, a person must enter into the Rule 10b5-1 trading plan in good faith and not with the intention of evading insider trading prohibitions, and must carry out the trading activity in accordance with the specifications of the plan. If a person deviates from or alters the plan while in possession of material nonpublic information, the defense will not be available for subsequent trades under that plan and the defense may even be retroactively lost for prior trades under the plan. Amendment of, or deviation from, a Rule 10b5-1 trading plan may make it difficult for an insider to demonstrate that he or she has satisfied the rule's good-faith requirement. Although a person may change the specifications of a Rule 10b5-1 trading plan during a time in which he or she does not possess material nonpublic information without losing the defense, the person will lose the defense if he or she enters into a corresponding or hedging transaction that has the effect of offsetting a trade made in accordance with the plan.

The SEC and courts often scrutinize the use of Rule 10b5-1 trading plans because of the potential for their abuse. The SEC's guidance on Rule 10b5-1 trading plans emphasizes that termination of a plan, or cancellation of one or more plan transactions, could affect the availability of the defense for prior plan transactions if it calls into question whether the rule's good-faith requirement was satisfied. The guidance also clarifies that the defense is not available if a person establishes a Rule 10b5-1 trading plan while aware of material nonpublic information, even if the plan is structured so that plan transactions will not begin until after the material nonpublic information is made public.

PROS AND CONS OF RULE 10b5-1 TRADING PLANS

Benefits:

- A Rule 10b5-1 trading plan provides an insider with an opportunity to diversify his or her holdings in the confidence that he or she will not violate federal insider trading rules, even if the insider is aware of material nonpublic information at the time a trade is executed under the plan.
- If publicly disclosed, a Rule 10b5-1 trading plan could deflect adverse investor and media reaction to transactions that may otherwise suggest that an insider took advantage of material nonpublic information.
- Prior public announcement of a Rule 10b5-1 trading plan could reduce the likelihood of a company becoming the target of stockholder litigation, since allegations of insider trading are frequently an element of class-action securities litigation.

Drawbacks:

- The insider loses some investment control over the trading activity.
- If public disclosure of a Rule 10b5-1 trading plan is made, any failure of the insider to sell in accordance with the plan could raise questions in the market.
- Trading under a Rule 10b5-1 trading plan does not eliminate the possibility that insider trading could be alleged. If sued, the insider has the burden of proving that he or she sold pursuant to a plan established under Rule 10b5-1.

BENEFITS AND DRAWBACKS

Rule 10b5-1 trading plans have both benefits and drawbacks. In addition, sales under these plans by directors, officers and 10% stockholders are not exempt from matching liability under Section 16. Rule 10b5-1 trading plans are not panaceas, but a properly established plan can help protect an insider from insider trading liability for transactions under the plan that occur while the insider is aware of material nonpublic information.

MARKET PRACTICES

As part of IPO planning, executives of companies going public sometimes adopt Rule 10b5-1 trading plans before the closing of the IPO. In this circumstance, the adoption of such plans (but not their specific terms) generally should be disclosed in the Form S-1. More commonly, Rule 10b5-1 trading plans are adopted following the IPO, either before or after expiration of the lockup period. Whether adopted before or after completion of the IPO, the plan terms will need to delay the commencement of sales until the expiration of the IPO lockup period.

The use of Rule 10b5-1 trading plans has grown significantly in recent years among executives of public companies of all sizes and maturities and particularly within larger companies. With increased scrutiny of insider trading by the SEC and investors, company oversight of Rule 10b5-1 trading plans—through review and approval of plans for compliance with insider trading policy, selection of brokerage firms to administer plans and even mandatory use of plans—has also increased.

