IPO Report

2022

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2022 IPO Report—What's Inside

REVIEW

Across the board, despite the continuing pall cast by the COVID-19 pandemic, 2021 was a year of very strong IPO deal flow, although aftermarket performance fell well short in comparison to the prior year and broad market indices. The surge in IPOs by special purpose acquisition companies (SPACs) continued at a blistering pace, producing another annual record despite wide swings in quarterly tallies.

Excluding SPAC IPOs and direct listings, the conventional IPO market produced 381 IPOs in 2021, almost double the 209 IPOs in 2020, and the highest annual count since 2000. Each quarter of 2021 accounted for the highest total for that quarter since 2000.

Total gross proceeds for the year were $134.94 billion, a figure that surpassed 2020's $76.32 billion tally by 77% and eclipsed 2000's $108.13 billion total to become the highest annual figure on record.

IPOs by emerging growth companies (EGCs) accounted for 93% of the year's IPOs—up from 90% in 2020.

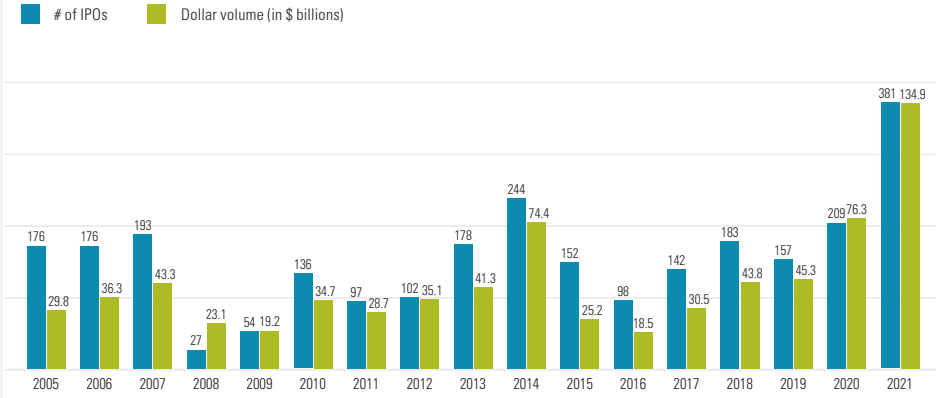
The median offering size for all 2021 IPOs was $176.9 million, down 2% from the $180.0 million median for 2020 but 72% higher than the $102.9 million for the five-year period from 2015 to 2019.

In 2021, the median offering size for IPOs by EGCs was $167.7 million, 5% higher than the $160.0 million in 2020. The median non-EGC offering size in 2021 was $498.8 billion, down 57% from the $1.17 billion in 2020.

The median annual revenue of all IPO companies in 2021 was $67.4 million, more than double the $31.0 million in 2020, and coincidentally equal to the median that prevailed during the five-year period from 2015 to 2019.

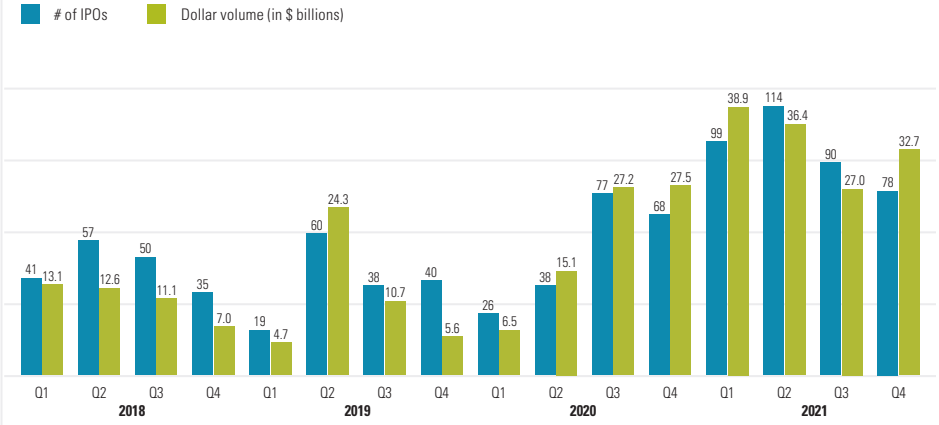
In 2021, 48% of life sciences IPO companies had revenue, down from 53% in 2020. Among non–life sciences IPO companies in 2021, median annual revenue was $203.2 million, 3% higher than the $197.2 million median in 2020.

US IPOs by Year—2005 to 2021



Source: SEC filings

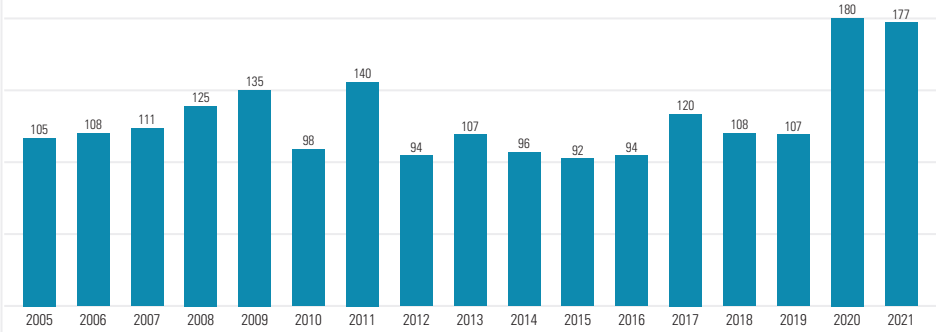
US IPOs by Quarter—2018 to 2021



Source: SEC filings

Median IPO Offering Size—2005 to 2021

$ millions



Source: SEC filings

EGC IPO companies in 2021 had median annual revenue of $41.8 million, compared to $1.53 billion for non-EGC IPO companies.

The percentage of profitable IPO companies increased to 28% in 2021, from 22% in 2020. Only 10% of life sciences IPO companies were profitable in 2021, compared to 38% of non–life sciences companies.

In 2021, the median IPO produced a first-day gain of 16%, compared to 23% in 2020. These figures represent the two highest median first-day gains since the 24% in 2000.

The median first-day gain for life sciences IPO companies in 2021 was 9%, compared to 17% for non–life sciences IPO companies. Both of these figures were lower than in 2020, when the median first-day gain for life sciences companies was 26%, compared to 20% for non–life sciences IPO companies.

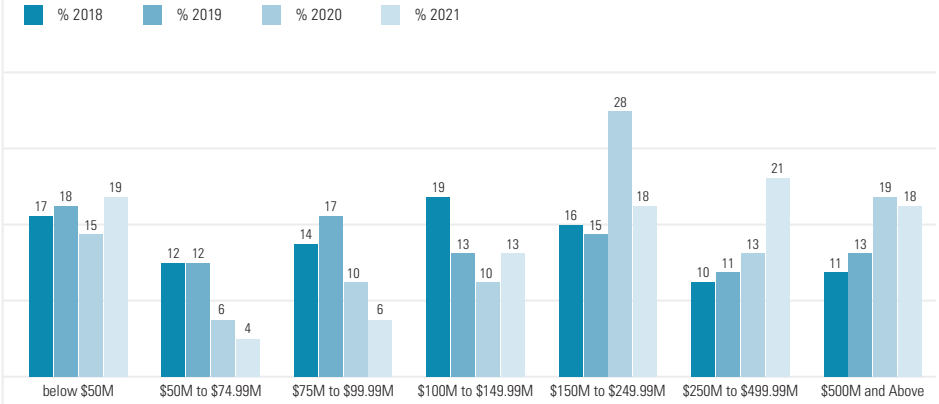
There were 24 "moonshots" (IPOs that double in price on their opening day) in 2021, one more than in 2020. For context, the highest number of moonshots in a single year between 2001 and 2019 was seven.

In 2021, 25% of IPOs were "broken" (IPOs whose stock closes below the offering price on their first trading day), up from 21% in 2020. A higher percentage of life sciences IPOs (28%) than non–life sciences IPOs (24%) were broken.

The median 2021 IPO company ended the year 19% below its offering price—the worst aftermarket performance since 2011. The year's best-performing IPOs were by Huadi International Group (trading 300% above its offering price at year-end), ZIM Integrated Shipping Services (292%), Esports Technologies (243%) and Regencell Bioscience Holdings (235%).

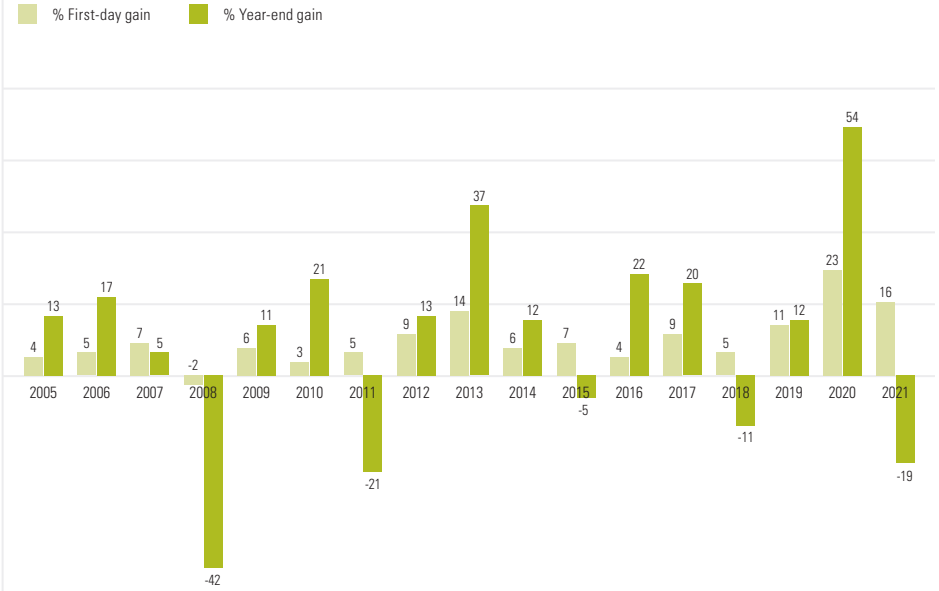
At the end of 2021, 64% of the year's IPO companies were trading below their offering price—the second-worst figure for this metric since 2000. Life sciences companies fared worse than their non–life sciences counterparts, with three-

Distribution of IPO Offering Size—2018 to 2021

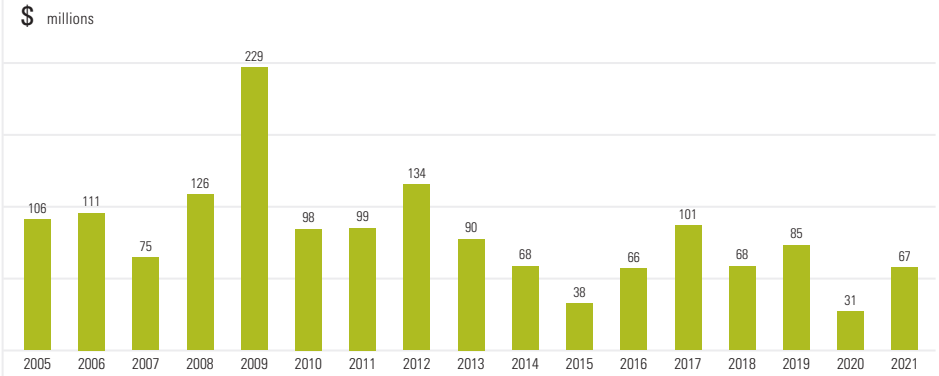


Source: SEC filings

Median IPO First-Day and Year-End Gain by Year—2005 to 2021



Median Annual Revenue of IPO Companies—2005 to 2021



Source: SEC filings and IPO Vital Signs

quarters trading below their offering price, compared to 57% of other companies.

Individual components of the IPO market fared as follows in 2021:

— ***VC-Backed IPOs***: The number of IPOs by venture capital–backed US issuers increased by 65%, growing from 95 in 2020 to 157 in 2021—the highest annual figure since the 201 in 2000. The market share of this segment, however, contracted from 64% to 56%. The median offering size for US VC-backed IPOs declined by 4%, from $182.7 million in 2020 to $176.0 million in 2021. In comparison, the median offering size for non–VC-backed companies was $191.2 million. At year-end, the median 2021 US venture–backed IPO company was trading 27% below its offering price.

— ***PE-Backed IPOs***: The number of private equity PE–backed IPOs by US issuers almost tripled, from 30 in 2020 to 86 in 2021. Overall, PE-backed issuers accounted for 31% of all US-issuer IPOs in 2021, compared to 20% in 2020. The median offering size for PE-backed IPOs in 2021 was $335.9 million, down by one-half from the $674.1 million median in the prior year but still the second-highest annual figure on record. The median PE-backed IPO company ended the year 3% below its offering price.

— ***Life Sciences IPOs***: There were 138 life sciences company IPOs in 2021, an increase of 33% from the 104 in 2020. The portion of the IPO market accounted for by life sciences companies decreased to 36% in 2021 from 50% in 2020, largely due to the increase in tech company IPOs. At $125.9 million, the median offering size for life sciences IPOs in 2021 was 21% lower than the $159.1 million in 2020. At year-end, the median life sciences IPO company was trading 27% below its offering price, compared to a loss of 11% for the median non–life sciences IPO company.

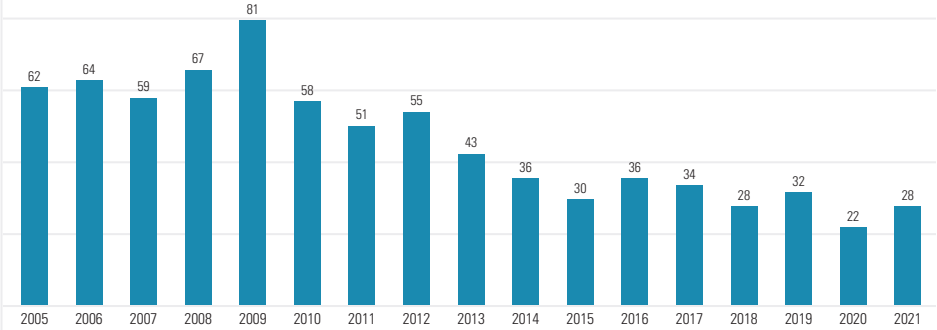
— ***Tech IPOs***: Deal flow in the technology sector more than doubled, jumping from 69 IPOs in 2020 to 148 IPOs in 2021—the sixth consecutive year of growth. The tech sector's share of the US IPO market increased to 39% in 2021 from 33% in 2020, representing the industry's highest market share since the 44% in 2012. The median offering size for tech IPOs in 2021 was $322.5 million, up 1% from the $319.0 million median in 2020. The median tech IPO company ended the year 16% below its offering price.

— ***Foreign-Issuer IPOs***: The number of US IPOs by foreign issuers increased by two-thirds, from 60 in 2020 to 100 in 2021. Foreign-issuer IPOs accounted for 26% of the market in 2021, down from 29% in 2020. Although this tally represents the highest annual number of foreign-issuer IPOs since the 107 in 2000, foreign issuers saw their lowest market share since the 20% in 2016. Among foreign issuers, Chinese companies led the year with 36 IPOs (China's highest annual total since the 40 in 2010), followed by companies from Israel and the United Kingdom (each with ten IPOs), Germany (six IPOs) and Switzerland (five IPOs). The median foreign-issuer IPO company ended the year down 35% from its offering price.

In 2021, 131 companies based in the eastern United States (east of the Mississippi River) completed IPOs, compared to 150 western US–based issuers. California led the state rankings with 97 IPOs, followed by New

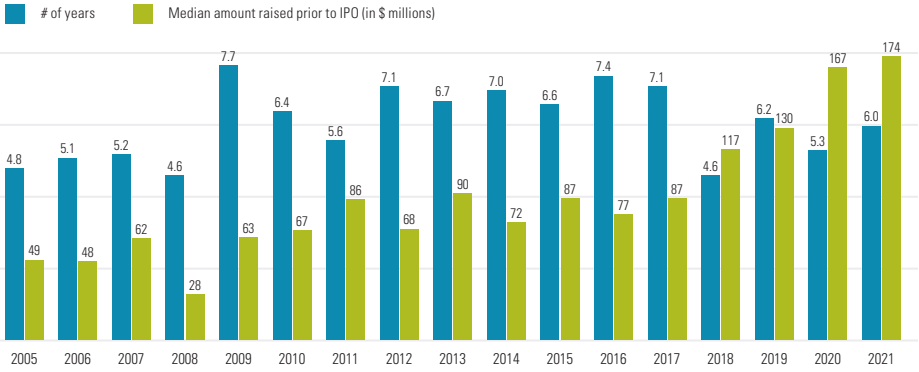
Percentage of Profitable IPO Companies—2005 to 2021

%



Source: SEC filings and IPO Vital Signs

Median Time to IPO and Median Amount Raised Prior to IPO—2005 to 2021



Source: Pitchbook

DIRECT LISTINGS

A "direct listing," in which a private company files a registration statement to register the resale of outstanding shares and concurrently lists its shares on a stock exchange, provides an alternative path to public ownership and liquidity. There were six direct listings in 2021, up from three in 2020, two in 2019, and one—the first direct listing—in 2018. Although the technique remains in its infancy, more can be expected in the coming year.

