

2016 IPO Report

CORPORATE



WILMERHALE® 

2	US Market Review and Outlook
6	Regional Market Review and Outlook <ul style="list-style-type: none">– California– Mid-Atlantic– New England– Tri-State
8	Some Facts About the IPO Market
9	JOBS Act Relief: An Update on EGC Elections
10	FAST Act Offers Additional Benefits to Emerging Growth Companies
12	The Changing Tides of Corporate Governance
14	Selected WilmerHale Public Offerings
16	Law Firm Rankings
18	Respecting Boundaries: A Brief Guide to Permissible Research Analyst Activities
20	Hot Topics in SEC Review
21	Ask Meredith: A Q&A with Former SEC Corp Fin Director Cross
22	SEC Renews Enforcement Focus on Financial Reporting
23	Liability Considerations for Directors and Officers in an IPO
26	Public Company Compensation and Section 162(m)
28	<i>Initial Public Offerings: A Practical Guide to Going Public</i>

2 US Market Review and Outlook

REVIEW

The 2015 IPO market produced 152 IPOs, a disappointing tally that lagged well behind the 244 IPOs in 2014 despite continued strength in the life sciences sector. Setting aside the anomalous years of 2008 and 2009, however, the 2015 total was largely in line with the annual average of 157 IPOs that prevailed over the ten-year period preceding 2014.

The year started slowly, with the first quarter producing 28 IPOs. The pace of new offerings increased to 63 in the second quarter—June’s 33 IPOs represented the highest monthly total since 2000. The IPO market struggled for the balance of the year, with deal flow hampered by heightened volatility and broad market declines. The major indices all hit yearly lows in late August, as the capital markets reeled from news of surprisingly slow economic growth in China. The third quarter produced 31 IPOs and the fourth quarter added 30 more. The year ended on a whimper, with only a pair of new offerings in December—the second-slowest December in the last fifteen years, eclipsed only by the donut in 2008 at the height of the financial crisis.

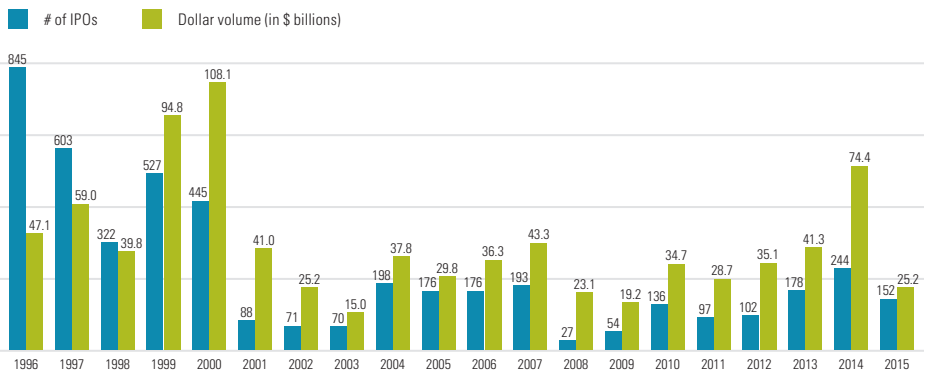
Gross proceeds for 2015 were \$25.17 billion, the third-lowest annual total over the past decade, and almost two-thirds below the \$74.39 billion raised by IPO companies in 2014. The 2015 total was almost one-quarter less than the average annual gross proceeds of \$32.92 billion over the ten-year period preceding 2014.

The median offering size declined for the second consecutive year, reaching \$91.7 million in 2015, down from \$96.0 million in 2014 and \$107.4 million in 2013. The 2015 figure represents the second-lowest annual median offering size since 2000.

The decline in gross proceeds and median offering size for 2015 are both explained, at least in part, by the high proportion of IPOs by life sciences companies, which typically have smaller offerings, and the overall dominance of IPOs by emerging growth companies (EGCs), of which most life sciences companies are a subset. Worsening market conditions in the second half of 2015 contributed to the reduction in the median offering size from the prior year.

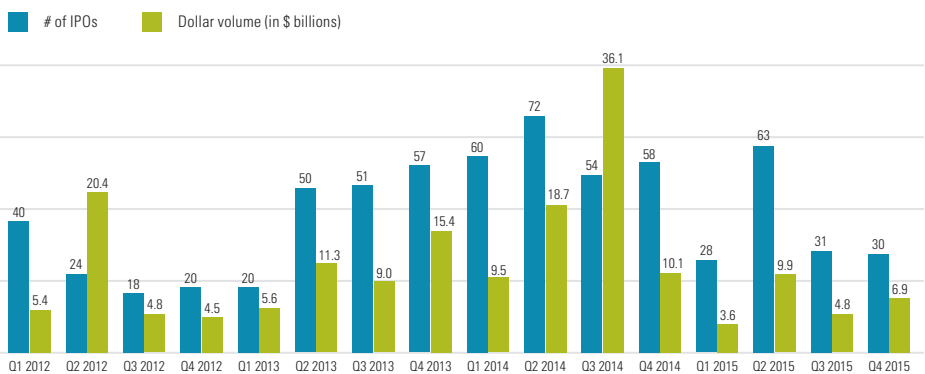
The paucity of large IPOs in 2015 also contributed to the gross proceeds shortfall

US IPOs by Year – 1996 to 2015



Source: SEC filings

US IPOs by Quarter – 2012 to 2015



Source: SEC filings

Median IPO Offering Size – 1996 to 2015



Source: SEC filings

compared to prior years. There was only a single billion-dollar IPO in 2015, and another seven IPOs that raised \$500 million or more, a stark decline from the prior two years. In 2014, there were nine billion-dollar IPOs, with an additional 15 that raised at least \$500 million, while 2013 generated six billion-dollar IPOs, and another 12 raised \$500 million or more.

Life sciences companies accounted for 47% of all US IPOs in 2015, up from 40% in 2014 and 28% in 2013. EGCs accounted for all but ten of the year's IPOs, or 93% of the total, compared to 85% of all IPOs in 2014 and 82% in 2013. The median offering size for life sciences IPOs increased from \$59.0 million in 2014 to \$71.8 million in 2015. Among non-life sciences IPO companies, the median offering size in 2015 was \$128.5 million, up slightly from the \$126.2 million figure in 2014, nearly matching the \$128.1 million median that prevailed over the five-year period preceding 2015. The median offering size for IPOs by EGCs in 2015 was \$81.0 million (down from \$86.7 million in 2014), compared to \$450.5 million for IPOs by non-EGCs (up from \$446.7 million in 2014).

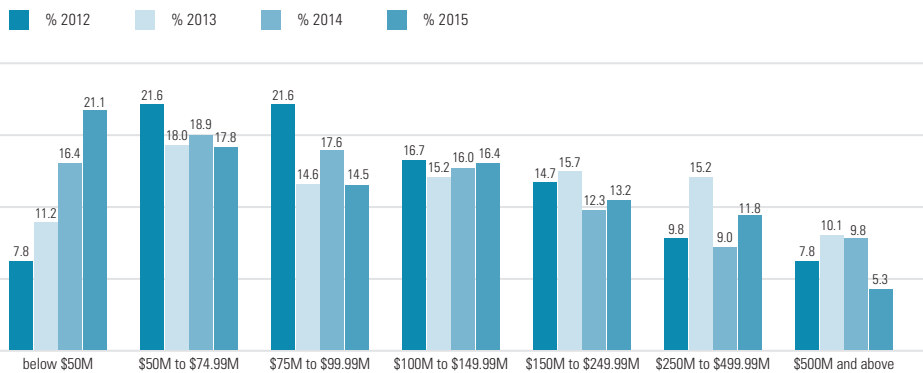
The average 2015 IPO produced a first-day gain of 16%, improving on the 14% first-day gain for all IPOs in 2014 and marking the second-highest annual figure since 2000 (trailing only the 21% average gain for 2013).

There were five “moonshots” (IPOs that double in price on their opening day) in 2015—down from seven in 2014. All five saw that gain erode in the aftermarket, ending the year trading an average of 23% below their first-day close.

In 2015, 26% of all IPOs were “broken” (IPOs whose stock closes below the offering price on their first day), just under the 27% tally for 2014 but slightly higher than the 25% figure that prevailed over the five-year period preceding 2014. Only six of 2015's 39 broken IPOs recovered their first-day loss by the end of the year.

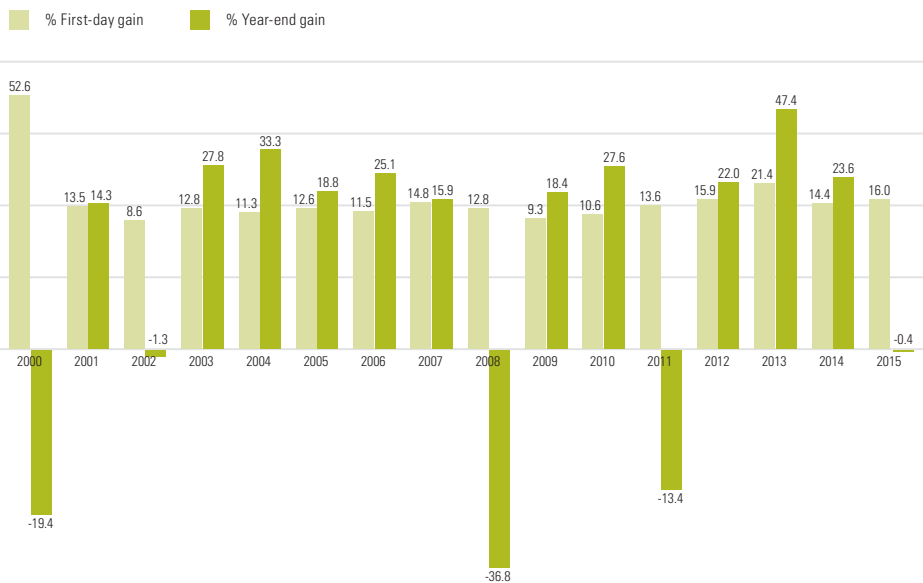
By year-end, the average 2015 IPO company had seen its first-day gain entirely erased, ending the year 0.4% below its offering price. While 28% of all 2015 IPO companies were trading at least 20% above their offering price at year-end, 55% were trading below their offering price and 68% were trading below their first-day closing price.

Distribution of IPO Offering Size – 2012 to 2015

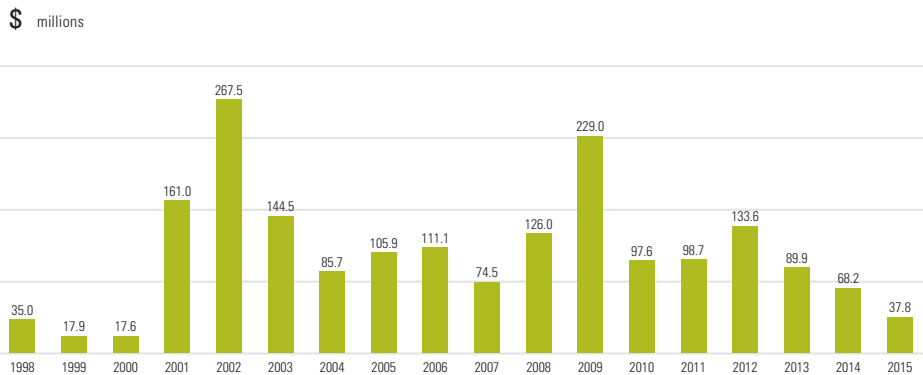


Source: SEC filings

Average IPO First-Day and Year-End Gain by Year – 2000 to 2015



Median Annual Revenue of IPO Companies – 1998 to 2015



Source: SEC filings and IPO Vital Signs

4 US Market Review and Outlook

All but one of the top ten performers at year-end, based on percentage gain from offering price, was a life sciences company. The year's best performer was Aclaris Therapeutics, which was trading 145% above its offering price at year-end, followed by Collegium Pharmaceutical (up 129%) and Spark Therapeutics (up 97%). The best-performing non-life sciences company was Shake Shack, up 89%.

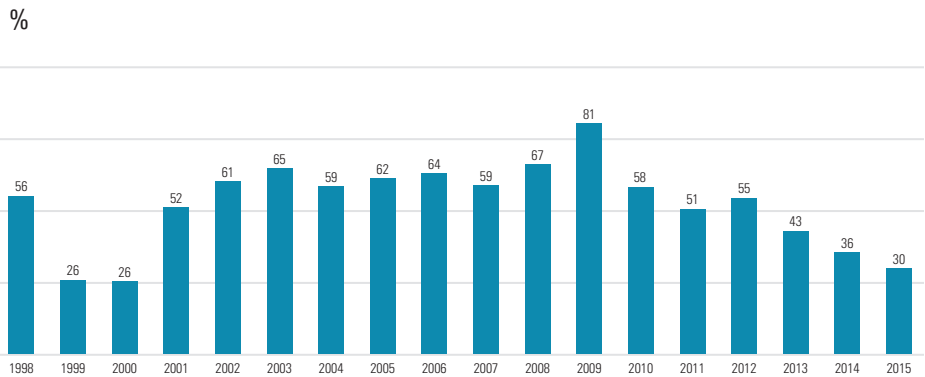
The prevalence of life sciences IPO companies affected median annual revenue and profitability statistics in 2015. The median annual revenue of all IPO companies in 2015 was \$37.8 million—45% less than the \$68.2 million figure for 2014 and 65% below the \$108.8 million figure for the five-year period preceding 2014. Life sciences IPO companies in 2015 had median annual revenue of \$0.1 million, compared to \$120.1 million for all other IPO companies.

The percentage of profitable IPO companies declined to 30% in 2015, from 36% in 2014 and 46% in 2013. Only 6% of life sciences IPO companies in 2015 were profitable, compared to 53% of all other IPO companies. The latter figure is comparable to the 57% figure that prevailed over the five-year period preceding 2015 for non-life sciences IPO companies.

Individual components of the IPO market fared as follows in 2015:

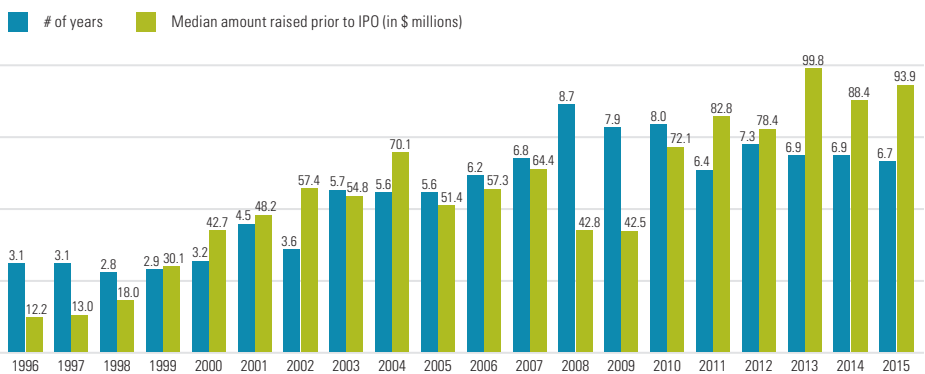
- VC-Backed IPOs:** The number of IPOs by venture capital-backed US issuers declined 38%, from 102 in 2014 to 63 in 2015, accounting for 54% of all US-issuer IPOs in 2015. The median offering size for US venture-backed IPOs increased 4%, from \$75.0 million in 2014 to \$77.9 million in 2015. The median deal size for non-VC-backed companies in 2015 was \$113.3 million. The average 2015 US issuer VC-backed IPO gained 3% from its offering price through year-end.
- PE-Backed IPOs:** Private equity-backed IPOs by US issuers declined 41%, from 46 in 2014 to 27 in 2015. Overall, PE-backed issuers accounted for 23% of all US-issuer IPOs in 2015, down from 25% in 2014. The median deal size for PE-backed IPOs in 2015 was \$222.5 million—almost triple the \$78.6 million figure for all other IPOs. The average PE-backed IPO in 2015 gained 4% from its offering price through year-end.