The accompanying table sets forth the prevalence of various practices relating to Rule 10b5-1 trading plans based on surveys of public companies of various sizes and industry sectors conducted by the National Association of Stock Plan Professionals in conjunction with survey partners. The study reporting the 2018 survey results also indicated, based on a review of Form 4 filings by the Washington Service Bureau, that insiders at 54% of S&P 500 companies used Rule 10b5-1 trading plans in 2017, compared to just 26% in 2003, when the rule was relatively new. ■

PRACTICE	PREVALENCE 2015	PREVALENCE 2018
PLAN ADMINISTRATION:		
Require prior review and approval of plan by company	87%	91%
Require participants to use brokerage firm selected by company	51%	57%
MANDATORY PARTICIPATION:		
Require officers to sell through plans	19%	18%*
Require directors to sell through plans	14%	11%*
"COOLING-OFF" PERIOD:		
Require "cooling-off" period between plan adoption and commencement of sales	89%	91%
Duration of "cooling-off" period, if required:		
< 30 days	14%	11%
30–60 days	58%	60%
full earnings cycle	14%	21%
other	13%	8%
PLAN TERM:		
Impose minimum/maximum term	Minimum and/or maximum: 37%	Minimum: 50% Maximum: 58%
Range of minimum/maximum terms, if imposed:		
minimum term	6–8 months (median)	< 6 months: 14% 6–12 months: 83% 18 months: 2%
maximum term	13–18 months (median)	1 year: 48% 1–2 years: 12% 2 years: 38% > 2 years: 2%
SCOPE OF SALES UNDER PLANS:		
Permit multiple, overlapping plans	33%	32%
Permit sales outside plan	53%	68%
Permit sales under plan during blackout periods	80%	90%
Impose restrictions on the frequency of sales or on how many shares may be sold	11%	25%
AMENDMENT AND TERMINATION:		
Permit participants to modify or amend plan (typically with frequency restrictions and waiting period before sales can resume)	54%	86%
Permit participants to terminate plan	69%	83%

* Another 31% are "strongly encouraged" to sell through plans.

Startup companies routinely rely on exemptions from the registration requirements of the Securities Act of 1933 to complete private placements of securities. In recent years, the pre-IPO financing toolkit has been significantly expanded as a result of the enactment of the JOBS Act and SEC rule changes.

More changes may be on the way. In December 2019 and March 2020, the SEC proposed various rule amendments, including to increase offering limits under some rules, revise certain individual investment limits, expand the pool of eligible investors, and permit additional methods of soliciting investors.

The Regulation D, crowdfunding and Regulation A exemptions discussed below are available to all eligible companies, whether or not they qualify as emerging growth companies under the JOBS Act, but are not available to "bad actors" under SEC rules or specified types of non-operating companies.

REGULATION D

Regulation D is available to both US and foreign companies, whether privately or publicly held. Regulation D consists of separate rules, the application of which may vary depending on the size and nature of the offering. Rule 506 under Regulation D is generally considered the most flexible and useful of these rules because it does not limit size, investment amount or the number of accredited investors, and does not impose specific disclosure requirements (unless the offering includes unaccredited investors). "Accredited investors" are high-income or high-net-worth individuals, entities satisfying specified standards, and certain other investors.

Historically, Regulation D prohibited general solicitation and advertising in connection with private placements conducted pursuant to Regulation D. As required by the JOBS Act, the SEC amended Rule 506 to permit general solicitation and advertising in private placements conducted under Rule 506(c) if the company takes reasonable steps to verify that all purchasers are accredited investors; each purchaser is (or the company reasonably believes that each purchaser is) an accredited investor; and all other applicable terms and conditions of Regulation D are satisfied.

Pre-existing Rule 506(b) remains available for offerings conducted without general solicitation or advertising. Although, to date, Rule 506(c) has been used far less frequently than Rule 506(b), the popularity of offerings involving general solicitation or advertising under Rule 506(c) is likely to grow as companies become more familiar and comfortable with Rule 506(c).

REGULATION CROWDFUNDING

In a "crowdfunding" financing, a company uses the Internet to seek small investments from a large number of investors. Such transactions must be registered or qualify for an exemption if they involve the offer and/or sale of securities. The JOBS Act created a new exemption that permits private US companies, without Securities Act registration, to publicly offer and sell securities in crowdfunding transactions raising up to $1.07 million within any 12-month period.

The SEC's rules implementing the crowdfunding exemption (referred to as "Regulation Crowdfunding") provide that:

— *Eligibility*: Crowdfunding is available to US companies that are not Exchange Act reporting companies.

— *Maximum Offering Size*: Within any 12-month period, the maximum offering size for crowdfunding transactions is $1.07 million.