York (33 IPOs), Massachusetts (31 IPOs), Texas (16 IPOs) and Florida (15 IPOs).

OUTLOOK

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

— ***Economic Growth***: Following strong GDP increases in the first and second quarters of 2021, economic growth slowed to a tepid 2.3% in the third quarter, hampered by pandemic concerns and persistent bottlenecks in the supply chain. A rebound in the fourth quarter helped buoy annual GDP growth, resulting in initial estimates of 5.7% for the year—the highest annual growth rate since 1984. Although the fluctuations in quarterly GDP point to a skittish economy that remains closely tied to COVID-19 infection levels, the widespread availability of vaccines and the development of new treatments provide hope for a "new normal." Apart from the pandemic, the economy also faces the headwinds of rising interest rates, inflationary pressures and, more recently, the economic fallout from Russia's invasion of Ukraine.

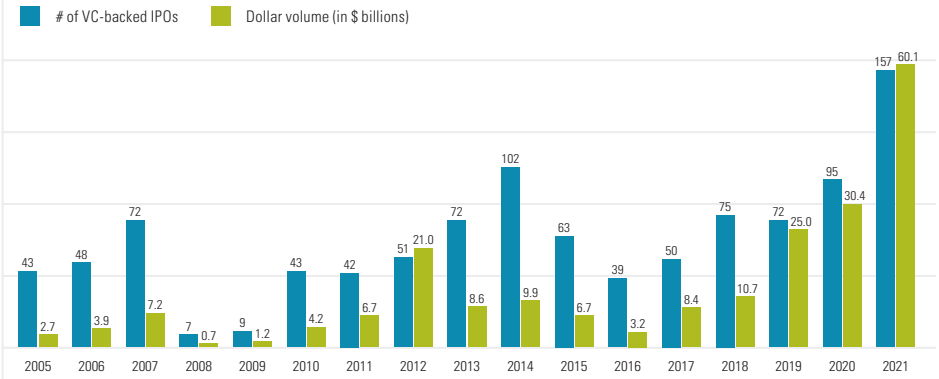
— ***Capital Market Conditions***: Despite market declines in the third quarter and apprehension following the emergence of each new COVID-19 variant, all major US stock indices ended the year in positive territory, with the Dow Jones Industrial Average up 19%, the Nasdaq Composite Index up 21% and the S&P 500 up 27%. With the median US IPO having outperformed the Dow and Nasdaq in only one of the last five years, some investor interest could shift from IPOs to pre-IPO opportunities.

— ***Venture Capital Pipeline***: VC-backed companies enjoyed a record level of investment in 2021, with more than twice as many rounds of at least $100 million than in 2020. While the ability to raise private "IPO-sized" rounds has become almost routine, allowing companies to delay their public debuts, the desire of investors for cash returns—combined with the favorable returns realized on many VC-backed IPOs in recent years—is likely to draw a steady stream of VC-backed companies to the public markets in 2022.

— ***Private Equity Impact***: Restocked with $475 billion of new capital in 2021, US private equity firms continue to hold large amounts of "dry powder" to deploy. The enormous amount of capital flowing into the PE market and the surge in SPAC IPOs has intensified competition for attractive deals and driven up prices, making it harder for PE firms to allocate investments 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 IPO market enters 2022 with a pipeline full of well-funded candidates and investors eager to embrace companies with exciting business models and new technologies. Although it will be difficult to top the IPO deal flow of 2021, robust capital market activity can be expected in the coming year.

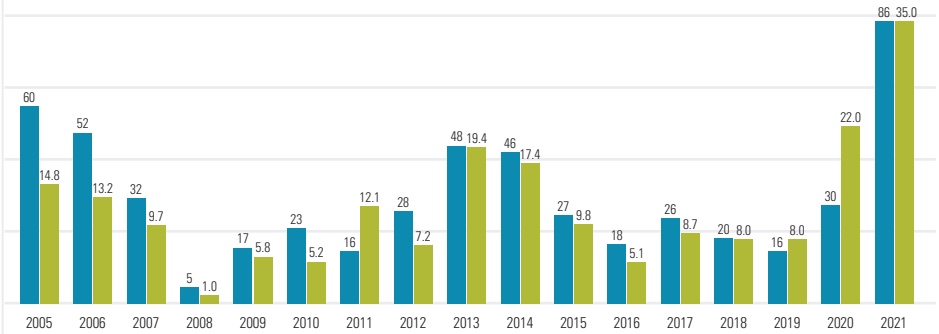
Venture Capital–Backed IPOs—2005 to 2021



Source: SEC filings

Based on US IPOs by VC-backed US issuers

Private Equity–Backed IPOs—2005 to 2021



Source: Refinitiv and SEC filings

Based on US IPOs by PE-backed US issuers

SPAC IPOS

In 2021, there were 613 SPAC IPOs with gross proceeds of $144.54 billion, more than double the 2020 tally of 248 SPAC IPOs with gross proceeds of $75.73 billion, and ten times the 2019 tally of 59 SPAC IPOs with gross proceeds of $12.07 billion. Deal flow in the SPAC IPO market outpaced the conventional IPO market for the second consecutive year, while SPAC IPO gross proceeds exceeded the conventional IPO market for the first time.

The first quarter of 2021 accounted for almost one-half of the year's total, with 298 SPAC IPOs raising $87.01 billion. Pricing activity declined sharply in the second quarter before rebounding in the third and fourth quarters. At year-end, 574 SPACs were searching for a business combination and another 272 SPACs were in IPO registration.

CALIFORNIA

The number of California IPOs increased for the fifth consecutive year, growing by 87%, from 52 in 2020 to 97 in 2021—the highest yearly count since the 131 IPOs in 2020.

Buoyed by eleven billion-dollar offerings, including the largest US IPO since 2014, gross proceeds increased by 92%, from $24.70 billion in 2020 to a record annual total of $47.36 billion in 2021.

The largest California IPO in 2021 came from electric vehicle maker Rivian Automotive ($11.93 billion), followed by offerings from Robinhood Markets ($2.09 billion), Applovin ($2.00 billion) and Olaplex ($1.55 billion).

Technology and life sciences companies accounted for 78% of the state's IPO total in 2021—down from their 90% share in 2020.

The number of venture-backed California IPOs increased from 42 in 2020 to 69 in 2021. The 2021 tally represents 44% of all US-issuer VC-backed IPOs, the same as in 2020 and just over the 43% that prevailed during the five-year period from 2015 to 2019.

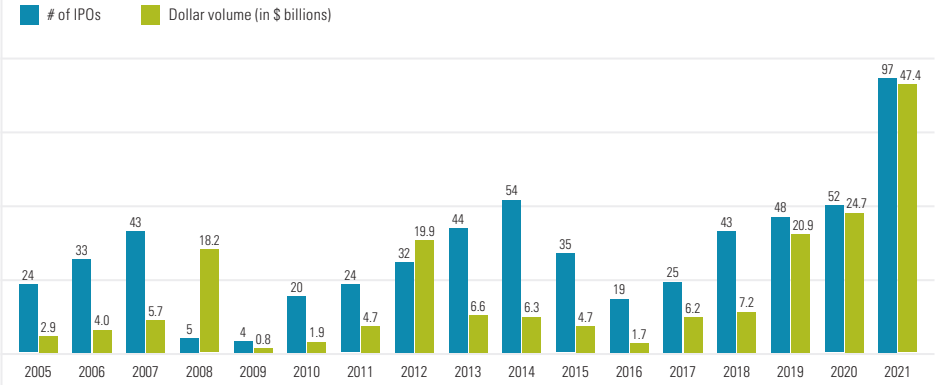
The median 2021 California IPO produced a first-day gain of 16%. Nano-cap cinema equipment maker Moving iMage was the state's top performer with a first-day gain of 700%, followed by Poshmark (up 142%), DICE Therapeutics (up 117%) and Design Therapeutics (up 107%).

At year-end, 60% of the state's 2021 IPOs were trading below their offering price, with the median California IPO down 14% from its offering price.

The best-performing California IPO of the year was Vera Therapeutics (up 143% at year end), followed by Confluent (up 112%), Prometheus Biosciences (up 108%) and Affirm Holdings (up 105%).

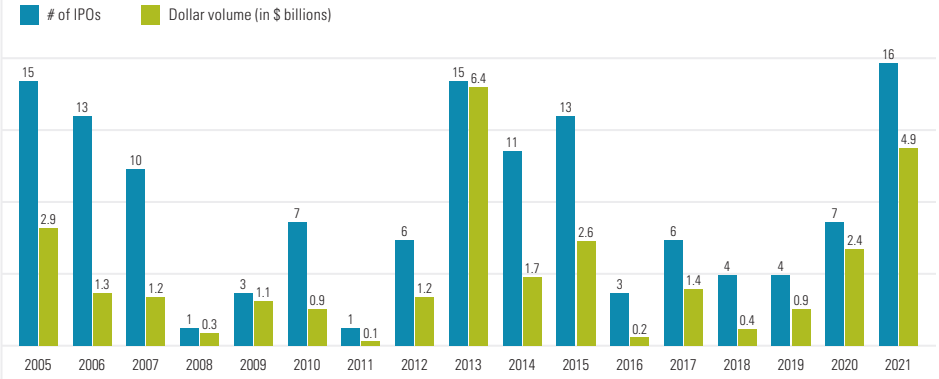
With the largest pool of venture capital–backed companies in the United States and a wealth of entrepreneurial talent, California should remain a major source of strong IPO candidates in the coming year, particularly from the technology and life sciences sectors.

California IPOs—2005 to 2021



Source: SEC filings

Mid-Atlantic IPOs—2005 to 2021



Source: SEC filings

MID-ATLANTIC

The mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia produced 16 IPOs in 2021, up from seven in 2020 and the highest annual tally since the 24 in 2000.

North Carolina produced six of the region's IPOs in 2021, with Maryland and Virginia each contributing five.

Gross proceeds in the mid-Atlantic region more than doubled for the second consecutive year, growing from $2.38 billion in 2020 to $4.86 billion in 2021.

The largest mid-Atlantic IPOs of 2021 came from Virginia-based Fluence Energy ($868 million), followed by a trio of North Carolina–based companies—Driven Brands ($700 million), AvidXchange ($660 million) and Krispy Kreme ($500 million).

The median 2021 mid-Atlantic IPO produced a first-day gain of 22%, led by Xometry (up 99%), Privia Health (up 51%) and Neximmune (up 49%).

At year-end, in contrast to nationwide results, 56% of the region's 2021 IPOs were trading above their offering price, with the median mid-Atlantic IPO trading up 10%. The region's best-performing IPOs at year-end were Driven Brands Holdings (up 53%), Bowman Consulting Group (up 52%) and Fluence Energy (up 27%).

The region's traditional strengths in the life sciences, technology, financial services and defense sectors should continue to produce attractive IPO candidates in 2022.

NEW ENGLAND

After nearly doubling between 2019 and 2020, the number of New England IPOs increased at a more measured pace in 2021, climbing 17%, from 29 in 2020 to 34.

Massachusetts accounted for all but three of the region's IPOs in 2021—the state's tally of 31 IPOs was the third-highest state total in the country—with Connecticut accounting for the remaining three.

Gross proceeds in the region, which had more than tripled between 2019 and 2020, inched up 3%, from $6.28 billion in 2020 to $6.47 billion in 2021.

The largest New England IPO in 2021 was by Toast ($870 million), provider of a cloud-based software and payments platform for the restaurant industry, followed by Signify Health ($564 million) and Definitive Healthcare ($420 million).

With 27 life sciences company IPOs in 2021, the region accounted for 25% of all US-issuer life sciences IPOs in the country, compared to 30% in 2020.

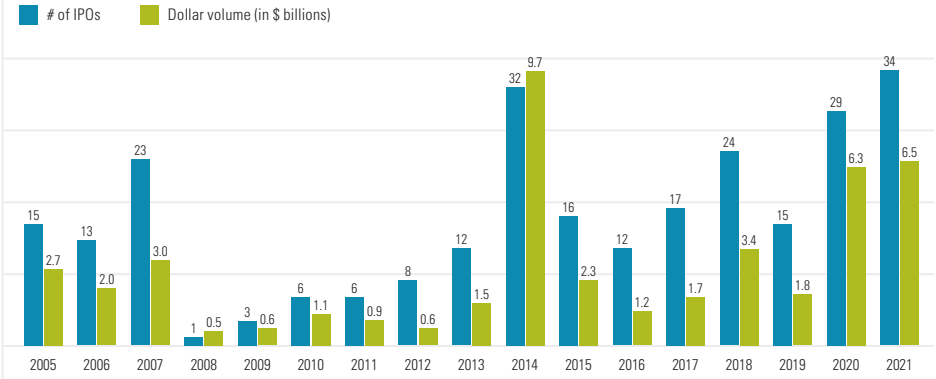
The number of venture-backed New England IPOs increased from 26 in 2020 to 30 in 2021. The region accounted for 19% of all US-issuer VC-backed IPOs in 2021, down from 27% in 2020.

The median 2021 New England IPO produced a first-day gain of 17%. The region's top performers in first-day trading were Vor Biopharma (up 108% from its offering price), Ikena Oncology (up 100%) and Verve Therapeutics (up 68%).

At year-end, the median New England IPO was down 21% from its offering price, with 74% of the region's IPOs trading below their offering price. The best-performing New England IPOs at year-end were Verve Therapeutics (up 94%), Flywire (up 59%) and SEMrush Holdings (up 49%).

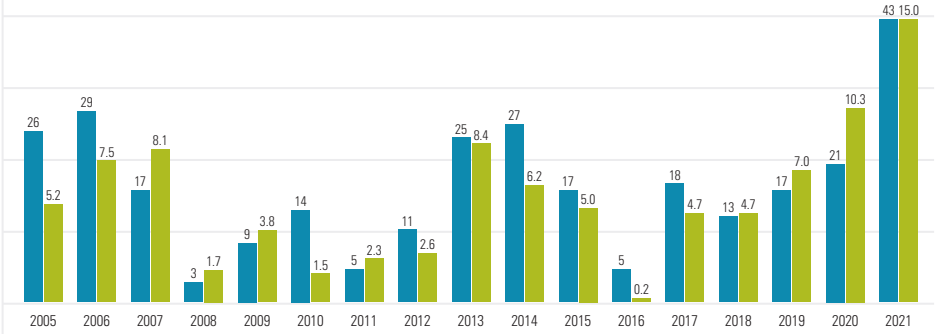
With the region's world-renowned universities and research institutions continuing to spawn tech and life sciences companies, and with strong levels of venture capital investment, New England should continue to generate compelling IPO candidates in the coming year.

New England IPOs—2005 to 2021



Source: SEC filings

Tri-State IPOs—2005 to 2021



Source: SEC filings

TRI-STATE

The number of IPOs in the tri-state region of New York, New Jersey and Pennsylvania more than doubled, from 21 in 2020 to 43 in 2021.

New York produced 33 of the region's 2021 IPOs, representing the second-highest state total in the country for the first time since 2013, with Pennsylvania accounting for six and New Jersey the remaining four.

Gross proceeds from tri-state IPOs increased by 46%, from $10.26 billion in 2020 to $15.01 billion in 2021, led by GlobalFoundries ($2.59 billion), Oscar Health ($1.44 billion) and UiPath ($1.34 billion).

The tri-state region produced 20 VC-backed IPOs in 2021, up from 12 the prior year and its highest tally since 1999.

The median 2021 tri-state IPO produced a first-day gain of 6%. The region's top performers in first-day trading were Glimpse Group (up 152% from its offering price), Stronghold Digital Mining (up 52%) and Braze (up 44%).

At year-end, the median tri-state IPO was down 25% from its offering price. The best performing tri-state IPO was by authentication solutions provider authID.ai (up 100% from its offering price at year-end), followed by DigitalOcean Holdings (up 71%) and Hayward Holdings (up 54%).

With a high level of venture capital activity and a sophisticated capital markets ecosystem in the region, the coming year should see tri-state IPOs from 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 IPO companies. 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 public company life, 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, such as life sciences and medical devices, patents are *de rigueur.*
- **Substantial Revenue:** Substantial revenue is generally 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 have visibility into sustained 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. Substantial post-IPO ownership by insiders may mean a larger market cap is required to provide ample float.

HOW DO YOU COMPARE?

Set forth below are selected key metrics about the IPO market, based on combined data for all US IPOs during the three-year period from 2019 through 2021.