Percentage of Profitable IPO Companies – 1998 to 2015



Source: SEC filings and IPO Vital Signs

Median Time to IPO and Median Amount Raised Prior to IPO – 1996 to 2015



Source: Dow Jones VentureSource and SEC filings

- Life Sciences IPOs:** Although the number of life sciences company IPOs declined from 98 in 2014 to 72 in 2015, the sector captured 47% of the US IPO market in 2015. The average life sciences IPO company in 2015 ended the year down 1% from its offering price, and 61% of the year's crop were trading below their offering price at year-end.
- Tech IPOs:** Deal flow in the technology sector declined by almost half, from 69 IPOs in 2014 to 35 IPOs in 2015—the lowest annual number since 2009. The tech sector's share of the US IPO market has now fallen for five consecutive years, from 46% in 2011 to 23% in 2015. The average tech IPO ended the year with a gain of 2% from its offering price, compared to an average loss of 1% for non-tech IPOs.
- Foreign Issuer IPOs:** The number of US IPOs by foreign issuers declined by 42% from 60 in 2014 (25% of the market) to 35 in 2015 (23% of the market). Among foreign issuers in 2015, Chinese companies led with five IPOs, followed by issuers from Canada, Israel and the United Kingdom (each with four IPOs). The average foreign issuer IPO company ended the year trading 3% below its offering price.

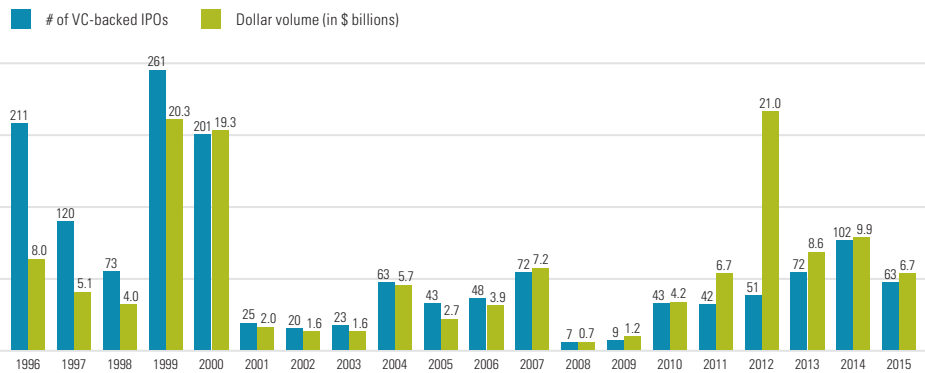
In 2015, 62 companies based in the eastern United States (east of the Mississippi River) completed IPOs. Western US-based issuers accounted for 55 IPOs, and foreign issuers accounted for the remaining 35 IPOs. California led the state rankings with 35 IPOs, followed by Massachusetts (with 14 IPOs), New York and Texas (each with nine IPOs).

OUTLOOK

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

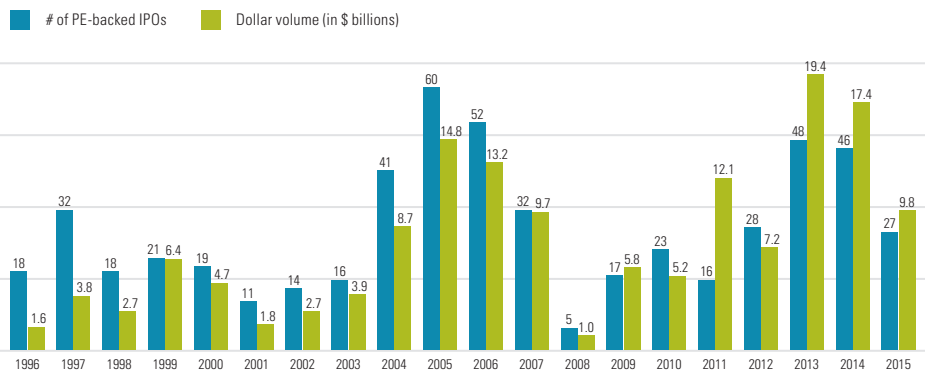
- Economic Growth:** While the US economy has continued to improve in a number of key metrics, global economic growth remains anemic at best, with economic stagnation affecting many countries. Slowing growth in China—until now a stalwart of economic growth—is having a ripple effect on the US capital markets. Rather than stimulating economic growth, the sharp decline in oil prices is further weighing on the IPO market. Moreover, after seven years with interest rates at historic lows, the Federal Reserve raised its benchmark interest rate in late 2015, raising the specter of further hikes in 2016. A clearer view of sustained economic growth will be key if the IPO market is to maintain or increase the pace that prevailed in 2015.
- Capital Market Conditions:** After several years of impressive gains, the major US indices posted mixed results in 2015, with the S&P 500 and Dow Jones Industrial Average down 1% and 2% respectively, and the Nasdaq Composite Index up 6%. All three declined sharply in the first two months of 2016. In addition, volatility increased in the second half of 2015 and remained high into early 2016. A return to more robust and less volatile capital market conditions would contribute to increased IPO activity.
- Venture Capital Pipeline:** Before declining by nearly 40% in 2015, VC-backed IPOs had resurged over the preceding five years. In spite of 2015’s disappointing performance, the pool of attractive VC-backed IPO candidates remains large, including approximately 150 “unicorns” (private tech companies valued at \$1 billion or more). Many VC-backed companies may have delayed their IPOs because it has been easy to raise capital privately in recent years, but—as more questions are raised about excessive private valuations—other VC-backed companies may be deterred by the harsh reality of the public markets.
- Private Equity Impact:** Private equity firms are still sitting on near-record levels of “dry powder” (unspent capital that

Venture Capital–Backed IPOs – 1996 to 2015



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

Private Equity–Backed IPOs – 1996 to 2015



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

investors have committed to provide) and the supply of capital is causing competition for quality deals to intensify, driving up prices. The recent hike in interest rates may cause headwinds for highly leveraged private equity–backed companies that are eyeing IPOs in 2016. With uncertain economic times, however, investors may have a greater affinity for IPOs by PE-backed companies with proven profitability and cash flows.

- Impact of JOBS Act:** The extent to which the JOBS Act has prompted IPOs by companies that otherwise would not have gone public is unknown. What is clear, however, is that the confidential submission provisions of the act and the significant increase in the maximum number of stockholders that a private company may have without registering

as a public company have given EGCs more flexibility in timing their IPOs. The FAST Act’s recent changes to the JOBS Act—most notably those that permit EGCs, in certain circumstances, to omit financial information for historical periods otherwise required in a registration statement and reduce the minimum period of time between public filing and the road show from 21 to 15 days—should further smooth the IPO journey for EGCs.

Although the IPO market entered 2016 at the slowest pace since 2009, without a single IPO in January and only four in February, a number of qualified companies are poised to come to market when conditions are more conducive. As long as favorable economic tailwinds continue to prevail, the currently stalled deal flow can be expected to resume as capital market conditions improve. ■

6 Regional Market Review and Outlook

CALIFORNIA

After five successive years of growth, the California IPO market contracted in 2015. The year produced 35 IPOs, 34% fewer than the 54 IPOs in 2014.

Gross proceeds in 2015 were \$4.70 billion, down 25% from the \$6.26 billion in 2014. The decline in gross proceeds from California IPOs in 2015 reflects decreased deal flow and the continued presence of a large number of smaller offerings by life sciences companies.

The largest California IPO in 2015 came from Fitbit (\$732 million)—the fourth-largest US IPO of the year—followed by offerings from Pure Storage (\$425 million) and 8point3 Energy Partners (\$420 million).

The California IPO market continues to be dominated by technology and life sciences companies, which together accounted for 91% of the state's offerings in 2015, compared to an average of 57% for all other states.

The number of venture-backed California IPOs decreased by 32%, from 44 in 2014 to 30 in 2015—representing 48% of all US issuer VC-backed IPOs.

The average California IPO in 2015 produced a first-day gain of 20%, but by year-end that gain was whittled down to 0.5% in the aftermarket. At year-end, 49% of the state's IPOs were trading above their offering price, slightly higher than the 44% figure for all other US IPOs in 2015.

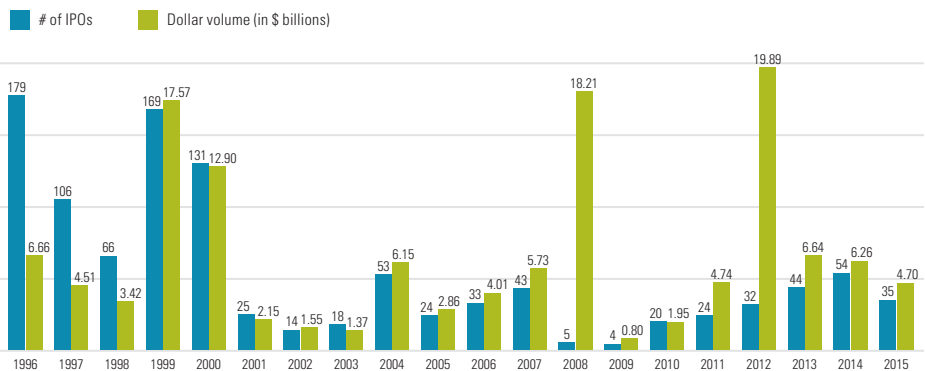
The five best-performing California IPOs were all from life sciences companies, led by Penumbra (up 79% at year-end), Avinger (up 75%) and CytomX Therapeutics (up 74%).

With the largest pool of venture capital-backed companies in the country and a wealth of entrepreneurial talent, California should remain a major source of attractive IPO candidates in 2016, particularly from the technology and life sciences sectors.

MID-ATLANTIC

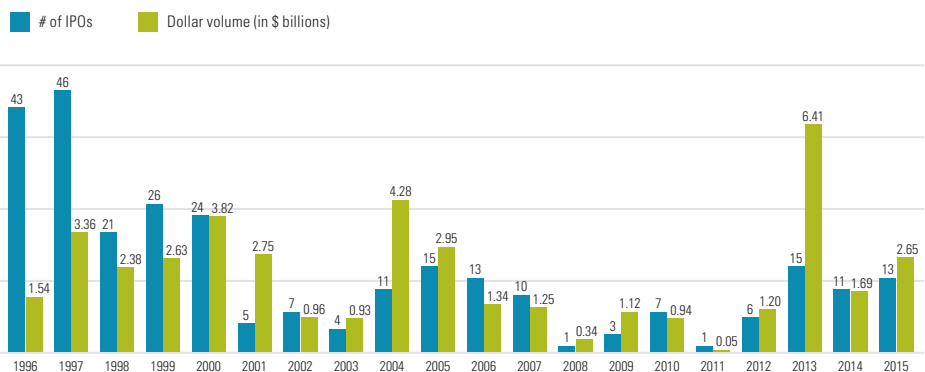
The number of IPOs in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of

California IPOs – 1996 to 2015



Source: SEC filings

Mid-Atlantic IPOs – 1996 to 2015



Source: SEC filings

Columbia bucked the overall market trend, increasing from 11 in 2014 to 13 in 2015. The tally in 2015 was the third-highest annual figure in the region since 2000, behind only the 15 IPOs in both 2014 and 2005.

Maryland led the region for the second time in the last four years, with six IPOs, followed by North Carolina with four. Virginia accounted for the remaining three IPOs from the region.

Gross proceeds increased 57%, from \$1.69 billion in 2014 to \$2.65 billion in 2015—the second-highest figure for the region over the last ten years.

The largest mid-Atlantic IPOs of 2015 came from TerraForm Global (\$675 million) and Inovalon Holdings (\$600 million).

Despite strong deal flow in 2015, the region's IPOs fared poorly in terms of first-day gains and aftermarket performance. The average mid-Atlantic IPO produced a first-day gain of only 4%, compared to 17% for all other US IPOs. At year-end, only two of the region's 2015 IPOs were trading above their offering price, and the average mid-Atlantic IPO company was down 32% from its offering price.

Life sciences and technology companies led the region in 2015, producing more than half of the year's mid-Atlantic IPOs, with additional offerings from healthcare, energy and financial services companies. With improvements in market conditions, companies from the life sciences and technology sectors, along with companies from other industries, should be viable IPO candidates in 2016.

NEW ENGLAND

After nearly tripling between 2013 and 2014, the number of New England IPOs dropped from 32 in 2014 to 16 in 2015. Despite the decline, the 2015 figure represents the third-highest annual total in the region since 2000, trailing only 2014's rich yield and the 23 IPOs in 2007.

Massachusetts accounted for 14 of the region's IPOs in 2015—the second-highest state total in the country for the third consecutive year, behind only California—with Connecticut and New Hampshire each adding one IPO.

Gross proceeds in the region declined 77%, to \$2.25 billion in 2015 from \$9.72 billion in 2014—the 2014 figure having been inflated by two of the three largest US IPOs of that year.

The largest New England IPO in 2015 was by Blue Buffalo Pet Products (\$677 million), followed by Press Ganey Holdings (\$223 million) and Planet Fitness (\$216 million).

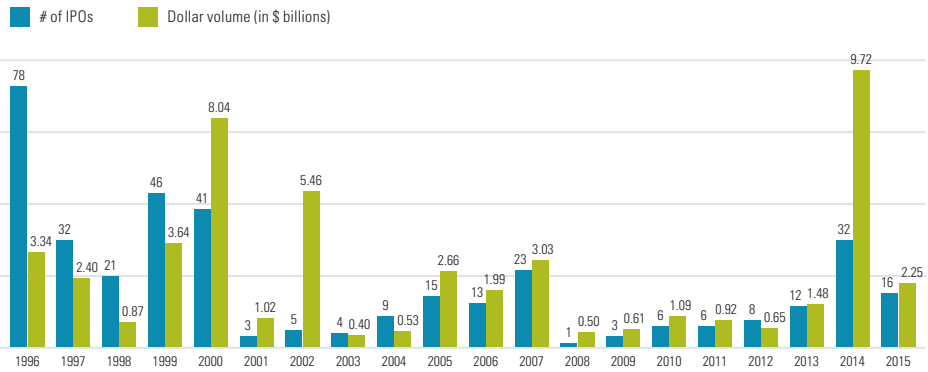
Technology and life sciences companies accounted for all but two of the region's IPOs in 2015. While the number of venture-backed New England IPOs decreased from 25 in 2014 to 12 in 2015, the region still accounted for roughly one-fifth of all US issuer VC-backed IPOs.

Life sciences companies accounted for three-quarters of the region's IPOs in 2015, all coming from Massachusetts, and representing 24% of all life sciences IPOs by US issuers.

At year-end, the average New England IPO was up 21% from its offering price, led by Collegium Pharmaceutical (up 129% at year-end), Seres Therapeutics (up 95%) and Inotek Pharmaceuticals (up 89%).

