



4

Role of the law firm

Alan F Denenberg, Joseph A Hall and Deanna L Kirkpatrick,
Davis Polk & Wardwell

Davis Polk & Wardwell looks at the role of the law firm and the legal issues associated with a NASDAQ initial public offering

The increasing complexity of the regulatory framework governing securities offerings in the United States, together with the often complex interplay of the business, legal and accounting considerations in going public, make the role of legal counsel to the issuer an increasingly important part of the initial public offering (IPO) process. In essence, the role of legal counsel is to help navigate the complex regulatory requirements associated with going public and to facilitate and coordinate the activities of the other parties involved in the process (e.g., accountants, underwriters and regulators). This chapter looks at the various issues to be considered by US and Canadian companies contemplating an IPO.

Overview

Legal framework

The offering of securities by an issuer to the public in the United States is subject to the regulatory framework of the Securities Act of 1933 in addition to certain other regulatory requirements, including the rules of the Financial Industry Regulatory Authority (FINRA) and applicable listing requirements. Under the Securities Act, securities may be offered and sold to the public only by means of a registration statement, which includes a prospectus containing information about the issuer that provides potential investors with a basis upon which to make an investment decision. Once public, a company is subject to ongoing reporting requirements and other

obligations under the Securities Exchange Act of 1934, as well as the applicable listing rules.

General timeline

A typical IPO takes four to five months from the initial organizational meeting to the pricing date. Certain matters associated with going public (e.g., the preparation and audit of financial statements) may require additional time and should be considered up to one year before the proposed IPO. It may also be advisable to resolve certain other issues (e.g., outstanding litigation) in advance of the IPO to avoid negative disclosure that could affect the marketability of the offering. Furthermore, certain actions that require shareholder approval (e.g., charter amendments and the adoption of benefit plans) are usually easier to accomplish before the IPO. Finally, a company may need to seek the consent of customers and other third parties that it proposes to mention in the registration statement.

Registration statement

For an IPO, US issuers use a Form S-1 registration statement, which requires extensive information about the issuer's business and financial performance. Representatives of the company, together with its legal counsel, prepare the initial draft of the registration statement and prospectus. The entire working group, including the accountants, underwriters and underwriters' counsel, then reviews and comments on the

document at drafting sessions held over a number of weeks.

The purpose of the registration statement is to:

- comply with legal requirements – it is illegal to use a prospectus that does not comply with Section 10 of the Securities Act;
- provide a disclosure document – liability is imposed for material misstatements and omissions; and
- serve as a marketing document – the prospectus is used to interest potential investors in buying stock in the IPO.

Companies that are foreign private issuers (described in greater detail below) generally use a Form F-1 registration statement in connection with their IPO. Form F-1 permits more limited disclosure in certain areas such as executive compensation and related-party transactions, but also requires certain disclosures unique to foreign private issuers, such as a description of any limitations on the right to hold or vote securities that are applicable to persons who are not citizens or residents of the issuer's home country, and a reconciliation to US generally accepted accounting principles (GAAP) of financial statements prepared in accordance with GAAP of the home jurisdiction or the inclusion of financial statements prepared in accordance with International Financial Reporting Standards, as adopted by the International Accounting Standards Board.

Canadian companies which are foreign private issuers and have been subject to the continuous disclosure requirements of a Canadian securities regulatory authority for at least 12 months and have a public equity float of at least \$75 million may use a Form F-10 registration statement. Form F-10, adopted by the Securities and Exchange Commission (SEC) in 1991, permits a prospective Canadian issuer to prepare a disclosure document in accordance with the requirements of the relevant Canadian jurisdiction and use that document for purposes of its US IPO.

Document due diligence

In order to facilitate the due diligence process conducted by the underwriters and their counsel, the company creates a comprehensive dataroom of corporate records, contracts and other legal and regulatory documents. Contracts should be reviewed to ensure that they are current, complete and signed by all parties.

Execution team

The IPO process will require a substantial time commitment from the company's management team. In particular, senior management representatives will be expected to participate in due diligence and preparation of the prospectus, and will play the key role in the IPO marketing process (or roadshow). Many issuers find it helpful to designate one person to attend all working

group meetings and to follow up information requests and coordinate with company representatives.

Role of lead underwriters

The company's lead underwriters will have views as to how to position the company best from a marketing perspective, as well as the appropriate capital structure and shareholder rights. In addition, the underwriters will require a lock-up on all shares owned by executive officers, board members and other stockholders restricting transfers of any stock they own for a period of 180 days after pricing to avoid sales of significant amounts of stock disrupting the secondary market for the company's stock shortly after the IPO. As lock-ups are often difficult to obtain from non-insider shareholders, venture capital investor agreements often provide that the shares of common stock issued in a venture capital financing will be subject to a lock-up upon an IPO. In addition, the lead underwriters and their counsel will be involved in preparing the prospectus.