Percentage of IPO companies qualifying as EGCs under JOBS Act	92%
Median offering size	$163.9 million (18% below $50 million and 17% above $500 million)
Median annual revenue of IPO companies	$59 million (48% below $50 million and 15% above $500 million)
Percentage of IPO companies that are profitable	27%
State of incorporation of IPO companies	Delaware—95% No other state over 3%
Percentage of IPOs including selling stockholders, and median percentage of offering represented by those shares	Percentage of IPOs—20% Median percentage of offering—32%
Percentage of IPOs including directed share programs, and median percentage of offering represented by those shares	Percentage of IPOs—44% Median percentage of offering—5%
Percentage of IPO companies disclosing adoption of ESPP	69%
Percentage of IPO companies using a "Big 4" accounting firm	74%
Stock exchange on which the company's common stock is listed	Nasdaq—78% NYSE—22%
Median underwriting discount	7%
Number of SEC comments contained in initial comment letter	Median—16 25th percentile—12 75th percentile—21
Median number of Form S-1 amendments (excluding exhibits-only amendments) filed before effectiveness	Four
Time elapsed from initial confidential submission to initial public filing of Form S-1	Median—72 calendar days 25th percentile—56 calendar days 75th percentile—106 calendar days
Time elapsed from initial confidential submission or initial public filing to effectiveness of Form S-1	Median—104 calendar days 25th percentile—83 calendar days 75th percentile—158 calendar days
Median offering expenses	Legal—$1,800,000 Accounting—$1,032,500 Total—$3,873,750

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. ■

SEC and stock exchange rules impose a variety of independence and other requirements for boards and board committees of public companies, and some states now impose additional diversity requirements. Few private companies satisfy all these requirements. An essential element of a company's IPO planning is to assess the composition of the company's board and board committees and develop a plan to come into full compliance with the applicable requirements within the prescribed timelines.

Although phase-in rules apply to many of these requirements, a company planning to go public ideally should begin discussing potential changes in board composition that may be needed to satisfy all the requirements at least six to twelve months before the IPO. Time will be needed to recruit new members, particularly diverse directors.

Companies are often surprised by how challenging it can be to recruit new directors. This task has increased in difficulty due to a variety of factors, including more stringent independence requirements, the heavier workloads now expected of directors, a perception of increased personal exposure to liability and, most recently, stricter investor policies against director "over-boarding" (several major institutional investors will vote against a director if that director sits on more than four boards or, in the case of a director who is an executive officer, sits on more than two boards). The company should also plan for the possibility that existing directors affiliated with venture capital or private equity investors may want to leave the board shortly following the IPO.

BOARD OF DIRECTORS

— ***Independence:*** Subject to phase-in rules, Nasdaq and NYSE require a majority of the members of the board, and all members of the audit, compensation, and corporate governance and nominating committees, to be independent within one year after the company's IPO.

— ***Determination of Independence:*** In order for a director to be considered independent, Nasdaq and the NYSE require that:

- the director not have any relationship with the company that would be prohibited by that stock exchange's "bright-line" independence standards; and
- the board, after taking into account all relevant information, affirmatively determine that the director is independent.

— ***Impact of Stock Ownership:*** Stock ownership, regardless of how high the level, is generally not viewed as an impediment to independence (but may preclude service on the audit committee, as noted below).

— ***Diversity:*** Nasdaq rules and state law requirements impose board diversity requirements in some circumstances:

- ***Nasdaq:*** Subject to phase-in rules, a company listing on Nasdaq in connection with an IPO must have—or explain why it does not have—at least two diverse directors (including one female and one underrepresented minority or LGBTQ+) by the later of two years from the date of listing or the date it files a proxy statement for its second annual meeting of stockholders.
- ***State Laws:*** Depending on board size, California requires public companies headquartered in California to have up to three female directors (requirement became effective at the end of 2021) and up to three directors from

INDEPENDENCE PHASE-IN RULES

ELEMENT	NASDAQ	NYSE
Independent board of directors	The board must be composed of a majority of independent directors within one year of the listing date.	
Audit Committee	The audit committee must have at least one independent member by the listing date, at least a majority of independent members within 90 days of listing, and must be fully independent within one year of listing.[1]	The audit committee must have at least one independent member by the listing date, at least a majority of independent members within 90 days of the effective date of its Form S-1, and must be fully independent within one year of the effective date of the Form S-1.
Compensation Committee	The compensation committee must have at least one independent member by the listing date, at least a majority of independent members within 90 days of listing, and must be fully independent within one year of listing.	The compensation committee must have at least one independent member by the earlier of the date the IPO closes or five business days from the listing date, at least a majority of independent members within 90 days of the listing date, and must be fully independent within one year of the listing date.
Nominating Committee	If the company elects to establish a nominating committee, the committee must have at least one independent member by the listing date, at least a majority of independent members within 90 days of listing, and must be fully independent within one year of listing.	The nominating committee must have at least one independent member by the earlier of the date the IPO closes or five business days from the listing date, at least a majority of independent members within 90 days of the listing date, and must be fully independent within one year of the listing date.

[1] Nasdaq also has a temporary "exceptional and limited circumstances" exception for one non-independent member. This exception allows one director who is independent under Rule 10A-3 but not independent under the general Nasdaq standard, and who is not a current executive officer or employee of the company (or a family member of a current executive officer of the company), to serve on the audit committee for up to two years if the board determines that such service is required by the best interests of the company and its stockholders. A person serving on the audit committee under this exception may not chair the audit committee. Similar exceptions apply to the compensation and nominating committees of Nasdaq-listed companies. Very few companies take advantage of these exceptions.

"underrepresented communities" by the end of 2022. Washington requires public companies incorporated in Washington (subject to several exceptions, including for emerging growth companies, smaller reporting companies and controlled companies) to have boards on which at least 25% of the members are women or to provide a "board diversity discussion and analysis" to stockholders. Various other states are considering similar board quota and/or diversity disclosure requirements. (Board diversity is discussed further on pages 12–13.)

— ***Size:*** Neither SEC, Nasdaq nor NYSE rules stipulate board size.

AUDIT COMMITTEE

— ***General:*** Subject to phase-in rules, Nasdaq and NYSE require listed companies to have an audit committee composed of at least three members of the board of directors, each of whom is (1) independent within the meaning of the general Nasdaq or NYSE rules described above and (2) independent within the stricter meaning of SEC Rule 10A-3.

— ***"Super Independence":*** Rule 10A-3 precludes a person from serving on the audit committee if the person:

- accepts, directly or indirectly, any consulting, advisory or other compensatory fees from the company (other than compensation for board service and certain retirement compensation); or
- is an "affiliate" of the company (a person who, directly or indirectly, controls, is controlled by, or is under common control with, the company).

— ***Impact of Stock Ownership:*** A person can be an "affiliate" due to large stock ownership. Rule 10A-3 contains a safe harbor for ownership of 10% (post-offering) or less. Ownership of 20% (post-offering) is generally viewed as the upper bound, although even higher examples exist.

— ***Financial Literacy:*** Nasdaq and NYSE rules require each member of the audit committee to be financially literate, with at least one member having experience in finance or accounting.

— ***Audit Committee Financial Expert:*** Each public company is required to disclose annually whether or not its audit committee has at least one member who is an "audit committee financial expert," as defined in SEC rules, and, if not, to explain why it does not. This effectively requires every public company to have an audit committee financial expert.

— ***Size***: Nasdaq requires the audit committee to have a minimum of three members at all times. NYSE requires the audit committee to have at least one member by the listing date, at least two members within 90 days of the listing date, and at least three members within one year of the listing date.

COMPENSATION COMMITTEE

— ***General:*** Nasdaq and NYSE require listed companies to have a compensation committee composed of members of the board of directors who are independent within the meaning of the general Nasdaq or NYSE rules described above.

— ***"Enhanced Independence":*** Nasdaq and the NYSE require that, in determining the independence of members of the compensation committee, the board must consider all factors relevant to whether a director has a relationship that is material to that director's ability to be independent of management, including:

- the source of compensation of such director, including any consulting, advisory or other compensatory fees paid by the company to such director; and
- whether such director is affiliated with the company.

— ***Impact of Stock Ownership:*** Nasdaq and the NYSE have indicated that ownership of company stock, even if it represents a controlling interest, does not automatically disqualify a director from service on the compensation committee.

— ***Rule 16b-3:*** Section 16(b) of the Securities Exchange Act of 1934 requires directors, executive officers and 10% stockholders to disgorge to the company any "profit" realized through any purchase and sale (or any sale and purchase) of equity securities of the company within a period of less than six months. SEC Rule 16b-3 provides that the grant of a stock option or other equity compensation

BRIGHT-LINE INDEPENDENCE STANDARDS

While there are some differences between the bright-line independence standards of Nasdaq and the NYSE, as a general matter a person cannot be considered independent if:

— he or she is, or at any time during the past three years was, an employee of the company;

— his or her family member is, or at any time during the past three years was, an executive officer of the company, with an exception for interim service as an executive officer (for a period not exceeding one year under Nasdaq rules; NYSE rules do not specify a maximum period of interim service);

— he or she (or a family member) has, or at any time during the past three years had, a "compensation committee interlock," which exists when an executive officer of Company A serves on the compensation committee of Company B at the same time that a director of Company A (or his or her family member) serves as an executive officer of Company B;

— he or she (or a family member) has, or at any time during the past three years had, certain specified relationships with the company's auditor, including the company's internal auditor in the case of the NYSE;

— he or she (or a family member) has certain specified relationships with another entity that, in the past three years, received payments from or made payments to the company for property or services in excess of:

- in the case of Nasdaq, the greater of $200,000 and 5% of the recipient's gross revenues for that year; or
- in the case of the NYSE, the greater of $1 million and 2% of the other company's gross revenues for that year; or

— he or she (or a family member) received compensation from the company in excess of $120,000 during any twelve-month period within the past three years, other than compensation for service on the board or a board committee, compensation paid to a family member as a non-executive employee, and certain other exempted payments.

award will not be considered a matchable purchase if the grant is approved by a board committee consisting of two or more directors, each of whom is a "non-employee director" within the meaning of Rule 16b-3. Although workarounds exist, it is desirable for each member of the compensation committee to qualify as a "non-employee director."

- *Size:* Nasdaq requires that the compensation committee consist of at least two directors, while the NYSE does not specify a minimum number of members.

OTHER STANDING COMMITTEES

Post-IPO, public company boards—particularly among larger companies—sometimes voluntarily create other standing committees to help fulfill board duties. According to the 2021 U.S. Spencer Stuart Board Index, among S&P 500 companies, the average number of standing board committees is 4.2, with the following prevalence:

- Executive committee—27% (down from 33% in 2016)
- Finance committee—27% (down from 31% in 2016)
- Science and technology committee—13% (up from 9% in 2016)
- Risk committee—12% (unchanged from 2016)
- Environment, health and safety committee—11% (up from 7% in 2016)
- Public policy/social and corporate responsibility committee—7% (down from 10% in 2016)
- Legal/compliance committee—6% (up from 5% in 2016)
- Investment/pension committee—3% (unchanged from 2016)
- Acquisitions/corporate development committee—2% (unchanged from 2016)
- Strategy and planning committee—2% (unchanged from 2016)

The 200 public technology companies covered by the 2021 U.S. Technology Spencer Stuart Board Index have fewer standing board committees on average than S&P 500 companies and are less likely to have most types of standing committees covered by both reports.

CORPORATE GOVERNANCE AND NOMINATING COMMITTEE

- *NYSE:* NYSE rules require each listed company to have a nominating or corporate governance committee composed solely of independent directors under the NYSE's general definition of independence.
- *Nasdaq:* Although not mandating that each listed company establish a nominating or corporate governance committee, Nasdaq rules require director nominees to be selected, or recommended for selection by the board, by either a nominating committee composed solely of independent directors or by a majority of the independent members of the board. Most Nasdaq-listed companies elect to have a nominating and corporate governance committee to satisfy this requirement.
- *Size:* Neither NYSE nor Nasdaq prescribe any minimum size for the nominating and corporate governance committee.

EXEMPTIONS

- *Controlled Companies:* A controlled company is exempt from the requirements that a majority of the directors be independent and that the board maintain a separate compensation committee and a separate corporate governance and nominating committee (or, in the case of Nasdaq, have a majority of the independent directors make nominations). A controlled company is not exempt from audit committee requirements.
- *Smaller Reporting Companies:* A smaller reporting company is required to comply with all director independence and board committee requirements, except that it is exempt from the "enhanced independence" requirements for compensation committee members mandated by the Dodd-Frank Act.
- *Foreign Private Issuers:* A foreign private issuer is permitted to follow its home-country practices in lieu of some corporate governance requirements as long as it satisfies Exchange Act requirements for audit committees and makes public disclosure of the home-country practices it follows. A foreign private issuer is also exempt from the requirements that a majority of the directors be independent and that the board maintain a separate compensation committee and a separate corporate governance and nominating committee (or, in the case of Nasdaq, have a majority of the independent directors make nominations).

DEFINITIONS

For purposes of various exemptions, the following definitions apply:

- Controlled Company: A company in which a majority of the voting power for the election of directors is held by an individual, a group, or another company.
- Smaller Reporting Company: A company that, as of the last business day of its most recently completed second fiscal quarter, has a public float of less than $250 million or, if the company has a public float of less than $700 million or has no public float, had less than $100 million in revenue in its most recent fiscal year.
- Foreign Private Issuer: A company organized under the laws of a foreign country and in which 50% or less of its outstanding voting securities are directly or indirectly owned of record by US residents, or in which a majority of its executive officers or directors are not US citizens or residents, a majority of its assets are not located in the United States and its business is not administered principally in the United States.
- Emerging Growth Company: A company that had total annual gross revenues of less than $1.07 billion (subject to adjustment every five years for inflation, with the next adjustment due in April 2022) during its most recently completed fiscal year. A company's EGC status lasts until the last day of the fiscal year following the fifth anniversary of its IPO, subject to earlier termination in specified circumstances.

An important threshold question for an IPO company that qualifies for exemptions from corporate governance requirements is whether to take advantage of the exemptions, as the absence of these investor protections may be perceived negatively in the market and adversely affect the marketing of the offering. ■

Board Diversity Planning Now Part of the IPO Process

In recent years a variety of stakeholders have become increasingly vocal in advocating for more diversity on public company boards. The efforts to increase board diversity—by securities regulators, stock exchanges, proxy advisory firms, institutional investors, state legislatures, and even investment bankers, among others—have gained traction and now affect both the IPO process and life as a public company.

Recruitment of new directors has always been on the checklist when preparing for life as a public company, primarily to satisfy stock exchange independence requirements. The recruitment of diverse board candidates is now also an important part of that checklist, and could even impact the company's choice of lead IPO underwriter.

Recruiting new directors is not a new challenge in the IPO process—time is needed to identify and vet suitable candidates. Recruiting new diverse directors can be especially challenging due to the large number of public companies currently seeking to enhance their board diversity. Regardless of whether a search firm is used to increase the pool of candidates, the process of identifying new directors typically involves an unexpectedly large amount of board time and effort.

Accordingly, companies should begin thinking about the recruitment of diverse directors as soon as they conclude that an IPO is a realistic goal. While securing new directors is not an absolute requirement for an IPO, starting the recruitment process early enough that new directors can be onboarded before the IPO will likely accelerate their integration into the fabric of the board.

SEC RULES

An SEC rule requires public companies to disclose in their proxy statement whether—and if so, how—diversity is considered in identifying director nominees. The SEC left it to each company to determine how it defines diversity when adopting this requirement. In partial response to this SEC rule and other efforts to increase the gender diversity of boards, many public companies now include in their corporate governance guidelines a statement about giving consideration to diversity in evaluating director candidates and requiring the same of any third parties hired to conduct a director search.

During 2022, the SEC is expected to propose several ESG-related rule changes, including enhanced disclosure requirements regarding board diversity.

NASDAQ RULES

In August 2021, the SEC approved new Nasdaq rules that, subject to a phase-in period, require every Nasdaq-listed company to:

- have—or explain why it does not have—at least two board members who are diverse, including one who self-identifies as female and one who self-identifies as an underrepresented minority or LGBTQ+; and
- publicly disclose, at least once per year, in a standardized matrix format prescribed by Nasdaq, aggregated information on the voluntarily self-identified gender, racial/ethnic and LGBTQ+ status of the company's directors, to the extent permitted by applicable law.

Less stringent thresholds apply for foreign issuers, smaller reporting companies, and boards with five or fewer members. SPACs that have not completed a business combination transaction are exempt from the rules.

A company going public is not required to be in compliance with the rules at the time of its IPO or to include in the Form S-1 any diversity information pursuant to the rules. Instead, following completion of the initial phase-in period, a company listing on Nasdaq in connection with an IPO generally must have—or explain why it does not have—at least one diverse director by the later of one year from the date of listing or the date the company files a proxy statement for its first annual meeting of stockholders and at least two diverse directors by the later of two years from the date of listing or the date it files a proxy statement for its second annual meeting of stockholders.

PROXY ADVISOR POLICIES

The two leading proxy advisory firms, ISS and Glass Lewis, have each adopted voting policies relating to board diversity.

For Russell 3000 and S&P 1500 companies, ISS will generally recommend voting

FORMAT OF NASDAQ ANNUAL DISCLOSURE REQUIREMENT

BOARD DIVERSITY MATRIX (AS OF [DATE])				
Total Number of Directors	#			
	Female	Male	Non-Binary	Did Not Disclose Gender
PART I: Gender Identity				
Directors	#	#	#	#
PART II: Demographic Background				
African American or Black	#	#	#	#
Alaskan Native or Native American	#	#	#	#
Asian	#	#	#	#
Hispanic or Latinx	#	#	#	#
Native Hawaiian or Pacific Islander	#	#	#	#
White	#	#	#	#
Two or More Races or Ethnicities	#	#	#	#
LGBTQ+	#			
Did Not Disclose Demographic Background	#			

against the chair of the nominating committee where there are no women on the board or where there are no racially or ethnically diverse members. That recommendation could extend to other directors on a case-by-case basis. Beginning in 2023, ISS plans to apply its gender diversity policy to all companies.