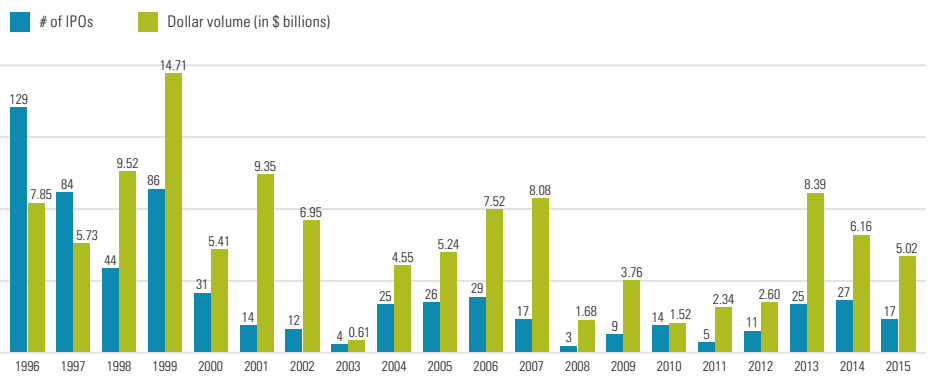
Drawing on the region's world-renowned universities and research institutions, and with strong levels of venture capital investment, New England should continue to generate attractive IPO candidates from the life sciences and technology sectors. Editas Medicine, for example, completed the nation's first IPO of the year in early February, followed by another Massachusetts life sciences company a week later. Several technology companies are poised to follow suit.

New England IPOs – 1996 to 2015



Source: SEC filings

Tri-State IPOs – 1996 to 2015



Source: SEC filings

TRI-STATE

The number of IPOs in the tri-state region of New York, New Jersey and Pennsylvania declined from 27 in 2014 to 17 in 2015. Despite the decline, the 2015 count is equal to the average annual number of IPOs that prevailed over the ten-year period preceding 2015.

New York produced nine of the region's 2015 IPOs, followed by Pennsylvania with six and New Jersey with two.

Gross proceeds declined 19%, from \$6.16 billion in 2014 to \$5.02 billion in 2015. The largest 2015 IPOs in the region came from First Data (\$2.56 billion)—the only billion-dollar tri-state IPO of the year—and Party City Holdco (\$372 million).

Technology and life sciences-related companies accounted for 65% of the region's offerings in 2015, down from the 70% in 2014.

The average tri-state IPO in 2015 produced a first-day gain of 26% and ended the year up 4% from its offering price.

The three best-performing IPOs in the region came from Spark Therapeutics (up 145% at year-end), Shake Shack (up 97%) and Virtu Financial (up 89%).

With venture capital activity in the tri-state region now trailing only that of California, the region should continue to produce qualified IPO companies in 2016, particularly from the life sciences and technology sectors. ■

8 Some Facts About the IPO Market

PROFILE OF SUCCESSFUL IPO CANDIDATES

What does it really take to go public?

There is no single profile of a successful IPO company, but in general the most attractive candidates have the following attributes:

- Outstanding Management:** An investment truism is that investors invest in people, and this is even truer for companies going public. Every company going public needs experienced and talented management with high integrity, a vision for the future, lots of energy to withstand the rigors of the IPO process, and a proven ability to execute.
- Market Differentiation:** IPO candidates need a superior technology, product or service in a large and growing market. Ideally, they are viewed as market leaders. Appropriate intellectual property protection is expected of technology companies, and in some sectors patents are *de rigueur*.
- Substantial Revenue:** With some exceptions, substantial revenue is expected—at least \$50 million to \$75 million annually—in order to provide a platform for attractive levels of profitability and market capitalization.
- Revenue Growth:** Consistent and strong revenue growth—25% or more annually—is usually needed, unless the company has other compelling features. The company should be able to anticipate continued and predictable expansion to avoid the market punishment that accompanies revenue and earnings surprises.
- Profitability:** Strong IPO candidates generally have track records of earnings and a demonstrated ability to enhance margins over time.
- Market Capitalization:** The company's potential market capitalization should be at least \$200 million to \$250 million, in order to facilitate development of a liquid trading market. If a large portion of the company will be owned by insiders following the IPO, a larger market cap may be needed to provide ample float.


How Do You Compare?

Set forth below are selected metrics about the IPO market, based on combined data for all US IPOs from 2013 through 2015.

Percentage of IPO companies qualifying as "emerging growth companies" under JOBS Act	86%
Median offering size	\$100.0 million (16% below \$50 million and 9% above \$500 million)
Median annual revenue of IPO companies	\$64.5 million (45% below \$50 million and 19% above \$500 million)
Percentage of IPO companies that are profitable	37%
State of incorporation of IPO companies	Delaware—94% No other state over 1%
Percentage of IPOs including selling stockholders, and median percentage of offering represented by those shares	Percentage of IPOs—26% Median percentage of offering—31%
Percentage of IPOs including directed share programs, and median percentage of offering represented by those shares	Percentage of IPOs—40% Median percentage of offering—5%
Percentage of IPO companies disclosing adoption of ESPP	44%
Percentage of IPO companies using a "Big 4" accounting firm	80%
Stock exchange on which the company's common stock is listed	Nasdaq—62% NYSE—38%
Median underwriting discount	7%
Number of SEC comments contained in initial comment letter	Median—33 25th percentile—24 75th percentile—44
Median number of Form S-1 amendments (excluding exhibits-only amendments) filed before effectiveness	Five
Time elapsed from initial confidential submission to initial public filing of Form S-1 (EGCs only)	Median—63 calendar days 25th percentile—44 calendar days 75th percentile—99 calendar days
Overall time elapsed from initial filing (or confidential submission) to effectiveness of Form S-1	Median—113 calendar days 25th percentile—89 calendar days 75th percentile—158 calendar days
Median offering expenses (2015 IPOs)	Legal—\$1,500,000 Accounting—\$850,000 Total—\$3,200,000

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

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

 The cornerstone of the JOBS Act is the creation of an “IPO on-ramp” that provides “emerging growth companies” (EGCs) with a phase-in period, which can last until the last day of the fiscal year following the fifth anniversary of an IPO, to come into full compliance with certain disclosure and accounting requirements. Although the overwhelming majority of all IPO candidates are likely to qualify as EGCs—approximately 85% of all IPO companies since the enactment of the JOBS Act have been EGCs—the extent to which EGC standards are being adopted in IPOs varies. Moreover, practices differ between life sciences companies and other types of IPO companies.

CONFIDENTIAL SUBMISSION OF FORM S-1

An EGC is able to submit a draft Form S-1 registration statement to the SEC for confidential review instead of filing it publicly on the SEC’s EDGAR system. A Form S-1 that is confidentially submitted must be substantially complete, including all required financial statements and signed audit reports. The SEC review process for a confidential submission is the same as for a public filing. A confidentially submitted Form S-1 must be filed publicly no later than 15 days before the road show commences (reduced from 21 days under the FAST Act, effective December 4, 2015).

Confidential submission enables an EGC to maintain its IPO plans in secrecy and delay disclosure of sensitive information to competitors and employees until much later in the process. Depending on the timing, confidential review also means that the EGC can withdraw the Form S-1 without any public disclosure at all if, for example, the SEC raises serious disclosure issues that the EGC does not want made public or market conditions make it apparent that an offering cannot proceed. Confidential submission will, however, delay any perceived benefits of public filing, such as the attraction of potential acquirers in a “dual-track” IPO process.

REDUCED FINANCIAL DISCLOSURE

In the Form S-1, EGCs are required to provide only two years of audited financial statements (instead of three years), plus unaudited interim financial statements,

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

Some investors prefer to continue to receive three full years of audited financial statements and five years of selected financial data, and an EGC may be disadvantaged if it provides less financial information than its non-EGC peers. These deviations from historical norms are more likely to be acceptable to investors in the case of EGCs for which older financial information is largely irrelevant, such as startups in the life sciences industry.

ACCOUNTING AND AUDITING RELIEF

EGCs may choose not to be subject to any accounting standards that are adopted or revised on or after April 5, 2012, until these standards are required to be applied to non-public companies. This election must be made on an “all or nothing” basis, and a decision not to adopt the extended transition is irrevocable. Although appealing, this decision could make it harder for a company to transition out of EGC status, both from a technical accounting perspective and due to the potential need to reset market expectations. Moreover, the benefits are difficult to assess, as it is hard to predict which accounting standards will be affected in the future, and an EGC’s election to take advantage of the extended transition period could make it more difficult for investors to compare its financial statements to those of its non-EGC comps.

In addition, EGCs are automatically exempt from any future mandatory audit firm rotation requirement and any rules requiring that auditors supplement their audit reports with additional information about the audit or financial statements of the company (a so-called auditor discussion and analysis) that the PCAOB might adopt. Any other new auditing standards will not apply to audits of EGCs unless the SEC determines that application of the new rules to audits of EGCs is necessary or appropriate in the public interest. To date, all new auditing standards have been applied to audits of EGCs.

REDUCED EXECUTIVE COMPENSATION DISCLOSURE

An EGC need not provide Compensation Discussion and Analysis (CD&A); compensation information is required only for three named executive officers (including the CEO); and only three of the seven compensation tables otherwise required must be provided. Investors generally appear willing to accept reduced compensation disclosures in IPOs.

SECTION 404(B) EXEMPTION


EGCs are exempt from the requirement under Section 404(b) of the Sarbanes-Oxley Act that an independent registered public accounting firm audit and report on the effectiveness of a company’s internal control over financial reporting (ICFR), beginning with the company’s second Form 10-K. It seems likely that many EGCs will adopt this exemption, although the election need not be disclosed in advance in the Form S-1. ■

EGC Elections

Based on IPOs initiated after enactment of the JOBS Act and completed by EGCs through 2015, below are the rates of adoption with respect to several key items of EGC relief:

ITEM	LIFE SCIENCES COMPANIES	TECH COMPANIES	OTHER COMPANIES
Confidential submission of Form S-1	95%	95%	86%
Two years of audited financial statements	87%	30%	59%
Deferred application of new or revised accounting standards	11%	11%	14%
Omission of CD&A	100%	98%	95%

10 FAST Act Offers Additional Benefits to Emerging Growth Companies

 On December 4, 2015, the Fixing America's Surface Transportation Act (FAST Act) was signed into law. Although aimed principally at authorizing spending on highway and transit projects, the FAST Act included amendments to the JOBS Act that further streamline the IPO process for emerging growth companies (EGCs) and amended several other securities law provisions that should benefit a variety of public and private companies, including EGCs.

PUBLIC FILING PRIOR TO ROAD SHOW

Under the JOBS Act, an EGC was required to publicly file its IPO registration statement on Form S-1 (for domestic US issuers) or Form F-1 (for foreign private issuers) no later than 21 days before commencing the road show (or 21 days before effectiveness of the registration statement, if there is no road show). The FAST Act reduced this time period to 15 days.

This reduction may enable an EGC to get to market faster when the IPO “window” is open—potentially very valuable given the volatility of the IPO market—but may also prompt EGCs to reevaluate the timing of activities that are commonly conducted in the period between the initial public disclosure of a proposed IPO and the launch of the IPO roadshow, such as attending to registration rights notices and waivers, and obtaining lockup agreements and questionnaires from stockholders who had not been privy to the company's IPO plans.

EGC GRACE PERIOD

Under the JOBS Act, an issuer must qualify as an EGC in order to elect confidential review of a draft registration statement and to take advantage of the other relief available to EGCs, and eligibility as an EGC is re-determined at the time of the initial public filing of the registration statement. The FAST Act provides a grace period for an issuer that is an EGC at the time it confidentially submits or publicly files a registration statement for an IPO but ceases to be an EGC prior to completion of the IPO. In this limited circumstance, the issuer will continue to be treated as an EGC through the earlier of:

- the date on which the issuer consummates its IPO pursuant to such registration statement; or
- the end of the one-year period beginning on the date the issuer ceases to be an EGC.

The SEC staff had previously interpreted the JOBS Act such that if an issuer publicly filed a registration statement at a time when it qualified as an EGC, the disclosure provisions for EGCs would continue to apply through effectiveness of the registration statement even if the issuer lost its EGC status during registration. The FAST Act extends this relief to circumstances where an issuer qualifies as an EGC at the time of confidential submission of the registration statement. Absent this change, if an issuer ceased to qualify as an EGC while undergoing confidential review, it would be required to publicly file a registration statement that complied with the disclosure rules and regulations applicable to companies that are not EGCs in order to continue the review process.

OMISSION OF CERTAIN FINANCIAL STATEMENTS

Effective January 3, 2016, the FAST Act amended the JOBS Act to permit an EGC that files (or submits for confidential review) a registration statement on Form S-1 or Form F-1 to omit financial information for historical periods otherwise required by Regulation S-X as of the time of filing (or confidential submission) of such registration statement, provided that:

- the omitted financial information relates to a historical period that the issuer reasonably believes will not be required to be included in the registration statement at the time of the contemplated offering; and
- prior to the issuer distributing a preliminary prospectus to investors, such registration statement is amended to include all financial information required by Regulation S-X at the date of such amendment.

Shortly after enactment of the FAST Act, the SEC staff issued several interpretations of this amendment. In an interpretation that narrows the usefulness of the amendment for many EGC issuers, the staff concluded that an issuer may not omit interim financial statements for a period

that will be included within required financial statements covering a longer interim or annual period at the time of the offering, even though the shorter period will not be presented separately at that time. In another interpretation, the staff concluded that an EGC issuer may omit financial statements of other entities—such as financial statements of an acquired business required by Rule 3-05 of Regulation S-X—if the issuer reasonably believes that those financial statements will not be required at the time of the offering.

Treatment of Interim Financial Statements

The staff provided the following example of when an EGC may—and may not—omit interim financial statements from a registration statement: “[C]onsider a calendar year-end EGC that submits or files a registration statement in December 2015 and reasonably expects to commence its offering in April 2016, when annual financial statements for 2015 and 2014 will be required. This issuer may omit its 2013 annual financial statements from the December filing. However, the issuer may not omit its nine-month 2014 and 2015 interim financial statements because those statements include financial information that relates to annual financial statements that will be required at the time of the offering in April 2016.”

As a result of this amendment, EGC issuers can avoid devoting time and resources to preparing financial statements and related disclosures solely to comply with technical requirements at the time of filing (or confidential submission) that would not otherwise be required at the time of the offering. This amendment may also enable EGC issuers to avoid the expense of having the omitted financial statements audited by an independent auditor, although some auditor involvement with the omitted financial statements will still be required if financial information contained in such financial statements is included in the registration statement, such as in the section setting forth selected financial data (particularly if the auditor is expected to provide “comfort” on such financial information).

FORWARD INCORPORATION BY REFERENCE FOR FORM S-1

A “short-form” Form S-3 registration statement permits the issuer to incorporate by reference information from its prior Exchange Act filings (rather than repeat that information in the Form S-3) and to incorporate by reference information from its future Exchange Act filings (rather than amend the Form S-3 to add that information). Form S-3 is available only to issuers satisfying specified issuer and transaction standards. A “smaller reporting company” (defined as a public company that, as of the last business day of its most recently completed second fiscal quarter, had a public float of less than \$75 million) often cannot meet the standards for use of Form S-3, and instead must use Form S-1. Prior to the enactment of the FAST Act, a Form S-1 registration statement did not permit forward incorporation by reference, making its use for resale registrations more cumbersome and expensive than the use of Form S-3.

As required by the FAST Act, on January 13, 2016, the SEC revised its rules to permit a smaller reporting company to incorporate by reference in a Form S-1 registration statement any documents that it files with the SEC after the effective date of the Form S-1. This change will allow smaller reporting companies that are not eligible to register shares for resale using Form S-3 to avoid having to file post-effective amendments solely for the purpose of keeping a resale Form S-1 current. In adopting these rule changes, the SEC indicated that the staff will consider whether the amendments should be made available to a larger group of registrants and for additional form types (such as Form F-1).