Accounting issues

The preparation of financial statements and related disclosure is often the most time-consuming aspect of the transaction and the item most likely to become a gating issue. SEC rules require the company to present audited income statements covering the last three fiscal years and balance sheets as of the end of the last two fiscal years. In addition,

the company will be required to present selected financial data for five years (the earliest two years of which may be unaudited).

The audited annual financial statements must include the most recently closed fiscal year, unless the effective date will be within 45 days of the end of the fiscal year and audited financial statements for the most recent fiscal year are not yet available. In addition, US companies must provide interim financial statements, which may be unaudited, for quarterly periods following the most recent audited fiscal year (these may be unaudited). A company should consult its accountants to determine the scope of the required audited and unaudited financial statements.

In certain circumstances a company may be required to include in the registration statement financial statements relating to the acquisition. Proposed 'probable' acquisition transactions may also require disclosure. In the case of significant acquisition transactions that have not yet been reflected in a company's financial statements for a full fiscal year, a *pro forma* presentation showing the combined companies' results may be required. *Pro forma* financial statements may also be required in the case of a significant pre-IPO disposition of assets. Consents from the accountants of acquired companies may be required and underwriters will typically require a comfort letter from these accountants, in addition to the auditor of the issuer's financial statements.

One area that the SEC regularly comments on is the accounting treatment of equity awards issued prior to the IPO. The SEC is likely to require a company to demonstrate that the price of equity awards fairly reflects the value of the company's common stock at the time of issuance and that, if it does not, the company's results of operations, as reported in the registration statement, include the appropriate amount of expense associated with the award. A company should carefully consider and document valuation factors relevant to past equity awards, and consider retaining a valuation firm to provide a valuation at the time of their issuance.

SEC review process

The SEC reviews registration statements on a selective basis. However, IPOs will almost always receive a full SEC review. Legal counsel should anticipate potential areas of SEC concern and address them in the initial filing so as to reduce the degree to which the SEC will request revisions and help to expedite the review process. After filing, the registration statement will be assigned to a specific SEC branch and an examiner in that branch will coordinate the review process. In addition, an accounting examiner will be assigned to examine the financial statements and other financial information included in the registration statement.

Once the SEC has completed its initial review (usually around 30 days after the initial

filing), the branch chief will issue a comment letter to the issuer, which typically:

- requests additional disclosure in the prospectus;
- asks questions about accounting treatment; and
- seeks additional information about the company and the filing.

After reviewing the comment letter, counsel to the issuer may decide to discuss certain comments with the SEC examiner. Following that, an amendment to the registration statement is prepared by the company and its counsel and filed with the SEC. The filing is accompanied by a transmittal letter that describes the issuer's response to each comment raised in the comment letter and identifies the page of the prospectus where any additional language has been inserted in response to a comment. The SEC review process often involves several amendments to the registration statement until the SEC is satisfied that its comments and concerns have been addressed and it is prepared to declare the registration statement effective. As securities cannot be sold to investors until the SEC has declared the registration statement effective (which typically occurs at the end of the roadshow), a key role of the issuer's counsel is to help the working group understand at what point the roadshow can begin.

Amendments to the registration statement are available to the public immediately upon

filing. However, a foreign private issuer may keep its initial IPO filing and subsequent amendments confidential until the filing of the version of the preliminary prospectus to be used for marketing of the offering.

FINRA

FINRA must also review and clear the IPO prior to pricing. FINRA regulations focus on the amount of underwriting compensation received by the underwriters, which not only includes the commission paid to the underwriters, but also may include other forms of consideration, such as stock received by a member of the underwriting syndicate during the six months preceding the initial filing date of the registration statement. As the SEC will not declare a registration statement effective until FINRA has cleared the offering, the underwriters and their counsel must anticipate and address any underwriting compensation issues well in advance of the proposed pricing date.

Foreign private issuers

Non-US companies issuing securities in the United States are generally subject to US securities laws. However, US securities laws provide that a non-US company that qualifies as a foreign private issuer is subject to somewhat narrower disclosure obligations than a US issuer and is exempt from the application of certain US securities law provisions (e.g., proxy rules). Prospective Canadian issuers that wish to benefit from

this more advantageous treatment must determine whether they are a foreign private issuer. All foreign issuers that are not foreign governments are foreign private issuers, unless more than 50% of the outstanding voting securities of the issuer are owned either directly or indirectly by US residents and either:

- a majority of the executive officers or directors of the issuer are US citizens or residents;
- more than 50% of the issuer's assets are located in the United States; or
- the issuer's business is principally administered in the United States.

Ticker symbol

The company must select and reserve a ticker symbol. A company that wishes to list on NASDAQ may reserve a ticker symbol up to six months in advance of an initial listing application submission. Only one ticker symbol may be reserved and the reservation will remain in place for up to six months.

Transfer agent

The company should also select a transfer agent to handle transfers of its common stock and other publicly traded securities.

Key considerations

Communications

Pre-filing period

The pre-filing period runs from the time when the company decides to pursue an IPO to the

time when the company files the registration statement with the SEC.