For Russell 3000 companies, Glass Lewis will generally recommend voting against the nominating committee chair of a board with fewer than two gender diverse directors and against the entire nominating committee of a board with no gender diverse directors. For annual meetings held after January 1, 2023, Glass Lewis will move from a fixed numerical approach and will recommend voting against the nominating committee chair of a board at a Russell 3000 company that has less than 30% gender diversity. In addition, Glass Lewis will recommend voting against the chair of the nominating and/or governance committee of S&P 500 companies that provide insufficient board diversity disclosure. Glass Lewis will also make recommendations in accordance with mandatory board composition requirements set forth in applicable state laws.

INSTITUTIONAL INVESTOR POLICIES

The three largest institutional stockholders—BlackRock, State Street Global Advisors and Vanguard—each include a separate section on board diversity in their voting guidelines and have increased their engagement with public companies about board diversity in recent years. While the views of these investors largely overlap with other diversity requirements, their influence on proxy voting should be considered by companies building their boards.

STATE LAW REQUIREMENTS

States are playing an increasingly active role in promoting board diversity among companies that are incorporated under their laws or satisfy other criteria. For example, California and Washington mandate specified levels and types of board diversity, while Illinois, Maryland and New York mandate disclosure regarding board diversity. Other states are considering mandatory board diversity legislation, or have adopted (or are considering) non-binding resolutions urging public companies to increase board diversity. This is a quickly evolving area; companies need to monitor developments in applicable states to remain in compliance.

IPO PROCESS AND INVESTMENT BANKERS

Because the operative characteristics of diversity extend beyond visible attributes, companies should consider adding self-identification questions to their director recruiting documents and IPO director questionnaires.

While diversity self-identification is customary in the employee hiring process, it has only recently migrated to the director recruitment process.

Goldman Sachs has formally acknowledged the importance of board diversity in its client engagement policies. In February 2020, Goldman announced that it will only underwrite IPOs of companies that have at least one diverse board member and, starting in 2021, would "raise this target to two diverse candidates for each of our IPO clients." While no other bulge-bracket investment banks have followed Goldman's lead, the momentum created by the various other stakeholders discussed above is driving all companies considering an IPO to give more thought to board diversity. ■

INSTITUTIONAL INVESTOR BOARD DIVERSITY POLICIES

Blackrock	Blackrock assesses a board's diversity in the context of a company's domicile, business model and strategy. Blackrock believes boards should aspire to 30% diversity of membership and encourages companies to have at least two directors who identify as female and at least one who identifies as a member of an underrepresented group (defined as individuals who identify as Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, or Native Hawaiian or Pacific Islander; individuals who identify as LGBTQ+; individuals who identify as underrepresented based on national, indigenous, religious or cultural identity; individuals with disabilities; and veterans). Blackrock requests boards to disclose: (a) the aspects of diversity that the company believes are relevant to its business and how the diversity characteristics of the board, in aggregate, are aligned with the company's long-term strategy and business model; (b) the process by which candidates are identified and selected, including whether professional firms or other resources outside of incumbent directors' networks have been engaged to identify and/or assess candidates, and whether a diverse slate of nominees is considered for all available board nominations; and (c) the process by which boards evaluate themselves and any significant outcomes of the evaluation process, without divulging inappropriate and/or sensitive details.
State Street	For Russell 3000 companies, State Street may vote against the nominating committee chair or the board leader, in the absence of a nominating committee, if a company doesn't have at least one female board member. Additionally, if a company fails to meet this expectation for three consecutive years, State Street may vote against all incumbent members of the nominating committee. If a company in the S&P 500 does not disclose the gender, racial and ethnic composition of its board, or does not have at least one director from an underrepresented racial or ethnic community, State Street will vote against the nominating committee chair.
Vanguard	Vanguard will generally vote against the nominating and/or governance committee chair (or other director if needed) if a company's board is making "insufficient progress" in its diversity composition and/or in addressing its board diversity-related disclosures. The factors Vanguard will consider include applicable market regulations and expectations, along with additional company-specific context. Vanguard also believes that board composition should appropriately represent the company's markets and long-term strategic needs, and that boards should demonstrate how they intend to continue making progress.

Duty of Oversight Is Mission Critical for Boards

Recent Litigation Highlights Importance of Reporting Systems

While the fiduciary duties of directors and officers are the same whether a company is privately owned or publicly traded, the risk of claims by dissatisfied stockholders alleging breaches of these fiduciary duties becomes much more significant once the company is public.

One particular type of breach of fiduciary duty claims—those based on an alleged failure of the board's duty of oversight—has become especially common in recent years, and highlights how important it is for the board of an IPO company to ensure the company has appropriate reporting systems and controls and procedures in place from its first day as a public company.

WHAT IS REQUIRED?

The duty of oversight requires directors to make a good faith effort to implement an oversight system and then monitor it. Allegations that directors violated their duty of oversight are often referred to as *Caremark* claims, after a landmark 1996 case involving that company.

Oversight liability can arise if either:

- the directors utterly fail to implement any reporting or information system or controls ("failure to implement" claims); or
- having implemented such a system or controls, the directors consciously fail to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention ("failure to follow-up" claims).

While *Caremark* claims have historically been described as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," since mid-2019 Delaware courts have allowed *Caremark* claims to proceed in at least six cases in which the court determined that the plaintiffs adequately alleged that directors had abdicated their oversight responsibility by failing to implement and/or monitor an oversight system.

RECENT CASES ALLOWING *CAREMARK* CLAIMS TO PROCEED

Most notably, in *Marchand v. Barnhill*, a case stemming from a listeria outbreak involving Blue Bell Creameries that resulted in three deaths and caused the company to recall all of its products, cease production at all plants and dismiss over one-third of its employees, the Delaware Supreme Court reversed the lower court's dismissal of a stockholder's *Caremark* claim. The allegations upon which the court allowed a "failure to implement" claim to proceed included that:

- food safety was the mission-critical compliance issue for Blue Bell;
- the board did not have a committee overseeing food safety;
- there was no board-level process to address food safety issues or protocol for advising the board of food safety reports and developments; and
- board minutes did not mention discussion about food safety concerns existing prior to the listeria outbreak or generally reflect discussion of food safety matters.

BOARD FIDUCIARY DUTIES

The fiduciary duties of directors and officers under Delaware law consist of:

- the ***duty of care***—an obligation to act on an informed basis after due consideration of relevant materials and appropriate deliberations; and
- the ***duty of loyalty***—an obligation to refrain from deriving a benefit from a transaction not generally available to all stockholders, and to otherwise act in good faith.

A board's duties are enhanced in the acquisition context, especially when the company is going to be acquired.

While almost every company going public will include in its charter a provision eliminating the personal monetary liability of directors (but not officers, as this is not authorized by the Delaware corporation statute) for violations of the duty of care, breaches of the duty of oversight are considered to be non-exculpable breaches of the duty of loyalty and directors who violate the duty of oversight may therefore face personal liability.

BOARD ACTIONS TO FULFILL OVERSIGHT OBLIGATIONS

Summarized below are some of the actions a board of directors can take to help fulfill and document its oversight obligations and minimize the risk of liability under the *Caremark* standards of liability.

To address its obligation to implement appropriate reporting or information systems or controls, the board should:

- Ensure management and the board each has a process for identifying and regularly reviewing key risks, and document those processes;
- Explicitly assign responsibility for oversight of key risks (either to the full board or a board committee) and include corresponding proxy disclosure once public; a separate risk committee is not required and has not become very common outside the financial services industry;
- Not rely solely on the existence of regulatory requirements—such as SEC or other reporting requirements, or FDA requirements for life sciences companies—as a basis for assuming an adequate reporting system exists;
- Avoid being completely dependent on management reporting, including by having the board (or designated board committee) hear directly from chief compliance and risk officers, and ensure there are systems in place for employees and corporate partners to raise concerns; and
- Establish an expectation and protocol for management to promptly report significant regulatory or compliance developments to the board (or designated board committee).

To address its obligation to monitor or oversee the operation of the systems or controls the board has implemented, the board (or designated board committee) should:

- Be vigilant for warning signs (often referred to as yellow or red flags) and follow up when identified, including giving consideration to the engagement of outside advisors;
- Receive regular reports on key risk and regulatory issues;
- Ensure that meeting minutes demonstrate that the board (or designated board committee) is regularly exercising oversight and following up on potential concerns; and
- Exercise care in informal communications (such as emails and texts), because such materials may in some situations need to be produced in response to a books and records request.

Since *Marchand*, Delaware's Chancery Courts have allowed *Caremark* claims to proceed in cases involving, among others, a life sciences company whose lead product candidate suffered from a low confirmed success rate and ultimately ran into FDA problems; an auto parts manufacturer that had persistent problems with internal controls and oversight of related person transactions ultimately requiring it to restate its financial statements; and a pharmaceutical company whose subsidiary engaged in, and ultimately pleaded guilty to, criminal activities relating to the inappropriate repacking of oncology drugs into syringes.

NO ONE-SIZE-FITS-ALL APPROACH TO OVERSEEING RISK

Discharging their duty of oversight requires directors to do more than rely on government regulation of a company's industry or general discussions of operational issues 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 company's key risks, especially those that relate to "mission-critical" regulatory matters, legal compliance and public safety.

There is no one-size-fits-all approach. 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. For example, the board of a life sciences company is not required to have a shadow regulatory group or to hire independent external experts as long as the board itself includes directors with sufficient experience in the areas of key regulatory risk faced by the company, but FDA and other regulatory matters should be on the agenda for every regular board meeting.

DO YOUR WORK AND DOCUMENT IT

Practically speaking, directors need to be able to demonstrate that they have been proactive in discharging their risk oversight responsibilities. This generally means being able to show that:

- the company has sufficient reporting and compliance systems;
- regulatory and compliance issues are effectively reported to the board; and
- when issues are reported to the board, the board takes initiative to address such issues.

The importance of contemporaneously documenting the board's oversight, including in minutes of board meetings, has taken on increased significance given that it is now common for plaintiffs' lawyers to use information gathered through books and records requests in an effort to craft a complaint that is more likely to withstand a company's motion to dismiss. Under Section 220 of the Delaware General Corporation Law, a stockholder can demand inspection of a company's books and records by demonstrating, among other things, that the inspection is for a "proper purpose," such as to investigate wrongdoing by the board. Recent cases suggest that the scope of books and records access may be broadening, stockholder purposes are more likely to be found proper, and courts are more willing to consider awarding legal fees to stockholders when companies inappropriately refuse to produce documents.

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. ■

CAUTIONARY TALE FROM RECENT CAREMARK CLAIM

In October 2021, the Delaware Chancery Court dismissed claims against the directors of Marriott, a hospitality company that in 2018 discovered a data security breach perpetrated since 2014 through the reservation database of a hotel chain that Marriott acquired in 2016. The breach exposed the personal information of approximately 500 million guests.

In dismissing the plaintiff's "failure to implement" claims, the court concluded that none of the directors faced a substantial likelihood of liability because:

- Marriott's board consistently ranked cybersecurity as one of the company's primary risks;
- The board and its audit committee were routinely apprised of cybersecurity risks and mitigation efforts and received annual reports that specifically evaluated cyber risks;
- The company engaged outside consultants to improve, and auditors to audit, its corporate cybersecurity practices; and
- Management provided the board with the information and reports plaintiff described as red flags.

The court also dismissed the plaintiff's "failure to follow-up claims," finding that plaintiffs had not adequately pleaded that Marriott's board learned of, or remained idle with respect to, any legal or regulatory violations.

Now the cautionary tale: While the claims against the Marriott board were dismissed, the court's opinion raised its own red flag: "Oversight violations are typically found where companies—particularly those operating within a highly-regulated industry—violate the law or run afoul of regulatory mandates. But as the legal and regulatory frameworks governing cybersecurity advance and the risks become manifest, corporate governance must evolve to address them. The corporate harms presented by non-compliance with cybersecurity safeguards increasingly call upon directors to ensure that companies have appropriate oversight systems in place."

As a result, all boards are now well advised to treat cybersecurity risk as mission critical.

PROTECTING DIRECTORS FROM LIABILITY

As part of its IPO preparations, a company should ensure that its corporate charter provides, to the maximum extent permitted by law, for indemnification of, and advancement of expenses to, directors and the exculpation of directors from personal monetary liability for breaches of the duty of care. The company should also procure an adequate D&O insurance policy before pricing its IPO (D&O insurance is discussed further on page 23). To supplement these measures, many public companies also enter into separate indemnification agreements with each director and officer. Many director candidates will not join a board that does not offer these protections.

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verve THERAPEUTICS	VIRIDIAN	Apellis	bioxcel therapeutics	Decibel THERAPEUTICS	THESEUS	editas MEDICINE	cue	xilio THERAPEUTICS
Initial Public Offering of Common Stock	*Public Offering of Common Stock and Preferred Stock*	*Public Offering of Common Stock*	*Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*
$306,682,000	**$97,750,000**	**$402,500,000**	**$100,013,500**	**$137,916,000**	**$178,755,000**	**$265,650,000**	**$230,000,000**	**$129,906,000**
July 2021	**September 2021**	**November 2021**	**June 2021**	**February 2021**	**October 2021**	**January 2021**	**September 2021**	**October 2021**
Counsel to Issuer	Counsel to Underwriters	Counsel to Issuer	Counsel to Underwriters	Counsel to Issuer	Counsel to Underwriters	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer

YDyne THERAPEUTICS	Blue Apron	Oncorus	IVERIC bio	generation bio	ICOSAVAX	imara	PerkinElmer For the Better	
Initial Public Offering of Common Stock	*Capital Raise (public rights offering and related PIPE transactions)*	*Initial Public Offering of Common Stock*	*Public Offerings of Common Stock*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offerings of Senior Notes*	
$267,697,000	**$78,000,000**	**$98,370,000**	**$288,581,000**	**$230,000,000**	**$209,300,000**	**$86,480,000**	**$3,100,000,000**	
Public Offering of Common Stock	**November 2021**	**February 2021**	**July and October 2021**	*Public Offering of Common Stock*	**August 2021**	*Public Offering of Common Stock*	**March and September 2021**	
$168,000,000	Counsel to Issuer	Counsel to Underwriters	Counsel to Issuer	**$225,400,000**	Counsel to Underwriters	**$50,000,000**	Counsel to Issuer	
January 2021				**January 2021**		**July 2021**		
Counsel to Issuer				Counsel to Issuer		Counsel to Issuer		

MicroStrategy	INOVIO POWERING DNA MEDICINES	**Jackson Acquisition Company**	ThermoFisher SCIENTIFIC	Fulcrum Therapeutics	KYMERA	Jounce THERAPEUTICS	ikena ONCOLOGY	STATE STREET
Rule 144A Placements of Convertible Senior Notes	*Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offerings of Senior Notes*	*Public Offerings of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offerings of Senior Subordinated Notes*
$1,050,000,000	**$173,017,500**	**$200,000,000**	**$8,950,000,000**	**$194,810,000**	**$199,750,500**	**$64,687,500**	**$143,750,000**	**$850,000,000**
February 2021	**January 2021**	**December 2021**	**August and October 2021**	**January and August 2021**	**August 2020**	**March 2021**	**March 2021**	**March 2021**
Senior Secured Notes	Counsel to Underwriters	Counsel to Issuer	**€8,050,000,000** (including €550,000,000 of sustainability notes)	Counsel to Issuer	*Public Offering of Common Stock*	Counsel to Issuer	Counsel to Underwriters	*Common Stock*
$500,000,000			**October and November 2021**		**$257,008,000**			**$1,903,041,000**
June 2021			Counsel to Issuer		**July 2021**			**September 2021**
Counsel to Issuer					Counsel to Underwriters			*Senior Notes*
								$2,000,000,000
								November 2021 and February 2022
								Counsel to Issuer

AMERESCO Green • Clean • Sustainable	ARCELLX	TechTarget	**Crescera Capital Acquisition Corp.**	CINCOR	ANALOG DEVICES	Werewolf THERAPEUTICS	DANAHER	
Public Offering of Common Stock	*Initial Public Offering of Common Stock*	*Rule 144A Placement of Convertible Senior Notes*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Public Offering of Senior Notes*	*Initial Public Offering of Common Stock*	*Public Offering of Senior Notes*	
$161,920,000	**$142,312,500**	**$414,000,000**	**$201,250,000**	**$193,600,000**	**$4,000,000,000** (including $750,000,000 of sustainability-linked notes)	**$120,000,000**	**$1,000,000,000**	
March 2021	**February 2022**	**December 2021**	**November 2021**	**January 2022**	**October 2021**	**May 2021**	**December 2021**	
Counsel to Issuer	Counsel to Underwriters	Counsel to Issuer	Counsel to Underwriters	Counsel to Underwriters	Counsel to Issuer	Counsel to Issuer	Counsel to Issuer	

WILMERHALE®

IPOs Find Their New Normal

Beginning in March 2020, with most of the business world working from home due to the COVID-19 pandemic, the IPO process became completely virtual, a shift that produced no adverse consequences while yielding unexpected efficiencies.