— *Investor Limits*: The maximum amount an investor may invest in any crowdfunded offerings in a 12-month period is equal to:

- the greater of $2,200 or 5% of the annual income or net worth of the investor, if both the annual income and net worth of the investor are less than $107,000; or
- 10% of the annual income or net worth of the investor, not to exceed a maximum aggregate investment of $107,000 by the investor, if either the annual income or net worth of the investor is equal to or more than $107,000.

For a natural person, annual income and net worth may be calculated jointly with the annual income and net worth of the person's spouse.

— *Mandatory Use of Intermediary*: An intermediary—either a registered broker-dealer or a "funding portal"—must be used to effect crowdfunding transactions through an Internet website. The intermediary must register with the SEC, assure that investment limits are not exceeded and satisfy other requirements.

— *Disclosure Requirements*: The company must file with the SEC and provide to investors and the intermediary an offering statement on Form C that includes specified information regarding the company and its management, the offering, and the intermediary's financial interests in the company and the offering. The Form C must also include, for the company's two most recent fiscal years, financial statements that have been:

- certified by the company's CEO, for offerings of $107,000 or less;
- reviewed (but not audited) by an independent public accountant, for offerings of more than $107,000 but not more than $535,000; and
- reviewed (but not audited) by an independent public accountant, for offerings of more than $535,000 (except that the financial statements must be audited if the offering is not the company's first crowdfunded offering).

— *Updates and Progress Reports*: The company must update its Form C to disclose material changes; must disclose (in SEC filings or on the intermediary's platform) its progress in meeting the target offering amount; and, within five business days after the offering, must file a Form C-U with the SEC to report the total offering proceeds.

— *Offering Timeline*: Offerings must be held open for at least 21 days and potential investors can cancel an investment commitment until 48 hours prior to the offering deadline.

— *Investor Solicitation*: The company may communicate with investors about itself and the offering through the intermediary's platform. Advertisements must be limited to a statement that the company is conducting an offering, the name of the intermediary through which the offering is being conducted and a link to its platform, the terms of the offering, contact information for the company, and a brief description of the company's business. Promoters must disclose the receipt of compensation in each communication.

— *Reporting Obligations*: Following completion of a crowdfunding transaction, the company must, within 120 days after the end of each fiscal year, post on its website and file with the SEC an annual report updating much of the Form C information. This reporting obligation generally lasts until the company registers as a reporting company under the Exchange Act.

— *Resale Limitations*: Investors may not resell securities purchased in crowdfunding transactions for one year, except to the company, to an accredited investor, to family members, in connection with death or divorce, or in an SEC registered offering.

The dollar thresholds specified above are subject to adjustment for inflation every five years.

REGULATION A+

In addition to creating the crowdfunding exemption, the JOBS Act sought to revitalize Regulation A, which has existed since the dawn of federal securities law. Regulation A provides an exemption from registration for small public offerings but had seldom been used, partly due to the $5 million maximum offering size. To address the perceived limitations in Regulation A, the JOBS Act effectively created a new exemption dubbed "Regulation A+."

There are two tiers of Regulation A+ offerings, with different offering caps, disclosure requirements and ongoing reporting obligations:

— Tier 1 offerings may raise up to $20 million, including no more than $6 million offered by selling stockholders, in a 12-month period; and

— Tier 2 offerings may raise up to $50 million, including no more than $15 million offered by selling stockholders, in a 12-month period.

For offerings up to $20 million, the company may elect to proceed under either tier.

Provisions Applicable to Both Tier 1 and Tier 2 Offerings

— *Eligibility*: Regulation A+ is available to non-reporting US and Canadian companies.

— *Disclosure Requirements*: Offerings are made pursuant to an offering statement that includes basic information about the company, its management and the offering. It also must include balance sheets as of the company's two most recent fiscal year-ends and other financial statements not older than nine months.

— *SEC Filing and Review*: Offering statements must be filed with the SEC (on Form 1-A) and are subject to SEC review. Companies may submit draft offering statements for nonpublic SEC review prior to filing.

— *Resales*: Securities sold pursuant to Regulation A+ are freely transferable, except by affiliates of the company.

— *Investor Solicitation*: The company may solicit investor interest using written "testing-the-waters" materials filed with the SEC.

Provisions Applicable Only to Tier 2 Offerings

— *Investor Limits*: Investors that do not qualify as accredited investors are limited to purchasing no more than 10% of the greater of the investor's annual income or net worth (for an entity, the limit is 10% of the greater of the entity's annual revenue or net assets at fiscal year-end).