NEW RESALE EXEMPTION

The FAST Act added a new statutory exemption to the Securities Act for certain resales of restricted securities. New Section 4(a)(7) provides a non-exclusive exemption from registration for any resale transaction, regardless of whether the issuer is publicly or privately held, where:

- each purchaser is an accredited investor;
- neither the seller nor any person acting on the seller’s behalf engages in any form of general solicitation or general advertising;

- the seller is not the issuer or a direct or indirect subsidiary of the issuer;
- neither the seller nor any person that has been or will be paid remuneration or a commission for their participation in connection with the transaction would be disqualified as a “bad actor” under Rule 506(d)(1) of Regulation D or is subject to a statutory disqualification described under Section 3(a)(39) of the Exchange Act;
- the issuer is not in bankruptcy or receivership and is not a blank check, blind pool or shell company that has no specific business plan or purpose or has indicated that its primary business plan is to engage in an acquisition of an unidentified person;
- the transaction does not relate to an unsold allotment to, or a subscription or participation by, a broker or dealer as an underwriter of the security or a redistribution;
- the transaction involves securities of a class that has been authorized and outstanding for at least 90 days prior the transaction date; and
- perhaps most importantly—in the case of an issuer that is not a reporting company under the Exchange Act, is not exempt from the reporting requirements pursuant to Rule 12g3-2(b) of the Exchange Act, or is not a foreign government eligible to register securities on Schedule B—the issuer provides to the seller and the prospective purchaser the information specified below.

The securities sold in an exempted transaction under Section 4(a)(7) will be deemed to be “restricted securities” within the meaning of Rule 144 and “covered securities” under the Securities Act for purposes of preemption of state “blue sky” regulations.

The Section 4(a)(7) exemption may have a significant impact on private resale transactions in the securities of both privately and publicly held issuers. The new exemption provides clarity for private resales in circumstances in which Rule 144(b)(1) is unavailable (such as sales by affiliates, or sales by non-affiliates who do not satisfy the holding period requirement) and can eliminate the need to rely on the so-called Section 4(a)(1½) exemption, and could facilitate the development of a private resale market. ■

Information Requirements for Non-Reporting Issuers

In order for the Section 4(a)(7) exemption to be available, a non-reporting issuer must provide to the seller and the prospective purchaser the following information, which must be reasonably current in relation to the date of the resale transaction:

- the issuer’s name, the address of the issuer’s principal executive office, and the names of the issuer’s officers and directors;
- the title and class of the security and the amount outstanding as of the end of the issuer’s most recent fiscal year;
- the name and address of the transfer agent, corporate secretary or other person responsible for stock transfers;
- a statement of the nature of the issuer’s business and the products and services it offers;
- the names of the broker, dealer or agent that will be paid any commission or remuneration in connection with the transaction;
- the issuer’s most recent balance sheet and profit and loss statement and similar financial statements for the two preceding fiscal years, prepared in accordance with GAAP, or in the case of a foreign private issuer, in accordance with IFRS; and
- if the seller is an affiliate of the issuer, a brief statement regarding the nature of the affiliation, and a certification by such seller that it has no reasonable grounds to believe that the issuer is in violation of the securities laws or regulations.

The balance sheet will be presumed reasonably current if it is as of a date less than sixteen months before the transaction, and the profit and loss statement will be presumed reasonably current if it is for the 12 months preceding the date of the balance sheet. If the balance sheet is not as of a date less than six months before the transaction date, it must be accompanied by additional statements of profit and loss for the period from the date of such balance sheet to a date less than six months before the transaction date.

12 The Changing Tides of Corporate Governance

During the past several years, there has been a growing divide between the corporate governance provisions adopted by companies going public compared to those maintained by established public companies. This is especially apparent when the governance practices of IPO companies are compared to those of companies in the S&P 500 index. To some extent, perhaps even a great extent, the differences make sense and it is unlikely there will ever be complete convergence. However, the corporate governance choices of companies going public, and of recent post-IPO companies, may soon come under increasing scrutiny from institutional investors and proxy advisory firms.

THE GREAT DIVIDE

The current divide in corporate governance practices has had more to do with the elimination by established public companies of previously standard provisions, often in response to direct or indirect pressure from stockholders and proxy advisory firms, than with an increased prevalence of these provisions among IPO companies.

The biggest gaps in governance practices relate to how the board of directors is elected, with 77% of companies going public continuing to adopt a classified board structure under which only one-third of the director seats are voted on by stockholders each year. In contrast, nearly 90% of S&P 500 companies now provide for annual election of all directors. A majority of S&P 500 companies had classified boards as recently as 2006. Another example of the current split in governance practices is the vote standard applicable to electing directors, with a plurality vote standard continuing to be the norm among IPO companies while more than 88% of S&P 500 companies have adopted a majority vote standard. Prior to 2006, virtually no company had anything but a plurality standard in place.

Beyond the differences in adoption rates for the common anti-takeover provisions highlighted in the table to the right, differences also exist with respect to a number of other corporate governance and compensation-related practices.

For example, IPO companies are much less likely than established public companies to:

- allow proxy access (this practice is unheard of among IPO companies, whereas over 25% of S&P 500 companies now provide proxy access, or have committed to providing it soon, up from a mere handful of public companies, of any size, prior to 2014);
- maintain strict limits on the number of other boards on which the company's directors and officers may serve (often referred to as an over-boarding policy);
- adopt a clawback policy requiring executives to pay back any compensation deemed in hindsight to have been erroneously paid as a result of a restatement of the company's financial statements (this distinction will be eliminated when the SEC adopts, and Nasdaq and the NYSE implement, rules mandated by the Dodd-Frank Act that will require all public companies listed on Nasdaq or the NYSE to adopt a clawback policy);
- adopt minimum equity ownership requirements for directors and officers;

- grant performance-based equity awards (as opposed to equity awards that vest based solely on continued employment); or
- primarily rely on formulas, rather than discretion, to determine payouts under cash bonus programs.

Despite these differences, some corporate governance practices remain commonplace across public companies, with more than 90% of IPO companies and more than 90% of S&P 500 companies imposing advance notice requirements and authorizing "blank check" preferred stock. In addition, exclusive forum provisions, which are a relatively recent phenomenon, are increasingly being adopted by both types of companies.

IPO COMPANIES OFTEN FACE DIFFERENT CONSIDERATIONS

The consideration of which corporate governance provisions to implement is somewhat different for IPO companies than for established public companies. As a general matter, companies adopt takeover defenses in order to help:

Prevalence of Takeover Defenses Among IPO Companies and Established Public Companies

	IPO COMPANIES	ESTABLISHED PUBLIC COMPANIES	
		S&P 500	RUSSELL 3000
Classified board	77%	10%	43%
Supermajority voting requirements to approve mergers or change corporate charter and bylaws	75%	21% to 42%, depending on type of action	18% to 57%, depending on type of action
Prohibition of stockholders' right to act by written consent	88%	71%	72%
Limitation of stockholders' right to call special meetings	93%	39%	51%
Advance notice requirements	95%	95%	91%
Section 203 of the Delaware corporation statute (not opt out)*	77%	96%	89%
Blank check preferred stock	96%	96%	95%
Multi-class capital structure	7%	9%	11%
Exclusive forum provisions*	55%	30%	33%
Stockholder rights plan	1%	4%	7%

*Delaware corporations only

Source: IPO company data is based on WilmerHale analysis of SEC filings from 2007 to 2015 (2011–2015 only for exclusive forum provisions) for US issuers. Established public company data is from SharkRepellent.net at year-end 2015.

- ensure stability and continuity in decision-making and leadership that will enable the company to focus on long-term value creation;
- provide the board with adequate time to evaluate and react in an informed manner to unsolicited acquisition proposals;
- provide negotiating leverage for the board; and
- maximize overall stockholder value by providing economic disincentives against inadequate, unfair or coercive bids.

For IPO companies, the need for takeover defenses is often greater given the company's state of development, high growth prospects and low market capitalization, although adoption rates vary among types of IPO companies. Moreover, the existence of strong takeover defenses has not historically had an adverse effect on the marketing of IPOs.

Furthermore, in contrast to the profiles of many established public companies, the governance practices of IPO companies often reflect the high concentration of ownership that will continue to exist following the IPO; the more hands-on nature of the board of directors in place at the time of an IPO (which results in part from the meaningful ownership stakes that many directors hold); and the greater need for flexibility in designing compensation programs that goes hand-in-hand with the uncertainties inherent in companies pursuing new and innovative business models.

ENHANCED SCRUTINY AHEAD

Notwithstanding the different considerations faced by IPO companies, the governance practices of newly public companies may start to come under challenge sooner than in the past.

One major reason is a new voting policy adopted by ISS, the leading proxy advisory firm, which is effective for stockholder meetings on or after February 1, 2016. The new policy is likely to result in more negative vote recommendations on directors where, prior to an IPO, the company adopts charter or bylaw provisions considered by ISS to be adverse to stockholder rights, such as a classified board. Under the new policy,

Differences in Anti-Takeover Practices Among Types of IPO Companies

	ALL IPO COMPANIES	VC-BACKED COMPANIES	PE-BACKED COMPANIES	OTHER IPO COMPANIES
Classified board	77%	88%	78%	49%
Supermajority voting requirements to approve mergers or change corporate charter and bylaws	75%	84%	78%	51%
Prohibition of stockholders' right to act by written consent	88%	94%	90%	70%
Limitation of stockholders' right to call special meetings	93%	96%	97%	81%
Advance notice requirements	95%	98%	97%	85%
Section 203 of the Delaware corporation statute (not opt out)*	77%	97%	39%	73%
Blank check preferred stock	96%	97%	99%	89%
Multi-class capital structure	7%	6%	6%	12%
Exclusive forum provisions*	55%	51%	66%	50%
Stockholder rights plan	1%	2%	0.5%	1%

*Delaware corporations only

Source: WilmerHale analysis of SEC filings from 2007 to 2015 (2011–2015 only for exclusive forum provisions) for US issuers.

ISS will consider the following factors in making its voting recommendations:

- the level of impairment of stockholder rights caused by the provision;
- the company's or the board's rationale for adopting the provision;
- the provision's impact on the ability of stockholders to change the company's governance structure in the future (such as limitations on the stockholders' right to amend the bylaws or charter, or supermajority vote requirements to amend the bylaws or charter);
- the ability of stockholders to hold directors accountable through annual director elections, or whether the company has a classified board structure; and
- a public commitment to put the provision to a stockholder vote within three years after the date of the company's IPO.

Importantly, ISS will now consider making a negative vote recommendation on directors at all future stockholder meetings until the adverse provision is either removed by the board or submitted to a vote of public stockholders.

This is not the first time ISS has increased its scrutiny of newly public companies.

In 2012, ISS began to subject equity plans adopted by IPO companies to ISS's full equity plan analysis even when stockholder approval was being sought solely to preserve tax deductibility under Section 162(m). Previously, ISS support for such proposals was almost automatic, even if the plan otherwise contained provisions that ISS did not like.

































Recent ISS comments suggest that its policy changes align with growing investor sentiment. An ISS representative recently noted that ISS has received feedback from Council of Institutional Investors members indicating that they may stop giving IPO companies a "free pass" at the first or second stockholder meeting after a company goes public.

It remains to be seen whether these changing tides will lead to a major course correction not unlike what has transpired among more established public companies, but directors of newly public companies are well advised to prepare for some potentially rough seas ahead. ■

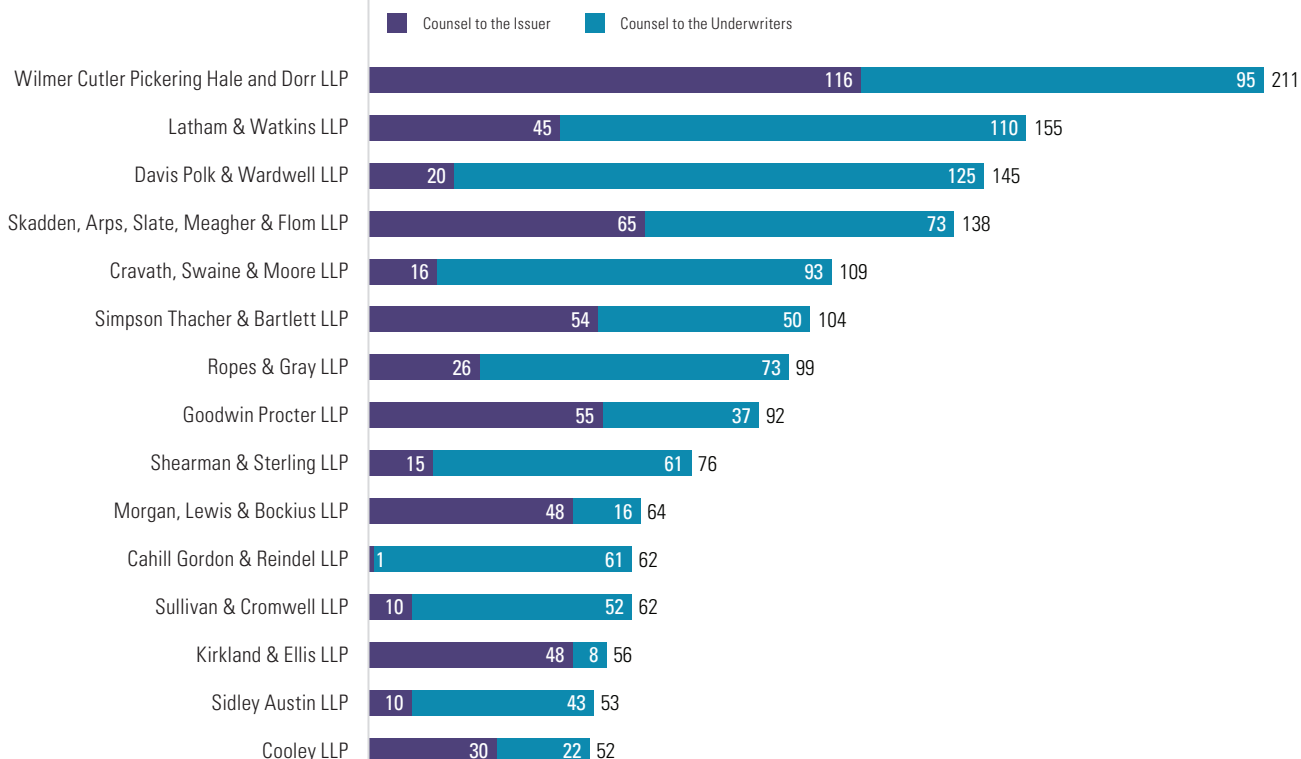
Counsel of Choice for Public Offerings

SERVING INDUSTRY LEADERS IN TECHNOLOGY, LIFE SCIENCES, ENERGY AND CLEANTECH, FINANCIAL SERVICES, COMMUNICATIONS AND BEYOND



