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Strategic Business Planning Analysis and Marketing the High Technology Initial Public Offering Candidate

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STRATEGIC BUSINESS PLANNING ANALYSIS
AND MARKETING THE HIGH TECHNOLOGY INITIAL PUBLIC OFFERING CANDIDATE

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I. INTRODUCTION

One of the most significant events for any business enterprise occurs when it undertakes the initial offering and sale of its securities to the public investment community. A financing effort of this type, commonly referred to as an "initial public offering" or "IPO," has been the subject of any number of books and articles which focus upon one or more of the major aspects of the regulatory framework that underlies and, in large part, defines the "marketing" process involved in this type of transaction. This article recognizes the existence of this regulatory environment and posits a few suggestions as to how the day-to-day practice of strategic business planning can be used by an issuer involved in the "high technology" area and its professional advisors, legal and otherwise, in satisfying the legal disclosure obligations that arise in the course of an IPO while effectively marketing the issuer to the investment community.

The framework of strategic business planning is an unfamiliar, yet appropriate, part of the disclosure and marketing process for an IPO. In order to understand its application, it is necessary to place it within some of the broader regulatory considerations that exist with respect to any public offering of securities. Accordingly, this article is organized as follows:

1. The next section is devoted to a discussion of the regulatory environment for an IPO, particularly the registration framework of Section 5 of the Federal Securities Act of

1. "Marketing" is to be distinguished from "selling" in the context of this article. As noted below, the federal securities laws impose a number of strict restrictions upon the manner in which the selling effort is to be conducted in an IPO. In this article, marketing takes on a more strategic role and focuses upon the issuer's intentions in the market (i.e., the investment community to which it is offering its securities) and the marketing strategy which it will use in drafting the required disclosure documents (i.e., the statutory prospectus, as referred to below) to differentiate its own unique strategic advantages in order to achieve success for the offering.

2. While an effort will be made to present illustrations that reflect the author's experience with companies involved in industries which are typically associated with "high technology" (e.g., computers, software, biotechnology and telecommunications), the lessons in the article are intended to be useful to any issuer which has experienced growth through the use of venture capital and other private placement equity and debt capital.
1933, as amended (the "Securities Act"). Section 5 covers two important parts of the IPO process: the manner in which the offering can be conducted and the content of the information to be supplied to the investment community.

2. Satisfying the disclosure requirements of Section 5 does not necessarily mean that the information is conveyed to the investment community in a manner that assures the success of the offering. Accordingly, the third section describes the IPO marketplace: the characteristics of issuers who have successfully completed the IPO process. Knowledge of these various "success factors" will allow the issuer to focus the tone of its regulatory disclosures in a manner which meets the "needs" of the IPO customer base: the investment community.

3. Disclosure of any kind requires information regarding the issuer, its managers, its customers, its competitors and the broader environment in which each of those groups must operate. Accordingly, the fourth section briefly covers the process of "understanding" the issuer and the due diligence investigation which is such an important part of an IPO.

4. The fifth section describes how the information regarding the issuer can be analyzed, using a strategic business planning framework similar to that used by the issuer in its day-to-day business operations, in order to identify the issuer's strategic advantages in a manner that facilitates their use in the IPO disclosure documents.

5. The sixth section illustrates three important areas where disclosure and marketing can co-exist: the discussion in the prospectus of the issuer's business, customers and competitors; the discussion in the prospectus of the risk factors associated with the issuer and the offering; and the Management's Discussion and Analysis of Financial Condition and Results of Operations, or "MD&A", which is that portion of the discussion in the prospectus of the issuer's financial condition and prospects which provides the greatest opportunity for highlighting its strengths and aspirations.

6. The final section posits a few closing thoughts upon the role of marketing and strategic planning in the IPO process and sets forth some basic suggestions to issuers who
ultimately aspire to use an IPO as a future financing vehicle.

II. THE REGULATORY ENVIRONMENT

A. The Registration Framework of Section 5 of the Securities Act of 1933

There is no question that an IPO, as a financing transaction, presents a great deal of regulatory complexity. Although each of the states, as well as the regulatory and certification body of the securities and investment banking industry in the United States, have taken an interest in various aspects of the offer and sale of securities, it is the registration process of the Securities Act that is most evident to persons seeking to raise capital for a business enterprise through a securities offering. Fundamentally, unless an exemption is available, Section 5 of the Securities Act prohibits "offers" and "sales" of securities unless the registration process is utilized. If the registration process is required, a registration statement relating to the offering must be filed with the federal Securities and Exchange Commission ("SEC") before any offer can legally be made, and the registration statement must become "effective" before any sale can legally be consummated.

The registration requirements of Section 5 govern the manner in which the offer and sale of securities in an IPO is to be conducted. Section 5(c) regulates activities of a prospective "issuer," defined in Section 2(4) of the Securities Act as any person who issues or proposes to issue a security, prior to the filing of a registration statement with respect to the offered securities and relevant transaction. While an issuer is permitted to engage in preliminary negotiations with a prospective managing underwriter regarding the

3. Obviously, not every securities offering requires the filing of a registration statement. The exemptions from Section 5 are set forth in Sections 3 and 4 of the Securities Act and should be quite familiar to the high technology IPO candidate which has received venture capital funding prior to the time of the IPO. Section 3 exempts transactions in certain securities from registration, and also contains exemptions for securities offered and sold in a specified type of transaction (i.e., the intrastate offering) which, in effect, supplement the transactional exemptions of Section 4. Section 4(1) exempts transactions by any person other than an "issuer," an "underwriter" or a "dealer" (i.e., any person who acts as an agent, broker or principal in the business of dealing or trading in securities). However, with respect to dealer transactions, Section 4(3) and related Rule 174 provides an exemption from the registration requirements, other than transactions which occur during a specified period of time (i.e., 25 or 90 days, depending on the circumstances) following an IPO. Finally, Sections 4(2), 4(6) and Regulation D, as well as other rules promulgated pursuant to Section 3 of the Securities Act, contain a number of exemptions for issuer transactions which do not involve any public offering (i.e., a so-called "private placement").
 offerings⁴, it is generally the case that no activities can occur during this “prefiling” period which might constitute an “offer to sell.”⁵ Accordingly, no prospective purchasers can be contacted, lest an offer be made, no written materials that might be deemed to be an illegal prospectus⁶ can be circulated to the investment community, and things such as press releases, press conferences and publicity campaigns should be avoided if they would have the effect of stimulating or conditioning the market for the offering.⁷

Offering activities may begin in earnest once the registration statement has been filed with the SEC. As the issuer and its professional advisors await comments from the SEC and the other regulatory agencies on the registration statement during this “waiting period,” Section 5(b)(1) will permit oral offers and offers made through a prospectus which meets the requirements of Section 10 of the Securities Act, the form of which is included as an integral part of the registration statement. However, no additional written sales materials,⁸ so-called “free-writing,” may be used until after the

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⁴ Section 2(3) of the Securities Act specifically excludes from the definition of the term “offer,” as used in Section 5(c) of the Securities Act, “preliminary negotiations” between an issuer (or any controlling person of the issuer) proposing to offer securities and any underwriter or among underwriters “who are or are to be in privity of contract with the issuer [or controlling person].”

⁵ Section 2(3) of the Securities Act defines “offer to sell” to “include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.” See generally the following SEC Releases concerning communications by a registrant: Nos. 33-3844 (October 8, 1957), 33-5180 (August 16, 1971), 33-5929 (May 5, 1978), and the following SEC Releases regarding communications by a broker-dealer: Nos. 33-5697 (May 28, 1964), 33-6492 (October 5, 1983) and 33-6550 (September 19, 1984).

⁶ Section 2(10) of the Securities Act provides that “the term ‘prospectus’ means any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.” As noted below, Section 2(10) itself contains an exception from the term “prospectus” for certain “free-writing” materials, and various other exceptions have been promulgated under Rules 134 and 135 adopted by the SEC.

⁷ An issuer may continue, in the normal course of its business, to disclose factual information in public reports and announcements without any mention of the proposed offering. However, it is often difficult to distinguish between factual information and selling documentation and it has been noted that the legality of a communication or publication will be analyzed in light of “the nature and content of the publication, the scope of the distribution of the publication, the length of time between the dates of publication and the subsequent filing of the registration statement, and the relationship of the issuer to the person responsible for the publication.” See Orrick, Some Observations on the Administration of the Securities Laws, 42 MiNN. L. Rev. 25, 38 (1957). Another significant factor in close cases is the past practice of the issuer, since the SEC is more inclined to take a “no-action” position regarding a given public relations activity during the prefiling period upon a showing that a specific form of communication had been utilized by the issuer prior to commencement of the IPO.

⁸ As is the case during the prefiling period, each “communication” during the waiting period will be reviewed in order to determine whether or not it constitutes a “prospectus.” If the communication is considered to be a prospectus, and it does not meet the requirements of
registration statement has been declared effective by the SEC, and only then when preceded by or accompanied with a final prospectus meeting the requirements of Section 10(a) of the Securities Act. Accordingly, the prospectus is the primary marketing tool for the IPO until the registration statement has become effective.

B. Regulatory Disclosure Requirements

The specific disclosure requirements of Section 5 are implemented by the provisions of Regulations C, S-K, and S-X, as Section 10 of the Securities Act, then the restrictions of Section 5(b)(1) will have been violated.

9. Section 2(10) of the Securities Act excepts from the definition of "prospectus" any communication sent or given after the effective date of the registration statement if it is proved that prior to or simultaneously with such communication a written final prospectus meeting the requirements of Section 10(a) was sent or given to the recipient. Under this exception, supplemental sales literature, the so-called "free-writing," can be given to a potential investor provided that it is accompanied or preceded by the final prospectus.