— *Financial Statements*: The financial statements included in the offering statement and annual reports must be audited.

— *Periodic Reporting Requirements*: The company is required to file annual reports, semi-annual reports and current event reports with the SEC that are similar to the requirements for public company reporting under the Exchange Act.

RULES 147 AND 147A

In an effort to modernize and expand the federal exemptions for intrastate securities offerings, including intrastate crowdfunding transactions, the SEC amended Rule 147 and adopted a new companion Rule 147A in 2017. The amendments to Rule 147 include new and revised residency and "doing business" requirements and an integration safe harbor. Rule 147A is substantively identical to Rule 147, but allows unlimited offers (but no sales) outside the applicable state, and also allows the company to be incorporated or organized outside the applicable state so long as the company can demonstrate the "in-state" nature of its business. Offerings under both rules must comply with applicable state blue sky laws.

PRACTICAL TAKEAWAYS

Due to the disclosure, financial statement and ongoing reporting requirements of the crowdfunding exemption, its practical utility is limited, particularly for pre-IPO companies whose capital needs usually exceed the maximum offering size. Although Regulation A+ permits significantly larger offerings, an offering under Tier 2 imposes limits on the amount of securities that may be sold to unaccredited investors and requires audited financial statements and ongoing public reporting. Rules 147 and 147A are generally of limited interest other than to local companies whose fundraising can be confined to in-state residents. As a result of these limitations, pre-IPO companies typically find that the use of Regulation D for an offering of any size—either under Rule 506(c) permitting general solicitation but limited to accredited investors, or under Rule 506(b) prohibiting general solicitation but not limited to accredited investors—has more appeal than the newer exemptions. ■

COMPARISON OF PRIVATE OFFERING EXEMPTIONS

Below is a high-level comparison of selected aspects of the exemptions from registration under Regulation D, Regulation Crowdfunding and Regulation A+.

	REGULATION D		REGULATION CROWDFUNDING*	REGULATION A+	
	Rule 506(b)	Rule 506(c)		Tier 1	Tier 2
ELIGIBILITY	Any company not otherwise disqualified	Any company not otherwise disqualified	Non-reporting US companies not otherwise disqualified	Non-reporting US and Canadian companies not otherwise disqualified	Non-reporting US and Canadian companies not otherwise disqualified
MAXIMUM OFFERING SIZE	Unlimited	Unlimited	$1 million in any 12-month period	$20 million in any 12-month period	$50 million in any 12-month period
MAXIMUM PER-INVESTOR DOLLAR AMOUNT	Unlimited	Unlimited	Up to $100,000, depending on investor's annual income and net worth	Unlimited	Accredited investors: unlimited Unaccredited investors: 10% of annual income or net worth Entities: 10% of annual revenue or net assets
MAXIMUM NUMBER OF INVESTORS	Accredited investors: unlimited Unaccredited investors: 35	Unlimited	Unlimited	Unlimited	Unlimited
NATURE OF INVESTORS	No restrictions, except unaccredited investors must be financially sophisticated	Accredited investors only	No restrictions	No restrictions	No restrictions
INTERMEDIARY	Not required	Not required	Required	Not required	Not required

* Does not reflect temporary, conditional relief that permits eligible companies affected by the COVID-19 pandemic to expedite crowdfunding offerings launched by August 31, 2020.

Most companies completing underwritten IPOs can satisfy the standards for listing their common stock on Nasdaq or the NYSE. Following its IPO, however, a listed company can become subject to delisting if it does not meet the applicable exchange's standards for continued listing.

Some companies become subject to delisting for failing to remain in compliance with financial parameters, such as income, revenue or cash flow metrics, or market parameters, such as minimum trading prices or market capitalization. On occasion, Nasdaq and the NYSE temporarily suspend compliance with market price–based listing requirements in response to broad market disruptions, such as the dramatic market decline that occurred during the coronavirus pandemic in March 2020.

Companies can also face delisting when they are unable to file SEC reports on a timely basis. This can happen, for example, when a restatement delays the release of financial statements. An exchange may also initiate delisting for violations of corporate governance requirements, although this is relatively uncommon.