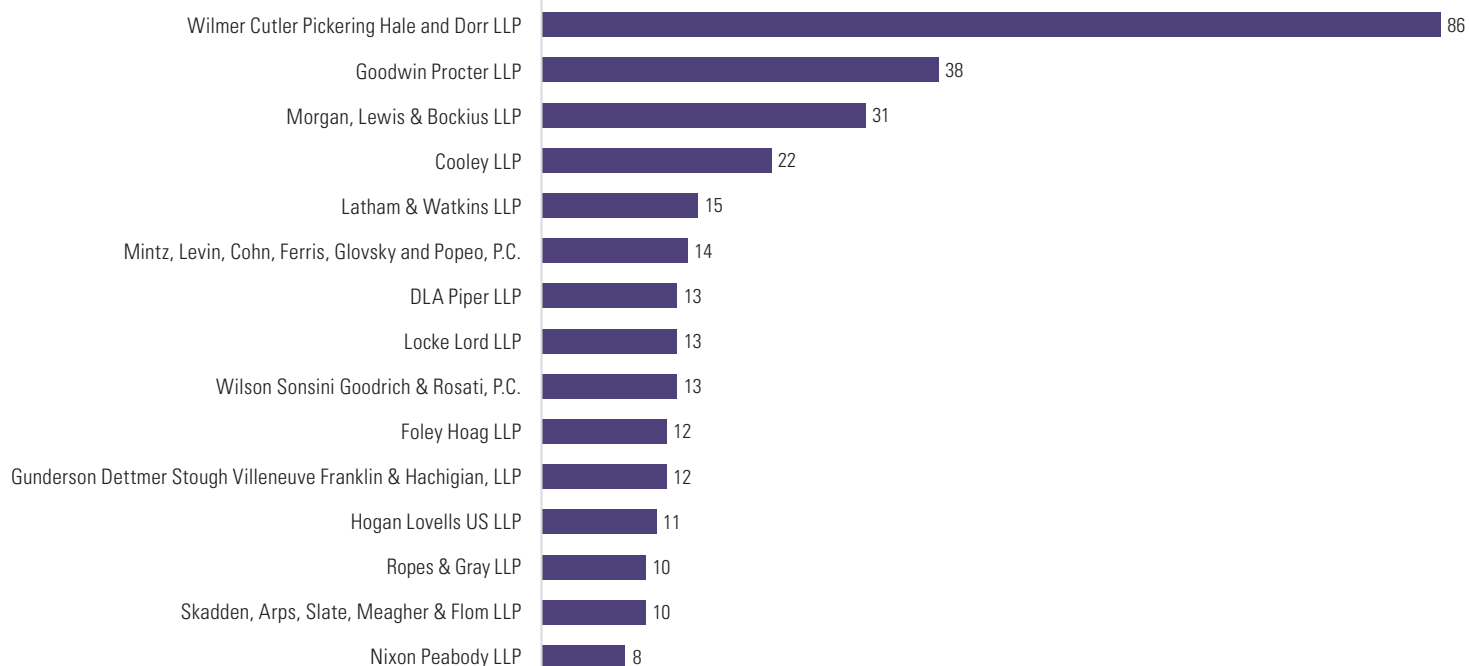
 <p>Initial Public Offering of Common Stock \$155,250,000 Counsel to Issuer July 2015</p>	 <p>Public Offering of Common Stock \$262,200,000 Counsel to Issuer March 2015</p>	 <p>Initial Public Offering of American Depositary Shares representing Ordinary Shares \$191,250,000 Counsel to Underwriters May 2015</p>	 <p>Public Offerings of Common Stock \$344,879,500 Counsel to Issuer February 2015 and December 2015</p>	 <p>Public Offerings of Common Stock \$569,718,750 Counsel to Issuer February 2015 and April 2015</p>	 <p>Public Offering of Common Stock \$69,000,000 Counsel to Issuer June 2015</p>	 <p>Public Offering of Common Stock \$166,755,500 Counsel to Underwriters March 2015</p>	 <p>Initial Public Offering of Common Stock \$108,560,000 Counsel to Issuer February 2016</p>	
 <p>Initial Public Offering of Common Stock \$60,000,000 Counsel to Issuer February 2015</p>	 <p>Public Offering of Common Stock \$86,250,000 Counsel to Issuer February 2015</p>	 <p>Public Offering of Common Stock \$69,000,000 Counsel to Issuer March 2015</p>	 <p>Public Offering of 3.900% and 5.300% Senior Notes \$1,250,000,000 Counsel to Issuer December 2015</p>	 <p>Public Offering of Common Stock \$173,075,000 Counsel to Issuer March 2015</p>	 <p>Public Offerings of Common Stock \$149,000,000 Counsel to Issuer January 2015 and December 2015</p>	 <p>Public Offering of 7.75% Senior Subordinated Notes \$60,000,000 Counsel to Issuer February 2015</p>	 <p>Public Offering of Common Stock \$141,450,000 Counsel to Issuer February 2015</p>	 <p>Public Offering of 4.900% Senior Notes \$500,000,000 Counsel to Issuer March 2016</p>
 <p>Public Offerings of Depositary Shares representing Non-Cumulative Perpetual Preferred Stock and Senior Notes \$750,000,000 and \$3,000,000,000 Counsel to Issuer May and August 2015</p>	 <p>Initial Public Offering of American Depositary Shares representing Shares \$64,400,000 Counsel to Underwriters June 2015</p>	 <p>Public Offerings of Common Stock \$262,500,000 Counsel to Issuer March 2015 and January 2016</p>	 <p>Public Offering of Common Stock \$101,200,000 Counsel to Issuer June 2015</p>	 <p>Public Offering of Common Stock \$49,995,000 Counsel to Issuer March 2015</p>	 <p>Initial Public Offering of American Depositary Shares representing Ordinary Shares \$39,278,250 Counsel to Issuer March 2015</p>	 <p>Public Offerings of Senior Notes and Senior Notes €2,700,000,000 and \$2,000,000,000 Counsel to Issuer July and September 2015</p>	 <p>Public Offering of Common Stock \$78,775,000 Counsel to Underwriters August 2015</p>	
 <p>Public Offerings of 2.150% and 1.500% Senior Notes €925,000,000 and 2.150% and 3.650% Senior Notes \$800,000,000 Counsel to Issuer July, November and December 2015</p>	 <p>Initial Public Offering of Common Stock \$48,300,000 Counsel to Underwriters August 2015</p>	 <p>Rule 144A Placement of 3.00% Convertible Senior Notes \$150,000,000 Counsel to Issuer August 2015</p>	 <p>Initial Public Offering of American Depositary Shares representing Common Shares \$106,087,500 Counsel to Issuer September 2015</p>	 <p>Public Offering of Floating Rate Notes \$1,000,000,000 Counsel to Underwriters January 2015</p>	 <p>Rule 144A Placement of 7.0% Senior Notes \$275,000,000 Counsel to Issuer March 2015</p>	 <p>Public Offering of Common Stock \$149,988,750 Counsel to Underwriters July 2015</p>		

Eastern US IPOs – 1996 to 2015



Source: SEC filings

Company Counsel in Eastern US VC-Backed IPOs – 1996 to 2015

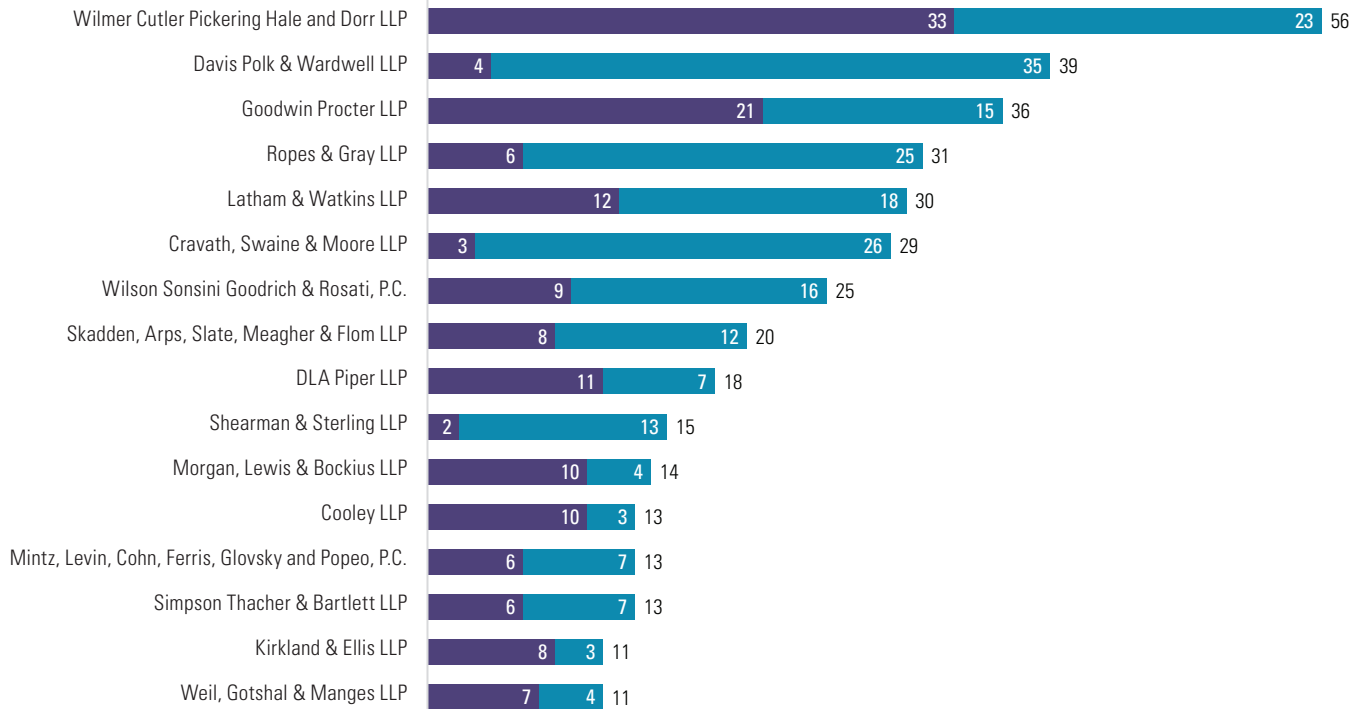


Source: Dow Jones VentureSource and SEC filings

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

Eastern US Technology Company IPOs – 2000 to 2015

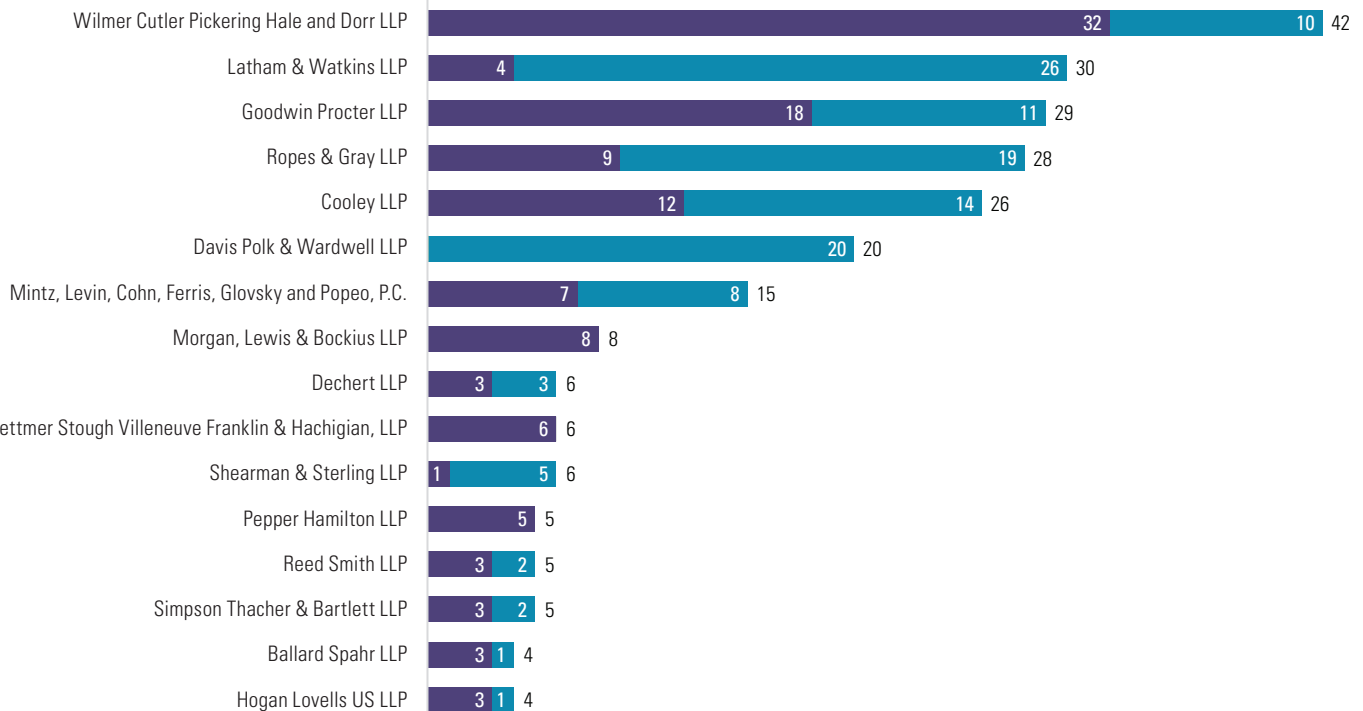
■ Counsel to the Issuer ■ Counsel to the Underwriters



Source: SEC filings

Eastern US Life Sciences Company IPOs – 2004 to 2015

■ Counsel to the Issuer ■ Counsel to the Underwriters



Source: SEC filings

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

BACKGROUND

Equity research analysts play a significant role in the IPO process and perform important functions both before and after an IPO. For example, research analysts employed by investment banking firms develop earnings estimates, help educate the sales forces of the managing underwriters about the company and its investment merits, and can generate investor interest in the company after the IPO through their research coverage.

The permitted activities of research analysts, and the manner in which analysts interact with companies, investors and investment banking personnel, are subject to various restrictions arising under:

- the “global settlement,” pursuant to which most major investment banking firms, in settlement of litigation brought by the SEC, other regulators and the New York attorney general, agreed to separate their research and investment banking functions and severely limit the interactions between equity research analysts and investment bankers; and
- rules governing research analyst conflicts of interest administered by the Financial Industry Regulatory Authority (FINRA), the principal self-regulatory organization for securities firms doing business in the United States.

The global settlement was entered into in 2003 and modified in 2010. FINRA’s research analyst conflict-of-interest rules, originally adopted in 2002 by the predecessors to FINRA, have been amended several times, including changes made with respect to emerging growth companies (EGCs) as a result of the 2012 enactment of the JOBS Act. In 2015, FINRA replaced these rules with new Rule 2241 and issued significant new interpretations.

The thrust of these requirements is to limit interactions between equity research analysts and investment bankers in order to avoid inappropriate influence by investment banking personnel over research decisions and opinions and to mandate the disclosure of information that bears on actual or potential conflicts of interest involving analysts. The two central

prohibitions under FINRA’s research conflict-of-interest rules are that firms may not offer favorable research, a specific rating or a specific price target to induce investment banking business, and research analysts may not participate in efforts to solicit investment banking business.

The most significant implications of these requirements for IPO companies are summarized below.

RELATIONSHIPS WITH RESEARCH ANALYSTS

The onus is on the company to cultivate relationships with research analysts independently of its investment banking relationships. Because many contacts between analysts and investment banking personnel are prohibited or otherwise restricted, the company should establish and maintain a separate line of communication with each analyst, rather than relying on investment bankers as intermediaries. This process should begin early, in order for the company to benefit from analysts’ perspectives on the company and its position in the market.

Before the company makes clear its intention to proceed with an IPO, discussions with research analysts could, for example, address the company’s competitors, the IPO market and the company’s readiness for an offering. However, from the time it becomes evident that the company intends to proceed with an IPO until it selects its IPO underwriters, the company’s contacts with research analysts employed by prospective underwriters will be limited to vetting and due diligence by analysts, and the analysts will be prohibited from providing their views to the company, including input on the company’s market positioning or valuation. Following its selection of the lead underwriter or underwriters, the company can consult with the underwriters’ research analysts about valuation, pricing and structuring of the offering.