10. Obviously, the preliminary prospectus can, and will, be supplemented during the waiting period by oral presentations by broker-dealers to prospective retail and institutional customers. Similarly, members of the issuer's management team will make oral statements in the course of "road show" presentations to various institutional investors. However, the content of these oral presentations should not deviate substantially from information regarding the issuer presented in the prospectus, since all material information must be included therein.

11. Promulgated under the Securities Act, Rules 400 to 494 of Regulation C set forth the various procedural guidelines relating to the preparation of Securities Act registration statements, including requirements relating to the number of copies to file, the size of paper, the size of type, the preparation of requests for confidential treatment, the preparation and filing of amendments and making the registration statement effective.


13. Regulation S-X sets forth the requirements with respect to the form and content of the financial statements to be filed with the SEC in connection with all filings under the Securities Act, proxy and information statements filed under Section 14 of the Exchange Act, registration statements filed under Section 12 of the Exchange Act, reports filed under Section 13 or 15(d) of the Exchange Act, and registration statements and shareholder reports filed under the Investment Company Act of 1940, and the Public Utility Holding Company Act of 1935. The term "financial statements" is defined to encompass the basic financial statements and the related footnotes and schedules thereto. The requirements of Regulation S-X are intended to be in addition to, and not in lieu of, the procedures of "generally accepted accounting principles," and are supplemented by other requirements found in various provisions of Regulation S-K, as well as the SEC's Financial Reporting Releases and Staff Accounting Bulletins ("SABs") which contain opinions regarding major accounting questions, administrative interpretations and policies with respect to financial statements and other matters of importance to registrants and their independent accountants.
promulgated under the Securities Act, and the applicable registration form which, in the case of an IPO by a domestic issuer, is either Form S-1 or Form S-18. Moreover, due consideration must be paid to the broad disclosure requirements set forth in Sections 11, 12 and 17 under the Securities Act, and Rule 10b-5 promulgated under the Exchange Act, which collectively require that all material information be included in the prospectus, whether or not specifically prescribed by any item on the specific registration form. In addition, other information may be required by the National Association of Securities Dealers, Inc. ("NASD") and the various state securities or "Blue Sky" administrators.

On their face, the disclosure requirements of the registration process are relatively uniform; however, depending upon the context, regulators may focus upon different aspects of the disclosure regarding the issuer and the terms of the offering. For example, while the SEC is primarily concerned with the accuracy and breadth of the issuer’s disclosure in the prospectus, the NASD will examine the underwriting arrangements and compensation and other aspects of the proposed distribution.14 Moreover, "full disclosure" alone will not necessarily satisfy the requirements of the administration of the Blue Sky laws in those states which conduct a "merit" review covering a number of items relating to the actual terms of the offering and the historical relationships amongst various company insiders.15

Regulation S-K is the core of the informational requirements of the SEC's integrated disclosure system16 and includes nine parts,

14. See the NASD's Interpretations of Article III, Section 1 of the NASD's Rules of Fair Practice relating to various aspects of the underwriters' compensation and arrangements (i.e., the "Review of Corporate Financing"), which appears in NASD Manual (CCH) ¶ 2151.02, and "Free-Riding and Withholding," which appears at NASD Manual (CCH) ¶ 2151.06.

15. For example, merit review states will scrutinize the percentage of the issuer's capital that has been contributed by members of the founding or promoting group (i.e., the "promoters' equity" issue), the prices at which outstanding securities have previously been issued to insiders and the relationship of those prices to the IPO price (i.e., the "promoters' stock" issue), loans and other relationships between insiders and the issuer, the level of selling expenses in the offering, the amount of the IPO price and the dilution to be sustained by new public shareholders, and a variety of other issues relating to the issuer's charter and bylaw provisions. The investigation required as part of the preparation of the issuer's IPO strategic business plan should also permit the issuer to identify potential Blue Sky problems prior to the filing of the documents with the state securities administrators. A recent survey of merit regulation requirements can be found in Liebolt, "State Securities Registration Requirements: Forms, Procedures, Requirements," in Blue Sky Laws 1989 at 481 (P.L.I. Course Handbook Series No. 654, 1989); see also, Braisted, "Merit Regulation" in the same volume at 61.

16. In 1982, the SEC adopted a program of integrated disclosure that was intended to reduce burdens on registrants while at the same time ensuring that security holders, investors
of which seven are substantive. The first part, designated "General," explains the application of Regulation S-K and sets forth the SEC's policy with respect to the use of projections.

The ninth part includes a listing of industry guides. The remaining portions of Regulation S-K include specific disclosure requirements in principal categories which are set forth below:

1. **Securities Act Standardized Items (Items 501 through 510).**
   These items are common to Securities Act registrations on Forms S-1-2-3 and Form S-18 and, together with the description of securities required by Item 202 of Regulation S-K, generally must appear in each prospectus filed as part of the aforementioned registration statement forms. However, the information pertaining to the expenses of the offering, and certain specified undertakings relating to its ongoing obligations to make future reports and disclosures to its shareholders in accordance with the requirements of the federal securities laws, need only appear in the registration statement and are not included in the prospectus distributed to the investment community. These so-called "Standard Items" relate to the content of the cover page, the inside front cover page, and the outside back cover page of the prospectus. They include appropriate summary and risk factor sections, a use of proceeds section, a dilution section, a description of the securities and how the offering price was determined, ratio of earnings to fixed charges, a description of the plan of distribu-

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and other marketplace participants had access to meaningful and timely information with regard to the issuer upon which they could base their own individual investment decisions. See Release No. 33-6383 (March 3, 1982), [Transfer Binder—Accounting Series Releases] Fed. Sec. L.Rep. (CCH) ¶ 72,328.

18. Regulation S-K, Item 800.
19. Regulation S-K, Item 801(b). The industry guides are those relating to electric or gas utilities, oil and gas programs, real estate limited partnerships, bank holding companies, and oil and gas operations of producing oil and gas companies.
21. **Id.** at Item 512.
22. **Id.** at Item 501.
23. **Id.** at Item 502.
24. **Id.** at Item 503.
25. **Id.** at Item 504.
26. **Id.** at Item 506.
27. **Id.** at Item 202.
28. **Id.** at Item 505.
29. **Id.** at Item 503(d).
tion,\textsuperscript{30} information pertaining to selling security holders,\textsuperscript{31} if appropriate, and disclosures relating to and the interest in the issuer of named experts and counsel.\textsuperscript{32} If the issuer has \textit{not} undertaken to submit the question of whether indemnification of officers and directors against liabilities under the Securities Act is against public policy to a court of competent jurisdiction, and if the indemnification provisions have not been waived, the prospectus must disclose that it is the SEC's position that these provisions are against public policy.\textsuperscript{33}

2. \textit{Description of Business, Properties and Legal Proceedings (Items 101 through 103).} These items include a description of the issuer's business, a description of the issuer's properties, and a description of certain specified legal proceedings relating to the issuer. As noted below, the description of the issuer's business is intended to be extremely broad, covering various aspects of the issuer's products and services, customer base and research and development activities, as well as the competitive factors confronting the issuer. The description should be carefully drafted to comply with the applicable disclosure requirements, to provide a "baseline" for future disclosures regarding developments in the issuer's business, and should capture the specific "strategic advantages" that will enhance the marketability of the issuer and its securities.

3. \textit{Securities (Items 201 and 202).} Pursuant to Item 202, each issuer must supply a description of the securities being offered, as well as any of its other outstanding securities of the issuer. In addition, Item 201 requires the disclosure of information regarding the market for, and dividends on, common equity of the issuer. In the case of the IPO issuer, such disclosure typically is limited to a statement that no public market has previously existed for the offered securities and a description of the issuer's past and expected future policies regarding the payment of dividends.

4. \textit{Financial Information (Items 301 through 304).} Form S-1 requires the issuer to supply selected financial information; the MD&A; and a description of any disagreements with

\textsuperscript{30} Id. at Item 508.
\textsuperscript{31} Id. at Item 507.
\textsuperscript{32} Id. at Item 509.
\textsuperscript{33} Id. at Item 510.
its accountants during a specified period of time. Although not applicable to "first-time" registrants (i.e., "IPOs"), Item 302 requires of other Form S-1 registrants certain supplementary financial information.

5. **Management and Certain Security Holders (Items 401 through 404).** On Form S-1, issuers must provide certain information regarding directors and executive officers, executive compensation, security ownership of management and significant security holders, and certain relationships and related transactions amongst the issuer and specified persons who manage or otherwise control the issuer. As noted below, matters concerning management composition, experience and compensation are of great importance to prospective investors, although the disclosure in the prospectus tends to be limited to the items specifically required by Regulation S-K.