During the pre-filing period the company is prohibited from making any oral or written offers to sell its securities or taking any actions that have the effect of conditioning the market for the sale of the company's securities. This ensures that the prospectus is the primary means by which investors receive information regarding the company and its securities.

In order to permit a company to continue to conduct business as usual during the registration process, historically the SEC has allowed companies to continue to issue press releases with respect to factual business developments and discuss products or potential products, provided that:

- the disclosure is consistent with prior practice;
- the disclosure is in customary form;
- the disclosure does not contain projections, forecasts, predictions, opinions or valuations; and
- the content, timing and distribution of the disclosure do not otherwise suggest that an IPO is underway.

These restrictions also apply to interviews and speeches; therefore, speeches and interviews by senior executives and board members should be carefully analyzed in advance.

The SEC generally reviews a company's website, recent press releases, recent news

articles and other publicity as part of its review of a company's IPO registration statement.

Material changes in the quantity or type of advertising around the time of an IPO can also attract SEC scrutiny.

In 2005 the SEC codified its views regarding a company's ability to continue customary and ordinary course communications. It provided a safe harbor during the quiet period for the regular release or dissemination by or on behalf of a company of communications containing factual business information, provided that certain conditions are fulfilled. In addition, a safe harbor exists for any communication made by or on behalf of a company more than 30 days before the filing of its IPO registration statement if that communication does not reference the IPO and the company takes reasonable steps within its control to prevent further distribution or publication of the communication within the 30-day period.

Failure to comply with these limitations on communications may result in the SEC delaying the IPO, and in certain circumstances can result in civil and criminal penalties.

Waiting period

The waiting period is the period between the filing of the registration statement and the time when the SEC declares the registration statement effective following completion of its review (usually the pricing date of the IPO).

During the waiting period, the prohibition on oral offers no longer applies. This permits

the marketing process to begin by means of a roadshow to investors. Offers to sell the company's securities can be made, but no sales can be completed. However, during this period written offers must be made by means of a prospectus that meets the requirements of the Securities Act. The term 'prospectus' is defined broadly to include any written communication (including emails, faxes and even 'blast' voicemails), or any communication by radio or television, that offers any security for sale.

Once it specifies a price range for the IPO, the preliminary prospectus contained in the registration statement may be distributed during the waiting period. In addition, SEC Rule 134 permits companies to issue a press release announcing the offering during the waiting period, provided that the information in the press release is confined to certain limited categories of information set out in the rule. In addition, certain written offers (or free writing prospectuses) are permitted after the filing of the registration statement subject to certain restrictions. However, as for the registration statement and prospectus, a company is liable for any material misstatements or omissions in a free writing prospectus. As a result, free writing prospectuses are used rarely in an IPO.

Post-effective period

The post-effective period is the period after the SEC has declared the registration statement effective – usually beginning on the IPO pricing date. Sales of a company's securities that are

preceded or accompanied by a copy of the final prospectus can be made once the registration statement is declared effective.

Corporate governance

In preparing for an IPO and listing on NASDAQ, a company will need to consider the corporate governance requirements under the Sarbanes-Oxley Act and related SEC rules, as well as additional corporate governance requirements of NASDAQ.

Independent directors

NASDAQ rules generally require the board of directors of a listed company to consist of a majority of independent directors, unless a majority of the company's voting power is held by an individual, a group or another company (in which case the listed company would be deemed a controlled company and would be exempt from certain NASDAQ governance rules). New public companies have one year from the date of listing to meet this requirement. The definition of 'independent director' established by NASDAQ requires that the board of directors make an affirmative determination of independence. In addition, NASDAQ has established certain categories of individuals whose relationships with the listed company make them ineligible to serve as independent directors (e.g., recently retired company officers), although such individuals may form a minority of the board. NASDAQ requires that independent directors hold regularly scheduled meetings.

Compensation committee

Subject to the controlled company exception, under NASDAQ rules compensation of the chief executive officer and other executive officers generally must be determined either by a majority of independent directors or by a compensation committee comprised of independent directors. Under limited circumstances, one member of the compensation committee may be a non-independent director, but may not serve for more than two years. In addition, a compensation committee of at least two independent directors will be required to comply with tax requirements regarding the grant of compensation to certain executive officers, including the chief executive officer, and SEC requirements regarding the granting of equity compensation. Compensation committees of companies completing an IPO must:

- have one independent member at the time of listing;
- have a majority of independent members within 90 days of listing; and
- be fully independent within one year of listing.

If a company establishes a compensation committee, a written charter or board resolution is required.

Nominating/corporate governance committee

Subject to the controlled company exception under NASDAQ rules, nominations of directors

generally must be determined either by a majority of independent directors or by a nominating committee comprised of independent directors. In certain circumstances one member of the nominating committee may be a non-independent director. That member may not serve for more than two years. The nominating/corporate governance committee is responsible for director and board committee nominations, developing and overseeing corporate governance policies and other specified matters. Nominating committees of companies completing an IPO must:

- have one independent member at the time of listing;
- have a majority of independent members within 90 days of listing; and
- be fully independent within one year of listing.