Nasdaq and the NYSE monitor compliance with listing standards and promptly notify listed companies of noncompliance. Both exchanges have elaborate delisting procedures, including notices, written submissions, hearings and appeals. The exchanges prefer not to lose listings and generally provide companies with an opportunity to regain compliance before they are delisted—for example, a company whose trading price is below the minimum to retain listing may be able to effect a reverse stock split to increase its trading price above the required minimum. However, sometimes delisting cannot be avoided. Companies that are delisted may reapply for listing once they are eligible.

DELISTING CONSEQUENCES

Involuntary delisting can have a variety of negative consequences for the company and its stockholders by:

- reducing the liquidity and market price of the company's common stock;
- limiting the company's access to capital through debt and equity financings;
- reducing the number of investors willing to hold or acquire the company's common stock;
- decreasing the amount of news and analyst coverage for the company;
- removing the company from the oversight function of the exchange on which it was previously listed; and
- limiting the company's ability to attract and retain personnel by means of equity compensation.

In addition, trading in the over-the-counter market—unlike trading on Nasdaq, the NYSE or another national securities exchange—is not exempt from state securities law requirements. As a result, blue sky filings may be required in each state where residents of the state seek to trade the common stock.

A listed company is required to file a Form 8-K with the SEC within four business days after receiving notice from the exchange that its common stock does not satisfy the standards for continued listing. If its stock is subsequently delisted, the company must file a second Form 8-K within four business days.

ALTERNATIVES FOR DELISTED COMPANIES

The alternatives available to a delisted company depend on the reasons for its delisting. If delisting was attributable to a quantitative failure, the company may be able to list its common stock on another exchange with less stringent requirements, or its common stock may be traded in the over-the-counter market. The over-the-counter market consists of interdealer quotation services for eligible equity securities. Unlike with stock exchanges, companies do not list their own stock for trading in the over-the-counter market. Rather, qualified broker-dealers submit a Form 211 to FINRA and begin quoting the stock in an interdealer quotation system. Trading of a company's stock in the over-the-counter market can occur without the company's knowledge, approval, or participation.

Historically, the best-known over-the-counter market was the Over-the-Counter Bulletin Board (OTCBB), operated by FINRA, which requires that a company be current in its public reporting requirements and have at least one market maker for its stock in order to be quoted. Today, the OTCBB has been largely supplanted by OTC Markets Group, a privately held company which operates three electronic quotation markets with different requirements:

- *OTCQX* (which is further segmented into OTCQX U.S., OTCQX International, and OTCQX U.S. Banks) is for companies that are current in their public reporting, satisfy specified financial, governance (US issuers only), and minimum bid price and public float requirements, have at least one market maker, and are not subject to bankruptcy proceedings.
- *OTCQB* is for companies that are current in their public reporting, undergo an annual verification and management certification process but need not satisfy any minimum financial standards, have a minimum bid price of $0.01 per share, satisfy minimum public float requirements, and are not subject to bankruptcy proceedings.
- *Pink* (formerly known as OTC Pink, and before that known as the Pink Sheets) is a speculative trading market without any listing or disclosure standards.

Securities that trade in the over-the-counter market are primarily owned by retail investors. Rule 15c2-11 under the Securities Exchange Act of 1934 sets out requirements with which a broker-dealer must comply before it can publish quotations for securities in the over-the-counter market. In September 2019, the SEC proposed amendments to Rule 15c2-11. The proposed amendments are designed to enhance investor protection by requiring that information about the issuer and the security be current and publicly available before a broker-dealer can begin publishing quotations for that security. If adopted, the proposed amendments may have a significant impact on trading in the over-the-counter market, particularly on the Pink market, which does not have any issuer disclosure standards. ■

Directors of a Delaware corporation who violate their duty of oversight may face personal liability for breach of the duty of loyalty. Under the seminal *Caremark* decision, oversight liability can arise if the directors completely fail to implement any controls over a company's operations or consciously fail to monitor or oversee those controls. Successfully pleading a *Caremark* claim is no small feat—a plaintiff must show that directors knew that they were not discharging their fiduciary obligations—and claims brought on this theory are usually dismissed before discovery begins.