RELATIONSHIPS WITH INVESTMENT BANKERS

Similarly, the company needs to maintain separate investment banker relationships. Since, as a practical matter, the company

cannot meet simultaneously with analysts and investment bankers during the IPO process except in joint due diligence sessions as described below (unless it is an EGC, in which case its management may meet simultaneously with analysts and investment bankers employed by an investment bank that is not subject to the global settlement), the bankers may not be aware of the company’s conversations with its analysts. Following the IPO closing, the company should remain in regular contact with the investment bankers to update them about its business and plans so that the bankers can help identify appropriate market opportunities for the company.

SELECTION OF MANAGING UNDERWRITERS

The company should finalize the managing underwriter group as soon as practicable. It used to be possible for a co-manager to join an IPO on the eve of the initial filing of the Form S-1 by piggybacking on diligence procedures that were already completed by other investment bankers on the offering. Now, a prospective co-manager is likely to decline to be named in the Form S-1 until its analyst completes independent diligence. The company should engage all co-managers, particularly those whose analysts expect to initiate research coverage on the company, sufficiently early in the process to give the analysts time to complete their diligence efforts without delaying the offering timetable. To the extent that all desired analyst diligence cannot be conducted in permissible joint due diligence sessions, as described below, the company will need to coordinate duplicative or supplemental diligence sessions.

ANALYST PARTICIPATION IN THE IPO PROCESS

Participation by research analysts in various aspects of the IPO process is constrained, in some cases depending on whether the company is an EGC and whether the analyst is employed by a firm subject to the global settlement:

- *IPO Pitches:* Analysts may attend IPO pitch meetings with EGCs at which investment banking personnel are present,

but analysts must limit their involvement to ministerial statements such as introducing themselves, outlining their research program, and asking follow-up questions to better understand factual statements made by the management of the EGC. In pitch meetings they are permitted to attend, analysts may not solicit investment banking business or engage in other prohibited conduct, such as giving “tacit acquiescence” to overtures from management that the company expects favorable research coverage in exchange for selecting the analyst’s firm to underwrite the IPO. Analysts may not attend pitch meetings for IPOs by companies that do not qualify as EGCs.

- *Due Diligence:* Following the selection of lead underwriters, analysts can participate in joint due diligence sessions with investment banking personnel. For analysts employed by firms subject to the global settlement, the joint due diligence sessions must be “chaperoned” (meaning the sessions must be conducted in the presence of the firm’s internal legal or compliance staff or underwriters’ or other counsel who are knowledgeable regarding research and investment banking conflicts and the terms of the global settlement).
- *Drafting Feedback:* Feedback on the Form S-1 from analysts, whether arising from permitted joint due diligence sessions or otherwise, must be filtered through legal or compliance personnel.
- *Road Show Presentations:* Analysts are prohibited from attending road show presentations (although analysts are permitted to listen to or view live road show presentations from a separate location without being identified as present, and may also meet separately with management), and are prohibited from directly or indirectly participating in road shows. Prohibited participation in road shows includes providing input on road show presentation preparations, reviewing draft road show presentation slides and other material to be used in the road show, and participating in road show practice sessions.
- *Communications with Investors:* Investment bankers cannot direct research analysts to contact prospective investors. Investment bankers employed by firms that are not subject to the global

settlement may, however, arrange (but not participate in) communications between analysts and prospective investors relating to an IPO by an EGC (but not an IPO by a company that does not qualify as an EGC). Analysts may communicate with prospective investors and help educate the sales forces, but communications must be outside the presence of investment banking personnel and company management. Written and oral communications by an analyst with prospective investors must be “fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.”

RESEARCH REPORTS


- *Pre-Publication Review:* A draft research report may not be provided to the company, except that sections of the report (other than the sections including the analyst’s research summary, research rating or price target) may be submitted to the company to verify the factual accuracy of information in those sections. A complete draft of the report must be provided to the analyst’s legal or compliance personnel in advance, and any change in the proposed rating or price target after submitting the draft sections to the company must be justified in writing by the analyst and authorized in writing by legal or compliance personnel.
- *Analyst Quiet Period:* Prior to the enactment of the JOBS Act, FINRA rules imposed a research analyst quiet period in connection with all IPOs and the expiration, termination or waiver of IPO lockup periods. The analyst quiet period is intended to permit market forces to determine the aftermarket price of a security uninfluenced by positive research reports from underwriters of the offering, and is in addition to the company quiet period arising under the Securities Act. All analyst quiet periods were eliminated for EGCs by the JOBS Act and subsequent FINRA rule amendments. For non-EGCs, FINRA Rule 2241 now provides that a research analyst employed by an underwriter or participating dealer in a company’s IPO may not publish a report or make a public appearance regarding the company for a period of ten days after

the IPO. Despite these rule changes, major investment banks generally are observing a voluntary 25-day post-IPO waiting period before initiating research coverage, for both EGCs and non-EGCs.

- *Timing Considerations:* To the extent there is flexibility, the company and managing underwriters should schedule the IPO pricing to avoid having the company’s first earnings release fall within any post-closing research quiet period that is applicable to the company or is voluntarily observed by the underwriters. Although an exception to the analyst quiet period for non-EGCs permits research reports and public appearances in response to “significant” news or events that have a material impact on a company’s operations, earnings or financial condition, a quarterly earnings announcement, by itself, does not generally fall within this exception. Even if preliminary results for the earnings period have been included in the final prospectus, the full earnings release will often include additional details, and an analyst’s report can provide helpful insights. The absence of immediate research coverage can be worrisome to newly public companies facing their first earnings release and investor conference call, particularly if the financial results are mixed. ■

Avoiding Violations

With investment banking and analyst functions largely separated, companies are often the principal source of inappropriate influence on research analysts. Both before and after closing its IPO, the company must respect the mandatory separation of investment banking and analyst functions and should avoid actions that might lead to a violation or the appearance of a violation. Company concerns about research coverage should be addressed directly to the analyst or research management and not to the investment bankers, since they are not permitted to serve as conduits for company comments about coverage issues. Similarly, questions and comments about the IPO or other investment banking transactions should be directed to the investment bankers and not the analysts.

 Form S-1 registration statements for IPOs are reviewed by the SEC staff before the offering can proceed. In general, a company's goal should be to complete the SEC review process as quickly as possible to maximize flexibility in timing the launch of the offering. Several topics of current review focus are described below.

EGC STATUS

If a company qualifies as an emerging growth company (EGC), the staff will expect the company to describe how and when it may lose EGC status and the various exemptions that are available to an EGC. If the company has elected to use the extended transition period for complying with new or revised accounting standards, the company should indicate that its financial statements may not be comparable to those of public companies that do comply with such accounting standards, or, if the company has not so elected, that the decision is irrevocable. The staff no longer insists that EGC status be disclosed on the prospectus cover.

QUIET PERIOD

After a company files a Form S-1, the staff routinely reviews press releases, newspaper and magazine stories, and the Internet, including the company's website, to determine whether the company has violated the SEC's quiet-period restrictions. Common sources of violations include interviews (particularly because the company cannot control the timing or content of publication); social media (when used to discuss the company's IPO plans externally); and widespread employee communications (when not effectively confined to an internal audience). Quiet period concerns can result in offering delays and undesirable prospectus disclosures, and can arise even after the staff has otherwise completed its review of the Form S-1.

MD&A / FINANCIAL STATEMENTS

Topics of staff focus in the MD&A and financial statements include the key metrics (often termed "key performance indicators," or KPIs) used by management to monitor and evaluate

the company's financial condition and operating performance; disclosure of known trends and uncertainties; revenue recognition; segment disclosures; stock-based compensation disclosures (revised staff guidance now permits much less detail than historically required); and acquisition accounting.

NON-GAAP FINANCIAL MEASURES

Although SEC guidance permits the use of non-GAAP financial measures, including in IPOs, the staff insists on compliance with the applicable rules and will object to the use of measures it considers misleading. Recent public comments by staff members suggest renewed focus on the accuracy and completeness of disclosures relating to non-GAAP financial measures, including why the measures are used, how they provide investors with useful information, the prominence accorded non-GAAP measures in relation to GAAP measures, and the existence of appropriate controls over the calculation of non-GAAP measures.

"FLASH RESULTS"

The inclusion of estimated financial results for a recently completed fiscal period ("flash results") will draw staff scrutiny: the presentation must be balanced and not misleading; both revenue and income metrics are typically necessary; if ranges are used, they must be narrow; and the basis for the numbers in the ranges must be explained.

EXECUTIVE COMPENSATION DISCLOSURES

Typical staff comments request more analysis in CD&A of the reasons for specific compensation decisions; a description of the CEO's role in determining compensation of other executive officers; the identification of peer companies used for benchmarking; and disclosure of the quantitative performance targets used for incentive compensation. (EGCs need not provide a CD&A, and most do not.)

RELATED-PERSON TRANSACTIONS

The staff is attuned to the nature and placement of disclosures concerning related person transactions. For example,

if an insider intends to purchase shares in the offering, the staff may require that appropriate disclosure be added to the prospectus cover. Material relationships between the company and the underwriters or selling stockholders also need to be disclosed.


RECURRING DRAFTING COMMENTS

Although the following comments usually can be anticipated and avoided, the staff routinely requests that companies:

- Condense the prospectus summary and make it more balanced
- Tailor the risk factors to be more specific to the company
- Eliminate industry and technical jargon
- Substantiate leadership claims and other assertions
- Reconcile inconsistencies within the prospectus and when compared to the company's website
- Remove disclaimers and mitigating language
- Provide the staff with industry research reports cited in the prospectus and file consents for any reports that are not publicly available
- Add explanations provided in response letters to the prospectus ■

SEC Review: What to Expect

- Initial comment letter, containing about 30–50 comments, in 27–30 days
- Total of 3–4 comment letters, with fewer comments and quicker turnaround each time
- Overall, comments focus on financial statements (16%), MD&A (15%), business (12%), prospectus summary (12%), risk factors (9%) and executive compensation (6%)
- Company-specific comments based on staff review of filing and other public disclosures
- Time from initial submission to pricing is typically about four months

 WilmerHale Partner Meredith Cross served as Director of the SEC's Division of Corporation Finance from June 2009 through December 2012. During her tenure at the SEC, she implemented many enhancements to the Division's review process, and oversaw the staff's review of some of the most high-profile IPOs in history. Below is Meredith's perspective on some of the most common questions we hear from IPO companies.

Every IPO undergoes SEC staff review. What can a company do to make that process go as smoothly as possible?

The process will go much more smoothly if you put in the work to make the first submission of your registration statement to the SEC as complete as possible. This includes looking at recent SEC staff comments to similarly situated companies, and addressing any issues that also apply to you. It is not likely that the staff will miss the issue in your filing, so addressing it up front can save you time. In some cases—in the event of an unusual accounting or financial statement presentation issue, for example—you may want to arrange for a pre-filing conference with the staff. Once you receive comments from the staff, answer every question in the letter and answer completely to avoid having several rounds of back-and-forth with the staff. If you do not understand the staff's comment, call the examiner for clarification before you respond.

Are there other times during the process when the company should pick up the phone and call the examiner?

Absolutely. In particular, it is a good idea to call your examiner if you have special timing needs. Although the staff has regular timing goals for their reviews, they are happy to try to work with you if you have legitimate timing issues. Also, sometimes during the comment process it may become apparent that you and your examiner are not understanding each other—in that case, a call can really help to get everyone on the same page.

What if you do that, but you still find yourself at an impasse with your examiner?

In that case, I would recommend that you call the examiner and ask to speak with the reviewer on the filing. If you are unable to resolve the issue with the reviewer, you may want to ask to speak to the supervisor. This

is not something that you should be afraid to do or that you will be penalized for doing. If, for some reason, the examiner does not facilitate the conversation for you, then you should feel free to contact the supervisor directly. The Division of Corporation Finance has posted a useful document on the SEC website outlining the filing review process, which includes a listing of the supervisors in each review office.

Speaking of filing reviews, are there topics that you expect will receive significant staff focus going forward?

The most frequent areas of staff comment have not changed significantly over the past few years. I expect that the staff will continue to focus on topics such as the use of non-GAAP financial measures in SEC filings and other public disclosures, segment reporting, and the sufficiency and completeness of MD&A disclosures. Recently, I have noticed an uptick in staff attention to non-GAAP measures, and I also expect that the staff will devote more attention to cybersecurity-related disclosures.

What do you see as the most significant impact of the JOBS Act on IPOs so far? Do you expect other significant changes in the future as a result of the JOBS Act and the FAST Act?

Confidential submission of draft registration statements under the JOBS Act has been widely embraced by emerging growth companies. Eligible companies also have been taking advantage of some of the reduced disclosure—particularly executive compensation disclosure—permitted under the JOBS Act, and in many cases are likely to take advantage of the new rules under the FAST Act permitting the exclusion of historical financial statements that will eventually be superseded by more recent financial statements by the time the marketing of the offering commences. In addition, companies are making some more use of the JOBS Act “testing-the-waters” provision than they did at the early stages of the JOBS Act.

IPO companies hear a lot about the concept of a quiet period. Does it really inhibit a company's ability to continue to communicate with its customers and employees?

The SEC staff is sensitive to the idea that companies need to be able to communicate with customers and employees during

the offering process, and understands that, to some extent, it is hard to contain that information. There have been some high-profile examples of IPO companies' communications with their employees being leaked and raising some issues for the companies in the IPO process. While the staff is not looking for “foot faults,” this is an area that does require some caution.

It is generally fine for an IPO company to keep communicating with its customers and employees using whatever well-established practices of communication it already has in place. Of course, you have to be careful about the content of the communications—it is not okay to talk about the IPO with customers unless a preliminary prospectus with a price range is available, and any discussion of the IPO with employees needs to be carefully thought through—so it is important to make sure that the people handling communications understand the ground rules.

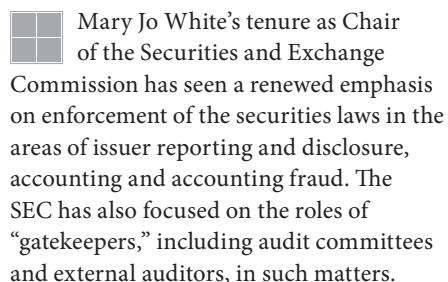
The timing of when the IPO window is open is almost impossible to predict. What happens if a company ends up needing to seek additional financing during the IPO process?

Companies have a fair bit of flexibility to seek financing during the IPO process. Capital raising outside the IPO is accommodated under the SEC's guidance on this topic, generally so long as you structure it carefully and you do not locate your private financing investors through the process of filing your IPO registration statement.

It's crystal ball time. Imagine we are discussing the IPO process 10 years from now. What do you think will be some of the major differences from today?

It is very hard to predict. As we've observed, some of the JOBS Act changes took hold quickly (like confidential submission) while others have taken longer (like testing-the-waters). Other JOBS Act provisions—such as those that raise the thresholds for SEC reporting and ease certain restrictions on, and create new avenues for, capital raising in unregistered transactions—may make it easier for companies to stay private. As a result, we may see fewer companies choosing to do IPOs, unless they can see very real benefits from being publicly traded. For those that choose to go public, recent changes under the FAST Act should further streamline the process. ■

22 SEC Renews Enforcement Focus on Financial Reporting

 Mary Jo White's tenure as Chair of the Securities and Exchange Commission has seen a renewed emphasis on enforcement of the securities laws in the areas of issuer reporting and disclosure, accounting and accounting fraud. The SEC has also focused on the roles of "gatekeepers," including audit committees and external auditors, in such matters.