If a company establishes a nominating committee, a written charter or board resolution is required. In addition, if the company is legally required by contract or otherwise to provide third parties with the ability to nominate directors (e.g., pursuant to a shareholders' agreement), the selection and nomination of such directors need not be subject to the independent nomination process.

Audit committee

NASDAQ rules provide that a listed company generally must have an audit committee

consisting entirely of independent directors. A company completing an IPO must have:

- at least one independent member at the time of listing;
- a majority of independent directors within 90 days of its registration statement being declared effective; and
- a fully independent audit committee within one year of its registration statement being declared effective.

However, if the company is a US reporting company prior to the IPO, it is required to have a fully independent audit committee on the date the registration statement is declared effective. In some limited circumstances, one member of the audit committee may be a non-independent director. Nonetheless, that member must:

- meet the SEC's additional independence requirements applicable to all audit committee members;
- not serve for more than two years; and
- not chair the audit committee.

NASDAQ requires that the audit committee have a written charter containing certain specified provisions and the SEC rules contain certain specific responsibilities of audit committees.

Financial expert

NASDAQ rules require that audit committee members be able to read and understand

fundamental financial statements, including the balance sheet, income statement and cash-flow statement. In addition, SEC rules require a company to disclose in its annual report whether the board has determined that the company has at least one 'financial expert' serving on its audit committee. If it does not, it must disclose why this is the case.

Codes of conduct

NASDAQ rules require that a listed company have a publicly available code of conduct for all directors, officers and employees. Any amendments to, or waivers from, the code's provisions for directors and executive officers must be disclosed. The code must be designed to deter wrongdoing and to promote:

- honest and ethical conduct;
- full, fair and timely disclosure;
- legal compliance; and
- prompt internal reporting of violations.

Disclosure committee

The SEC does not specify disclosure controls and procedures, but has suggested that companies form a disclosure committee to perform risk assessment, establish disclosure controls and procedures and ensure timely and accurate disclosure and compliance with Regulation FD. The disclosure committee should include:

- the principal accounting officer or controller;
- the general counsel or another senior legal officer;

- the principal risk management officer;
- the chief investor relations officer; and
- other officers or employees as the company deems appropriate.

A written charter should be adopted setting out the purpose of the disclosure committee.

Relationship with accountants

Public companies are also subject to the Sarbanes-Oxley rules governing the independence of the company's accountants. Under Sarbanes-Oxley the audit committee must pre-approve all audit and non-audit services. The company's accountants will be prohibited from performing certain services including bookkeeping, financial system design and implementation, appraisal and valuations, management and human resources, and most legal, actuarial and expert services.

In addition, the accountants must report certain information to the audit committee, including any disagreements with management, and the audit partners must rotate every five years. There is also a one-year cooling-off period before a former employee of the accountant can serve in a financial reporting capacity at the issuer.

The Public Company Accounting Oversight Board has also adopted accountant independence rules that prohibit independent accountants from providing certain tax services to audit clients and require the audit committee to pre-approve certain specified tax services.

Loans to directors and executive officers

Sarbanes-Oxley forbids 'issuers' (defined as any company that files a registration statement under the Securities Act, even before that registration statement becomes effective) from extending credit to their directors and executive officers. Legal counsel should analyze whether any of the company's current practices (e.g., company-paid life insurance premiums) or outstanding loans could trigger potential problems. In most instances, outstanding loans will need to be repaid before filing of the IPO registration statement.

Attorney conduct rules

SEC rules implementing the attorney conduct provisions of Sarbanes-Oxley will apply to lawyers employed in-house by the company. These rules require in-house attorneys to report 'up the ladder' a material violation of a securities law, a material breach of fiduciary duty or similar material violation of law.

Foreign private issuers

Foreign private issuers are permitted to follow home country practices in lieu of certain corporate governance requirements under the NASDAQ rules, subject to certain important exceptions, including the requirement to have an audit committee that meets the standards outlined above. Foreign private issuers must provide NASDAQ with a written statement of counsel certifying that the issuer's practices are not prohibited by the law of the home country, disclosing which corporate

governance requirements they do not follow and describing the practices that they do follow.

Corporate structure

Organizational structure and qualifications

It is often preferable for a company going public to have a simple organizational structure (i.e., a single corporation or parent-holding company with subsidiaries). Although not always feasible, a company may find it advisable to restructure its corporate holdings in order to create a simpler reporting entity, but it should also consider the tax and accounting consequences of any restructuring. A company and its subsidiaries should also ensure that they are qualified to operate in all requisite jurisdictions and that each entity is current in its payment obligations (e.g., state franchise taxes).

Capital structure

The company, together with its lead underwriters, will need to determine whether its capital structure is optimal for a public company and, more specifically, an IPO. In addition, it should review the terms of any outstanding convertible or exchangeable securities to determine the circumstances under which they will be converted into common stock. Particular attention should be given to convertible securities that survive an IPO.

