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Preparing a Venture-Backed Company for an IPO

While the IPO market for venture-backed companies has been somewhat limited in the last several years, an increase in venture-backed IPOs in 2004 and recent positive trends in both the U.S. economy in general and corporate technology spending in particular have fueled optimism about a resurgence of the IPO market. Companies contemplating an IPO should be aware that the sweeping changes in the regulatory landscape resulting from the Sarbanes-Oxley Act and related SEC, NASDAQ and NYSE rule changes have increased the importance of careful advance preparation. Key matters to be addressed by IPO candidates in the six to 12 months before an IPO include:

Building Relationships with Investment Bankers and Analysts. The much-publicized "global research analysts settlement" has significantly changed the interactions between companies and underwriting firms. Among the changes most relevant to pre-IPO companies are:

- research analysts may not participate in marketing pitches by investment bankers;
- investment bankers may not promise research coverage by their bank's analysts; and
- a company's interactions during the IPO process with the investment banking and the research divisions of the underwriters must be largely separate.

It is therefore critical for a company to cultivate relationships with both the investment bankers and the research analysts at potential underwriting firms.

Auditor Independence. The Sarbanes-Oxley Act and new SEC rules have significantly tightened the requirements for auditor independence. While the SEC auditor independence rules generally do not apply to private companies, a pre-IPO company's auditor must be independent with respect to each fiscal period (generally three full fiscal years) covered by the financial statements in the IPO registration statement. Accordingly, a company contemplating an IPO in the future should ensure that its auditor satisfies the SEC auditor independence rules even prior to the IPO. Among the items that would generally prevent an auditor from being considered independent is the provision by the auditor of specified types of non-audit services to the company, including bookkeeping services, financial information systems design and implementation services, appraisal services, management functions, and human resources services. Auditor independence would also be tainted if the company hires, in a senior financial role, any person who worked on the company's audit as an employee of the auditor during the prior year.

Controls and Procedures. The SEC has recently adopted a variety of rules relating to both "disclosure controls and procedures" and "internal control over financial reporting." These rules require public companies to establish and maintain such controls, to evaluate them on a periodic basis and to report on such evaluations in their periodic SEC filings. In addition, a public company's annual report must include a management report on the company's internal control over financial reporting, as well as an attestation report from the company's independent auditors.

These requirements make it critical for a company to establish and document robust controls and procedures prior to its IPO. Those controls and procedures are a necessary underpinning of the disclosures the company must make in its IPO registration statement and its periodic post-IPO filings, including the personal certifications of the CEO and the CFO that must be contained in post-IPO SEC filings. In addition, a company's controls and procedures will undoubtedly be the focus of due diligence by the IPO underwriters.

Executive Loans. One of the more publicized aspects of the Sarbanes-Oxley Act is its prohibition of personal loans to directors and executive officers of a public company. This prohibition becomes applicable to a private company upon the initial filing of its IPO registration statement. A company contemplating an IPO should generally refrain from making loans to its executive officers and directors. While some companies have chosen to make such loans, >>

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>> subject to a requirement to repay the loan prior to the filing of an IPO registration statement, this situation can create difficulties for a director or officer who lacks sufficient liquidity to repay the loan at that time. Moreover, forgiveness of the loan, while not illegal, can create tax, accounting and fiduciary duty issues.

Corporate Governance Issues. In the wake of the highly publicized corporate scandals of the past several years, the corporate governance standards applicable to public companies have been largely rewritten by the Sarbanes-Oxley Act, the SEC, NASDAQ and the NYSE. The most significant changes affecting pre-IPO companies are:

Each public company must have a board of directors comprised of a majority of "independent" directors, as defined by NASDAQ or NYSE rules. Although an IPO company has a grace period of one year from its initial listing to fully comply with this rule (as well as the audit committee rule described below), underwriters and investors often insist on compliance with those requirements at the time of the IPO. As a result of the increased liability and scrutiny to which directors of public companies are subject, it is often difficult to find well-qualified directors. In addition, because all directors of an IPO company have personal liability for material misstatements and omissions in the company's IPO registration statement, some individuals are reluctant to join the board of a company shortly prior to its IPO (and thus face liability for a registration statement describing a company with which they are relatively unfamiliar). Accordingly, it is never too early for a company contemplating an IPO at some point in the future to recruit independent directors.

Each public company must have an audit committee comprised of at least three persons, each of whom (1) is independent within the definition of NASDAQ or the NYSE, (2) satisfies the "super-independence" requirements of the SEC, and (3) is financially literate. In addition, at least one member of the audit committee must have accounting or financial management experience, and the company must disclose in its SEC filings whether the committee has at least one "audit committee financial expert," as defined by SEC rules. Again, it is advisable for a pre-IPO company to assess whether it needs additional directors for the audit committee, and to begin to recruit them, well in advance of the IPO.

Each public company must have, and make publicly available, a code of conduct for its directors, officers and employees, addressing matters such as conflicts of interest, accurate and timely public disclosure, compliance with laws and enforcement of the code's provisions. In addition, any waiver of the code for an executive officer or director must be approved by the board of directors and then publicly disclosed. Because of the public disclosure requirements, a pre-IPO company must carefully develop a code of conduct that, in addition to complying with the applicable legal requirements, takes appropriate account of the company's business and culture.

Recent changes to NASDAQ and NYSE rules have tightened the stockholder approval requirements such that virtually all new stock plans, as well as material amendments to existing stock plans, must be approved by stockholders of the company. In addition, the elimination of discretionary voting by brokers on stock plan proposals has made it harder for public companies to obtain stockholder approval for stock plan proposals. Accordingly, if a pre-IPO company foresees, within the next year or two, the adoption of a new stock plan (such as an employee stock purchase plan or a director stock option plan) or an amendment of its employee option plan to increase the number of shares covered by the plan, it should generally obtain stockholder approval of the new plan or plan amendment while it is still a private company and that vote is presumably easier to obtain. ■

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2005 Venture Guide,
published by Media Two, Inc.