At the same time, IPO deal flow increased substantially, shaking off steep stock market declines and economic concerns at the outset of the pandemic to produce the highest volume of conventional IPOs in two decades and an astonishing number of SPAC IPOs.

Although the frenzied pace of IPO activity will not continue indefinitely, many of the pandemic's IPO practices are likely to persist in the post-pandemic world. Various recent adjustments to post-IPO public company life are also likely to remain in place.

IPO PROCESS

— ***Overall Timeline***: Although timelines are affected by multiple factors, the pace of the overall IPO process has quickened during the pandemic. For conventional IPOs, the median time between the initial Form S-1 submission and effectiveness has declined, from 112 days in 2019 to 104 days in 2020 and then to 101 days in 2021—the lowest annual figure since at least 2007—even while deal volumes have surged.

— ***Due Diligence***: The universal use of virtual data rooms has prevented the pandemic from having any effect on documentary due diligence. Site visits—which ordinarily are not undertaken outside of manufacturing and certain other industries—are being conducted in accordance with local COVID-19 protocols.

— ***All-Hands Meetings***: Org meetings and drafting sessions (as well as board meetings) are being held virtually by videoconference and are proceeding seamlessly. Even before the pandemic, many in-person meetings had shifted online. Drafting sessions, for example, were often conducted remotely, with the registration statement displayed on the screen for group discussion and editing.

— ***Company Disclosures***: During 2020, the SEC staff issued guidance on disclosure considerations arising from the pandemic and its impact on company operations, liquidity and capital resources. Pandemic-related disclosures are now commonplace in risk factor disclosures, MD&A (with a focus on known trends and uncertainties associated with the pandemic) and elsewhere in IPO prospectuses.

— ***SEC Rule Amendments***: The SEC has taken several steps to facilitate document submissions. Most importantly, the agency adopted rules to permit the use of electronic signatures generated by DocuSign and other e-signature applications when filing registration statements and other documents. The SEC also established a secure file transfer process for the electronic submission of supplemental materials.

— ***Submission Process***: The lack of in-person meetings has not affected the ability of working groups to finalize the Form S-1 before each filing or submission. In recent years, lengthy in-person sessions at the financial printer had already begun to disappear, in favor of shorter sessions—often held by conference call—to fine-tune the Form S-1 just before submission.

— ***SEC Review***: The nature and timing of SEC review is unchanged (even before the pandemic, many staff members worked remotely). Nearly every IPO Form S-1 continues to receive a "full review."

— ***Marketing***: Road show and "test-the-waters" meetings are being held virtually, enabling company management to meet remotely with more potential investors in less time than required by in-person meetings—while saving money on travel expenses. "Test-the-waters" meetings are increasingly viewed as a core component of the marketing effort, rather than being primarily feedback-oriented. With investor meetings going virtual and no time wasted on travel, road show schedules have become shorter—thereby reducing exposure to market risk. Electronic road shows continue to supplement live road show meetings for retail investors.

— ***Pricing and Closing***: No IPOs have been canceled after pricing, despite the unprecedented market volatility that has prevailed at times since the pandemic's onset. Remote closings—which had already become the norm—are conducted by telephone and electronic document exchange.

POST-IPO MATTERS

Some SEC and stock exchange actions that were taken to reduce the pandemic's impact on public companies have ended, while modifications to other public company practices are likely to continue.

— ***Financial Guidance***: In light of the extraordinary economic uncertainty and operating volatility that characterized the early stages of the pandemic, many public companies withdrew pre-pandemic guidance, updated their guidance, or stopped providing guidance altogether. As economic concerns have been tempered and operations stabilized, most public companies that previously provided guidance have resumed doing so, while highlighting the continuing uncertainties created by the pandemic and sometimes using wider ranges than under prior practice.

— ***Annual Meetings***: Given the pandemic-era safety concerns posed by in-person meetings, and restrictions on the size of public gatherings, virtual-only annual meetings of stockholders have become commonplace. Institutional investors may urge public companies to resume in-person (or hybrid) annual meetings in the post-pandemic world, but the extent and timing of a widespread return to in-person annual meetings is uncertain.

— ***Liability and Enforcement***: According to Cornerstone Research, there were 19 federal and state securities class action filings involving COVID-19 disclosures in 2020, with another 10 such filings in the first half of 2021. The SEC's Division of Enforcement continues to bring enforcement actions against public companies for misleading disclosures about the financial effects of the pandemic. ■

Drafting Sessions in a Nutshell

Preparation of the Form S-1 requires hard work and close collaboration among the entire working group. The Form S-1 is not a "form" in the usual sense. Cutting and pasting from other IPO filings will not produce a prospectus that simultaneously discharges the company's disclosure obligations, tells a compelling story, encourages readers to invest, adequately communicates relevant risks, and still is succinct enough to hold an investor's attention.

By the time of the organizational (or "org") meeting, the company typically will have prepared a rough draft of the business section, or at least a detailed outline of the company's basic story and key messages. In parallel, company counsel will be preparing a draft of the balance of the Form S-1, with placeholders as needed.

Beginning with the org meeting, or shortly thereafter, drafting sessions of the core working group—the company's senior management, company counsel, the managing underwriters, underwriters' counsel and, for discussions focused on financial and accounting matters, the independent auditor—will be held to review and discuss the Form S-1. The drafting sessions will become increasingly granular with each successive meeting, as discussions progress from a conceptual level to nitty-gritty details.

At the org meeting, there will usually be a high-level discussion of the company's business, strategy and positioning. If an initial draft (or outline) of the business section has been distributed, there may be conceptual discussion of it at the org meeting.

In subsequent drafting sessions, the actual text of the draft document will be reviewed. Early on, this will take the form of section-by-section or paragraph-by-paragraph discussions, but fairly soon the working group will begin to focus on each sentence and even each word. The primary emphasis of the first few sessions will be the business section, with the financial statements, MD&A, risk factors, management, and executive compensation sections typically following. Proposed graphics should be shared early in the process to allow time to process revisions and produce high-resolution versions for inclusion in the prospectus. Toward the end of the drafting process, the group—usually led by the underwriters—will turn to the prospectus summary. The other sections of the Form S-1 are generally not discussed in detail in group drafting sessions. Instead, underwriters' counsel will gather input from the underwriters and combine this with its own comments in one or more markups of the Form S-1 to be provided to company counsel.

Following each drafting session, the draft document will be revised, generally by company counsel (although the underwriters will often hold the pen on the initial revisions to the business section), to reflect the working group input, and then recirculated in advance of the next drafting session. Comments are either provided during the drafting sessions or submitted separately in writing. Throughout the drafting process, Form S-1 disclosures will also be shaped by the ongoing due diligence.

Drafting will continue in this fashion until the company and underwriters are prepared for the initial submission of the Form S-1. The duration of this phase and the number of drafting sessions vary, but a total of four or five drafting sessions over a period of four to six weeks from the org meeting to the initial submission is typical. ■

TIPS FOR EFFECTIVE DRAFTING SESSIONS

Drafting sessions will proceed more smoothly and efficiently if the working group adheres to basic guidelines such as the following:

- *Duration and Frequency of Sessions*: Shorter, focused drafting sessions are typically the most productive. Until the end of the drafting process, when sessions typically turn to document cleanup and filing preparations, sessions generally should be limited to three or four hours. In order to provide ample time for updated drafts to be prepared, circulated and reviewed, drafting sessions should generally be held no more frequently than once a week. Twice-weekly sessions are often used when the prospectus is complex (such as the scientifically dense business section in a life sciences company prospectus) or the offering timeline unusually brisk—this trend has accelerated with remote sessions that do not require participants to travel.
- *Remote Sessions*: During the COVID-19 pandemic, drafting sessions have been held remotely by videoconference without significant issues. During live editing sessions, company counsel typically shares a computer screen and makes appropriate edits (or notes high-level concepts for offline incorporation). In the post-pandemic world, virtual sessions are likely to remain the preferred format, due to their time and expense savings and the convenience of easily viewable, live on-screen editing (as compared to projecting the document on a conference room wall). Selective in-person sessions may also be helpful toward the beginning of the process or for discussion of the most critical portions of the Form S-1.
- *Circulation of Drafts*: The draft sections of the Form S-1 to be discussed at a drafting session should be circulated sufficiently in advance to permit thoughtful review prior to the session and productive discussion at the session. The amount of review time needed will depend on the length, complexity and drafting stage of the sections to be discussed, and could range from as little as one day (such as for a near-final draft of the prospectus summary) to several days or more (such as for the first draft of the business section or MD&A). Similarly, participants who wish to propose significant revisions for consideration at the session should circulate the text prior to the session.
- *Nature of Comments*: Expectations about the nature of comments to be considered at the drafting session should be clarified in advance. At earlier stages in the drafting process, it will typically be more efficient to discuss foundational topics, such as company positioning and structuring of the business section, at a more abstract level, without focusing on specific wording. Later in the drafting process, the focus of the drafting sessions should shift to finalizing specific language, and participants should provide comments in the form of specific text and typewritten riders rather than conceptual comments.
- *Coordination of Underwriter Comments*: Comments from all managing underwriters should be coordinated through underwriters' counsel to avoid a situation in which each underwriter submits separate and potentially conflicting comments to company counsel.

Risky Business—Tips for Crafting Effective Risk Factors

A key component of an IPO prospectus is the risk factors section, which discusses the material factors that make an investment in the company speculative or risky. Required by SEC rules, risk factors should clearly describe each material risk the company faces and how that risk may impact the company's business, results and performance. Well-drafted risk factors that highlight the potential risks facing a company also serve another purpose—they can help protect against potential liability in securities litigation by refuting a claim that the company did not warn investors of such risks.

During the IPO process, the SEC staff reviews the risk factors as part of its overall review of the Form S-1 registration statement. Staff comments on risk factors frequently focus on making the discussion less generic and more specific to the company. The staff often asks the company to state the extent of each risk plainly and directly and to provide examples evidencing the risk. Other comments on risk factors may request that the company remove mitigating language and avoid redundancy, or may point out inconsistencies between the risk factors and other statements in the prospectus. An IPO cannot proceed until all staff comments are resolved.

Below are some tips for crafting effective risk factors:

- **Focus on the risks facing your company.** The risk factors section should address industry-specific, company-specific and investment-specific risks. These risks should be tailored to how they may specifically impact an investment in the company and explain why management is concerned about these risks, both near-term and long-term.

  While a company's disclosure may include risks that many companies face (such as retention of key personnel, clinical trial risks [for life sciences companies) and cybersecurity risks], the company should describe how these common risks are unique to the company or its securities. Generic recitations of every conceivable risk that the company or any other similar company might face should be avoided; a "kitchen sink" approach may dilute the value of the risk factors by burying the most important ones.

- **Get feedback from all relevant participants.** In order to make sure that the disclosure covers all material risks faced by the company, feedback should be sought from all key players—management, the board of directors, the independent auditor and outside legal counsel. Each group will bring its own perspective to the risks facing the company, including the potential significance and magnitude of those risks.

  Discussions with management about risk factors should extend from the finance and legal groups to include the company's senior personnel in each major business function. For a life sciences company, this means soliciting feedback from members of the R&D, medical and regulatory organizations. In many companies, cybersecurity considerations will require the involvement of information technology personnel. Once you know what is keeping members of the management team up at night, you will be able to prepare more meaningful risk factors.

- **Look at disclosures from comparable companies (but remember that they are only examples).** An important part of the preparation of risk factors is to look at the disclosures made by companies in the same industry with similar characteristics (often called "comps"). But don't automatically gravitate to the top leaders in your industry. For example, it usually is not a helpful exercise for a pre-clinical stage life sciences company to focus on the risk factors of a major pharmaceutical company with multiple approved products, or for an early-stage consumer e-commerce company to align its risk factors with those of the dominant players in its industry—in both cases the risks are likely very different. Most companies going public can readily identify their comps, and the company's IPO underwriters can usually validate or supplement the company's selections.

  Once comps are identified, a common technique for starting the drafting

RISK MISCHARACTERIZATION

Several recent cases have involved allegations that certain risks had been mischaracterized as merely hypothetical. In one prominent example, Facebook agreed to pay a $100 million penalty to settle SEC allegations that it had made misleading statements in its public filings for more than two years by presenting the risk of misuse of Facebook user data as merely hypothetical when it knew that a third-party developer had misused the user data. In another example, Pearson, a London-based public company, agreed to pay a $1 million penalty to settle SEC charges that it misled investors by referring to a data privacy incident as a hypothetical risk when, in fact, the cyber intrusion had already occurred.

RECENT SEC GUIDANCE

Recent SEC guidance affecting the risk factors section includes:

- *COVID-19*: In 2020, the SEC staff issued guidance regarding disclosure and other securities law obligations that public companies should consider with respect to the COVID-19 pandemic (CF Disclosure Guidance: Topics No. 9 and No. 9A, March 25 and June 23, 2020).
- *Cybersecurity*: In 2018, the SEC issued comprehensive guidance on cybersecurity disclosure by public companies (Securities Act Release No. 33-10459, February 21, 2018). The guidance states that cybersecurity risks should be disclosed if those risks are among the "most significant factors that make investments in the company's securities speculative or risky." In addition, the guidance indicates that companies may need to disclose previous or ongoing cybersecurity incidents in order to place discussions of these risks in the appropriate context and notes that disclosure of a material cybersecurity incident cannot be avoided merely because the incident is the subject of an ongoing internal or external investigation.
- *IP/Technology*: In 2019, the staff issued disclosure guidance with respect to intellectual property and technology risks that may occur when public companies engage in international operations (CF Disclosure Guidance: Topic No. 8, December 19, 2019).
- *LIBOR Transition*: In 2021, the staff issued its latest guidance on the risks associated with the mandatory transition from the London Interbank Offered Rate (LIBOR) benchmark interest rate for corporate debt (SEC Staff Statement on LIBOR Transition—Key Considerations for Market Participants, December 7, 2021).

process is to assemble a grid listing the risk factors contained in their SEC filings. This is a good way to identify risks you may not have thought about that should be included in your risk factors. Also, a review of relevant industry analyst commentary may identify additional risks that investors perceive to exist in the company's industry and should be addressed in the company's own risk factors.

- **Check your risk factors against the rest of the prospectus.** The risk factors should be prepared against the backdrop of all of a company's disclosure and should be consistent with how the company and its business are discussed throughout the entire prospectus. If risks and uncertainties facing a company are identified in the discussion of the business but not in the risk factors, the SEC is likely to ask about it. For example, if a company is involved with litigation regarding the intellectual property rights of one of its product candidates, there should be a corresponding risk factor that explains what would happen if those intellectual property rights were lost. New risks can arise at any time so you should be always asking if anything has changed that requires an update to any disclosure, including the risk factors.

- **Don't try to mitigate risks.** Once a risk has been identified, a natural instinct is to explain why the risk isn't as much of a risk as it may appear to be. While companies are allowed to provide mitigating disclosure in other sections of the prospectus (such as MD&A), companies are not allowed to mitigate any of the disclosure in the risk factors. If you try to mitigate risks, you can weaken the protective value of risk factors.

- **Don't characterize risks that have materialized as merely hypothetical.** Companies should not talk about the risk that an event "may" or "could" occur if in fact the event has occurred—instead, the risk factor should acknowledge that the event has occurred and describe its implications for the company.

- **Make the disclosure easily understandable.** The SEC has long championed the use of plain English in disclosure—clear, concise language that the average investor will understand. Avoid inside baseball and remember that the average investor does not live, sleep, eat and breathe the company the way you do. This means no legal jargon or highly technical terms. Risk factors should be drafted so that the key points are clear, easily identified and easy to understand. When possible, use tables and bullet lists to highlight your points.

- **Organize risk factors logically with relevant headings.** The discussion of risk factors must be organized logically with relevant headings and each risk factor should be set forth under a caption—typically consisting of several sentences—that adequately describes the risk. Risk factors should be grouped together by theme, such as risks related to the company's business and industry; risks related to the offering and ownership of the company's common stock; and, depending on the nature of the company's business, risks related to regulation, intellectual property or foreign operations. For example, a life sciences company should include all material risks that relate to the development, clinical testing and regulation of its products and product candidates in one section, with a heading that describes that category of risks. Within each grouping, risks generally should be listed in descending order of importance.

- **Comply with SEC rules on presentation.** The risk factors section must immediately follow the prospectus summary and must be captioned "Risk Factors," rather than with a euphemism such as "Investment Considerations." To the extent generic risk factors are included, they must be disclosed at the end of the section under the caption "General Risk Factors." If the discussion of risk factors is longer than 15 pages (which is almost always the case in an IPO), the prospectus summary must include a series of concise, bulleted or numbered statements—not longer than two pages—summarizing the principal risk factors.