6. **Exhibits and Miscellaneous Items (Item 601 and Items 701 and 702).** Item 601 lists the various Exhibits that must be filed with the registration statement and which would be available for review by the public, including members of the investment community and competitors of the issuer. Among the requirements of Item 601 is a description, as well as actual disclosure, of the contents of each material contract or agreement relating to the issuer’s business or the terms of the offering. The documents disclosed and described in accordance with these requirements supplement the requirements of Item 101 relating to the issuer’s business and operations. Due to the wide availability of these documents, which often include sensitive and strategically important information, consideration should be given to the process for requesting “confidential treatment” of certain information filed as part of Exhibits under Rule 406 of Regulation C. Item 701 relates to recent sales of unregistered securities of the issuer. Item 702 relates to any arrangement to insure or indemnify officers or directors against liabilities.34 In addition, consents of experts must

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34. Item 512(f) of Regulation S-K requires, among other things, that issuers that have agreed to indemnify a director, an officer, or a controlling person against liabilities under the Securities Act, and wish to have the effectiveness of its registration statement accelerated, must include an undertaking that (1) acknowledges that the SEC regards those provisions to be against public policy and (2) the registrant will not indemnify any person other than payment of the costs of a successful defense without submitting the issue of validity of those indemnification provisions to a court of competent jurisdiction. As a general rule, the high
be included as Exhibits to the registration statement.\textsuperscript{35}

Whatever the regulatory context, the extensive disclosure requirements in Regulation S-K are designed to insure that the issuer prepares and organizes a wide range of historical and prospective information regarding its business and operations. However, as noted above, the prospectus is also a "marketing tool," usually the issuer's first opportunity to describe and position itself and its business to the broader business and investment community, including not only the customers in the offering (i.e., the retail and institutional purchasers of the offered securities), but also the analysts and industry specialists who are in a position to positively influence the issuer's prospects and opportunities, including the level of its share price in the IPO and thereafter.

If the IPO prospectus is prepared properly, the issuer is not only able to comply with its disclosure obligations, but also able to make each of the specific sections a "showcase" for its own particular "strengths" and strategic advantages. Moreover, the type and format of disclosure in the IPO prospectus will become the basis for preparing future disclosure documents under the Exchange Act and the issuer's widely disseminated annual report. Accordingly, it is quite important that the initial analysis of the issuer's strategic advantages at the time of the IPO be broad and thorough, and completed in a fashion which enables the issuer and its counsel to quickly identify areas of possible change during the period beyond the filing and effectiveness of the registration statement.\textsuperscript{36}

\textsuperscript{35} Experts named in the registration statement as having prepared or certified any part of the registration statement or a report or evaluation for use in the registration statement may incur certain liabilities under Section 11 of the Securities Act. Section 7 of the Securities Act requires that the written consent of any of the persons so named be filed as part of the registration statement. Consents must be dated and at least one copy of each consent must be manually signed.

\textsuperscript{36} Due to the fact that the preliminary prospectus is widely disseminated within the investment community during the waiting period, care must be taken to insure that any material developments relating to the issuer are set forth in the final prospectus and that investors have adequate time to absorb the new information prior to the actual sale of the securities. In some instances, it may be necessary to "recirculate" the amended prospectus, thereby causing a delay in the timing of the offering. See Rule 460 and Exchange Act Rule 15(c)2-8 regarding recirculation. Accordingly, counsel should attempt to draft the prospectus in a manner that
III. UNDERSTANDING THE IPO MARKETPLACE

A. Market Profile of the IPO Issuer

Before undertaking a detailed analysis of the issuer in the context of the various regulatory disclosure requirements and the strategic planning framework, it is important to understand the ultimate goal and objective of the transaction: the successful completion of the offer and sale of the securities to the investment community. Accordingly, this section focuses upon the IPO marketplace and the characteristics of those issuers who have successfully completed the IPO process. Knowledge of these "success factors" will allow the issuer to focus the tone of its disclosures in the prospectus in a manner which meets the needs and concerns of the investment community.

Venture magazine publishes, on an annual basis, a survey of "entrepreneurial" companies which have "gone public" during the previous year. The study, published in April 1989\(^{37}\) disclosed that 1,550 firm-commitment IPOs were completed in the three year period ending on December 30, 1988, 732 of which were nonfinancial companies whose IPOs raised $5 million or more. Of those 732 companies, Venture focused upon those companies founded in 1979 or later who had at least one of the original founders remaining as part of the management team. Those companies were ranked from 1 to 100 based on the change in their market capitalization from the date of their IPO to December 30, 1988.

This "IPO Fast-Track 100" included companies with market capitalizations ranging from $34.9 million to $1.4 billion, and 46 companies had market capitalizations in excess of $100 million. The size of the IPO ranged from $5 million to $67.5 million, with the average size being $22.9 million and only 11 of the companies raising less than $10 million in the IPO. Almost one-quarter of the companies had done at least one subsequent public offering. Other characteristics of the "100" were as follows:

1. Revenues in the most recent 12-month period ranged from $20,000 to $1.5 billion; the median was $52.6 million.
2. 21 of the companies had net losses for the most recent 12-month period.
3. Almost two-thirds of the companies were located in either

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California, Massachusetts or Texas. Over three-quarters of the companies were engaged in one of six industries: computers and related equipment (25), software development and marketing (15), biotechnology (13), medical products and services (10), semiconductors (8), and telephone products and services (6).

4. 70 of the companies were backed by United States venture capital companies. Nine venture capital companies invested in five or more of the listed companies.

5. 58 of the companies were trading above their IPO price at December 30, 1988. 16 underwriters had managed the IPO for at least two of the companies, and 6 underwriters managed five or more offerings (the aggregate number of offerings managed by the 6 leading underwriters was 49).

6. Of the 74 companies for whom price-earnings ratios were reported, five companies had ratios equal to or in excess of 25 and 15 companies had ratios of less than 10.

The foregoing profile contemplates a relatively sophisticated IPO issuer, with experienced venture capital funding, significant market interest as indicated by the proposed size of the IPO (e.g., $20 to $25 million), revenues in excess of $50 million per annum, profitable, engaged in technology-driven industries with positive prospects for future growth, and represented in a firm-commitment underwriting by reputable and experienced investment bankers. As described in further detail below, the presence of each of the aforementioned characteristics will have a definite bearing on the management and completion of the IPO transaction.

Obviously, the companies chosen by Venture reflect a certain portion of the entire spectrum of issuers who have entered the IPO market. A different perspective on the topic is offered by a recent report sponsored by the NASD which purports to be a study of the economic impact of IPO's on the industrial competitiveness of the United States. The study compared the performance of 426 NASDAQ-listed companies that made IPO's from 1983 to 1985 and set forth the following conclusions:

1. Industry employment by IPO firms increased at a rate of

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38. See "The Economic Impact of IPOs on U.S. Industrial Competitiveness," a study supported by the NASD and authored by Glenn Yago and Jeff Tanenbaum of the W. Averell Harriman School for Management and Policy at the State University of New York (Stonybrook). The study was released by the NASD on December 11, 1989 and was summarized in an NASD news release entitled "Study Finds IPO Companies' Corporate Performance Superior to Industry Norms." Interestingly, the NASD itself noted that 85% of all IPOs brought to market during the past five years have been listed on NASDAQ.
30% per annum while employment at other public companies in the same industry decreased at an average rate of 6.5%. Companies in the services sector showed the most significant differential in new employment growth.

2. Sales at IPO firms grew at an average annual rate of 34.5%, compared with 9.4% for the industry as a whole. Note that this differential may be primarily a function of the relative developmental stages of the issuers and does not posit a conclusion as to whether or not the growth rate achieved by the IPO firms was sustainable or in line with expectations of the investment community, which has historically looked for growth rates of 50% per annum or higher. Sales per employee at IPO firms grew at an annual rate of 15.8%, versus 6.2% for all companies.

3. IPO firms increased their invested capital at an average annual rate of 51.8%, or more than seven times the industry average of 7.2%. Similar differentials were apparent with respect to increases in capital spending (62.7% to 6.0%), working capital (71.8% to 4.3%), net fixed assets (52.8% to 9.6%) and total assets (37.3% to 11.6%).

The study concluded that the “performance measures strongly suggest that the capital obtained through initial public offerings is an essential factor enabling these companies to outperform their industries and to maximize their competitiveness.” For purposes of this discussion, the more important information lies in the measures of growth and expansion derived from the performance of the IPO firms themselves. It would appear that a competitive IPO candidate must comfortably anticipate increases in such significant measures as sales, employment, capital investment and working assets which are similar to those achieved by their predecessors identified in the study and that the issuer’s plans and expectations with respect to each of those factors should be thoroughly discussed in the disclosure documents and marketing presentations.

B. Considerations Regarding Pricing of the IPO

Pricing of the offering is an issue which arises several times during the preparation of the disclosure documents and the marketing of the securities. First, an estimate of the offering price is usually discussed during the preliminary negotiations between the managing underwriter and the issuer although such estimates can hardly be considered a “promise” of the eventual IPO price. Second, the preliminary prospectus, when filed with the SEC six to
eight weeks before the proposed offering date, contains a range within which it is expected that the offering will be made. This range forms the basis for the managing underwriter’s marketing efforts during the “waiting” period. Finally, a final pricing meeting, involving the managing underwriter and representatives of the issuer, occurs immediately prior to the execution of the underwriting agreement on the eve of the offering.

While it is certainly true that each issuer brings to the marketplace its own unique strengths and characteristics, underwriters will make their initial pricing decision on the basis of a handful of somewhat objective measures. The primary components in this “pricing” decision with respect to an IPO seem to be the following:

*Value of “Comparable” Issuers.* Most underwriters base their initial valuation of the issuer on a comparison of various financial measures of “comparable” publicly traded companies in the issuer’s industry with similar size, growth, and earnings characteristics. For companies with an established earnings history and significant tangible assets, this means a comparison of reported pretax earnings, book values, revenues and cash flow.39 The managing underwriter applies to these measures a predetermined multiplier, such as a price/earnings ratio, based on an analysis of other publicly traded companies. Care is also taken to carefully scrutinize asset valuations in order to properly reflect current market conditions and replacement values.