The Delaware Supreme Court, in *Marchand v. Barnhill*, recently sounded a warning bell for directors, reminding them that as part of their duty of loyalty, they "must make a good faith effort to implement an oversight system and then monitor it." The case stems from the 2015 listeria outbreak involving Blue Bell Creameries. In an ensuing lawsuit, a stockholder alleged that the Blue Bell directors breached their duty of loyalty by failing to exercise their duty of oversight. In declining to dismiss the complaint, the court highlighted the following allegations:

- no board committee that addressed food safety existed;
- no regular process or protocols that required management to keep the board apprised of food safety compliance practices, risks or reports existed;
- no schedule for the board to consider on a regular basis, such as quarterly or biannually, whether any key food safety risks existed;
- during a key period leading up to the deaths of three customers, management received reports that contained what could be considered red, or at least yellow, flags, and the board minutes of the relevant period revealed no evidence that these were disclosed to the board;
- the board was given certain favorable information about food safety by management, but was not given important reports that presented a much different picture; and
- the board meeting minutes were devoid of any suggestion that there was any regular discussion of food safety issues.

In another recent case, *In re Clovis Oncology, Inc. Derivative Litigation*, the Delaware Chancery Court declined to dismiss a case alleging that the board of a publicly held biopharmaceutical company had breached its fiduciary duties by failing to oversee a clinical trial for the company's developmental lung cancer drug and then allowing the company to mislead the market regarding the drug's efficacy. The court found that the board had an adequate monitoring system in place but did not take appropriate action in response to warning signs flagged by the system. In its decision, the court observed that Delaware courts are more likely to find liability under *Caremark* for oversight failures involving compliance with regulatory mandates than for oversight failures involving ordinary business risks.

Similarly, in *Hughes v. Hu*, the Delaware Chancery Court rejected a motion to dismiss after finding that the company's audit committee had met only once per year, sometimes for as little as 30 minutes, and had failed to provide meaningful oversight over the company's financial statements and system of financial controls. The court noted that a company cannot survive a *Caremark* claim simply by having the "trappings" of internal controls while merely following management's recommendations. Instead, the board must show that it exercised some oversight.

The holdings in *Marchand, Clovis* and *Hughes* offer several significant takeaways for directors of Delaware corporations. Discharging the duty of oversight requires directors to do more than rely on government regulation of a company's industry or general discussions with management at board meetings. Rather, directors must demonstrate that they have used good faith efforts to put in place at the board level a reasonable system of monitoring and reporting about the corporation's central compliance risks. Boards have discretion to implement context- and industry-specific approaches to risk oversight that are tailored to the activities and resources of the businesses they oversee. In *Marchand*, the court acknowledged that case law gives deference to boards and that Delaware courts are not examining the effectiveness of a board-level compliance and reporting system after the fact.

Practically speaking, directors need to be able to demonstrate that they have been proactive in discharging their risk oversight responsibilities. This generally means that the company has sufficient compliance and reporting systems; that regulatory and compliance issues are effectively reported to the board; that when issues are reported to the board, the board takes initiative to remedy such issues; and that board minutes accurately reflect the reports made to the board and the board's response to those reports. Tasking a board committee with oversight of specific market or industry risks may help demonstrate the board's due care in monitoring such risks, though a separate committee is not required if oversight is handled by the full board.

Internal board policies and committee charters can document the compliance and reporting system, while meeting minutes can demonstrate that periodic monitoring has taken place. The *Marchand* decision underscores the importance of creating and maintaining appropriate minutes and other corporate records to demonstrate the board's discharge of its risk oversight responsibilities. Minutes should contain sufficiently detailed references to relevant risk-related discussions and should include both good and bad risk-related reports delivered to the board or committee. In *Hughes*, where the board was unable to produce any records for a certain time period, the court gave plaintiffs the benefit of the doubt and inferred no meetings had occurred.

Although the courts in these cases did not back away from previous statements that *Caremark* claims are difficult to plead and prove, the decisions have rejuvenated a largely dormant theory of director liability and may prompt an increase in such claims. Companies—especially those focused on a single, highly regulated product or service—are wise to take appropriate steps to deter *Caremark* claims. ■

In late 2019, the SEC released a statement highlighting eight areas that audit committees should focus on during a public company's reporting season.