- **Consider SEC guidance and comments.** The SEC periodically issues guidance on risk factor disclosures, covering emerging risks and other topics that the staff believes companies have not been adequately addressing. SEC guidance often serves as a road map for areas of particular focus in staff review. You should also review comment letters the SEC has sent to similarly situated companies on their risk factors. Reviewing these comments can help your company avoid receiving the same or similar comments on its risk factors. ■

RISK FACTORS BY THE NUMBERS

The typical length of risk factor sections—and the number of risk factors included—has increased dramatically over the years, in tandem with growth in the typical length of IPO prospectuses and heightened liability concerns. Whereas a decade or so ago it was commonplace for the risk factors section of an IPO prospectus to run 15–25 pages and to include 40–50 risk factors, today's norm is 30–55 pages and 65–80 risk factors. The percentage of SEC staff comments devoted to risk factors has also increased, due in part to the staff's efforts to focus on the most significant issues presented by the company's business and its disclosure in the prospectus. The following data from all US-issuer IPOs over the past 15 years illustrates these trends:

Period	Median Length of Risk Factors Section (pages)	Median Length of Prospectus (pages)	Length of Risk Factors as Percentage of Total Prospectus	Percentage of SEC Comments Devoted to Risk Factors
2007–2011	19	179	10.6%	8.3%
2012–2016	27	200	13.5%	9.1%
2017–2021	39	225	17.3%	11.8%

In almost comical contrast, the entire prospectus for Microsoft's 1986 IPO was less than 50 pages long and the risk factors section—entitled "Certain Factors"—consisted of seven fairly generic risks on two pages.

Why Due Diligence Matters

Bloomberg columnist Matt Levine, a former lawyer and investment banker, likes to say every bad thing that is done by or happens to a public company is securities fraud (although he acknowledges this is not exactly accurate). Applying this expression to an IPO, management should assume that any "bad" things in the company's history or current business—which may include things that are not actually illegal or wrong—that are not disclosed after the offering is complete could affect the market price of the company's stock and result in securities fraud claims brought by IPO investors.

To avoid this outcome, a key task for all IPO participants is to undertake a thorough process to identify and understand any "bad" things involving the company and, where appropriate, include disclosure in the Form S-1 informing prospective investors about such things. This "due diligence" is the essential process the IPO working group utilizes to unearth "bad" things, identify information that must be disclosed in the Form S-1 or that is otherwise relevant to an understanding of the company's business and finances, and investigate and verify statements made in the Form S-1.

THE PURPOSES OF DUE DILIGENCE

For companies—which are strictly liable for material misstatements or omissions in the Form S-1—the primary purpose of due diligence is enhanced disclosure, which reduces the likelihood of claims for securities fraud and of disgruntled investors following an IPO. Inaccurate or incomplete disclosures in the Form S-1 that come to light after the IPO can hurt the company's stock price and lead to unhappy investors, even if they do not sue. A company's due diligence also helps its directors and officers establish a due diligence defense.

The fiduciary duties and corporate responsibilities of directors and officers demand a prudent focus on due diligence. The specter of personal liability provides an additional incentive for due diligence, although directors and officers rarely make personal payments to settle IPO securities litigation, due to the availability of D&O insurance and the presence of more attractive defendants in most cases—the company, which lacks a due diligence defense, and the underwriters and auditors, which have much deeper pockets.

For underwriters, in addition to establishing a due diligence defense, the primary motivation for conducting due diligence is to avoid the reputational harm posed by a serious deficiency in a Form S-1 or an association with a failed company, and the desire to ensure a successful IPO. The commitment committees at investment banks that must approve any underwriting expect a detailed presentation from the banking team before agreeing to commit the bank to underwriting the deal.

SOURCES OF POTENTIAL LIABILITY

Section 11 of the Securities Act of 1933 provides the principal basis for civil liability in connection with an IPO. Offering participants can also incur liability under various other statutory provisions, including Section 12 of the Securities Act.

- ***Section 11***: Under Section 11(a), and subject to the due diligence defense (except for the company), the company, each director, each officer who signed the Form S-1, each underwriter, and each auditor and other person named as an expert in the Form S-1, may be liable if the Form S-1 contains any material misstatements or omissions. The potential liability of auditors and other experts extends only to the portions of the Form S-1 prepared or certified by such persons. Selling stockholders are not subject to Section 11 claims.
- ***Section 12***: Section 12(a)(2) provides IPO investors with recourse for material misstatements or omissions—including both written and oral statements—made in connection with the IPO, including road show presentations and "test-the-waters" communications. Section 12 claims generally may be brought against the company and underwriters and, in some cases, against selling stockholders.

THE DUE DILIGENCE PROCESS

Due diligence by the underwriters—who typically lead the overall diligence process—is a pervasive and constant accompaniment to the entire IPO process. Key components of due diligence include:

- review of the company's records, contracts, financial statements, business plans, public statements and communications, regulatory compliance, litigation, intellectual property and other relevant documents;
- diligence sessions with management, auditors and relevant third parties to learn about and evaluate the company and its prospects, including the particular risks it faces;
- inquiries of key customers, business partners and other relevant third parties regarding the company;
- searches of public records and background checks on directors, officers and principal stockholders;
- a "backup" process by which counsel independently substantiates factual statements made by the company in the Form S-1;
- ensuring that relevant diligence results are appropriately addressed in the Form S-1;
- "comfort" letters from the auditors and legal opinions from counsel; and
- thorough follow-up to resolve potential issues that arise. ■

THE DUE DILIGENCE DEFENSE

An important defense for defendants (other than the company) for both Section 11 and Section 12(a)(2) claims is the so-called due diligence defense. In effect, the defense permits a defendant to avoid liability by demonstrating that, after reasonable investigation, he or she believed the disclosure in question was true and correct in all material respects. There is no single blueprint for establishing a due diligence defense. The steps can vary based on a defendant's role in the offering and may depend in part on the particular facts and circumstances of the company and offering.

Directors' and officers' liability insurance (commonly called "D&O insurance") provides coverage for liabilities incurred in connection with service as a director or officer, including IPO liabilities if an appropriate policy is purchased. Nearly all public companies have at least some D&O insurance. Private company D&O policies, although not uncommon, typically have a public offering exclusion, so a company going public must purchase a new D&O policy to obtain coverage for the IPO and for its operations as a public company.

COMPONENTS OF D&O INSURANCE

There are three basic D&O insurance components for public companies: Side A, Side B and Side C. Side A can be purchased separately, Side A and Side B can be combined in "AB" insurance, or all three can be combined in "ABC" insurance.

- ***Side A***: Under Side A, the insurer promises to pay expenses incurred by directors or officers that are not indemnified by the company or that the company is financially unable to pay. Side A policies have exclusions for fraud, although a fraud exclusion typically does not prevent insurers from contributing to a settlement of a securities fraud claim. A variant on Side A, called "DIC Side A," provides coverage when there is a "difference in conditions" between the Side A policy and an underlying ABC policy.

- ***Side B***: Under Side B, the insurer promises to pay—after payment by the company of a stated amount referred to as a "retention"—indemnification expenses that the company must otherwise pay on account of a claim against a director or officer. Unlike Side A, Side B does not cover non-indemnifiable expenses. Side B works much like any other insurance: After paying the premium and any retention amount, and subject to the policy's exclusions, the insurer will pay up to the policy limit for many of the company's indemnity obligations to directors and officers (including most defense costs and many settlements or judgments).

- ***Side C***: Side C (also called entity coverage) covers the company itself for securities claims. The motivation for Side C coverage is to prevent the insurer from avoiding payment of a portion of the defense or settlement costs on the grounds that the coverage covers only the individual directors and officers and not the company (even though in most securities cases there is little incremental cost associated with defense of the company by the same counsel defending the company's directors and officers).

In addition to Side A, Side B and Side C coverage, some policies include additional coverage enhancements, typically subject to a sub-limit (or cap) on the amount payable by the insurer, for expenses incurred by the company in certain circumstances. Examples of coverage enhancements include an agreement by the insurer to cover expenses incurred in investigating a derivative demand (sometimes referred to as "Side D" coverage); coverage for other kinds of investigations; so-called crisis management coverage (for expenses incurred for public relations consultants in certain emergencies); and underwriter indemnity coverage (for expenses incurred pursuant to the company's obligation to indemnify the underwriters under an underwriting agreement).

Most IPO companies seek to purchase ABC insurance plus DIC Side A coverage. The principal advantage of ABC insurance is that it shifts the costs of defending claims against directors and officers to the insurer. ABC insurance also has the practical effect of facilitating settlements of securities claims because plaintiffs' lawyers tend to calibrate their settlement demands to the amount of available insurance and because directors generally find it easier to approve settlements when a substantial part of the cost is paid by insurance.

An alternative is to purchase Side A–only insurance. Side A insurance is cheaper than ABC insurance or ABC insurance plus DIC Side A insurance because the company is required to pay expenses that an ABC policy would otherwise cover. Because a Side A policy covers only the directors and officers, creditors in bankruptcy cannot assert that the policy proceeds are an asset of the bankruptcy estate that should be preserved to pay claims against the estate (although this issue also can be addressed by appropriate policy language in an ABC policy). Side A insurance cannot be exhausted by the costs of defending securities claims against the company.

PROCURING D&O INSURANCE

D&O insurance is usually purchased in tiers from multiple carriers. After selecting the type and amount of coverage, the company should ask company counsel to review the actual policy. All D&O policies are not the same, and many important provisions must be understood and, in some cases, negotiated.

In recent years, D&O insurance has become significantly more expensive, the size of each tier has tended to decrease (requiring more insurers to achieve desired coverage limits), retentions have increased dramatically, and available terms have become less favorable, as insurers seek to manage the risks that they underwrite. In general, D&O insurance is even more expensive and terms less favorable for companies going public via a SPAC business combination rather than a conventional IPO.

To reduce insurance expense, some companies have responded by reducing coverage under Sides B and C, coupled with significantly higher retentions. However, for companies embarking on an IPO—in which the company, the officers who sign the Form S-1 and all directors face liability for material misstatements or omissions in the Form S-1—ABC insurance remains the most popular alternative. ■

"CAPTIVE" D&O INSURANCE

In January 2022, the Delaware General Corporation Law was amended to permit Delaware corporations to employ "captive insurance" arrangements (insurance provided by or through a wholly owned subsidiary funded by the corporation) to protect indemnifiable persons. While too early to tell, some Delaware companies may wish to consider establishing captive arrangements as part of their D&O insurance programs to reduce the cost of traditional D&O insurance.

Don't Forget Pre-IPO Estate Planning

Wealth Transfer Techniques Can Be Particularly Effective in Advance of an IPO

Company executives should not overlook estate planning—perhaps more aptly named wealth transfer planning—in advance of an IPO. Many pre-IPO company executives probably do not consider themselves wealthy, and a simple will may be the extent of their estate planning. For an executive holding a substantial amount of company equity, however, an imminent IPO presents wealth transfer opportunities, no matter how humble the company's (or the executive's) beginnings. Expert advice is needed, as estate planning is a complex and fluid area of the law, and the following is merely a brief introduction to the topic.

TAXATION OF INDIVIDUALS AND ASSETS

Federal law imposes four types of taxes on individuals and their assets: gift, estate, generation-skipping transfer (GST) and income taxes. Many states impose income and estate taxes, but most do not impose gift or GST taxes. The following summary applies to federal tax law only, as of December 31, 2021. The federal gift, estate and GST tax exemptions described below are scheduled to revert to $5,000,000 in 2026 (adjusted for inflation measured from 2010).

- ***Gift Tax***: Gift taxes apply to gifts made during the lifetime of the donor and are imposed on the donor rather than the recipient. No gift tax is payable with respect to gifts to a US citizen spouse or to qualifying charities, or with respect to the payment of tuition and medical expenses on behalf of another person if paid directly to the educational institution or medical provider. Other than for eligible charitable donations, the donor may not deduct gifts from his or her taxable income. Each donor has an annual, per-recipient exclusion ($16,000 for 2022 and adjusted for inflation in subsequent years) and a lifetime exemption ($12,060,000 for 2022 and adjusted for inflation in subsequent years). Gifts that exceed the annual exclusion count against the lifetime exemption. A married couple may elect to combine their annual exclusions and lifetime exemptions when donating property owned by either of them (referred to as "gift splitting"). The maximum gift tax rate on taxable gifts is 40%.
- ***Estate Tax***: Estate taxes apply to assets owned upon death and are imposed on the decedent's estate. Transfers upon death to a US citizen spouse are exempt from tax in the decedent's estate, as are transfers to qualifying charities. For 2022, the first $12,060,000 (adjusted for inflation in subsequent years) of an estate is exempt, but this amount is subject to reduction by any portion of the lifetime gift tax exemption utilized, and the maximum estate tax rate on taxable estates is 40%.
- ***GST Tax***: The GST tax applies to transfers to or for the benefit of grandchildren or more remote descendants. GST tax is imposed at a flat rate equal to the highest estate tax rate and is in addition to applicable gift and estate taxes. There is a lifetime exemption equal in amount to the estate tax exemption ($12,060,000 for 2022 and adjusted for inflation in subsequent years).
- ***Income Tax***: Income taxes are imposed on compensation income, interest and dividend income, and capital gains at marginal rates that are as high as 37%. Certain taxpayers are subject to an additional 3.8% tax on net investment income.

WHY NOW?

Many estate planning techniques focus on asset transfers upon the death of the owner, but properly structured gifts during the owner's lifetime can produce even greater tax savings. Because gift taxes are based on the fair market value of the property at the time of transfer, the goal of pre-IPO estate planning is to transfer company stock before its value appreciates substantially and while its value is more uncertain, potentially providing flexibility in valuation. To maximize the tax savings, the transfers should occur as early as possible—when the stock has its lowest value—but significant benefits can still be realized when the transfers do not occur until IPO planning is underway. By contrast, charitable donations generally should be made of appreciated property—such as post-IPO stock—to maximize the value of the donor's income tax deduction.

BASIC WEALTH TRANSFER PLANNING TECHNIQUES

Wealth transfer planning has three principal objectives: minimization of gift, estate, GST and income taxes; preservation and management of assets; and protection of assets from creditors. Basic wealth transfer planning techniques, even in the absence of an IPO, include the use of:

- annual gift exclusions, to transfer modest amounts of wealth tax-free;
- tax-free payments of tuition and medical expenses, on behalf of family members, directly to an educational institution or medical provider;
- "Section 529" education savings plans funded with cash contributions below the donor's annual gift exclusion (which may be pre-funded in an amount up to five times the annual exclusion) and which permit investment earnings to accumulate free of federal (and some state) income taxes until withdrawn to pay qualifying educational expenses;
- the lifetime gift tax exemption, to remove assets and future appreciation from the taxable estate;
- the GST tax exemption, to insulate from the GST tax assets that pass (or may pass in the future) to grandchildren or more remote descendants;
- irrevocable insurance trusts, to remove life insurance proceeds from the taxable estate; and
- taxable gifts that exceed the annual and lifetime exemptions, to generate future tax savings.

ADVANCED PRE-IPO TECHNIQUES

Two common pre-IPO wealth transfer techniques are gifts of company stock to irrevocable trusts and gifts of company stock to grantor retained annuity trusts. Other structures are also possible.

Irrevocable Trusts

An irrevocable trust enables assets to appreciate in value outside of an estate and is an effective tool for leveraging

EXAMPLES OF USE OF GRAT FOR PRE-IPO STOCK

- The grantor transfers company stock in January 2022 to a three-year GRAT.
- The IRS benchmark rate for January 2022 is 1.6%.
- The company goes public in the fall of 2022.
- The company's stock appreciates 50% in the first year and 10% in each of the second and third years.
- If the company stock is valued at $1,000,000 upon transfer, the grantor receives annual annuity payments of $344,056 (a total of $1,032,168) and $676,175 passes free of gift tax to the beneficiaries at the end of the GRAT term.
- If the company stock is valued at $5,000,000 upon transfer, the grantor receives annual annuity payments of $1,720,282 (a total of $5,160,846) and $3,380,867 passes free of gift tax to the beneficiaries at the end of the GRAT term.

gift tax exemptions. In simple terms, the owner of the assets (called the "grantor") establishes a trust for the benefit of his or her children or other beneficiaries and funds it with a gift of company stock valued at no more than the then-available portion of the grantor's lifetime gift tax exemption. By applying the grantor's lifetime gift tax exemption, the initial stock gift is free of gift tax, and all future appreciation in the stock's value is excluded from the grantor's estate. If the grantor's grandchildren (current or future) are beneficiaries of the trust, the grantor's lifetime GST tax exemption can also be applied, to exempt from the GST tax any eventual transfers of trust assets to grandchildren or more remote descendants. If the grantor is married, the amount of company stock that can be transferred to the irrevocable trust without triggering any gift or GST tax can be doubled if the grantor elects with his or her spouse to engage in gift splitting (assuming the grantor's spouse has sufficient gift and GST tax exemptions available).

For income tax purposes, the cost basis of the assets transferred to the trust is the same as the cost basis in the grantor's hands when the assets are contributed to the trust. If the assets are sold by the trustees of the trust (or by any beneficiary to whom the assets are distributed by the trustees), federal capital gain taxes plus applicable state capital gain taxes may be incurred. In many cases, the trustees of an irrevocable trust initially funded solely with company stock sell shares over time to diversify the trust's holdings.

With a "non-grantor" trust, the trust, and in some circumstances the trust beneficiaries, pay the taxes on the trust's income (including capital gains attributable to trust assets). By contrast, with a "grantor" trust, the grantor continues to pay the income taxes, enabling the trust to grow without being diminished by income tax payments, and the grantor's payment of this income tax is not subject to gift tax or GST tax. A grantor trust typically contains provisions that allow it to be converted to a non-grantor trust, after which the trust and the trust beneficiaries, rather than the grantor, will be responsible for the trust's income taxes.