As SEC Enforcement Director Andrew Ceresney recently observed, "Comprehensive, accurate, and reliable financial reporting is the bedrock upon which our markets are based. Materially false or incomplete financial reporting saps investor confidence and erodes the integrity of our markets." In the wake of the financial crisis of 2007–2008, however, the SEC devoted fewer resources to accounting fraud, and the number of investigations and cases related to pure accounting fraud dropped. At the same time, the number of accounting restatements declined. Some SEC staff members expressed doubts that these declines resulted from a drop in actual fraud in financial reporting. Indeed, in 2013 Mr. Ceresney opined: "I find it hard to believe that we have so radically reduced the instances of accounting fraud simply due to reforms such as governance changes and certifications and other Sarbanes-Oxley innovations." He added, "We will not know whether there has been an overall reduction in accounting fraud until we devote the resources to find out."

Soon after her appointment as SEC Chair in April 2013, Ms. White made clear that she intended to pivot away from financial crisis cases and increase the SEC's enforcement focus on detecting and combating accounting fraud. Shortly thereafter, the SEC formed a Financial Reporting and Audit Task Force (now known as the Financial Reporting and Audit Group, or "FRAud Group"). Composed of attorneys and accountants from the Division of Enforcement, and working with other parts of the SEC, the task force's goals include fraud detection and "increased prosecution of violations involving false or misleading financial statements and disclosures." The task force's key areas of focus also include audit committees and auditors, who would be held accountable for "failing to recognize red flags." The

SEC sometimes refers to its efforts with respect to external auditors and other gatekeepers as "Operation Broken Gate."

The SEC's enforcement actions since 2013 appear to have borne out the SEC's promises. In a recent speech, Mr. Ceresney reported "good news" that the Enforcement Division has "succeeded in significantly increasing the quality and number of financial reporting cases." He noted that the SEC had more than doubled the number of cases in the issuer reporting and disclosure area, from 53 in fiscal year 2013 to 114 in fiscal year 2015, and had increased the number of parties charged with such violations—from 128 to 191 in the past two fiscal years. He also reported that the SEC had charged over 175 individuals in such matters during the past two years. Mr. Ceresney acknowledged that "there have been some signs of progress in the issuer reporting area more generally in recent years," particularly in the lower number of restatements. But he also indicated that the SEC continues to see many of the same causes of financial reporting problems as in the past, including:

- significant pressure to meet earnings and other performance expectations;
- excessive focus on short-term performance rather than longer-term success;
- poor oversight in units and subsidiaries;
- growth outpacing the reporting and accounting infrastructure; and
- management's over-reliance on processes, and poor "tone at the top."

As to gatekeepers, Mr. Ceresney noted that the SEC has not frequently brought cases against audit committee members. In his experience, "audit committee members in most cases carry out their duties with appropriate rigor." However, he cited cases against audit committee members who "approved public filings that they knew, were reckless in not knowing, or should have known were false because of other information available to them." He emphasized that "when an audit committee member learns of information suggesting that company filings are materially inaccurate, it is critical that he or she take concrete

steps to learn all relevant facts and cease annual and quarterly filings until he or she is satisfied with the accuracy of future filings."

Mr. Ceresney also highlighted the role of external auditors, noting that in 2015 the SEC brought its first cases against national audit firms for audit failures since 2009. In September 2015, it sanctioned a major audit firm for issuing false and misleading unqualified audit opinions, as well as five of the firm's partners, including national office personnel, for their roles in the deficient audits. In December 2015, the SEC charged that another major audit firm and two of its partners ignored red flags and fraud risks while conducting deficient audits of two public companies.


Finally, Ms. White has also recently reemphasized that the financial reporting area will be a high priority for the SEC's enforcement program: "Investors depend on comprehensive and accurate financial reporting, and so our fundamental objective is to raise the bar of compliance by issuers and their auditors and we will use all of our tools to do so."

The behavior of issuers, boards and management should not be driven by fear of enforcement actions. But the SEC's continued focus on issuer reporting and accounting, and its focus on gatekeepers, should reinforce the critical importance to companies of ensuring the accuracy and completeness of their financial statements; having adequate protections against fraud, including effective internal controls; and responding promptly and appropriately to any indications of accounting irregularities. ■



Blog: Focus on Audit Committees, Accounting and the Law

For a legal perspective on developments in accounting standards, financial reporting, auditing and regulation of the accounting profession, follow our blog, *Focus on Audit Committees, Accounting and the Law*, at www.wilmerhale.com/accountingandlawblog.

 An IPO company and other offering participants may be liable to investors if the company's registration statement is materially deficient or misleading. Below is an overview of the potential liability of directors and officers of a company going public, the "due diligence defense" to claims that may arise from the IPO, and techniques to minimize the risk of liability in connection with an IPO. The potential liability of the company itself, and of the underwriters, auditor and any selling stockholders in the IPO, is not discussed below.

SECTION 11

Section 11 of the Securities Act provides the principal basis for civil liability of directors and officers in connection with an IPO. Under Section 11(a), and subject to the due diligence defense discussed below, each person who was a director of the company at the time of the filing of the Form S-1, and each company officer who signs the Form S-1, may be liable if any part of the Form S-1, when it became effective, "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." A Section 11 plaintiff does not need to prove that the defendant knowingly, deliberately, recklessly or negligently was responsible for the material misstatement or omission. Statements of opinion and expressions of belief contained in a Form S-1 are not immune from liability under Section 11.

All directors (and each person named in the Form S-1 with his or her consent as having agreed to become a director) have potential liability under Section 11, whether or not they sign the Form S-1. In contrast, only those officers who sign the Form S-1—typically the CEO, CFO and, unless the CFO is also the principal accounting officer, the controller (or other officer who serves as the principal accounting officer)—are exposed to Section 11 liability. A director (or an officer signing the Form S-1) who resigns after filing but prior to the effectiveness of the Form S-1 may avoid liability by informing the SEC and the company in writing that he or she has resigned and is not "responsible for" the Form S-1.

DUE DILIGENCE DEFENSE

An important defense for directors and officers (and defendants other than the company) in securities law claims is the so-called due diligence defense. For purposes of the defense, Section 11 distinguishes between the non-expertised portions and the expertised portions of the Form S-1.

The portions of the Form S-1 prepared or certified by a named expert are considered expertised. Audited financial statements are considered expertised, but unaudited interim financial statements and non-GAAP financial measures are not. Similarly, numbers and other financial data contained in the Form S-1 are not considered expertised merely because they are derived from audited financial statements or covered by an auditor's comfort letter. Counsel to the company and counsel to the underwriters are not considered experts for purposes of Section 11.

In effect, Section 11 imposes a reasonable *investigation* standard for the non-expertised portions of the Form S-1 and a reasonable *reliance* standard for the expertised portions:

- *Non-Expertised Portions:* A defendant can avoid liability if he or she can sustain the burden of proof that, with respect to those portions of the Form S-1 that are not expertised, he or she "had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."
- *Expertised Portions:* Non-expert defendants are not required to make a reasonable investigation concerning the expertised portions of the Form S-1. In order to sustain their defense in this situation, non-expert defendants must merely prove that they had no reasonable grounds to believe, and did not believe, that the expertised portions were untrue, omitted material facts, or did not fairly represent the expert's statement.

In 1982, the SEC adopted Rule 176 under the Securities Act in an attempt to provide some guidance regarding the due diligence defense. The rule lists eight general factors

to be considered when assessing whether a reasonable investigation has been undertaken for Section 11 purposes:

- the type of company;
- the type of security;
- the type of person;
- the office held when the person is an officer;
- the presence or absence of another relationship to the company when the person is a director or proposed director;
- reasonable reliance on officers, employees and others whose duties should have given them knowledge of the particular facts;
- when the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter, and the availability of information with respect to the company; and
- whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

Rule 176 offers some context for helping assess whether a due diligence defense has been established, but hardly provides the kind of bright-line guidance directors and officers would prefer. The handful of reported federal court decisions interpreting the defense provides scant guidance, since the question is intensely fact-specific.

In the leading case construing the due diligence defense, *Escott v. BarChris Construction Corp.*, decided in 1968, the court set forth a two-pronged test for establishing the defense. The defendant must first establish that he or she conducted a reasonable investigation, and must then establish that, after the investigation, he or she had reasonable grounds to believe, and did believe, in the accuracy of the registration statement.

In *BarChris*, the purchasers of debentures issued by a bowling alley construction company sued the company, its directors, its officers who signed the registration statement, the underwriters, and the company's auditor for damages sustained as a result of false statements and material omissions in the prospectus. After an

Lessons from *BarChris*

While the *BarChris* court focused on what was insufficient to establish a due diligence defense and did not describe what would have been sufficient, except in general terms, the following lessons for directors and officers can be gleaned from the decision:

- A director, or an officer who signs the Form S-1, cannot avoid liability by suggesting that he or she did not read or understand it.
- Directors and officers must inquire about the portions of the Form S-1 with which they are unfamiliar or that they do not understand.
- A director cannot rely exclusively on assurances from senior management that the Form S-1 is accurate and complete.
- A person who becomes a director during the IPO process, but before effectiveness, has the same liability as all other directors.
- A director is not absolved from due diligence obligations simply because he or she is new to the board of directors.
- A cursory review of the Form S-1, by itself, is insufficient.
- A director who is deeply involved with the preparation of the Form S-1 is held to a higher standard of investigation than other directors.
- Directors and officers cannot assume that portions of the Form S-1 prepared early in the offering process, or based on pre-existing company documents, remain accurate and complete with the passage of time.
- The standard of conduct of a director or officer is not lower just because it is his or her first public offering.
- A director or officer cannot rely exclusively on the company's lawyers and auditors to make sure the Form S-1 is accurate and complete, especially if the director or officer has reason to believe parts of the Form S-1 are inaccurate.
- A subordinate financial officer who signs the Form S-1 as controller has the same liability as the more senior officers who also sign it.

extensive review of the facts, the court held that the individual defendants had not satisfied their due diligence obligations.

Subsequent case law offers little specific guidance on how to establish a due diligence defense. Courts have recognized, however, that not every director or officer should be held to the same standard. In a case from 1971, the court said, “[W]hat constitutes ‘reasonable investigation’ and a ‘reasonable ground to believe’ will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions.” In another case, decided in 1990, an outside director prevailed after demonstrating that he had reviewed multiple drafts of the registration statement, discussed aspects of it with management, and saw nothing suspicious or inconsistent with the knowledge he had acquired as a director. He regularly attended board meetings and was reasonably familiar with the company's business and operations.

In contrast, inside directors and officers with intimate knowledge of the company's business and affairs are usually expected to make a more complete investigation than outside directors. For example, in the *BarChris* case, the court noted that the CFO could not rely entirely on the audit firm with respect to the company's financial statements.

If a claim is made that the Form S-1 was materially deficient, ultimately a court will assess the reasonableness of the diligence process that was undertaken. The plaintiffs bringing the claim and the court assessing the claim's merits will have the benefit of hindsight, whereas it is impossible to be certain in advance that the investigation taken will be considered sufficient to sustain a due diligence defense. This residue of uncertainty steers most IPO companies, and their directors and officers, to seek indemnification and exculpation arrangements and D&O insurance.

INDEMNIFICATION AND EXPENSE ADVANCEMENT

Directors and officers are usually entitled to indemnification under the company's corporate charter or bylaws if they have met the applicable standard of conduct.

Under Delaware law, a corporation can indemnify a director or officer who “acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful.” For derivative claims (those brought against directors or officers by stockholders in the name of the corporation) in which a director or officer is found liable to the corporation, indemnification is permitted only to the extent the applicable court determines that, despite the adjudication of liability but in view of all the circumstances of the case, such director or officer is “fairly and reasonably” entitled to indemnity. The Delaware statute further provides that to the extent a director or officer is “successful on the merits or otherwise” in defense of a claim, such director or officer shall be indemnified against expenses actually and reasonably incurred in connection therewith.

In contemplation of an IPO, many companies also enter into separate indemnification agreements with each director and officer. An indemnification agreement provides the director or officer with a direct contractual claim against the company, in the event he or she seeks indemnification, and—unlike the corporate charter or bylaws—cannot be amended without the consent of the director or officer party to the agreement. In addition, the provisions of separate indemnification agreements are generally more favorable to directors and officers than corporate charter provisions, for example, by resolving uncertainties under the statute in their favor, establishing burdens of proof and presumptions that the company must overcome to deny indemnification, and providing for mandatory advancement of expenses as discussed below.

Indemnification rights under the corporate charter or bylaws, or a separate indemnification agreement, typically include expense advancement provisions. Indemnification and expense advancement are not the same. Indemnification occurs at the end of a lawsuit, when the company makes payment on behalf of directors or officers that will not be repaid. Advancement refers to payment by the company of a director's or officer's expenses (including

legal fees) in defending against a lawsuit as those expenses are incurred, subject to the obligation of the director or officer to repay the company if it is later determined that indemnification of the expenses would be improper. The right to expense advancement is as critical as the right to indemnification.

Unfortunately for directors and officers, the value of indemnification arrangements in an IPO is uncertain. In the opinion of the SEC (which every IPO company is required to acknowledge), indemnification of directors, officers and controlling persons for liabilities arising under the Securities Act is against public policy and unenforceable and therefore can be done only with court approval. However, the SEC's position on indemnification does not preclude expense advancement or liability insurance for the benefit of directors and officers.

EXCULPATION PROVISIONS

The corporate charter ordinarily also includes "exculpation" provisions that eliminate the personal monetary liability of directors to the company or its stockholders for breaches of fiduciary duty as a director, except to the extent not permitted by applicable state corporate law. In Delaware, for example, these provisions may not eliminate or limit the liability of a director for any breach of the director's duty of loyalty to the company or its stockholders; for acts or omissions not in good faith or those that involve intentional misconduct or a knowing violation of law; for unlawful dividends, stock repurchases, and stock redemptions; or for any transaction from which the director derived an improper personal benefit.

D&O INSURANCE

Directors' and officers' liability insurance provides coverage for liabilities incurred in connection with service as a director or officer, including IPO liabilities and derivative claims 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.

A company going public should procure an adequate D&O insurance policy before pricing the IPO. Significant time may be required to assess the company's needs, understand the alternatives, choose the carrier and coverage, review the policy, and complete all related arrangements. This process should begin well in advance of the anticipated offering date.

PUTTING THE RISK OF PERSONAL LIABILITY IN PERSPECTIVE

The above discussion is probably a bit worrisome for directors and officers, but the practical risk should be put in context. Is there potential liability for the company's directors and officers in an IPO? Yes. Should those directors and officers make sure the company hires qualified and experienced professional advisors for the IPO? Of course. Should the directors and officers take reasonable steps to avoid material misstatements and omissions in the Form S-1? Absolutely. Should they take their obligations very seriously? Without a doubt. Should the company purchase appropriate D&O insurance? Definitely. But should directors and officers be dissuaded from serving a company that is going public merely because of the potential for personal liability? Each person must decide for himself or herself, but most believe the answer is no.