*Projected Earnings.* In the case of high technology or other highly “volatile” companies without a steady private earnings history, valuations are based not only on past history, but also upon projected earnings. These projected earnings are often based on questionable assumptions of growth rates in excess of 50% per year and on the ability of the issuer to earn extremely high profit margins due to the unique nature of their “cutting-edge” products. As a result, it is not unheard of for an issuer to be valued at 20 to 25 times its projected earnings for the coming year, or at three to five times its projected revenues for that same period. Given the tremendous “leverage” in these assumptions, it is little wonder that new issues often are perceived as far too risky and certain investors pre-

39. Often these measures are calculated on an annualized “rolling” basis to take into account developments over the period that the registration statement is prepared and the offering is marketed. The advantage of this method is that the issuer will be rewarded for an ongoing trend of upward, improving performance; however, any “break” in the trend may work against the issuer’s efforts to secure a higher offering price. Upward trends must be closely analyzed and should be supported by a reasonable expectation that future measurement levels will not “flatten” or decline immediately following the offering.
fer to await further developments and purchase shares in the after market.40

Terms of the Offering. Apart from pricing, investors also examine other aspects of the offering such as whether or not the offering is large enough to insure sufficient after market "float," the ratio of debt to market capitalization, the book value dilution to be suffered by the new investors and the increase in value being provided to existing investors, the percentage of shares being sold in the offering which are being offered by existing shareholders, the degree of "overhang" with respect to shares that may be sold in the future by existing shareholders, underwriter warrants and other compensation, and any special rights granted to new investors with respect to antidilution protection and the like.41 Although somewhat more difficult to ascertain, the identity of other new investors, such as mutual and pension funds or insurance companies, may provide a useful indication of after market activity in the securities.

Supply and Demand. While "comparables" are useful in determining the initial range of prices within which it might be expected that a new issue could be successfully distributed, it is ultimately the demand for the issue that is the most important determinant of the price. Each potential investor makes his own assessment of the issuer based on his review of the issuer's history and prospects as set forth in the preliminary prospectus and in discussions during the waiting period. Based on that analysis, purchasers will advise the managing underwriter as to the number of shares of the new issue that they would be willing to purchase at a given price.

40. Companies without the requisite history of revenues and earnings are still able to go public if they have reached a point in their development where most of the technological, manufacturing and marketing risks have been reduced and a higher valuation is deserved based upon the anticipation of future profitability. Paradoxically, the higher valuations make such a company less attractive for further venture capital investing, since the venture capitalists would be unable to attain the return on their investment that is usually required to fulfill their own portfolio objectives.

41. It is generally believed that a minimum of 300,000 to 400,000 shares is necessary in the public "float" to support a national distribution and active trading market for the securities of an IPO issuer. As for price level, every effort is made to set the IPO price no lower than $10.00 per share, although if the size of the offering is smaller it may be more beneficial to set the IPO price below $10.00 rather than reduce the number of shares offered to less than 400,000. It is important to remember that sufficient "float" may be achieved by including shares from existing shareholders in a secondary distribution as part of the IPO, particularly if the desired proceeds to the issuer from the offering would not support the required breadth of distribution in a primary offering. While pricing levels are largely "artificial," and often attained through stock recapitalizations (i.e., stock splits or reverse stock splits) prior to the IPO, they do address psychological barriers that many investors have regarding offerings priced below $10.00 or, in some cases, $5.00. As a result of the foregoing, underwriters will often limit their interest to offerings where the aggregate offering price is at least $5,000,000.
Underwriters tend to judge the quality of demand as a function of the ratio between the number of shares to be offered and the number of anticipated orders for such shares within the IPO price range specified in the preliminary prospectus. Due to the expectation that a certain number of orders will not actually materialize, underwriters feel comfortable with pricing an offering within the original range when orders are two to three times greater than the number of shares being offered. If orders exceed the number of offered shares by as much as six times, the offering size may be expanded and/or the price raised to accommodate the level of demand. Conversely, low levels of demand will compel underwriters to lower the price or reduce the size of the offering.

Once the managing underwriter has an idea of the offering size and price which might be acceptable to potential purchasers, they usually discount the valuation to guard against the risk that new investors might be disappointed by the failure of the price of the offered securities to appreciate from the IPO price during the first few months following the completion of the offering. As such, managing underwriters attempt to price most new issues so that they will rise 10 to 20% during the three to six month period immediately following the offering and the offering price will usually reflect anywhere from a 5% to a 20% discount from comparable stocks, with discounts being larger when institutions, who tend to be more price sensitive, outnumber retail buyers in the group of initial purchasers.

C. Characteristics of a “Suitable” IPO Candidate

The primary purpose of this article is to stress the need for an issuer to focus upon its own unique strategic advantages in preparing for its IPO. However, it may be somewhat disconcerting for the issuer to realize that sophisticated investors tend to look at a number of other factors, some of which may seem to the issuer to be out of its control by the time the IPO is to be undertaken. Time after time, investors indicate the importance of such factors as past financial performance and the pricing of the most recent round of private equity financing, rather than recent product and strategic breakthroughs that promise to make historical measures irrelevant in anticipating the issuer’s future prospects.

Like any marketing transaction, an IPO requires the skill and experience of an appropriate “marketing specialist.” In the context of an IPO, this means the investment banking firm which serves as the managing underwriter of the offering and brings to the process
its ability to effectively analyze whether or not the investment community is likely to find the issuer to be “suitable” for a successful underwritten public offering of its securities. Experience has shown that one or more of the following factors, generally presented in order of prominence, tend to drive the assessment of the investment community regarding a new issue:

*Past Financial Performance.* As noted above, underwriters and investors both tend to base their initial valuation of the issuer on a comparison of various financial measures of “comparable” publicly traded companies in the issuer’s industry with similar size, growth and earnings characteristics. It appears that investors look for multiple quarters of profitability (or decreasing levels of losses) and a level of gross margin high enough to sustain growth yet low enough to dissuade excessive future competition,\(^4\) annual growth rates in excess of 30% per annum and a level of annual revenues in excess of $50 million, although in some cases investors may settle for a reasonable expectation that revenues will reach an appropriate level in the near future.

*Management.* For many investors, the issuer’s products and technology are far less important than the breadth and quality of the management team, particularly when the officers and directors have experience in successfully building a larger and more diversified company out of an issuer who has yet to develop a line of products, or when the success of the issuer’s strategic business plan depends upon key management decisions in the future. In particular, attention is paid to management incentives, through stock ownership and cash compensation, to assess the issuer’s ability to compete with comparable companies in order to recruit and motivate capable managers. Also, the relative absence of prior management changes are taken as indicators of stability and provide investors with comfort that the issuer will be able to weather any future competitive or operational problems.

*Managing Underwriter.* The reputation and record of the man-

\(^{42}\) Financial information regarding the issuer is set forth in summary fashion in the front part of the prospectus as well as in the audited financial statements required by Regulations S-K and S-X. In addition to the financial statements, care must be taken in the preparation of footnotes to the financial statements as well as in the drafting of the narrative description contained in the “MD&A.” Shareholder litigation in the context of poorly performing IPOs often centers around allegations that the issuer “massaged” financial statements prior to the offering. For example, it has been argued that companies record orders not yet backed up by contracts as sales, or book orders as sales when liberal payment terms suggest that the agreements are really a form of lease. Also, financial statements may overstate inventories, inflate their values, or fail to disclose the diminished values of obsolete inventories or equipment.
aging underwriter is a most important consideration in the purchaser's decision to participate in an IPO. Due to its position, and potential liabilities under the securities laws, the managing underwriter should have had the opportunity to closely and carefully study and analyze all aspects of the issuer's business prior to the offering. As such, the success of any one particular offering may depend, in large part, on the issuer's ability to retain the services of a managing underwriter significantly experienced with companies in the same or similar fields.

Business of the Issuer. For all of the care taken in determining the appropriate strategy for the issuer's business, many investors give only passing attention to understanding the underlying competitive components of the industry in which the issuer is involved. Each investor quickly scans the brief description of the issuer's business contained in the front part of the preliminary prospectus looking, primarily, for an indication that the issuer may occupy a leadership position in an industry or market which can support rapid and impressive levels of growth. Accordingly, great care is taken in drafting these few paragraphs in order to retain the investor's interest in the offering. It is only thereafter that an investor will seek, and expect, answers to the following questions in the prospectus:

1. How profitable is the issuer's industry and how large are the industry's profit margins? What trends are developing in the particular sector of the industry in which the issuer is competing, and who are or might become the issuer's major competitors? For example, is there an "industry standard" which stabilizes the basis for competition, or are the technology and product characteristics still developing?

2. Is the issuer a significant factor within each of its selected markets and on what basis, such as proprietary technology, does the issuer seek to compete? What is the issuer's reputation amongst customers, suppliers, competitors and the general business community?

3. Is future earnings growth, if any, to be achieved through

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43. There are periods in which the issuer's industry of concentration becomes one of the most important considerations in the investor's decision to invest, as investors perceive a need to get in on the "ground floor" of a given technology (e.g., biotechnology) without regard to the particular merits of the subject issuer. At other times, it is impossible for an issuer in a given industry to successfully undertake an offering due to general distrust of the prospects of the entire industry, often driven by the failure of only one or two particular issuers. As noted above, six industries accounted for 77 of the "IPO Fast-Track 100."
growth in market share or through growth in the overall market? What are future expectations for the market and how will they influence profit margins and the competitiveness of the issuer's present strategic advantages? For example, will the issuer need to develop new technology or will it be sufficient to compete on its ability to effectively manage advances in specific applications?

4. How are the proceeds of the offering to be utilized? Rather than specifying "general corporate purposes," issuers are often better advised to build a connection between the purpose for the offering and the issuer's pursuit of its overall goals and objectives. For example, if appropriate, the issuer should specify that proceeds will be applied toward purchasing a plant, new equipment or for repayment of debt (other than for redemption of shares held by current shareholders). Many investors will shy away from offerings intended for the purpose of acquisitions if they feel that such transactions will significantly divert the attention of management away from the issuer's current business.