Grantor Retained Annuity Trusts

Grantor retained annuity trusts (GRATs)—if structured as "zeroed-out" GRATs as described below—permit future appreciation in the value of an executive's company stock to be transferred to the executive's children or other beneficiaries, outside of the grantor's estate, without paying any gift taxes, and without depleting the executive's lifetime gift tax exemption. Any kind of assets may be contributed to a GRAT, but the technique is particularly powerful when a GRAT is funded with an asset—such as pre-IPO stock—that is expected to appreciate substantially during the GRAT term. GRATs may be used in tandem with, or independent of, other irrevocable trusts.

With the basic GRAT structure, the grantor contributes property to an irrevocable trust and receives an annual distribution—or "annuity"—from the trust for a period of years. At the end of the GRAT's term, the remaining trust assets, if any, are distributed to or held in trust for designated beneficiaries. With a so-called zeroed-out GRAT, the annuity payments are calculated to repay the grantor the fair market value of the assets (determined at the time the assets are contributed to the GRAT), plus a benchmark rate of return set by the IRS monthly to reflect prevailing interest rates, so that no gift tax applies to the original contribution to the GRAT. If the annuity payments are calculated to repay less than the fair market value of the contributed assets plus the benchmark rate of return, the difference is subject to gift tax upon the transfer of the assets, unless the donor has a sufficient lifetime gift tax exemption available to shelter the difference from gift tax.

The annuity payments may be made in whole or in part in cash, if the GRAT has any cash, or by returning company stock or other trust assets to the grantor. If the value of the trust property in any year is insufficient to satisfy the annuity payment required to be made that year, the trustees distribute all of the remaining trust property to the grantor, the GRAT terminates, and nothing is left for distribution to the trust's remainder beneficiaries. If, however, the trust property appreciates in value at a rate exceeding the benchmark rate, some trust assets—potentially a very substantial amount—will necessarily remain at the end of the GRAT term.

For income tax purposes, a GRAT is a grantor trust, and the grantor is required to report on his or her personal income tax return any income and capital gain attributable to the GRAT assets during the GRAT term. The grantor's payment of this income tax is the economic equivalent of a gift tax–free contribution of additional property to the GRAT. The annuity payments made by the GRAT to the grantor do not constitute additional taxable income to the grantor and can be used by the grantor to pay the GRAT's tax liabilities.

If the grantor dies during the GRAT term, his or her estate will receive the remaining annuity payments and some or all of the GRAT assets will be included in the grantor's estate for estate tax purposes. Any property remaining at the end of the GRAT term will be distributed to the trust's beneficiaries, but the full benefits of the GRAT will not have been realized.

For this reason, GRATs with short terms (such as two or three years) are typically recommended for pre-IPO stock.

Typically, the assets remaining at the end of the GRAT term are retained in trust for the benefit of the grantor's descendants. The distribution of assets in trust to a grantor's descendants, rather than outright to them, has several advantages, including flexibility regarding the timing, purposes and amounts of subsequent distributions to the beneficiaries, and the protection of trust assets from claims of beneficiaries' creditors.

Future grandchildren and more remote descendants are permissible beneficiaries of a GRAT but distributions to them would be subject to the GST tax. Because of limitations on the allocation of the grantor's GST tax exemption to trust assets, however, GRATs are typically better suited for asset transfers to (or in trust for) the grantor's children, rather than grandchildren and more remote descendants.

Transfer Restrictions and Securities Law Issues

Company stock held by executives typically is subject to contractual transfer restrictions. If the executive holds restricted stock subject to vesting, unvested shares typically cannot be transferred. Right of first refusal provisions frequently have an exception permitting the executive to transfer vested shares to trusts for the benefit of family members if the transferee agrees to be bound by the provisions. If the shares are subject to a pre-IPO voting agreement, the trust will also need to agree to adhere to it. The underwriters will probably insist that any trust formed by a company executive sign the same lockup agreement that is signed by other pre-IPO stockholders.

An exemption from registration should be available for an executive's transfer of company stock to a trust. After the company is public, the trust should be able to resell the shares pursuant to Rule 144, once the applicable holding period is satisfied, or the executive may be able to transfer to the trust any registration rights he or she has along with the shares.

RELATED MATTERS

For executives of pre-IPO companies, wealth transfer planning is an opportune time to consider various related matters that are routinely addressed in connection with estate planning.

- ***Will***: A will expresses a person's preferences for the disposition of his or her assets upon death, including the identity of the person (called the executor or personal representative) who will oversee the process. Without a will, state law will automatically stipulate the beneficiaries of the assets and a court will appoint an executor, neither of which may align with the decedent's wishes. If a person has minor children, a will can also name a guardian for the children following his or her death; although not bound by this designation, a court will ordinarily follow it. Once established, a will should be periodically reviewed and updated to reflect changed circumstances and preferences.
- ***Healthcare Proxy***: A healthcare proxy (also called a living will, healthcare directive, or power of attorney for healthcare) expresses a person's preferences regarding the nature and extent of medical treatment desired if he or she becomes unable to make or communicate healthcare decisions due to serious illness or unconsciousness and authorizes another person to make medical and healthcare decisions on his or her behalf. A separate authorization in compliance with the Health Insurance Portability and Accountability Act (HIPAA) for the release of medical records to the designated healthcare agent should accompany the healthcare proxy. Without a healthcare proxy, the family of a sick or injured person may be put through the additional anguish of seeking court orders to implement end-of-life care decisions.
- ***Durable Power of Attorney***: Similar to but broader in scope than a healthcare proxy, a durable power of attorney gives another individual the legal authority to act on his or her behalf, typically with respect to financial matters. It is said to be "durable" because it will remain in effect after the person's incapacity. The person granting the power of attorney must be competent at the time of grant and can revoke it at any time while competent.
- ***Asset Protection Techniques***: Anyone with significant assets, including executives of IPO companies, should take steps to shield his or her assets from claims. Various techniques are available, such as a homestead exemption for the executive's residence, the use of corporations for business activities, and the manner in which a married couple holds assets. One of the simplest and most effective devices is insurance, including the purchase of automobile insurance with coverage limits much higher than state law minimums (which often are quite low), and the purchase of an ample amount of personal "umbrella" liability insurance. ■

VALUATION CONSIDERATIONS

Gifts of company stock to GRATs or other irrevocable trusts must be valued at fair market value at the time of the transfer. Illiquid stock in a private company—such as pre-IPO stock held by a company executive—should be valued by an independent appraiser. An independent valuation of the common stock that is conducted contemporaneously for purposes of Section 409A of the Internal Revenue Code should be sufficient to value the executive's common stock, unless other circumstances exist that affect the executive differently than other holders of common stock. A valuation done only by the company's board of directors is subject to a higher risk of challenge by the IRS. Each time a GRAT makes an annuity payment in company stock, an updated independent valuation should be obtained to determine the correct number of shares to distribute.

In most instances, a gift tax return is required to be filed with the IRS upon funding a trust with company stock. Although a gift tax return is not required when funding a zeroed-out GRAT, because the value of the gift is zero, voluntary filing of a gift tax return is advisable. If the gift tax return fully discloses the property transferred to the GRAT and the manner in which the gift was valued at zero, and the return is not audited within three years after filing, the IRS cannot subsequently dispute the valuation. A copy of the valuation report should be attached to the gift tax return.

Flashy Numbers on the Rise

IPO Companies Increasingly Give Investors a Peek at Preliminary Financial Results

Although the financial statements contained in an IPO prospectus need not be updated as long as the most recent balance sheet is less than 135 days old, beginning the road show after the completion of a fiscal quarter but prior to the availability of financial statements for that quarter is often problematic. Prospective investors will be curious about the quarter's financial results, but the company (and the underwriters) will be reluctant to include preliminary information prematurely, and the SEC staff will scrutinize any estimated financial results for a recently completed fiscal period—often called "flash results"—that are included in the preliminary prospectus. Satisfying all these constituencies under the time pressure of launching the road show can be difficult.

Despite these challenges, the use of flash results has increased substantially over the past decade. The increase reflects investor expectations and the desire of companies to commence the road show as soon as conditions are receptive, even if it falls in between quarter-end and the availability of financial statements for that quarter.

Flash results, if included, are typically presented in the summary section of the preliminary prospectus under a caption entitled "Recent Developments." Aside from marketing considerations, whether to include flash results in the preliminary prospectus will depend on the length of time since the end of the quarter and the status of the company's normal quarter-end closing procedures, among other factors, including the following:

- ***Due Diligence***: As a threshold matter, due diligence must be satisfactorily addressed. The underwriters will need to fashion appropriate due diligence procedures, such as a review of the available financial information for the quarter, discussions with the company's finance personnel, and an assessment of the company's track record in developing reliable estimates of a quarter's financial results prior to completion of closing procedures. The nature of due diligence will depend in part on the availability of comfort on the flash results from the company's auditor.
- ***Auditor Comfort***: If the flash results include specific numbers extracted from the company's accounting records, agreed-upon comfort may be available from the auditor, but if the flash results consist of ranges, the auditor cannot provide any comfort. When comfort is not available, the underwriters may require the company's CFO to provide a closing certificate covering the flash results.
- ***Nature of Flash Results***: Based in part on the above considerations, the company needs to determine whether to present estimated revenue only, or both estimated revenue and income (or another P&L measure), and whether to present ranges or specific numbers. Revenue estimates are usually easier and faster to develop than income estimates, but the omission of an income measure may be misleading if inconsistent with estimated revenue or past income levels. In general, the use of ranges that are narrow and meaningful under the circumstances is considered acceptable. If a non-GAAP financial measure is presented, SEC rules require the company to reconcile the measure to the most directly comparable GAAP financial measure. A brief discussion of the quarter's results is often included. Other reliable financial or operating data may also be included.
- ***Related Disclosures***: The basis and limitations of the flash results should be explained in the preliminary prospectus. The company may alert investors that the final results may vary from the estimated results, but should not attempt to disclaim responsibility for the estimates. The disclosure may also state that the company's auditor has not audited, reviewed or compiled the flash results.
- ***Year-End Considerations***: If the company has completed its closing procedures for the fourth fiscal quarter and financial results for the quarter and year are available, but the year-end audit is not yet complete, the auditor cannot perform an AS 4105 review of that information but may be able to provide comfort on aspects of it.
- ***SEC Review***: The SEC staff will focus on whether the flash disclosure is balanced and not misleading, typically resulting in the inclusion of both revenue and income metrics. The examiner may also ask the company to justify the use of ranges, to explain the basis of the preliminary results, and to eliminate or revise excessive disclaimers. Proposed flash disclosures are submitted for review either as part of an amendment to the Form S-1 or separately to the examiner in advance of public filing.
- ***Timing Impact***: To avoid the awkwardness of circulating revised flash disclosures during the road show, underwriters generally prefer to clear the proposed disclosures with the SEC examiner before finalizing the preliminary prospectus. Several days, or more, can be required to resolve staff comments on flash disclosures. If necessary, flash results can also be introduced for the first time during the road show through the use of a free writing prospectus, but this approach is generally disfavored.
- ***Updating***: If financial statements covering a period for which flash results are included in the preliminary prospectus become available prior to pricing, the Form S-1 must be updated with those financial statements and related disclosures (such as MD&A). This circumstance can trigger the need to prepare and disseminate a free writing prospectus, potentially delaying completion of the offering. In most cases, however, the company should be able to predict when such financial statements will become available and plan accordingly. ■

PREVALENCE OF FLASH DISCLOSURES

Between 2017 and 2021, 27% of US IPO companies presented flash results (including 33% of all companies that completed IPOs in the second half of 2021), compared to 17% in the preceding five-year period and up from less than 5% between 2007 and 2010. Underscoring the additional challenges posed by the inclusion of flash results once a year-end audit is underway, only 6% of US IPO companies between 2017 and 2021 presented flash results for their fourth fiscal quarter (although that percentage was nearly double the figure for the preceding five-year period).

We Just Went Public and I Can't Sell My Stock?

Lockup agreements prohibit stockholders from selling shares acquired prior to an IPO—and often shares acquired in or after the IPO—for a specified period of time (most commonly 180 days) following the IPO. Typical lockup language is broad and, with only limited exceptions, sweeps in any sale, offer to sell, pledge, grant of an option to purchase, short sale, hedging transaction or other disposition of common stock of the company; any options or warrants to purchase any shares of common stock of the company; and any securities that are convertible into or represent the right to receive common stock of the company.

In the underwriting agreement, the company typically agrees that during the lockup period, subject to specified exceptions, it will not, without the prior written consent of the lead managing underwriters, offer, sell, contract to sell, pledge, grant any option to purchase, make any short sale, or otherwise transfer or dispose of, directly or indirectly, or file a registration statement relating to, any of its securities.

PURPOSES

The purpose of lockup agreements is to help maintain an orderly market in the company's common stock while the distribution of shares is completed and initial trading develops. In the absence of lockup agreements, many pre-IPO shares typically would be eligible for immediate sale in the public market, potentially flooding the market and exerting substantial downward pressure on the market price of the newly issued shares. Lockup agreements are also intended to avoid the negative signal that can be sent by insider sales soon after the IPO. Similarly, the company's lockup obligations are intended to minimize selling pressure and additional dilution during the lockup period.

PARTIES

All existing stockholders, option holders, directors and officers are usually asked to enter into lockup agreements in connection with an IPO. Although companies often believe that obtaining lockup agreements from the holders of 90% to 95% of the pre-IPO outstanding shares should be adequate, underwriters typically seek lockup agreements from all pre-IPO stockholders because 5% or 10% of a company's pre-IPO outstanding shares can represent a large percentage of the public float in the immediate aftermarket.

All parties typically sign the same form of lockup agreement, with occasional variations to implement pre-existing lockup arrangements previously negotiated by investors.

The company's financing agreements with pre-IPO investors and its pre-IPO employee stock plans will typically contain IPO lockup provisions. Pre-existing lockup agreements, however, generally do not provide the exact coverage requested by the underwriters and, in most cases, new lockup agreements—in the format preferred by the lead managing underwriters—will be sought.

TIMING

Lockup agreements are signed in advance of the IPO and generally go into effect immediately. Occasionally, the transfer restrictions in the lockup agreement do not become effective until the date of the preliminary prospectus used in the road show, or the date of the first public filing of the Form S-1. If the transfer restrictions go into effect at any time prior to the effectiveness of the Form S-1, pre-IPO private sales by stockholders or a pre-IPO acquisition of the company in a stock transaction will require consent of the underwriters absent specific exceptions in the lockup agreement.

Most lockup agreements provide for automatic termination if the IPO does not occur prior to a specified date. When negotiating the lockup agreement, the company should insist that the termination date be set several months or more after the anticipated offering date, or retain the option to extend the termination date if it is still pursuing the offering, to reduce the likelihood that the company will be forced to procure new lockup agreements if the IPO is delayed.

WHAT IS NEGOTIABLE?

The following lockup provisions are regularly negotiated:

- Pre-IPO stockholders routinely are granted the ability to make gifts and estate planning transfers as long as the recipients remain bound by the lockup.
- Stockholders who are not required to file Section 16 reports ordinarily are allowed to resell shares acquired in the open market.
- Section 16 insiders are often permitted to enter into Rule 10b5-1 trading plans as long as no sales are made pursuant to such plans during the lockup period.
- Lockup agreements sometimes permit cash exercises of options, the transfer of shares to the company, or "sell-to-cover" market transactions in connection with option exercises or upon the vesting or settlement of restricted stock or restricted stock units. These exceptions are often limited to the extent necessary to satisfy the payment of applicable withholding taxes and confined to transactions that will not require Section 16 reporting.
- The company's lockup obligations typically have exceptions for equity grants and issuances under stock plans described in the prospectus and issuances in connection with company acquisitions or strategic transactions (usually capped at a specified percentage of the total number of shares outstanding upon completion of the IPO), as long as each recipient enters into a lockup agreement for the remainder of the lockup period.

RELEASES

The lead managing underwriters (either one lead manager in its sole discretion, or two or more of the lead managers jointly, as specified in the lockup agreement) are permitted to release shares from the restrictions contained in lockup agreements, either selectively or *en masse*.

Pre-IPO investors sometimes seek a provision to the effect that a portion of the locked-up shares will be released if the company's stock is trading at least a specified percentage higher than the offering price within a prescribed time frame after the IPO (typically no sooner than 60 to 90 days after pricing). When the stock performs well, investors might prefer an early lockup release

to an underwritten secondary public offering because the lockup release permits investors to select the timing of sales and avoid the underwriting discount and potential liability associated with an underwritten public offering. Investors may also request time-based, staggered releases within the first 180 days, perhaps coupled with a longer lockup period for later release tranches.

Investors sometimes also request the inclusion of a "most favored nation" (MFN) provision requiring the lead managing underwriters to release them from the lockup to the same extent other stockholders are released. The likely effect of an MFN provision—absent a share threshold below which releases do not trigger the release of other shares—is that the lead managers will not grant any release requests. If included, an MFN provision often provides that the release of a stockholder from the lockup in connection with a registered follow-on public offering will not trigger the release of any other stockholder who is given the opportunity to participate in such public offering on a pro rata basis and declines to participate. Although discretionary lockup releases sometimes occur—most commonly when pre-IPO stockholders sell shares in a secondary public offering during the lockup period—MFN provisions are rare.