Consideration should also be given to whether a company has authorized a sufficient

number of shares of common stock to cover current and anticipated requirements. After becoming a public company it will be much more difficult to obtain requisite shareholder approval for an amendment to the certificate of incorporation to increase the share authorization. However, consideration should be given to any potential negative “overhang” perception associated with the amount of authorized share capital.

It is often advisable to adjust the number of shares outstanding (by stock split, reverse stock split or recapitalization) in order to achieve a share price and public float that is appropriate for a public company. In addition, the company should consider whether the amount of its outstanding debt is optimal and whether sources of future debt financing are adequate for a public company.

Charter and bylaws

A company’s governing documents should be reviewed to eliminate provisions that are inappropriate for a public company and to provide additional flexibility to company management. In particular:

- charter provisions such as pre-emptive rights, rights of first refusal, veto rights and rights to appoint directors are not typical for public companies;
- the authorization of ‘blank check’ preferred stock for future financing and for implementing takeover defenses may be advisable; and

- anti-takeover provisions (e.g., a classified board of directors or cumulative voting) should be discussed with the underwriters.

Corporate proceedings and approvals

The company’s lawyers should review its corporate records to ensure that minute books are complete. The company will need to ensure proper authorization for the IPO; in many cases it may be advisable to establish a pricing committee of the board of directors to negotiate the IPO price.

Sales of securities prior to the IPO

The company’s lawyers should review all previous issuances of securities (including grants of equity compensation awards) in order to confirm that all sales complied with applicable law:

- Securities Act compliance - the company will be required to include in the registration statement a description of sales of its securities within the past three years, together with an analysis of the basis on which those sales were exempt from registration under the Securities Act. The SEC frequently focuses on this disclosure, particularly if substantial sales of equity securities take place close to the time of the IPO. Private placements that are undertaken after the initial filing of the registration statement are subject to additional legal restrictions and are likely to be scrutinized carefully by the SEC. Any post-filing sales of

securities to individuals are likely to be problematic.

- Exchange Act compliance - under the Exchange Act, in the absence of an exemption an issuer with 500 or more record holders of a class of equity security may be required to register with the SEC. Stock options are a separate equity security for purposes of the 500-holder rule unless an exemption is available. Past failure to comply with this requirement could impede an IPO.
- State law compliance - the underwriters will typically request a legal opinion that all outstanding shares of the company’s common stock were duly authorized and validly issued and are fully paid and non-assessable.
- Blue-sky issues - once securities have been approved for listing on NASDAQ, state blue-sky laws are pre-empted, no filings are required and there is no need to obtain blue-sky resolutions. As long as listing approval is obtained before pricing, no action is required under blue-sky laws in connection with the IPO. However, past securities issuances should be reviewed for compliance with blue-sky laws.

Material contracts and documents

Documentation of business relationships

With respect to any material relationship with a customer, supplier, lender or other third party, current and complete documentation must be

available. In connection with the IPO, it may be advisable to document informal business arrangements formally and to negotiate renewals of any key contracts that expire in the near term. In addition, the company should ensure that it is in compliance with its financing documents and other material agreements. Necessary waivers or amendments should be obtained and any outstanding disputes should be resolved prior to the initial filing of the registration statement to the extent possible.

Protection of intellectual property rights

Ensuring proper protection of intellectual property (IP) rights is often critical for a company planning an IPO. IP lawyers should review any issues regarding the company's IP portfolio, including the following:

- For IP rights developed by or for the company (including internally developed patents and trademarks), it may be necessary to secure a written assignment of those rights from the employees or outside contractors responsible for the development of such rights.
- If trademarks are important to the company's business, it should conduct a trademark search to confirm that the marks do not conflict with those of other companies. Consideration should be given to registering the mark with the US Patent and Trademark Office.
- A review of IP rights licensed from others should also be undertaken to ensure that

the licenses are valid and in force. In addition, the company should ensure that it owns or has licenses for all the IP rights which it needs to operate.

- In addition to protecting its rights to existing intellectual property, a company should ensure that appropriate procedures are implemented to protect its IP rights in the future. Written non-disclosure agreements with third parties and assignment of invention and ownership agreements from employees should be obtained as a matter of course.
- Depending on the industry, outside IP counsel should be engaged to provide appropriate opinions to the underwriters.

Review contracts for problematic provisions

A company should conduct a review of its contractual arrangements in order to determine whether any provisions may be problematic for the IPO or for a public company. Some issues may be easily resolved (e.g., by giving required notice or meeting stated conditions), while others may require the company to obtain a waiver, consent or amendment and may require extensive negotiation and communication with counterparties. If possible, problematic provisions should be eliminated before the IPO. In general, problematic provisions would include:

- control rights that survive the IPO (e.g., veto provisions or rights to appoint directors);

- qualifying IPO provisions in shareholders' agreements requiring a minimum per-share IPO price or deal size;
- pre-emptive rights or anti-dilution provisions triggered by issuing equity (particularly if they survive the IPO);
- rights to receive shares in the IPO or registration rights that may be triggered by the IPO (including notice requirements);
- restrictions on payment of dividends, other than in bank loan agreements;
- non-compete clauses and other restrictions on the company's business;
- change of control provisions; and
- provisions in financing agreements (e.g., credit facilities, restricting the undertaking of a public offering or the use of IPO proceeds).