Risk Factors. In response to regulatory prodding and increasing exposure to potential shareholder litigation, issuer disclosure of risk factors and related discussions in the MD&A have taken on greater importance in recent years. Investors expect to see risk factors, although the need to enumerate more than five or six specific risk factors may diminish the apparent marketability of the offering. However, more important than the number of risk factors is the disclosure contained therein. In particular, attention must be paid to such things as the dependence of the issuer on the services of one or a few key employees, the existence of any significant intellectual property or antitrust litigation, the degree of competitive and/or product development uncertainty which exists in the market-

44. Obviously, the most attractive IPO candidate is a company with solid growth potential. Such growth potential should not only be a characteristic of the issuer, but it is also helpful if the issuer is involved in an industry in which each of the potential competitors is expected to enjoy significant growth appreciation in the years to come. Thus, the attractiveness of an IPO candidate to the investment community is the function of its own stage of development, its own potential, the growth potential of its industry and the competitors within its industry, and the business plans and earnings history of the issuer and its direct competitors.

45. Items 501(c)(4) and 503(c) of Regulation S-K require that the issuer, if appropriate, set forth on the page immediately following the cover page of the prospectus (or following the summary, if included) under an appropriate caption, a discussion of the principal factors that make the offering "speculative" or "one of high risk." The risk factors section should be relatively brief and should cross-reference to other detailed discussions that appears in the narrative description of the issuer's business.
place, the dependence of the issuer upon one or more suppliers or customers, high research or manufacturing costs, the effect of government regulation and the issuer's need for future financing to fund fixed obligations or business expansion.46

D. Prologue

The primary purpose of surveying the characteristics of a suitable IPO candidate is to provide prospective issuers with an idea of how its business and operations will be assessed by the investment community. The issuer should be able, in the course of drafting the prospectus, to highlight those items that correspond to the needs of the investment community. Also, in those cases where the issuer does not, for some reason, have one or more of the essential elements that appear to be present at the time of a successful IPO (e.g., profitability), the prospectus can be drafted in a manner which explains the reasons for the lack of profitability and suggests alternative forms of performance measurement which indicate the issuer has met its established product development goals and objectives and anticipates profitability on or before a specified future date.

Knowledge of the marketplace permits the issuer to properly "position" itself such that its strengths and weaknesses are properly explained to the investment community. Although the specific disclosure requirements imposed by Section 5 of the Securities Act are quite broad, they do not specifically require that the issuer disclose many of the items which appear to be important to the investment community. Therefore, disclosure without regard to these investor needs can be somewhat less than effective. Moreover, as described below, marketing of some of these characteristics can, and should, begin well in advance of the IPO in those circumstances where the privately-held issuer may come into contact with segments of the investment community.

46. In addition to the operational risks referred to above, risk factors typically include a number of "transactional" risks, such as: the potential volatility of the share price of the issuer's stock, the light trading market for the issuer's shares, the existence of a large "overhang" of previously issued but unregistered securities which might be sold into the market after the offering upon satisfaction of certain conditions imposed by SEC Rules 144 and 701, the existence of special relationships between the issuer and members of management or specified shareholders, the existence of "antitakeover" provisions in the issuer's charter documents and the ability of existing shareholders to continue to control the issuer after the offering due to large shareholdings.
IV. UNDERSTANDING THE ISSUER: THE DUE DILIGENCE INVESTIGATION

Given the importance of properly positioning the issuer in the eyes of the investment community prior to the IPO, a common understanding must be reached by management and their professional advisors (i.e., the managing underwriter and counsel for the issuer and the underwriters) as to how the issuer is to be described in the prospectus and during the various presentations to institutional investors. Such an understanding will ease the preparation of the description of the issuer's business in the prospectus and will also permit proper identification and description of the major risks and uncertainties that lie in the path of the issuer's future growth and development.

At the commencement of the offering, each of the participants will conduct their "due diligence" investigation regarding the issuer in order to verify the accuracy of disclosures made to potential investors and to establish the "due diligence defense" against various claims that may be brought under the federal securities laws by investors. Section 11 of the Securities Act contains an explicit due diligence defense for persons other than the issuer and a similar type of defense is also available under Section 12(2) of the Securities Act. While Rule 10b-5 under the Exchange Act does not contain an express due diligence defense, a plaintiff will usually attempt to demonstrate "scienter" on the part of the defendant by introducing evidence to the effect that the requisite due diligence was not undertaken and properly completed.

A defendant in a securities action will seek to establish that its "investigation" was "reasonable" and "independent," that it did not have access to information which would have revealed the alleged

47. Item 101(a) of Regulation S-K requires a description of the general development of the business of the issuer over the past five years or such shorter period that the issuer may have been engaged in business. Item 101(c) of Regulation S-K requires a narrative description of the business done and intended to be done by the issuer and sets forth thirteen specific items that, if applicable, should be addressed and discussed in the prospectus.

48. The issuer and the other parties to the registration process (i.e., the issuer's officers and directors, the underwriters, legal counsel, the accountants and other "experts" named in the registration statement) are subject to liability under various sections of the Securities Act, as well as under Rule 10b-5 of the Exchange Act, for material misstatements or omissions made in the course of the registration and offering process.

49. Section 11 contains due diligence standard of "reasonable investigation" and Section 12(2) utilizes a due diligence standard of "reasonable care." Case law indicates that the standards are not identical, although there is some debate as to which standard is more stringent. See Epstein, Reasonable Care in Section 12 of the Securities Act of 1933, 48 CHI. L. REV. 372 (1982); and Kominsky, Analysis of the Securities Litigation of Section 12(2) and How it Compares to Section 11, 13 HOUS. L. REV. 231 (1976).
misrepresentation or omission, and that the actual investigation itself was "complete." 50 The statutory standard of the prudent person, as well as various judicial interpretations, make it clear that IPO participants such as the underwriters cannot simply accept the statements of the issuer without attempting to verify such statements through their own independent efforts or with the assistance of agents such as their counsel.

What constitutes "reasonable investigation" is subject to great debate. 51 Unfortunately, Rule 176, which was originally promulgated by the SEC with respect to determining what constituted a "reasonable investigation" for purposes of Section 11, 52 provides little clear guidance as to the exact content and scope of a proper and complete due diligence investigation. The SEC and the NASD have attempted, in 1973 53 and 1975, 54 to alleviate some of the uncer-

50. As noted by Judge Weinstein in Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971); "There is little judicial gloss on this defense." See Escott v. Bar-Chris Construction Corp., 283 F. Supp. 643, 683 (S.D.N.Y. 1968); cf., Gilbert v. Nixon, 429 F.2d 384, 357 (10th Cir. 1970) (Section 12(a)); Demarco v. Edens, 390 F.2d 836, 842-843 (2d Cir. 1968). In fact, Judge McLean's opinion in Bar-Chris is the only one we have found which treats the subject at any length. The key to reasonable investigation as expressed in that opinion is independent verification of the registration statement by reference to original written records. "Judge McLean makes it plain that a completely independent and duplicative investigation is not required but, rather, that the defendants were expected to examine those documents which were readily available."

51. The topic of due diligence has not been the subject of a definitive treatise. However, numerous articles are available on the subject. One of the best recent treatments of the topic appears in Spanner, "A Litigation Perspective on the Prospectus Preparation Process for an Initial Public Offering," in 16 SEC. REG. L.J. 115 (Summer 1988), which also includes a number of annotations on the subject. Also, reference should be made to the two most notable cases on the subject: Escott v. Bar-Chris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) and Leasco which contains a number of annotations to commentary on the Bar-Chris case. Finally, with regard to due diligence procedures, see Sherman, "The Due Diligence Defense" in Mechanics of Underwriting 1989, P.L.I. No. 629 (1989) and Seegal, "Due Diligence Procedures in Initial Public Offerings" in How to Prepare An Initial Public Offering 1989, P.L.I. No. 656 (1989).

52. See SEC Rule 176 with respect to the "Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act," which was first proposed for adoption in SEC Release No. 33-6335 (August 6, 1981).

53. In its Notice to Members 73-17 (March 14, 1973) the NASD proposed an amendment to the NASD Rules which would have required every member firm engaged as a managing underwriter in connection with any public offering to establish and maintain written procedures to be followed by its personnel in the investigation of an issuer for which it proposed to make a distribution of securities. The proposal enumerated sixteen areas of inquiry which would be required to be included in the member's procedures although, according to the NASD, these were intended merely to represent "minimum standards of inquiry." The NASD's proposed areas for inquiry (excluding one lengthy item, Item 16, which related specifically to tax sheltered programs) were as follows:

"(1) Review by underwriters' counsel of the issuer's corporate charter, by-laws, and corporate minutes;
(2) Examination of the audited and unaudited financial statements of the issuer, including footnotes, for the preceding ten year period or for the entire period of the issuer's existence if less than ten years;
(3) Review of all changes in auditors by the issuer within the preceding ten year period if applicable and the reasons therefor;
(4) Review, with the issuer's auditors, of the financial statements which will appear in the prospectus or offering circular;
(5) Review of the issuer's budgets, budgeting procedures, and order/backlog figures;
(6) Review of internal projects of the issuer, including the intended use of the proceeds of the offering;
(7) Review of all pertinent marketing, scientific and/or engineering studies or reports concerning the issuer or its products during the previous ten year period or for the term of the issuer's existence if less than ten years;
(8) Consideration as to the necessity of third party review of appropriate portions of the inquiry if the issuer is a promotional organization or engaged in marketing high technology or previously unmarketed products;
(9) Investigation of the issuer's current and past relationships with banks, creditors, suppliers, competitors and trade associations;
(10) Communication with key company officials and appropriate marketing and operating personnel regarding the nature of the issuer's business and the role of each of the above individuals in the business operation;
(11) Inspection of the issuer's property, plan and equipment;
(12) Examination of business protection devices and related data such as trademarks, patents, copyrights and production obsolescence, among others;
(13) Review of available information with respect to the issuer's position within its industry;
(14) Review of pertinent management techniques, organization of management and the background of the management personnel of the issuer;
(15) Preparation and maintenance of memoranda pertaining to all meetings and/or conversations regarding the issuer held during the member's performance by it of its obligation of adequate inquiry.”

