

IPO Boot Camp

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**IPO READINESS: CORPORATE GOVERNANCE,
DOCUMENTATION AND EXECUTION**

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Corporate Governance - Board Composition

Basic Rule

- Majority of Board must be “independent”
 - One year transition period until full compliance is required

Exceptions

- Controlled Company
 - Defined as ‘person’ or ‘group’ has more than 50% of vote
 - Special situations
 - High vote stock
 - “Group” definition and implications
 - The average level of director independence at controlled companies was 41% versus 72% at non-controlled companies
- Foreign Private Issuers
 - Must disclose non-compliance in annual reports

Corporate Governance - Board Composition (cont'd)

Definition of Independence – Two Tests

- “Subjective test”
 - NYSE: No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company
 - NASDAQ: An independent director is a person other than an executive officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director

Corporate Governance - Board Composition (cont'd)

Definition of Independence – Two Tests (cont'd)

■ “Categorical test” of specific fact patterns

- Director or immediate family member is, or has been within the last three years, an executive officer, of the listed company. (Interim CEO is not disqualifying)
- Director or immediate family member (except non-EO family member) received more than \$120,000 in compensation from company in any twelve month period in last 3 years, other than director fees and pensions.
- Director is affiliated with internal or external auditor, or immediate family member is partner of firm or employee working on audit company's audit or did so in last 3 years.
- The director or an immediate family member is an executive officer of another company where any of the listed company's present executive officers was on compensation committee (3 year lockback).
- The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million (\$500K for NASDAQ), or 2% of such other company's consolidated gross revenues. Charitable contributions exempt under NYSE Rules, but disclosure is required.

NOTE: references to the "listed company" or "company" include any parent or subsidiary in a consolidated group with the listed company.

Corporate Governance - Board Composition (cont'd)

Special situations

- PE or VC sponsor
 - Management/termination fee
 - Share ownership

Corporate Governance – Audit Committee

Audit Committee

- Rule 10A3: must have 3 independent directors
 - Exchange independence AND
 - Additional independence
 - No affiliation with company: large shareholdings
 - Any payments from company other than director fees
- All must be financially literate
- Must disclose if none are financial experts [so effectively must have one]
- One at listing, one within 90 days and fully within one year
- 30% of controlled companies had fully independent audit committees at the IPO versus 83% of non-controlled companies

Exceptions

- FPI can have fewer than 3
- FPI only needs to satisfy additional independence rules

Corporate Governance – Compensation Committee

Compensation Committee

- Must have fully independent comp committee
 - One at listing, majority within 90 days and fully independent within one year
- Special independence rules
 - Exchange independence
 - Additional independence rules: the board must consider all factors material to that director's ability to be independent from management, including:
 - (A) the source of compensation of such director; and
 - (B) whether such director is affiliated with the listed company

Exceptions

- Controlled company
- FPI
- However, Section 16 and IRS rules both encourage an independent committee

NOTE: Ownership of even a significant amount of stock, by itself, as a bar to an independence finding unlike with audit committee independence.

Corporate Governance – Nominating Committee

Nominating Committee

- Independent directors
 - NYSE requires committee
 - NASDAQ permits informal actions
- One year transition period

Exceptions

- Controlled company
- FPIs

Corporate Governance – Loans to Directors and Executive Officers and Audit Pre-Approval Rules

Loans to Directors and Executive Officers

- Prohibited to provide or arrange for loans
- Grandfathering is for loans outstanding in 2002 – not ones made before IPO
- Can solve through forgiveness or refinancing
- Lots of unintended consequences

Audit Pre-Approval Rules

- Any engagement of auditor for audit or non-audit services must be pre-approved by audit committee
- Can approve specified services in advance

Corporate Governance – Whistleblower Hotline

Whistleblower Hotline

- Must set up ability for people to anonymously report accounting issues to audit committee
 - Can go through GC
 - Experience is that most complaints are HR-related

Corporate Governance – Internal Audit Function

Internal Audit Function

- Required by NYSE, with one year transition period
- NASDAQ proposed a similar rule but withdrew its proposal
- FPIs exempt

Corporate Governance – Code of Conduct

Code of Conduct

- SEC requires disclosure of whether issuer has one applicable to senior management governing specified issues [effectively required]
- Exchanges require more fulsome one applicable to all
 - FPIs exempt but routinely comply