Ensure that transactions with affiliates are documented with arm's-length terms

In general, the registration statement must include a description of all transactions with affiliates in the past three years. A public company entering into transactions with related parties (including shareholders, officers and directors) should obtain contractual terms no less favorable to the company than terms that could be arranged with a third party. A company should determine whether the terms of its existing contracts and arrangements with affiliates are fair to the company; if not, it should consider whether it can revise or eliminate any unfavorable terms. To the extent that a company has undocumented

understandings with an affiliate, appropriate documentation should be developed.

Directors and officers

The company should consider entering into indemnification agreements with and/or obtaining liability insurance for the benefit of its directors and executive officers. In addition, it may be appropriate to obtain key-person insurance.

Public filing of material contracts

The SEC requires that each of the company's material contracts be filed as an exhibit to the registration statement. Material contracts should be reviewed to ensure that the filing will not violate any confidentiality agreement or result in the inadvertent disclosure of proprietary information. It is possible to obtain confidential treatment for sensitive information (e.g., pricing information); however, the SEC limits the extent to which confidential treatment will be afforded. If confidential treatment is requested, additional time to obtain SEC clearance of the IPO may be required.

Tax issues

Tax history

As part of the due diligence process, the company should ensure that all state and federal income tax returns have been filed and all issues involving potential material tax liability have been identified. The company should also undertake a review of its elections to identify potential material tax liability exposure relating to such elections.

Net operating losses

Certain provisions of the Internal Revenue Code limit the ability of the company to carry forward net operating losses upon the occurrence of a substantial change in the ownership of the company. An IPO can often cause or contribute to such a change. Tax lawyers can assist a company in considering the effects of these rules and possible structuring alternatives.

Tax implications for existing shareholders

The IPO may create tax issues for the shareholders and option holders of the company and its subsidiaries. Careful tax planning and communication with the company's share and option holders can often ensure tax-efficient results in the IPO.

Employee matters

Equity compensation plans

The company should review its existing compensation and benefit plans to ensure that plan terms are appropriate for a public company and that a sufficient number of shares have been authorized for issuance under the plans.

Since NASDAQ rules require public company plans to be approved by shareholders, a new plan or amendments to an existing plan should be approved by shareholders before completion of the IPO. In addition, establishing the plan before the IPO and describing the plan in the registration statement will make the plan eligible for a grandfather exemption under

Section 162(m) of the Internal Revenue Code for at least three years.

Employment agreements and related-person transactions

The company should review employment, severance or change of control agreements and related-person transaction arrangements that it has with its executive officers and directors. Public companies must disclose detailed information regarding compensation and related-person transactions with their executive officers and directors. In both the IPO registration statement and subsequent annual disclosures, compensation information for the five most highly compensated executive officers must be disclosed in a series of specified tables and charts. There is also a requirement to provide narrative disclosure regarding the determination of executive compensation awards, including any performance targets that are material to an understanding of the issuer's compensatory plans. The SEC has made it clear that all forms of executive compensation must be disclosed unless the rules specifically exclude an item. The company should anticipate any issues that might arise in connection with such disclosures and any unconventional transactions should be modified.

In addition, consideration should be given to whether non-compete and other restrictive covenants are required. In order to be enforceable, such agreements must be reasonable in scope and duration. In some states, including California, non-compete

agreements are generally void as against public policy.

Tax deduction issues

The company should also consider the federal tax implications of its compensation and benefit plans. For example, Section 162(m) of the Internal Revenue Code denies public companies a deduction for compensation paid to the chief executive officer and certain other highly compensated executive officers to the extent that the compensation for the taxable year exceeds \$1 million, unless such compensation qualifies as “performance-based compensation” under Section 162(m). In general, compensation arising on exercise of a stock option will not qualify as performance based unless:

- the exercise price is at least equal to fair market value on the date of grant;
- the option was granted by a compensation committee comprised solely of two or more independent directors; and
- the plan approved by the public company's shareholders states the maximum number of shares with respect to which options may be granted during a specified period to any employee.

For stock options granted under a plan approved before the IPO and described in the registration statement, Section 162(m) generally provides a ‘grandfather’ period until the first shareholder meeting after the third calendar year following the IPO.

Certain golden-parachute payments to officers are also non-deductible to the corporation and subject to an excise tax imposed on the individual. In general, if a change of control benefit exceeds three times the average annual compensation of the executive in the five most recent taxable years (the base amount), the amount by which the benefit exceeds the base amount will be subject to a 20% excise tax and the corporation loses any tax deduction that may be available for that excess amount. Public companies have less flexibility to avoid this parachute tax than private companies, and although the company may not anticipate a change of control in the near future, any review of employment, severance and change of control arrangements should include consideration of potential parachute tax issues.