54. The 1973 NASD proposal received extensive adverse comment and, as such, was never adopted. In 1975, the NASD announced its Proposed Statement of Policy of Board of Governors concerning Due Diligence Requirements for Public Offerings of Securities in NASD Notice to Members 75-33 (April 25, 1975). Rather than requiring by rule that underwriters establish their own “due diligence standards,” as had been the case in the 1973 proposals, the 1975 Proposed Statement stressed the underwriter's responsibilities and liabilities for compliance with the federal securities laws and emphasized the need for each member firm to insure that an adequate due diligence investigation has been performed prior to participating in the distribution. As to IPOs, the NASD asserted “that an underwriter's due diligence responsibility is most important in initial offerings of speculative or promotional issuers. Thus, a particularly thorough and intensive due diligence investigation is necessary in connection with an offering of a company either in the developmental stage or a promotional company engaged in marketing highly technical products particularly where such distribution is a first time offering.” The NASD then offered the following suggestions as to due diligence investigations:

Areas which appear to be covered at minimum in most due diligence investigations performed in connection with corporate offerings... include a review of the issuer's corporate charter, by-laws and corporate minutes including executive committee minutes for at least the previous five (5) years (or for the entire life of the issuer if it has been in existence a shorter period; or for even a longer period than five years if circumstances dictate such) and a review of the issuer's
guidelines. While these guidelines were never adopted, in part due to widespread fears within the securities industry that the procedures would be used to establish, rather than mitigate liability, they do provide some useful instruction on the overall scope and content of the due diligence investigation and should be supplemented by the following additional procedures:

1. Carefully review each of the disclosure items listed for Form S-1 to insure that answers have been obtained which are sufficient to fully address the required disclosures.

2. Obtain and review all of the issuer's material contracts.

3. Review each of the issuer's financial statements (audited and unaudited), business and operating plans, budgets, forecasts, financial projections and similar materials and questionnaires. Also, examine the issuer's financing and business plan and its impact on, and consistency with, the projected use of proceeds set forth in the registration statement.

4. If practicable, sample selected correspondence files of the issuer that relate to known areas of concern, as well as those of the issuer's principal officers.

The 1975 Proposed Statement of Policy was not adopted. Various members of the securities industry expressed concern that the opportunity for liability on the part of an underwriter could be substantially increased if he failed to fulfill his own standards for due diligence investigations. Also, the NASD was concerned that underwriters who fulfilled the required due diligence procedures but nevertheless were held liable for failure to meet the due diligence standards under the Securities Act could possibly attempt to recover against NASD.
5. Have an officers' and directors' questionnaire completed by each officer and director.

6. Review the prior issuances of all securities and the documentation relating thereto for the purpose of assuring compliance with the securities laws. Review any prior agreements to determine whether there may be outstanding registration or first refusal rights and also examine any representations and warranties made therein to prior investors.

7. Review the response of issuer's counsel to prior requests of the auditors.

8. Review files pertaining to pending or threatened litigation.

9. Review title opinions or title insurance policies relating to principal real estate assets, and conduct an inspection of the premises.

10. Examine all loan agreements to determine restrictions, if any, on dividends or that might otherwise be relevant to the offering or to the disclosure.

11. Review all employment contracts, employee benefit plans, stock option, and SAR plans relevant to executive compensation.

12. Review insurance policies, including those pertaining to general liability.

13. Review government permits and governmental regulations peculiarly applicable to the issuer (including environmental regulation), and, to the extent necessary, obtain expert advice (whether or not to be presented on the authority of an expert) with respect to those regulations and their impact on the issuer's business.

Experience indicates that the due diligence investigation should consist not only of obtaining and reviewing basic documentary information and conducting face-to-face interviews with representatives of the issuer, but also should involve a number of additional steps designed to familiarize the parties with the issuer's

55. Interviews should be conducted with key officials of the issuer, the issuer's accountants, suppliers and customers and other persons having useful information relating to the issuer. Typically, the meeting following the organizational meeting will consist of an extensive due diligence session at which each of the key officers and employees of the issuer is separately interviewed. In those interviews, each officer will be asked to comment not only on his own job functions, but upon the overall performance of the issuer and the competitive environment in which it operates. If necessary, one or more "follow-up" sessions will be scheduled and legal due diligence will be simultaneously conducted by counsel for the underwriters.
business, industry and overall competitive environment. Among these procedures would be a review of industry publications and disclosure documents of companies engaged in the same or similar lines of business, actual observations of the issuer's business operations and reports from consultants. Moreover, management itself should provide the other parties with its own assessment of the key measures, guides and controls which they believe are important to monitoring and evaluating the issuer's performance.

The foregoing general listing implies a large and time-consuming effort, but one that is necessary in order to truly understand the issuer and its business. Although Rule 176 appears to draw distinctions between the amount of due diligence that might be necessary in a given offering, in reality it is most likely that officers, counsel and the managing underwriter, at the very least, will undertake the same type of due diligence investigation in every offering, regardless of the exact terms of the offered security and the terms of the underwriting engagement. Moreover, it is clear that in an IPO the onus of full and complete investigation will fall squarely upon the shoulders of all of the participants given the concerns of the SEC and the marketplace regarding new and "untested" issuers.

V. PREPARING THE IPO STRATEGIC BUSINESS PLAN

A. Introduction

The previous sections of this article have focused upon the various disclosure requirements imposed by the SEC and the other regulatory bodies which are active in the review of any IPO transaction, the perceived needs of the investment community with respect to purchasing the securities of an IPO issuer, and the "process" of collecting information regarding the issuer for preparation of the disclosure documents. In this section, we turn to a description of how the information might be used not only to satisfy the disclosure requirements, but also to identify the unique strategic advantages of the issuer which can be the focus of marketing efforts in the issuer's day-to-day business activities and in the financing transaction itself.

Experience has shown that an issuer's strategic advantages are best identified at the time an IPO is being seriously considered

56. To find prospectuses of similar companies, a useful guide is the CCH Federal Securities Law Reporter, which contains a list of registrations by business categories. Investment banking firms also may be a useful source for prospectuses of similar companies. Entire registration statements can be obtained, by citing the appropriate file number, from the SEC's public reference facilities or through commercial services.
through the process of preparing a formal business plan.\footnote{57} This plan can become the basis for drafting the prospectus, collecting the information necessary to respond to the concerns of each of the regulators and for allowing each of the parties to satisfy their due diligence obligations. The exercise of putting together such a business plan is not directly intended to draft the prospectus, although presumably much of the contents thereof can easily be lifted from the business plan.\footnote{58} Instead, the interview and investigation process
that goes into the formulation of the plan will ensure that the prospectus drafting is completed within the broader context of the issuer's overall strategic business objectives.

The balance of this section is devoted to a discussion of four distinct strategic elements, each of which must be considered individually and collectively in light of the disclosure requirements imposed under the federal securities laws and the known concerns of the investment community. These strategic elements can be initially organized as follows:

1. The strengths, weaknesses and constituencies of the issuer must first be evaluated. This means identifying the issuer's assets, resources, products and skills, as well as the interests of its managers, shareholders, employees, strategic partners (e.g., suppliers and distributors), customers, financial community representatives (e.g., commercial and investment bankers) and the local community, among other groups. In addition, an effort should be made to assess the various advantages and disadvantages of the IPO to the issuer.

2. After the evaluation of the issuer has been completed and the issuer's strengths and internal objectives are understood, it is then necessary to examine the marketplace within which the issuer's products and services are to be distributed. Accordingly, the "needs" of the issuer's current and projected customers should be analyzed. The issuer is then able to make some preliminary determination as to its strategies with respect to products and services, positioning, pricing, distribution, market selection and manufacturing.

3. The formulation of the issuer's strategies with respect to markets and customer needs cannot be made in isolation. Instead, reference must be made to skills and strategies of actual and potential competitors. An understanding of the competition permits the issuer to determine for itself the appropriate manner in which it should compete in the marketplace and assists in the selection of those possible written in a fashion which can be adopted for use in the front part of the prospectus, which is closely read by the investment community, and in the introductory paragraphs of the narrative description of the issuer's business contained in the prospectus. Also, the required descriptions of the issuer's products, the marketplace, the competition and the regulatory environment should easily be available from a well done business plan, although care must be taken as to the degree to which the issuer's own marketing and competitive strategies can, or should, be described in the prospectus.
strategies which will prove the most effective and profitable. Also, the ability to measure competitive forces in various markets should lead to the selection of those markets in which the issuer's particular strengths will provide the greatest advantage.

4. Finally, the issuer, its customers and its competitors must also operate within a number of large and turbulent external environments. The rapid changes in technology, customer needs, governmental regulation and social values make it essential that an issuer be able to establish the proper "planning environment."

B. Evaluation of the Issuer

The first step in the preparation of the IPO strategic business plan is a candid appraisal of the issuer's strategic capabilities (i.e., its strengths and weakness), both in isolation and in relation to actual and potential competitors, as well as the needs of the marketplace. In practice, the issuer is really its managers and the principal shareholders who set the direction for the issuer's business and select the IPO as the most attractive financing vehicle at the time of the proposed offering. Each of these persons must attempt to identify the issuer's own unique human, technical and financial assets and resources and articulate its varied strategies in the areas of product development, human resources, finance, production and distribution and service.