Corporate Governance – Disclosure Controls and SOX 404

Disclosure Controls

- Must be in place at listing

Internal Controls/SOX 404

- Must have internal controls over financial reporting at listing; SOX 404 in effect year following listing
- Exception: EGC for up to 5 years

Executive Compensation

Must Disclose Compensation of NEO's in the Prospectus for Domestic Issuers Named Executive Officers (NEOs)

- STEP 1: Identify executive officers – Rule 405
 - Executive officer = Issuer's president, any VP in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions
 - Executive officers of subsidiaries may be deemed executive officers of the IPOing company
- STEP 2: Identify named executive officers (NEOs)
 - NEOs - Item 402(a)(3)
 - All individuals serving as the issuer's CEO, regardless of compensation level;
 - All individuals serving as the issuer's CFO, regardless of compensation level;
 - Issuer's three most highly compensated executive officers other than the CEO and CFO who were serving as executive officers at the end of the last completed fiscal year; and
 - Up to two additional individuals for whom disclosure would have been provided pursuant to the above but for the fact that the individual was not serving as an executive officer of the issuer at the end of the last completed fiscal year
 - Any CEO or CFO serving during the last completed fiscal year is a NEO
 - Highly compensated NEOs are determined on the basis of compensation paid or accrued during the last completed fiscal year
 - EXAMPLE: Any Form S-1 filed in 2016 will include highly compensated executive officers based on their 2015 compensation

Executive Compensation – CD&A and Other Disclosures

CD&A and Other Disclosures

- Compensation discussion & analysis (CD&A)
- Summary compensation table
- Related tables and narrative
 - Grants of plan-based awards
 - Outstanding equity awards at fiscal year-end
 - Option exercises and stock vested
 - Pension benefits
 - Non-qualified deferred compensation
 - Potential payments upon a termination of employment or a change in control
 - Director compensation

Executive Compensation – Emerging Growth Companies

Reduced Disclosure for Emerging Growth Companies (EGCs)

- No need for a CD&A
- Only requires
 - Compensation of three (rather than five) executive officers, consisting of the CEO and two other most highly compensated executive officers (*i.e.*, not automatically the CFO)
 - Summary Compensation Table and related narrative disclosure
 - Outstanding Equity Awards at Fiscal Year-End table
 - Director Compensation table
 - Additional narrative disclosure (*e.g.*, material terms of retirement plans, termination payments and change in control arrangements)

Executive Compensation – Employment Agreements

Employment Agreements

- Should executive officers enter into new, or amend existing, employment agreements, offer letters or “change in control” agreements?
 - Private company executives often do not have employment agreements, and existing agreements may not be appropriate
 - Executive concern re: a termination of employment or a possible “change in control” transaction
 - Opportunity to provide for covenants
 - Underwriters’ / company’s concern of flight risk
- Counsel should review existing arrangements to ensure that they are consistent with the company’s goals as a public company

Executive Compensation - Historical Compensation Plans

Historical Equity and Performance-Based Compensation Plans

- Review plans to determine impact of IPO and potential employee terminations / change in control
- Treatment of historical outstanding equity awards
 - Will vesting be accelerated?
 - Will awards be rolled over into awards under new equity plan?
- Treatment of historical performance-based awards
 - Will bonus plans continue with the same metrics or will new plans be developed?

Executive Compensation – Post-IPO Compensation Plans

Post-IPO Equity and Performance-Based Compensation Plans (Prospective)

- Considerations
 - How many shares should we reserve?
 - Can awards be granted in connection with the IPO?
 - Should directors receive equity awards?

Executive Compensation – Section 162(m)

Section 162(m) – Applies to Both Equity and Cash

- General rule: Under Section 162(m) of the Internal Revenue Code, compensation paid to NEOs (other than the CFO) in excess of \$1 million is not deductible by the issuer
- Exception: Qualifying performance-based compensation granted by an independent committee
- Transition for IPOing issuers: Recognizing that the shareholders of an IPOing issuer are aware of the issuer's compensation arrangements when they decide to invest, Congress has permitted a transition period before full compliance with Section 162(m)
 - *Condition*: Equity compensation and other performance-based compensation plans must be disclosed in the Form S-1
 - *Duration*: Section 162(m) generally does not apply until 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 IPO occurs
 - EXAMPLE: IPO in 2016 → generally, transition relief until shareholder meeting in 2020