In addition, Section 409A of the Internal Revenue Code governs the taxation of non-qualified deferred compensation by subjecting non-compliant non-qualified deferred compensation to an additional 20% tax, plus interest. To avoid the imposition of additional tax and interest, public companies are required to delay certain separation-related payments to specified employees by six months. The applicable regulations provide public companies with flexibility in how they determine the identity of their ‘specified employees.’

ERISA plans

Generally, the rules of the Employee Retirement Income Security Act of 1974 (ERISA) apply equally to plans of public and

private companies and their affiliates. However, further examination of these issues may be advisable prior to the IPO.

Obligations after the IPO

Following its IPO a company will become subject to the reporting and governance requirements of the federal securities laws and NASDAQ. The following is a broad overview of a company's responsibilities as a public company. As the matters summarized below are complex, the following should only be used as a guide for determining when it may be necessary to discuss the best course of action with counsel.

Communications with investors and analysts

Public company communications with investors and analysts are highly regulated and can give rise to significant liability for the company and its officers and directors. Officers and directors who are authorized to speak on behalf of a company need to become thoroughly familiar with the relevant rules, including Regulation FD (regulating the disclosure of material non-public information) and Regulation G (regulating the disclosure of non-GAAP financial information).

Regulation FD

Under Regulation FD material information may not be disclosed selectively to securities analysts or investors, or others who may trade or recommend trading in a company's securities. Exceptions permit disclosure to

persons bound by confidentiality agreements that prohibit trading based on the information and to persons who are not acting as investors (e.g., credit rating agencies, customers and suppliers). However, extreme caution should be used in relying on any Regulation FD exception. Regulation FD violations often receive wide publicity and the SEC investigates promptly and thoroughly. In some circumstances the SEC considers the mere reaffirmation of previously announced guidance to be material information within the meaning of Regulation FD. If material information is inadvertently disclosed, the company must disclose it to the market promptly and in any event within 24 hours. Procedures should be put into place at the time of the IPO to limit the number of persons authorized to speak to the press and analysts.

Regulation G

Regulation G applies to filings, press releases and public statements that contain non-GAAP financial measures, such as EBITDA (earnings before interest, taxes, depreciation and amortization) or core earnings. When a company releases a non-GAAP financial measure, it must simultaneously release a reconciliation to the most comparable GAAP measure.

Regulatory reporting requirements

Once public, a US company will become subject to the reporting requirements of the federal securities laws, including the

obligations to report specified events on Form 8-K within four business days of occurrence and to file quarterly reports on Form 10-Q, annual reports on Form 10-K and proxy statements on Schedule 14A.

Current reporting requirement – Form 8-K

The following events, among others, must be reported on Form 8-K within four business days:

- earnings releases;
- direct financial obligations and off-balance-sheet arrangements, and acceleration events under such arrangements;
- material impairment charges;
- errors in financial statements;
- resignation or replacement of accountants and changes in fiscal year;
- entry into, amendment or termination of material agreements;
- acquisition or disposition of significant assets;
- unregistered sales of equity securities;
- modification of rights of security holders;
- failure to satisfy continuing listing requirements;
- director or principal officer departures and appointments;
- change of control;
- charter or bylaw amendments; and
- code of conduct amendments or waivers.

Quarterly reporting requirement – Form 10-Q

A quarterly report on Form 10-Q must be filed with the SEC within 45 days of the end of the

first three fiscal quarters. After a company has been a reporting company for 12 months, this deadline is shortened to 40 days.

Annual reporting requirement – Form 10-K

An annual report on Form 10-K must be filed with the SEC within 90 days of the end of the fiscal year. After a company has been a reporting company for 12 months, this deadline is shortened to 75 days and is further shortened to 60 days if the company becomes a ‘large accelerated filer’ (a company with an equity float of \$700 million held by non-affiliates).

Annual report and proxy statement

If a company uses the annual proxy statement to provide to shareholders the management compensation information required by Form 10-K (in lieu of providing it in Form 10-K), the annual report and proxy must be filed with the SEC within 120 days of the end of the fiscal year. In any event, it must be filed with the SEC concurrently with mailing to shareholders. In addition, NASDAQ-listed companies are required to distribute annual reports containing audited financial statements to their shareholders. The distribution must occur within a reasonable period of time prior to the company’s annual meeting and the report must be filed with NASDAQ at the time it is distributed to shareholders.

NASDAQ reporting requirements

NASDAQ requires advance notice of certain types of press releases, Form 8-K filings and other material events.