FINRA Rule 5131 requires the book-running lead manager to notify the company at least two business days before the release or waiver of any lockup or other restriction on the transfer of shares by company directors or officers, and requires the book-running lead manager (or the company) to announce the release or waiver, except where its sole purpose is to permit a transfer of shares without consideration and where the transferee agrees in writing to be bound by the same lockup agreement. (A lockup release to permit the sale of locked-up shares in a registered public offering may be disclosed in the registration statement for the offering.) Public announcement of a lockup release can adversely hurt the stock's market price.

A board of directors must be mindful of its fiduciary duties when agreeing to the release of some, but not all, stockholders from lockup agreements. In a case involving Zynga's IPO, the Delaware Court of Chancery refused to dismiss a lawsuit brought against Zynga's board of directors alleging that the board had breached its fiduciary duties by modifying Zynga's IPO lockup agreements (with the consent of the IPO underwriters) to enable certain stockholders, including half the board, to sell a portion of their shares in a registered public offering (underwritten by the same underwriters) two months before the IPO lockup period would have expired. Based on the court's holding, the release of shares from lockup restrictions for a rational business reason should be protected by the business judgment rule if approved by disinterested, independent directors.

EVOLVING PRACTICES

The scope, duration and release conditions of lockup agreements have historically been all but non-negotiable in IPOs.

In recent years, with keen competition among investment banks to lead the IPOs of strong candidates, and the rise of SPAC mergers and direct listings—often with more flexible lockups, or none at all in the case of most direct listings—as viable alternatives to conventional IPOs, companies and investors increasingly have been able to negotiate more favorable lockup terms. This trend, which is particularly evident among technology companies, often results in complex lockup formulations that defy easy characterization.

The following types of lockup terms that diverge from historical norms have become more common in the last two years:

- shorter lockup periods for a portion of the shares held by non-executive employees;
- staged, time-based releases for all holders, beginning sooner than 180 days after pricing;
- early release provisions for a portion of the locked-up shares based on the aftermarket trading price of the company's stock (typically 25–33% above the IPO price, generally not sooner than 60–90 days after the IPO, often not before the company's first earnings release, and sometimes excluding directors and officers); and
- expiration of the lockup period for some or all locked-up shares shortly before the beginning of the company's first or second regularly scheduled quarter-end "blackout" period following its IPO, effectively reducing the lockup duration by anywhere from a few days to several weeks or more, depending on the timing of the scheduled termination date in relation to the applicable quarter-end and the company's insider trading policy.

Of these examples, the "blackout" provision has been the most common. ■

"BLACKOUT" PERIODS—AVOIDING UNINTENDED LOCKUP EXTENSIONS

When negotiating the terms of the lockup agreement, the company should consider how the anticipated expiration date of the lockup period will fall in relation to broadly applicable and regularly scheduled quarter-end "blackout" periods during which trading in company securities will not be permitted under the company's insider trading policy following the closing of the IPO. For example, because lockup agreements typically are signed before the exact offering date is known, the lockup period could be scheduled to expire during a blackout period, which would have the unintended consequence of extending the lockup until the end of the blackout period for all holders—typically directors, officers and many (or all) employees—subject to blackout periods prescribed by the company's insider trading policy.

Underwriters have become more willing to address this issue by providing that the lockup will expire (for all or a portion of the locked-up shares) a specified number of days prior to the beginning of the blackout period, but no sooner than a specified minimum number of days after the offering. Alternatively, if not all employees are subject to the company's regular, quarter-end blackout periods, and the company wants the lockup to expire on the same date for all holders, the lockup agreement could provide that the lockup period will not expire until the opening of the regular trading window after the blackout period ends (typically the beginning of the third trading day after the company's issuance of an earnings release for the quarter). Although this approach ensures uniform treatment of all holders, it could result in a lengthier lockup than intended.

Are You an Officer?

You May Need a Scorecard to Keep Track of the Answer

This seemingly simple question often yields a surprisingly complex answer because SEC rules, state corporate law, federal tax law and common parlance provide multiple definitions of "officer." The answers under these different definitions are significant, as they can trigger various disclosure obligations and potential liabilities.

CORPORATE OFFICERS

A company's "corporate officers" are defined by state corporate law and the company's bylaws. Corporate officers have the authority and duties specified in the bylaws or established by the board, can generally create binding obligations on behalf of the company, and often receive the benefit of any indemnification provisions contained in a company's charter or bylaws. In addition, employees with titles ordinarily conferred on officers (such as vice president) can have "apparent authority" or "implied authority" to bind the company in dealing with third parties even if they are not appointed corporate officers. There are no specific SEC disclosure obligations that flow from "corporate officer" status.

OFFICERS

Rule 3b-2 under the Exchange Act defines a company's "officers" as its president, vice president, secretary, treasury or principal financial officer, controller or principal accounting officer, and any person routinely performing corresponding functions for the company. This definition, although expansive, has limited practical significance since most required management disclosures apply to "executive officers" and not "officers" generally.

EXECUTIVE OFFICERS

Rule 3b-7 under the Exchange Act defines a company's "executive officers" as its president; any vice president in charge of a principal business unit, division or function; any other officer who performs a policy-making function; and any other person who performs similar policy-making functions.

NAMED EXECUTIVE OFFICERS

Item 402(a)(3) of Regulation S-K defines a company's "named executive officers" (NEOs) as anyone who served as the principal executive officer or principal financial officer during the company's previous fiscal year, regardless of compensation, and the other three highest-paid executive officers who were serving as executive officers at the end of the company's previous fiscal year (plus up to two additional individuals who served as executive officers during the last completed year and for whom disclosure would have been required but for the fact that they were not serving as executive officers of the company at the end of the year). Emerging growth companies and smaller reporting companies are only required to identify three NEOs (including anyone who served as the principal executive officer during the previous fiscal year), plus up to two additional individuals who served as executive officers during the last completed year and for whom disclosure would have been required but for the fact that they were not serving as executive officers at the end of the year.

PRINCIPAL OFFICERS

Various SEC rules and forms reference—but do not define—a company's "principal executive officer" (almost always the CEO), "principal financial officer" (almost always the CFO) and "principal accounting officer" (usually the CFO or controller). These officers must sign (and potentially have personal liability for) registration statements (such as a Form S-1 for an IPO) and certain other SEC filings.

SECTION 16 OFFICERS

Specified officers of every public company—often referred to as "Section 16 officers"—are subject to the public reporting and short-swing liability provisions of Section 16 of the Exchange Act. Pursuant to Rule 16a-1(f) under the Exchange Act, a company's Section 16 officers generally are the same as its executive officers, except that the principal accounting officer (or the controller, if there is no principal accounting officer) automatically is a Section 16 officer even if the company does not otherwise consider such person to be an executive officer. References in stock exchange rules to "executive officers" (for example, the requirement for compensation committee approval of executive compensation) generally mean Section 16 officers.

OFFICERS SUBJECT TO SECTION 162(m)

Section 162(m) of the Internal Revenue Code disallows a federal income tax deduction by a public company for compensation in excess of $1 million paid in a single tax year to a "covered employee," generally defined as the principal executive officer, the principal financial officer, the other three highest-paid officers, and any individual who has been such a "covered employee" for any tax year beginning on or after January 1, 2017. For tax years beginning after December 31, 2026, an additional five highest compensated employees (even if not officers) will also be considered "covered employees."

C-LEVEL OFFICERS

The colloquial phrase "C-level officers" may refer to a company's chief executive officer, chief financial officer, chief operating officer, chief accounting officer and chief legal officer (and perhaps other chiefs). These terms are sometimes used—but not defined—in SEC rules. ■

WHO ARE THE EXECUTIVE OFFICERS?

The determination of the company's executive officers is often difficult. The CEO and CFO are always executive officers, but beyond that there typically is some subjectivity in applying the SEC's definition. The "policy-making" test, for example, can be challenging to apply if the company has one or two executives who control decision-making or a management structure that treats a large group of leaders as peers. Many companies find it helpful, in applying the relevant definitions, to focus on the universe of officers who report directly to the CEO or, if the company has multiple levels of vice president, on those at or above a specified level, such as executive vice president.

The Form S-1 for an IPO must include specified information about a company's directors, officers, 5% stockholders and any selling stockholders. Below is an overview of the principal disclosures that are required.

BIOGRAPHICAL AND BACKGROUND INFORMATION

- The Form S-1 must include biographical and background information (perhaps including diversity characteristics) for each *director and executive officer.*
- The required information includes specified bankruptcy, criminal, injunction, securities violation and stock exchange matters that occurred during the past ten years and that are material to an evaluation of the ability or integrity of a *director or executive officer.*

COMPENSATION

- The Form S-1 must include extensive compensation information for each of the company's *named executive officers* (NEOs).
- Compensation disclosures are for the fiscal year preceding the initial Form S-1 submission plus subsequently completed fiscal years prior to effectiveness of the Form S-1.
- The Form S-1 must disclose *director* compensation (including consulting arrangements).

STOCK OWNERSHIP

- The Form S-1 must disclose the beneficial stock ownership of each *director, NEO, 5% stockholder and selling stockholder.* For this purpose, a person is considered to have beneficial ownership of all company securities over which the person has or shares (or has the right to acquire within 60 days) voting or investment power.
- Each *director, officer and 10% stockholder* must file Form 3 with the SEC to report beneficial stock ownership (based on "pecuniary interest") as of the IPO and, post-IPO, must file Forms 4 and 5 to report all changes in beneficial ownership.
- Post-IPO, each *5% stockholder* must also file a Schedule 13D or 13G to report beneficial stock ownership (based on voting or investment power) and must amend such filings to report certain changes.

RELATED PERSON TRANSACTIONS

- The Form S-1 must disclose all transactions in which the company was a participant since the beginning of its third preceding full fiscal year that involved an amount in excess of $120,000 and in which a *director or executive officer* (or any immediate family member of the foregoing) had or will have a direct or indirect material interest.
- The Form S-1 must disclose all transactions in which the company was a participant since the beginning of its third preceding full fiscal year that involved an amount in excess of $120,000 and in which a then-*5% stockholder* (or any immediate family member of the *5% stockholder*) had or will have a direct or indirect material interest.

SELLING STOCKHOLDERS

- The Form S-1 must disclose the name and beneficial stock ownership of each *selling stockholder*, state the number of shares to be sold by each *selling stockholder*, and indicate the nature of any position, office or other material relationship that any *selling stockholder* has had with the company or any of its predecessors or affiliates within the past three years.
- If a *selling stockholder* is not a natural person, the Form S-1 must also identify any persons (entities or natural persons) who control the *selling stockholder*, and who have had a material relationship with the company or any of its predecessors or affiliates within the past three years, and describe the nature of any such relationships.
- The company may make beneficial ownership disclosures for *selling stockholders* on an unnamed group basis, as opposed to an individual basis, where the aggregate holding of the group is less than 1% of the company's outstanding shares prior to the IPO.

FINRA RELATIONSHIPS

In order to obtain approval of the IPO's underwriting arrangements from the Financial Industry Regulatory Authority (FINRA), the managing underwriters must provide representations and information to FINRA relating to arrangements, relationships and affiliations between the company or its *stockholders* and FINRA members. This information is not publicly disclosed, but the Form S-1 must disclose any relationship between the company and a FINRA member participating in the IPO that gives rise to a "conflict of interest" under FINRA rules.

FinCEN CERTIFICATIONS

Under Financial Crimes Enforcement Network (FinCEN) rules, financial institutions (including underwriters) are required to identify and verify the identity of the individuals who own or control legal entity customers. As a result, a FinCEN certification form, together with copies of identifying documentation, must be provided by each *selling stockholder* that is a legal entity. FinCEN certifications must also be obtained from the company; a single individual (such as the CEO) with significant responsibility to control, manage or direct the company; and each individual (if any) who directly or indirectly owns 25% or more of the equity interests of the company. ■

OBTAINING REQUIRED INFORMATION

Required information is elicited from the company's directors, officers and 5% stockholders through the use of a questionnaire (commonly called the "D&O questionnaire"). These same persons, along with the company and anyone else who acquired company securities (including warrants, options or other equity-based awards) within the 180 days preceding the date of the initial Form S-1 submission, complete a separate "FINRA questionnaire." If the offering includes selling stockholders, a separate questionnaire eliciting required selling stockholder disclosures

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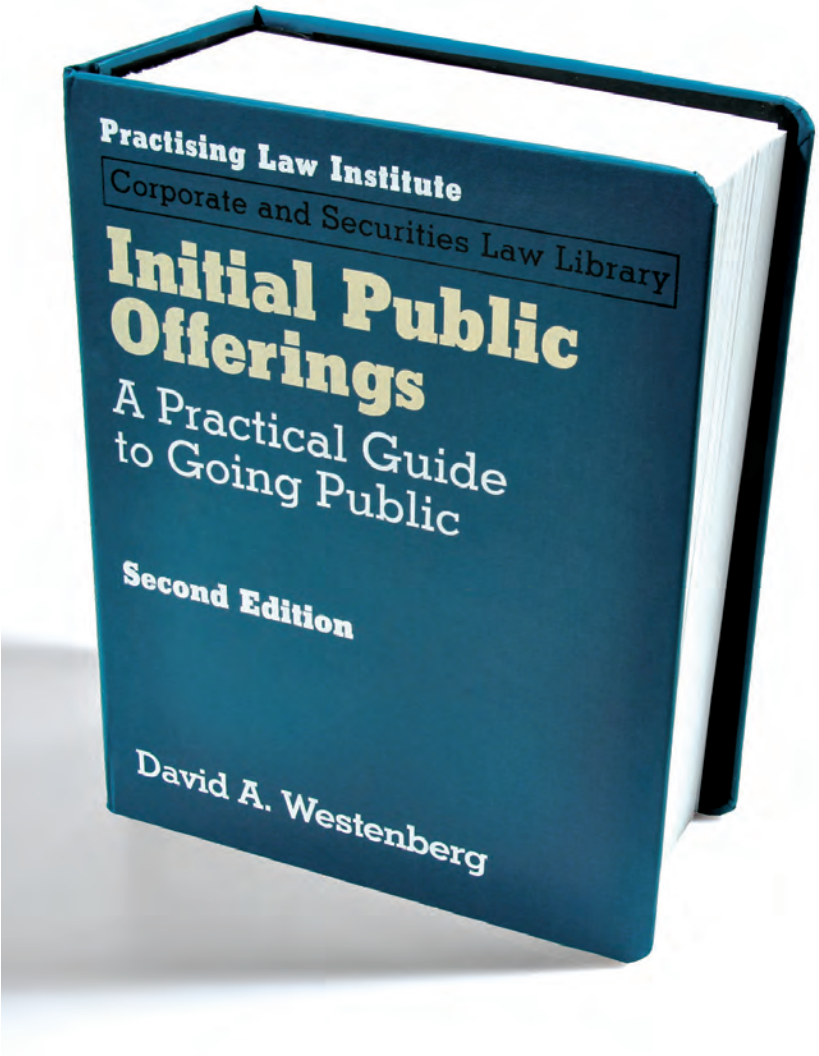

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"CEOs should keep this book at their side from the moment they first seriously consider an IPO … and will soon find it dog-eared with sections that inspire clarity and confidence."
— Don Bulens, CEO of EqualLogic at the time it pursued a dual-track IPO

"A must-read for company executives, securities lawyers and capital markets professionals alike."
— John Tyree, Managing Director, Morgan Stanley

More information at **IPOguidebook.com**
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Want to know more about the venture capital and M&A markets?

WilmerHale's *2022 Venture Capital Report* offers an in-depth US venture capital market analysis and outlook, including industry and regional breakdowns. We provide useful tips to help startups pave the way to an IPO or company sale from the outset, as well as simple steps to shore up your company's IP without breaking the bank. We also look at the ways in which an increasingly remote workforce is re-mapping the landscape of state tax compliance and discuss immigration basics for startups thinking of hiring skilled workers from overseas. Finally, we offer a roundup of deal term trends in VC-backed company M&A transactions and convertible note, SAFE and venture capital financings.

See our *2022 M&A Report* for a global M&A market review and outlook, plus an update on takeover defenses for public companies. We review the rise of SPAC mergers and direct listings to create a new multi-track road to liquidity and take a closer look at the SPAC phenomenon and headwinds that have slowed its wild ride. We also examine the anti-corruption issues companies must address in the M&A context, compare public and private company M&A deal terms, and review deal term trends in VC-backed company acquisitions.

www.wilmerhale.com/2022IPOreport.

Data Sources: WilmerHale compiled all data in this report unless otherwise indicated. Direct listings and offerings by special purpose acquisition companies, REITs, bank conversions, closed-end investment trusts, oil & gas limited partnerships and unit trusts are excluded from IPO data, except as otherwise indicated. Offering proceeds generally exclude proceeds from exercise of underwriters' over-allotment options, if applicable. Venture capital data is sourced from SEC filings and PitchBook. Private equity–backed IPO data is sourced from SEC filings and Refinitiv.

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