1. Description of the Issuer

The purpose of this introductory section is to provide a description of the history and status of the issuer. The narrative should be in general terms, with particular details to follow in the specific sections below relating to products, human resources, technology, customers, competition, employees and the like.

1. When was the issuer formed, by whom and for what reason? Generally describe the issuer's business and its evolution since the date that the issuer was originally formed. Has the issuer recently undergone any material change in its line of business, usually evidenced by significant acquisitions, mergers or divestitures, plant closings, new product lines or discontinued products or services?

Item 101(a) of Regulation S-K requires information relating to fundamental developments regarding the issuer over at least the last five years (or shorter period if the issuer has not been in existence for five years), including the nature and results of any bankruptcy
or similar proceedings, material reclassifications or mergers, material acquisitions and dispositions, material changes in the mode of conducting business. In addition to the disclosures required by Item 101(a), Item 101(c) of Regulation S-K requires a description of the business done and intended to be done by the issuer, focusing upon the issuer's dominant industry segment or each reportable industry segment about which financial information is presented in the financial statements included in the prospectus.

Not only must an effort be made to understand the historical development of the issuer but, in the case of certain issuers who have not yet achieved profitability, the prospectus should set forth a proposed plan of operations for a future period that may, depending upon the timing of the original filings extend for up to one year after the filing of the registration statement. If required, the operating plan should indicate the issuer's opinion as to the period of time that the proceeds from the offering will satisfy cash requirements and should also include an explanation of material product research and development, anticipated material acquisitions of plant and equipment, and any anticipated material changes in the number of employees in various functional departments.

Even if a plan of operations is not required for the prospectus, it is not a bad idea to include the information as part of the strategic business plan. While an IPO candidate may have achieved "profitability," the investment community will require a reasonable expectation of continued rapid growth and expansion. Accordingly, material research and development activities, plant and equipment acquisitions and hiring efforts should be anticipated and catalogued in order to understand the direction of the issuer's strategic efforts. The exercise of preparing a plan of operations will also allow the participants to draft a more focused description of the use of proceeds and the MD&A.

The description of the history of an issuer in the high technology area will probably identify a "founding" team, one or more of whom may have left their previous employers with the intent of developing a technical or product concept that did not fit into that company's projected product line, and a group of private investors who contributed financing and managerial assistance. In addition, development of the issuer should reflect the attainment of various milestones: recruitment of experienced management personnel, if necessary; expansion of human resource capabilities in research, manufacturing, sales and finance; "beta-site" testing and initial sales of products and services; formalization of one or more supply and
distribution arrangements; and additional rounds of financing of successively higher valuations.

It would be somewhat unlikely for a high technology IPO candidate to have undergone a material change in its line of business since venture capital funding is usually provided for a very focused product or technical effort. Similarly, material acquisition and divestiture activity would be uncommon, although the proceeds of the offering could be utilized to undertake a program of strategic acquisitions in the future. Finally, frequent changes in product and service offerings by a new market entrant tend to impede the issuer's ability to build a base of customer loyalty and trust.

2. What industry is the issuer involved in, who are the major competitors and what are the prospects for the growth and evolution of the industry and the markets therein?

Items 101(b) and 101(d) of Regulation S-K require financial information about the issuer's industry segments, foreign and domestic operations and export sales. Moreover, as noted above, the investment community will focus very closely on the trends in, and the characteristics of, the issuer's industry, including the key problems facing the issuer's industry, market characteristics, and financial results for other companies. An understanding of, and a narrative section describing, the historical development of the industry can provide a useful background for positioning the issuer and its strategic advantage in the prospectus.

Clearly, there are advantages to being in the "right" industry, as demonstrated by the concentration of the "Venture 100" in the industry segments described above. Moreover, venture capitalists and investment bankers have distinct preferences as to those industry segments and markets in which they will participate. However, the recent market for seasoned high technology companies has been somewhat sluggish, causing prospective high technology IPO candidates to seek and exploit definitive "niches" within the broader marketplace. Accordingly, the relevant "marketplace" for an issuer may be somewhat narrow and may include only those areas within the broader industry in which the issuer has some sort of technical or marketing advantage and which, by reason of its size or the skills involved, appears to be somewhat protected from competition.

3. Who are the key members of the issuer's management team,

59. See "High Tech Tops '89 IPO Market" at C1 of the January 15, 1990 edition of the San Francisco Chronicle. The article contained a quote by Roger McNamee, manager of T. Rowe Price's Science and Technology fund that 1989 "was the year of the niche IPO."
as well as any non-management employees who are important for the issuer's future development and success?

As noted above, the most important consideration in evaluating a prospective IPO candidate for many investors is the breadth and quality of its management team. Items 401 - 404 of Regulation S-K require certain specified information regarding the directors and executive officers of the issuer,\(^60\) the security ownership of certain beneficial owners and management\(^61\) and a description of certain relationships and related transactions between the issuer and its various affiliates.\(^62\) In addition, in the case of high technology issuers, it is quite likely that one or more key technical employees can be identified as a valuable human resource of the issuer, even though such employees are not involved in the day-to-day management of the issuer.

Being a public company imposes tremendous strains upon the management team given the need to be cognizant of the demands and requirements of the investment community. Officers must be familiar with, and not antagonistic to, the varied requirements imposed on a public company and must be willing to engage sophisticated professional advisors to assist them in discharging their responsibilities. If the issuer does not already have in place a network of sophisticated controls and forecasting ability in order to implement its strategic business plans, the construction of such a system should be undertaken immediately and should have every prospect for success prior to the commencement of the offering.

A good sense of management’s skills and temperament can be obtained through the due diligence process itself. An effort should be made to examine the issuer’s existing procedures with respect to corporate governance. For high technology companies with venture capital financing, it is likely that the outside investors will have required that the chief executive and financial officers, as well as the other functional leaders in the areas of manufacturing, research and sales, make detailed reports to the Board of Directors on a monthly or quarterly basis. Moreover, any perceived management “weak-

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60. See Items 401(a) and 401(b) of Regulation S-K.
61. See Items 403(a) and 403(b) of Regulation S-K.
62. See Item 404 of Regulation S-K. The disclosures required by Item 404 regarding various “insider” and “promoter” transactions are closely reviewed by Blue Sky authorities in accordance with established guidelines designed to analyze the inherent fairness of the transaction to the new public investors. Generally, while disclosure of the relationship is all that is required under federal securities laws, Blue Sky authorities will require that various loans and other arrangements be cancelled and repaid as a condition to approval of the offering in that state.
ness” raises immediate concerns amongst outside investors, as well as with prospective underwriters.

Compensation and commitment are important factors in the analysis of management. While investors appreciate the presence of skilled and talented managerial personnel, an issuer’s dependence upon the availability of a small group of key managers or employees should be disclosed as a potential risk factor with respect to the offering. In those cases, investors will look to the terms of any employment arrangement between the issuer and such manager or employee, including equity and cash compensation, and will try to get a sense of whether or not the issuer can continue to offer a compensation package which compares favorably with any recruiting efforts of competitive firms.

Outside investors will require that management, as well as any key non-management employees, agree to a “vesting” schedule with respect to their equity interest in the issuer, thereby insuring that the employee will remain with the issuer in order to obtain the full benefit of his skills and experience and to assist in the long-term development of the issuer’s business plan. Vesting schedules are typically imposed in almost all cases with respect to stock purchases and option grants for a high technology company, although an issuer may choose to issue or grant “fully vested” shares or options which take into account the fact that the employee has already completed a specified minimum period of service with the issuer.

Issues regarding equity and cash compensation really become a matter of commitment on the part of managers and key employees to the overall success of the issuer. In that regard, the following points are worth making:

1. The tradeoff between equity and cash compensation arises very early in the development of a prospective IPO candidate. Venture capitalists will often structure offers to key employees such that they may strike the appropriate balance between equity compensation, the value of which is a function of future profitability of the issuer, and cash compensation, which, barring adverse circumstances, tends to be devoid of either excessive downside or upside in the early years of business.

2. In some cases, cash compensation in the form of bonuses tied to profitability may be made available to members of the management team. However, any such arrangements may not be appropriate for a public company, in which case equity incentives become more attractive.
3. Obviously, an IPO is a liquidity event for venture capitalists and members of the management group. The investment community will appreciate that managers, many of whom will have purchased their shares at substantially reduced prices, may wish to sell some of their shares at the time of the IPO. However, the investment community will also want to insure that managers and key employees retain an equity interest which is "significant" and which, if appropriate, remains subject to further vesting.

4. One often ignored element of management commitment is the ability of managers and key employees to utilize their skills and services with potential competitors. As noted below in the discussion of the issuer's technology rights, employees should be required to execute various non-disclosure agreements relating to the issuer's own trade secrets and competitive information. Moreover, managers and key employees may become subject to non-competition agreements, subject to any restrictions on the enforceability of such agreements under applicable law.

The opportunities to discuss management skills and experience are relatively scarce in the context of the prospectus, although investors will be able to do their own background investigations and will usually rely upon the judgment of the venture capitalists in the selection of appropriate members of the management team. Also, the IPO process itself is a key test for management personnel and its ability to articulate and define the issuer's strategic advantages. The ability of management to clearly and concisely express the issuer's strategic mission is most evident in the prospectus drafting process, as well as in the oral presentations to prospective managing underwriters and, after the registration statement has been filed, the presentations to institutional investors in the various road shows.