Executive Compensation - Pre-IPO Equity Awards

Pre-IPO Equity Awards - Compliance Check

- Federal securities laws
 - Exemptions available to private companies under '33 Act
 - *Rule 701*
 - Sales must be pursuant to a written “compensatory benefit plan” (or a written contract that relates to compensation)
 - Applies to employees, directors and consultants who provide *bona fide* services to the issuer
 - *Regulation D*
 - Rule 506: Offering to accredited investors (*i.e.*, directors and executive officers and certain sophisticated investors) and up to 35 non-accredited investors (disclosure required for non-accredited investors)
 - *Regulation S* (available for certain offshore offerings)
 - Because of the JOBS Act, '34 Act registration is not likely to be required
- State securities laws (aka “Blue Sky” laws)
- “Cheap stock”

Documentation – Key Documents

Key Documents are:

- S-1 or F-1 registration statement, which is the prospectus
- Analyst presentation
- Testing-the-waters deck
- Roadshow deck
- Various legal documents, including Underwriting Agreement, Comfort Letter and Legal opinions

Documentation is basis for legal liability and marketing – they must be accurate, and require lots of company attention

- Important to pick an IPO czar to coordinate company preparation and review, who has knowledge of company and ability to get others to cooperate
- Management should review document and be comfortable with it

Documentation – Registration Statement

S-1 or F-1 Registration Statement

- Key sections will include:
 - Prospectus Summary (or the “box”) – an overview of the company and its strengths and strategies – underwriter should be asked to draft this –
 - Risk Factors
 - Management’s discussion and analysis of financial condition and results of operations
 - Business
 - Description of capital stock
 - Executive compensation disclosure
 - Related party transactions
 - Description of board, structure and governance
 - Financial statements
 - Exhibits, including material contracts – note confidentiality issues
 - Most material contracts have provisions requiring consent to describe in F-1 and file with SEC
 - It is possible to request confidential treatment of certain terms

Documentation - Analyst Presentation

Analyst Presentation

- Overview of company
- Includes model/financial projections

Becomes basis for roadshow (minus projections)

Documentation - Testing the Waters/Roadshow

Testing the Waters/Roadshow Documentation

- Subject to liability like a prospectus
 - Should conform to prospectus
 - Reviewed by lawyers

TTW materials must be provided to the SEC

Documentation - Other Documents

Underwriting Agreement

- Agreed before launch, but executed at pricing, when underwriter commits to buy stock
- Include indemnity of the underwriters by the company

Comfort Letter

- Agreed before launch, but executed at pricing
- Auditors confirm the numbers are audited or reviewed, and that all numbers in the F-1 are derived from financial records – the so-called ‘circle-up’ or ‘tick and tie’

Opinions

- Agreed before launch, but executed at closing
- Both counsel opine on validity of offering, and deliver a “10b-5” statement that document is materially accurate
- Because of this letter, counsel is actively involved in due diligence, not just legal but also business and accounting

Execution Timetable

IPO Offering Timeline 4-5 Months

Phase 1 Preparation and Analysis

5-7 Weeks

Determine structure and size of IPO

Organizational meeting/management due diligence presentations to bookrunners

Other due diligence

- Financial
- Customer/Partner
- Accounting
- Legal

Draft registration statement

Prepare audited financials

Bookrunner research diligence

Valuation

- Prepare financial model
- Preliminary valuation advice

Board meeting to approve filing S-1/F-1

File S-1/F-1 and issue press release

Phase 2 Submit or File/SEC Review

10-11 weeks

- Prepare and rehearse testing-the-waters and roadshow presentation

- Conduct testing-the-waters meetings

- Underwriters prepare internal Selling Memoranda

- Target key investors

- Receive and respond to various rounds of SEC comments

- For EGCs that have submitted confidentially, public filing must be made at least 21 days before roadshow
- Decision to launch
- Print red herrings

Phase 3 Marketing

2-3 Weeks
(After Decision to Launch)

- Research teach-ins to salesforce

- Management salesforce presentations

- Roadshow

Phase 4 Pricing and Aftermarket Management

1 week

Pricing day

- S-1/F-1 declared effective
- Pricing and allocation
- Deliver comfort letter
- Sign underwriting agreement
- Press release

Four business days post pricing

- Print final prospectus
- Closing

Ongoing Post-Offering

Aftermarket activities

- Stabilization
- Initiation of research coverage
- Investor relations activities