The reality is that few outside directors have ever been required to make personal payments to resolve securities litigation. This is particularly true in an IPO for several reasons: the extensive due diligence that accompanies every IPO results in better disclosure and a reduced likelihood of litigation; the circumstances of an IPO present more attractive defendants (such as the company, without a due diligence defense, and the underwriters and auditor, with much deeper pockets); IPO companies are usually solvent during the period when claims can be brought; most IPO companies carry D&O insurance; both plaintiffs and defendants have strong incentives to settle through a combination of D&O insurance proceeds and company payments; and the overall number and value of securities class-action settlements, in general, has been declining. The incidence of personal liability for officers signing the Form S-1 and inside directors is higher than for outside directors, but is still very much the exception and not the rule. ■

Establishing a Due Diligence Defense

There is no single blueprint for a due diligence defense. Perhaps the best that can be said is that each director and officer must undertake an investigation that a reasonably prudent person in the same position would conduct. Summarized below are illustrative steps routinely undertaken by directors and officers in connection with an IPO.

- Participate in drafting sessions (in the case of officers) and in board meetings (in the case of directors) at which the Form S-1 is reviewed and discussed.
- Review and comment on drafts of the Form S-1, inquire about parts that are not understood, and follow up on areas that appear incorrect or incomplete until satisfactory responses are received.
- Be generally advised by company counsel on disclosure requirements and liability standards in an IPO.
- Seek advice from company counsel on specific disclosure requirements under applicable SEC and exchange rules, as questions arise.
- Review key disclosure decisions and unusual disclosures with company counsel.
- Confirm that the company personnel with the most knowledge of the subject matter covered by the Form S-1 have reviewed the Form S-1 for accuracy and completeness.
- If the company has separate counsel for specialized areas such as intellectual property or regulatory matters, confirm that counsel has reviewed the applicable portions of the Form S-1.
- Make sure that information supplied by third parties for the Form S-1 is obtained from reliable sources.
- Ensure that the underwriters and their counsel receive access to all documents, information and persons, inside and outside the company, requested as part of their due diligence.
- Hire qualified and experienced law and audit firms for the IPO.

26 Public Company Compensation and Section 162(m)

 A company going public must become familiar with a wide variety of requirements and rules that were inapplicable while the company was privately held, including some that will affect its executive compensation practices. Below is an overview of one such provision, Section 162(m) of the Internal Revenue Code (Code).

Q1: What is Section 162(m)?

Compensation paid by a company to its employees is generally deductible by a company, whether publicly or privately held, when determining the company's taxable income. However, Section 162(m) generally limits to \$1 million the amount a public company can deduct from its taxable income for the compensation it pays to any "covered employee" in a taxable year.

Q2: Who are the "covered employees"?

Generally, the deduction limitation applies to compensation paid by the company to:

- the CEO (or an individual acting in the capacity of the CEO) as of the close of the taxable year; and
- the three highest-paid executive officers of the company for the taxable year (other than the CEO and the CFO).

However, the IRS recently issued guidance stating that, in the case of "smaller reporting companies" eligible to take advantage of the relaxed disclosure requirements under Regulation S-K, the deduction limitation applies to compensation paid to:

- the CEO (or an individual acting in the capacity of the CEO) as of the close of the taxable year; and
- the two highest-paid executive officers of the company for the taxable year (other than the CEO).

The same rule may also apply to emerging growth companies that are, like smaller reporting companies, eligible to take advantage of the relaxed disclosure requirements under Regulation S-K. Note that, because of a quirk of cross-referencing between the Code and SEC rules, a company's CFO will be a "covered employee" only if the CFO is among the two highest-paid executive officers of a company eligible to take

advantage of the relaxed disclosure requirements under Regulation S-K.

In all cases, the deduction limitation applies only to persons employed at the end of the taxable year.

Q3: Does Section 162(m) apply as soon as a company goes public?

Not necessarily. The Code provides for a transition period during which any compensation paid under a compensation plan or agreement that was in place while the company was privately held will not be subject to the deduction limitation. However, a company that goes public via an IPO must have included adequate disclosure of each such plan or agreement in its prospectus for the plan or agreement to be eligible for the transition relief.

Q4: How long does the transition period last?

The transition period for each existing plan or agreement lasts until the earliest of:

- the expiration of the plan or agreement;
- the material modification of the plan or agreement;
- the issuance of all employer stock and other compensation that has been allocated under the plan; or
- the first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the initial public offering occurs, with a shortened period for companies that become public without an IPO.

This means that the transition period for any plan or agreement can last for up to approximately three and a half years after an IPO.

Q5: Is that why IPO companies typically adopt new stock incentive plans and employment agreements prior to the closing of the IPO?

There are many reasons to adopt a new stock incentive plan and employment agreements before an IPO. Being able to take advantage of the Section 162(m) transition period is certainly one of them.

Q6: How does Section 162(m) affect the number of shares available for issuance under a stock incentive plan?

To postpone the application of the Section 162(m) deduction limitation for as long as possible, the plan should be designed such that shareholder approval to increase the number of shares available for issuance under the plan is not required for at least three years following the IPO. Running out of shares entirely or increasing the number of shares available under the plan both have the effect of ending the Section 162(m) transition period. IPO companies adopting new plans may include an evergreen feature under which a fixed number of shares is automatically added to the plan annually. Evergreen features are disliked by institutional investors. Therefore, if the evergreen feature does not provide for sufficient replenishment of shares, when the company seeks shareholder approval of a plan increase not only will the Section 162(m) transition period end but the company should expect to remove the evergreen provision entirely to win shareholder approval.

Q7: Are there other stock incentive plan design features that are influenced by Section 162(m)?

Yes. For awards under a plan to comply with the performance-based compensation exception to the deduction limitation of Section 162(m), the plan must include certain specific provisions (see Q11–Q16). These provisions can be included upon adoption of the plan or by amendment at the end of the transition period.

Q8: Following expiration of the transition period, will all compensation paid to the company's covered employees be subject to the deduction limitation of Section 162(m)?

Yes, unless the compensation qualifies as performance-based compensation. However, compensation resulting from equity awards other than restricted stock units granted during the transition period will not be subject to the deduction limitation even if it is paid after the expiration of the transition period.

Q9: Should the company care?

That really depends on the company. Newly public companies with no taxable income and/or significant losses will care less about the deduction limitation than other public companies. But even if a newly public company doesn't immediately care about

the deduction limitation, it may care about it within a few years after going public.

Q10: So can a company ignore Section 162(m) until it determines that the limitation matters?

Ignoring Section 162(m) until the limitation actually affects the determination of a company's taxable income could result in some non-deductible compensation. Take an option, for example. Compensatory options typically have a term (and can be exercised once vested during that term) of between seven and ten years from the grant date. Compensation is considered paid on an option (and the related tax deduction can be taken) when the option is exercised, but generally a company cannot predict at the time the option is granted when it will be exercised. It could be that by the time the option is exercised the company has used up all of its net operating losses and the deduction limitation has become important to the company. Or, it could be that the recipient of an option was not a covered employee when the option was granted but is a covered employee at the time it is exercised.

Q11: What is performance-based compensation?

The deduction limitation of Section 162(m) does not apply to compensation that qualifies as performance-based compensation. To qualify as performance-based, compensation must be paid:

- solely on account of the attainment of one or more pre-established, objective performance goals that were established by a compensation committee comprised solely of two or more "outside directors" and are disclosed to (and subsequently approved by) the shareholders of the public company before the compensation is paid; and
- following certification in writing by the compensation committee that the performance goals and any other material terms were in fact satisfied.

Q12: What is a pre-established, objective performance goal?

A performance goal is considered "pre-established" if it is established in writing

no later than 90 days after the beginning of the period of service to which the performance goal relates. The outcome must be substantially uncertain at the time the goal is established. However, in no event will a goal be considered "pre-established" if it is established after 25% of the period of service to which the goal relates has elapsed.

A performance goal is considered "objective" if a third party knowing the relevant facts could determine whether the goal is met. Performance goals can be based on one or more business metrics that apply to the individual employee, a business unit, or the company as a whole. The performance goal must also state, in terms of an objective formula or standard, the method for calculating the amount of compensation payable if the goal is achieved. A performance goal may not provide for discretion to increase the payment upon achievement of the goal but may permit the exercise of negative discretion (that is, reducing the compensation otherwise payable) provided the exercise of negative discretion with respect to one employee does not result in the increase of compensation to another.

Q13: Who sets the performance goals?

The performance goals must be established by a compensation committee that is comprised only of two or more "outside directors." For this purpose, an "outside director" is a director who:

- is not a current employee of the company;
- is not a former employee of the company who receives compensation for prior services (other than benefits under a tax-qualified retirement plan);
- has never been an officer of the company; and
- does not receive remuneration from the company, either directly or indirectly, in any capacity other than as a director.

Q14: Are "outside directors" the same as "independent directors" under stock exchange rules or "non-employee directors" under SEC rules?

Not exactly. There are minor but important differences in these definitions,

which serve different purposes.

The good news is that an IPO company ordinarily is able to constitute its board of directors and board committees to satisfy each of these definitions.

Q15: Do performance goals need to be approved by shareholders?

Yes. The material terms of the performance goals must be disclosed to, and approved by, the company's shareholders before the compensation is paid. For this purpose, the material terms include:

- identification of the group of employees eligible to receive the compensation;
- a description of the business criteria on which the performance goal is based; and
- either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained.

Once the material terms are disclosed and approved, no additional disclosure or approval of any performance goal is required unless the compensation committee changes the material terms of the performance goal. If the compensation committee has the authority to change the targets under a shareholder-approved performance goal, the material terms of that performance goal must be disclosed and reapproved every five years.

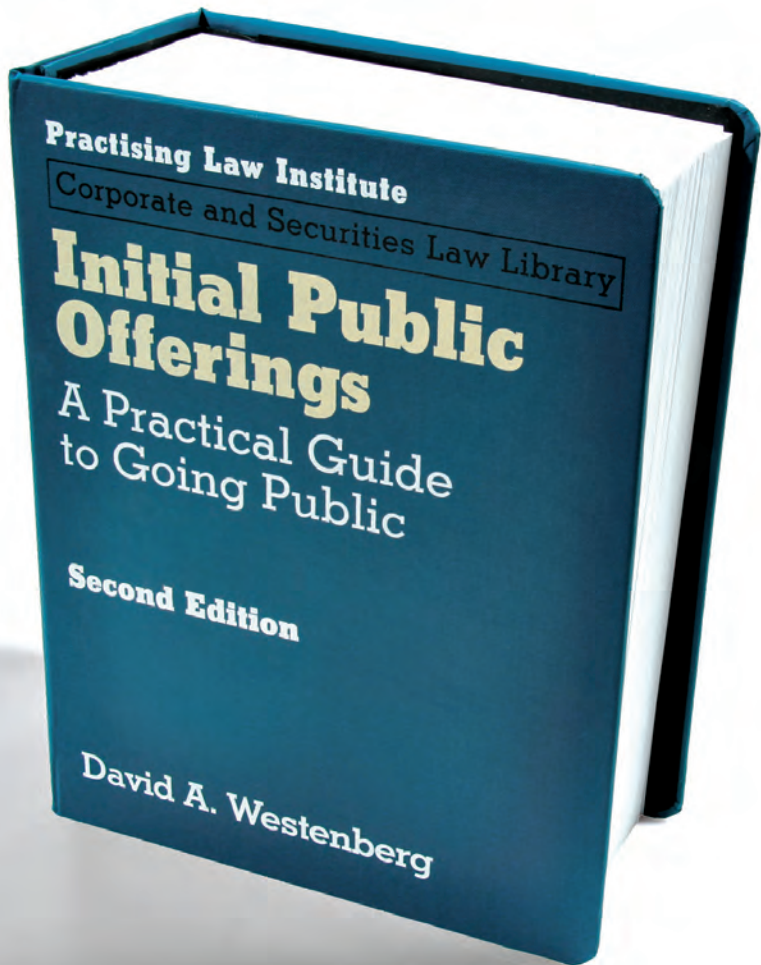
Q16: Can the compensation attributable to options be performance-based compensation?

Yes, if:

- the option is granted or awarded by a qualifying compensation committee;
- the plan under which the option is granted states the maximum number of shares with respect to which options may be granted during a specified period to any employee; and
- the option's exercise price is no less than the fair market value of the stock underlying the option on the date of grant, unless the grant, vesting or exercisability of the option is otherwise subject to the attainment of a pre-established, objective performance goal. ■

We Wrote the Book on Going Public.

You can write the next chapter.



“[This book] is quickly becoming the bible of the I.P.O. market.”

— *The New York Times*
(The Deal Professor, January 19, 2010)

“Comprehensive in scope, informative, incisive, and...an important reference and informational tool.”

— *Burton Award, Outstanding Authoritative Book by a Partner in a Law Firm, 2013*

“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
Book available from PLI.edu



Follow WilmerHale's IPO blog at
www.wilmerhale.com/IPOBlog



Want to know more about the venture capital and M&A markets?

Our *2016 Venture Capital Report* offers an in-depth analysis of, and outlook for, the US and European venture capital markets. The report features industry and regional breakdowns, and a look at trends in venture capital financing, convertible debt and VC-backed company M&A deal terms. We also highlight two new funding techniques that have expanded the pre-IPO financing toolkit; five common mistakes made by fledging entrepreneurs; and four things you need to know about doing business in California.

See our *2016 M&A Report* for a detailed review of, and outlook for, the global M&A market. Other highlights include a comparison of deal terms in public and private acquisitions; updates on takeover defenses and public company deal litigation; practical guidance on avoiding antitrust violations in pre-merger integration planning; a look at what buyers need to know about appraisal claims in private company mergers; and a survey of key terms and issues in sales of VC-backed companies.

To request a copy of any of the reports described above, or to obtain additional copies of the *2016 IPO Report*, please contact the WilmerHale Client Development Department at ClientDevelopment@wilmerhale.com or call +1 617 526 5600. An electronic copy of this report can be found at www.wilmerhale.com/2016IPOreport.

Data Sources: WilmerHale compiled all data in this report unless otherwise indicated. Offerings by REITs, bank conversions, closed-end investment trusts, special purpose acquisition companies, oil & gas limited partnerships and unit trusts are excluded from IPO data. Offering proceeds generally exclude proceeds from exercise of underwriters' over-allotment options, if applicable. For law firm rankings, IPOs are included under the current name of each law firm. Venture capital data is sourced primarily from Dow Jones VentureSource. Private equity-backed IPO data is sourced primarily from Thomson Reuters.



Mixed Sources
 Product group from well-managed forests, controlled sources and recycled wood or fiber
 www.fsc.org Cert no. BV-COC-070904
 © 1996 Forest Stewardship Council

16_0031 KW 3/16 6,000

WilmerHale recognizes its corporate responsibility to environmental stewardship.

Connect with us   

wilmerhale.com

Wilmer Cutler Pickering Hale and Dorr LLP is a Delaware limited liability partnership. WilmerHale principal law offices: 60 State Street, Boston, Massachusetts 02109, +1 617 526 6000; 1875 Pennsylvania Avenue, NW, Washington, DC 20006, +1 202 663 6000. Our United Kingdom office is operated under a separate Delaware limited liability partnership of solicitors and registered foreign lawyers authorized and regulated by the Solicitors Regulation Authority (SRA No. 287488). Our professional rules can be found at www.sra.org.uk/solicitors/code-of-conduct.page. A list of partners and their professional qualifications is available for inspection at our UK office. In Beijing, we are registered to operate as a Foreign Law Firm Representative Office. This material is for general informational purposes only and does not represent our advice as to any particular set of facts; nor does it represent any undertaking to keep recipients advised of all legal developments. Prior results do not guarantee a similar outcome. © 2016 Wilmer Cutler Pickering Hale and Dorr LLP