Foreign private issuers

Foreign private issuers must currently file an annual report on Form 20-F rather than Form 10-K within six months of year-end. However, the SEC has recently proposed to shorten this deadline. Canadian foreign private issuers that have been subject to the continuous disclosure requirements of any Canadian securities regulatory authority for at least 12 months and have a public equity float of at least \$75 million may satisfy their Exchange Act reporting obligations by filing annual information required by applicable law in Canada in an annual report on Form 40-F. In addition, foreign private issuers are not required to file quarterly reports on Form 10-Q or current reports on Form 8-K; rather, they must file reports on Form 6-K containing information that the issuer:

- makes or is required to make public under the laws of its jurisdiction of incorporation;
- files or is required to file under the rules of any stock exchange on which its securities are traded and made public by that stock exchange; and
- otherwise distributes or is required to distribute to its shareholders.

Finally, foreign private issuers are not subject to the proxy solicitation requirements under the Exchange Act.

Sarbanes-Oxley 404

The company must ensure that its accounting and financial reporting controls and

procedures are adequate to address the needs of a public reporting company in light of the requirements of Sarbanes-Oxley. Rules adopted by the SEC pursuant to Sarbanes-Oxley impose requirements on public companies with respect to maintaining and publicly reporting on their disclosure controls and internal control over financial reporting, including providing an annual management report attested to by the company's independent accountants (or Sarbanes-Oxley 404 report) on the effectiveness of internal control over financial reporting. In addition, the chief executive and chief financial officers must personally certify the effectiveness of disclosure and internal controls. The company will be required to include a Sarbanes-Oxley 404 report beginning with its second annual report on Form 10-K.

Certification requirements

The chief executive officer and chief financial officer must attach certifications to the company's Forms 10-K and 10-Q as to the completeness and accuracy of the filings, including those required by Section 906 of Sarbanes-Oxley. The Section 906 certification, which carries criminal liability, requires the chief executive officer and chief financial officer to certify that each periodic report filed with the SEC containing financial statements "fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act and that information contained in the periodic report fairly presents, in all

material respects, the financial condition and results of operations of the issuer."

Trading by officers, directors and large shareholders

The federal securities laws restrict trading in a company's securities by officers, directors and other affiliates of the company and impose reporting obligations on holders of more than 5% of the company's common stock.

Insider trading

Buying or selling stock on the basis of material non-public information, or tipping others who buy or sell on the basis of such information, is illegal. Officers and directors (and their immediate family members) may consider establishing Rule 10b5-1 plans for buying and selling the company's stock. Purchases and sales outside Rule 10b5-1 plans should take place only in open window periods, and then only when the director or officer is not in possession of material information that has not been disclosed to the market. Rule 10b5-1 plans have come under increasing scrutiny from the SEC and as a result officers and directors should consult with counsel prior to entering into a 10b5-1 plan. In addition, both the SEC and FINRA regularly conduct insider trading surveillance, focusing in particular on unusual market activity before the announcement of material information.

Section 16

Directors, executive officers and 10% shareholders are subject to the short-swing

profit prohibitions of Section 16 of the Exchange Act. Section 16 applies whenever there is a sale and purchase, or purchase and sale, of stock within a six-month period. Even transactions in the six months before the IPO by officers and directors may need to be reviewed to prevent inadvertent Section 16 problems. Directors, executive officers and 10% shareholders must report their initial holdings on Form 3 on the same day that the company is considered a public company (which may precede the closing of the IPO). In addition, they must report their purchases and sales (including equity compensation grants and sales to cover exercise price and tax withholding) on Form 4 within two business

days of the event. Gifts can be reported on Form 5 within 45 days of the end of the fiscal year. Foreign private issuers are not subject to Section 16.

The Section 16 reporting and short-swing profit rules should be reviewed with all of the company's executive officers and directors before the IPO.

Section 13

Once a company's common stock is listed on NASDAQ, any person that beneficially owns more than 5% of the company's outstanding voting shares is required to send to the company and file with the SEC a Schedule 13D or Schedule 13G disclosing its holdings.

Conclusion

The process of going public in the United States requires significant planning and a thorough understanding of the regulatory framework. An effectively managed IPO is a rewarding experience for all those involved and marks an exciting milestone in the life of a company. Close coordination during the offering process among members of the working group is essential to facilitate smooth execution and ensure a successful IPO. The role of legal counsel is an integral and important part of this process.

DAVIS POLK & WARDWELL

For nearly 160 years, Davis Polk & Wardwell has advised clients ranging from start-up and emerging companies to industry-leading corporations and global financial institutions on their most challenging legal and business matters.

We rank among the world's preeminent law firms across the entire range of our practice, which spans such areas as:

- » Antitrust
- » Capital Markets
- » Credit
- » Commercial Litigation
- » Corporate Governance
- » Executive Compensation and Employee Benefits
- » Intellectual Property
- » Investigations and Enforcement Actions
- » Investment Management
- » Insolvency and Restructuring
- » Mergers and Acquisitions
- » Private Equity
- » Securities Litigation
- » Tax

New York | Menlo Park | Washington DC

London | Paris | Frankfurt | Madrid | Tokyo | Beijing | Hong Kong

www.dpw.com