Penned by SEC Chair Jay Clayton, Division of Corporation Finance Director William Hinman and Chief Accountant Sagar Teotia, the statement reiterates that the strength of the US capital markets, and the confidence of investors in those markets, is driven by the continued quality and reliability of financial reporting. The statement acknowledges the "vital role" that audit committees play in the financial reporting system through their oversight of financial reporting, including the internal control over financial reporting (ICFR) and the external, independent audit process, and emphasizes that "[e]ffective oversight by strong, active, knowledgeable and independent audit committees significantly furthers the collective goal of providing high-quality, reliable financial information to investors and our markets."

The statement specifically encourages audit committees to address the following topics:

GENERAL OBSERVATIONS

- *Tone at the Top*: Focus on the "tone at the top" to create and maintain an environment that supports the integrity of the financial reporting process and the independence of the audit, including through clear and proactive communication with the auditor and management.
- *Auditor Independence*: Periodically evaluate the sufficiency of the auditor's and the company's processes for monitoring compliance with auditor independence rules, including whether such processes account for corporate changes or other events that could affect the auditor independence determination.
- *Generally Accepted Accounting Principles (GAAP)*: Proactively engage with the auditor and management regarding new accounting standards to understand management's implementation plan, assess whether such plan allows sufficient time and resources for management to develop well-reasoned judgments and accounting policies, and understand management's approach to establishing and monitoring controls and procedures around new standard adoption and transition.
- *Internal Control over Financial Reporting*: If ICFR issues are detected, understand and monitor management's remediation plans, making clear that prompt, effective remediation is a high priority.
- *Communications to the Audit Committee from the Independent Auditor*: Incorporate into the audit committee's ongoing duties any insights from the committee's required dialogue with the company's auditor under Public Company Accounting Oversight Board (PCAOB) Auditing Standard 1301, *Communications with Audit Committees* (AS 1301).

SPECIFIC OBSERVATIONS

- *Non-GAAP Measures*: Actively participate in the review and presentation of non-GAAP measures and metrics, which includes understanding from management why such measures and metrics are used and how they are being presented over time.
- *Reference Rate Reform (LIBOR)*: Engage with management to understand the company's plan for identifying and addressing risks related to the expected discontinuation of LIBOR after 2021 and the transition to an alternative reference rate.
- *Critical Audit Matters (CAMs)*: Remain engaged with the auditors through the CAMs implementation process, which includes having substantive discussions about the audit, the nature of each expected CAM and how the auditor is addressing such CAMs in the audit.

The statement is the latest in a long line of guidance from the SEC and its staff in recent years directed toward public company boards, indicating that the current SEC Chair and staff expect directors to have a prominent role in a number of matters related to the securities laws. Generally speaking, it is constructive when the SEC offers transparent insights regarding matters of importance to corporate boards, while at the same time recognizing that corporate governance is a matter of state law. Other recent SEC and staff statements address:

- disclosure and other securities law obligations that companies should consider with respect to COVID-19 (CF Disclosure Guidance: Topic No. 9);
- intellectual property and technology risks associated with international business operations (CF Disclosure Guidance: Topic No. 8);
- public company cybersecurity disclosures (Release Nos. 33-10459 and 34-82746); and
- expectations for board analyses regarding the exclusion of certain shareholder proposals under Rules 14a-8(i)(5) and (7) (Staff Legal Bulletin Nos. 14I, 14J and 14K). ■

AUDITOR COMMUNICATIONS TO THE AUDIT COMMITTEE

The guidance contained in the SEC's statement supplements—but does not change—an audit committee's existing function and responsibilities. Although the PCAOB does not have direct authority over audit committees, many of its auditing standards directly affect the functioning of audit committees by mandating specific interactions between independent registered public accounting firms, who are under the PCAOB's direct authority, and audit committees.

For example, AS 1301 prescribes communications that the company's auditor must make to the audit committee. AS 1301 seeks to enhance the "relevance, timeliness, and quality" of the information conveyed by the auditor to the audit committee, particularly with respect to the auditor's assessment of significant risk of financial statement misstatement and other matters that could affect the integrity of the financial statements, and to promote constructive dialogue, as opposed to "check the box" communications, between auditors and audit committees.

Under AS 1301, the matters the auditor must discuss with the audit committee fall into several general areas, including appointment and retention of the auditor; obtaining information and communicating the audit strategy; results of the audit; form and documentation of communications; the auditor's evaluation of the company's identification of, accounting for and disclosure of its relationships with related parties; and timing.

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