4. Who are the issuer's major "stakeholders" and what are their particular goals and objectives with respect to the future of, and their involvement with, the issuer?

In addition to the management and key employees of the issuer, an effort should be made to identify and describe each of the issuer's other "stakeholders," those persons and groups who have an interest or share in the commercial success and continuity of the issuer as a business enterprise. Logically, these groups can be segmented as follows:

*Shareholders.* The issuer's shareholders consist of at least three distinct groups: founding shareholders, who acquired their shares
at, or immediately following, the formation of the issuer; employee shareholders, who acquired their shares as part of the issuer's incentive compensation plans; and "investors," venture capital and other investors whose equity interest in the issuer arises out of participation in one or more financing transactions.

One of the most important factors in the assessment of a potential IPO candidate by the investment community is its prior "investment history." Disclosures in the registration statement provide the reader with a sense of the timing of each round of venture capital financing, the price per share paid by private investors in each round and the relation of the shareholdings of the private investors to founders and employees. Thereafter, investors look at the history of an issuer's private equity financing from a number of perspectives. First, they look at the timing and pricing of the most recent round of equity and compare it to the "markup," if any, reflected in the proposed IPO price. As a rule of thumb, if the round was raised in the last year, an offering price that exceeds the price in the last equity financing by more than two times may reflect too high a valuation for the IPO.63

Second, investors look to see the "quality" of the private round investors. The presence of solid and successful venture capital investors is a significant plus, even if such investors are selling some of their shares in the offering. It is understood that venture capital investors often have their own liquidity needs which are independent of the future prospects of the issuer. Moreover, like "specialty" underwriters, the reputation of a venture capitalist in picking "winners" in a given industry can also lend prestige to an issuer's IPO aspirations. Several publications track the identity of the venture capital groups which have been affiliated with successful IPOs.

Finally, investors will attempt to discern how the sequence of private financings compare to the original projections of the issuer. If the issuer was forced to utilize much higher levels of private financing than originally expected, it may bring into question the reasons for attempting to secure public financing at this point in time.64

63. Investor concern regarding a significant short-term "markup" runs contrary to the requirements typically imposed by venture capital investors with respect to the circumstances when their preferred stock would be automatically converted into common stock in connection with an IPO. Typically, automatic conversion will only be required if the IPO price reflects a markup of two to three times the price paid by the venture capitalists. However, the price paid by the venture capitalists will reflect a discount which takes into account the illiquid nature of the investment.

64. Once again, attention should be given to the use of proceeds discussion, which may indicate that the offering is being undertaken for purposes typically associated with growth and development during the "private-company" phase. Investors will also compare the rela-
Moreover, understanding the return on investment requirements of private institutional investors, an analysis of the timing and pricing of private equity rounds allows an investor to focus upon specific problems which may have arisen with respect to technology development and product introduction, each of which may be symptoms of larger flaws in the issuer's overall strategy. Conversely, unduly high private valuations may lead investors to question the issuer's ability to maintain the requisite growth patterns in the future.65

Management may need to convince existing shareholders to "give up" special rights and privileges at the time of the IPO which they may have been granted in connection with prior private placement financings. For example, private placement financings for the high technology company prior to the IPO usually involves the issuance of shares of convertible preferred stock with a variety of statutory and contractual preferences and rights with respect to voting, liquidation, redemption and dividends. Unless provision has been made for the termination of such rights upon the occurrence of an IPO of the requisite size and price level, typically by automatic conversion into shares of the common stock being offered to the public, management and advocates of the IPO may need to negotiate with the holders of such shares in the event that the managing underwriter believes that the offering will not be successful unless the capital structure of the issuer is modified.

It is worth noting that in those cases where the IPO is undertaken in close proximity to a large private placement financing, underwriters are becoming more comfortable with doing transactions where the preferred stock remains outstanding; particularly when the issuer is unwilling to accede to possible demands by the later round investors that their shares be redeemed at a premium or that their shares be included as part of a large secondary distribution in the IPO. Although holders of the preferred shares will ultimately be able to "tack" their preexisting holding period for those shares, for purposes of using Rule 144 to sell the shares of common stock issued upon conversion thereof, it will usually be some period of

65. An even more interesting issue arises when a private company has had to attract investment by giving up to a corporate investor certain specified future rights, such as the ability to market products or otherwise fully commercialize and exploit its own proprietary technologies. The question arises as to whether or not such a relationship adversely impacts the ability of the issuer to provide a stream of future revenues that will accrue to the advantage of the public investors.
time before the holders can use Rule 144 or desire to effect a sale at a price level which meets their investment return expectations.

**Employees.** Human resources are an important potential success factor for any issuer and, as such, are treated in greater detail below. The required disclosures regarding an issuer's human resources are quite limited, with Item 101(c)(xiii) of Regulation S-K simply requiring disclosure of the number of persons employed by the issuer. However, an effort should be made to catalog any anticipated material changes in the number of employees in the various departments such as research and development, production, sales or administration.

As noted above, employees will also be shareholders of the high technology IPO candidate, either by virtue of direct purchases of shares or the prospective exercise of options granted pursuant to the issuer's incentive compensation plans. The relative amount of employee shareholdings makes it unlikely that the employee group will be able to act as a block with respect to any matter of corporate governance. However, the ability of employees to derive liquidity for their shareholdings through the IPO is often considered to be one of the advantages to an issuer considering such a transaction and also may enhance the issuer's ability to attract and retain new employees after the offering.

**Strategic Partners.** The concept of "strategic partnering" has become quite popular in recent years, although the term has rarely been clearly defined. In the present context, a strategic partner is a third party with whom the issuer has entered into a contractual relationship to provide the issuer with products and services which are essential to the development, production and distribution of its own products and services. Suppliers and distributors clearly meet this definition, as would parties participating in joint research and development efforts. Such firms might also be shareholders of, or have a significant financial interest in, the issuer, thereby providing capital in addition to products and services.

Almost every high technology firm enters into one or more key supply arrangements with respect to components of its products and services. Accordingly, one of the first things that should be done in the course of understanding the issuer's business is to formulate a detailed breakdown of major suppliers of raw materials and other goods and services necessary for the manufacture and

66. The source and availability of raw materials is required discussion under Item 101(b) of Regulation S-K. "Supplier" can take on a number of meanings, depending upon
sale of the issuer's products. Once the list has been compiled, the issuer should be questioned as to whether or not there are other sources readily available or is the issuer dependent to any degree on any one supplier. Also, the issuer should explain the consequences, if any, of losing access to the products and services of a given supplier, either due to the termination of a specified contractual arrangement or discontinuation of business by the supplier.

The existence of a "supplier" strategy is often overlooked. Suppliers may be able to exert a good deal of influence over the issuer's strategic plans, due to the fact that it often becomes difficult for the issuer to "switch" suppliers due to cost factors and the fact that suppliers often tend to do business with, and form their own strategic partnerships with, competitors of the issuer. Also, suppliers often attempt to expand their own existing lines of products and services in a manner that creates potential competition for the issuer, depending upon the relationship of the supplier's products and services to the end product of the issuer's manufacturing process.

A high technology issuer may, early in its development process, enter into a long-term supply contract with one or more parties in an attempt to "lock-in" pricing and component availability parameters during the period of rapid growth and product development. However, the existence of a long-term supply contract can be a "mixed blessing," since it might foreclose the issuer from pursuing other supply and/or manufacturing opportunities that may be more cost-effective. As noted above, management must analyze what would happen in the event that key suppliers are unable to perform. Specifically, how would such an event effect the time required to fill the issuer's own orders, the exposure of the issuer to possible price "squeezes," and any issues of quality and compatibility of goods received from different suppliers.

At the time of the IPO, if not sooner, the issuer must analyze the competitive environment confronting each of its major suppliers, be it industry concentration or technological development, and then attempt to formulate a "resource plan" which identifies various strategies relating to licensing, long-term contracts, acquisition and diversification and, perhaps, suitable components of the "supply process" which might be brought "in-house," thereby tempering any "supplier power" over the issuer. A similar analysis should

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67. Although not strictly necessary as part of the narrative business plan, a listing should be available of names, addresses and volume of purchases.
be undertaken with respect to the use of the services of subcontractors and/or processors of its products or components of subassemblies.

A similar analysis should be done with respect to each of the issuer's key distributors, as well as any third parties which provide significant research, developing or marketing services to the issuer. Not only should the terms of the specific relationship be analyzed with respect to pricing, duration, exclusivity and similar factors, but an effort should also be made to understand how each distributor, researcher or other consultant views its own competitive environment. For example, will the third party enter into similar arrangements with competitors of the issuer which will impede the effectiveness of the existing relationship, or will the third party choose to expend its resources in other areas, thereby diminishing the quality of products and services provided to the issuer? As is the case with suppliers, significant potential problems with distribution may lead to a decision to bring such capabilities "in-house."

Finally, consideration should be given to the practices of competitors regarding forming and maintaining strategic partnerships. For example, have competitors shown that there is significant "value-added" to be achieved by partnering with other firms with respect to research, manufacturing, technology and marketing, or is the "price" perceived to be too great? The element of "risk" in assessing a potential strategic partnership really is measured in many of the same ways that the competitive strengths of the issuer itself are to be analyzed. In particular, a high technology company may be concerned that "technology-sharing" relationships as part of a commercial strategic partnership may undercut the confidential and proprietary nature of its own technology rights.

If commercial partnerships are perceived to be too risky or expensive, "special" partnerships with universities are possible alternatives. A great number of high technology companies utilize the services of university employees and research departments located in close geographical proximity to the issuer. In addition, universities are becoming much more sophisticated regarding the potential commercial value of the research efforts of its employees. Whatever form the strategic alliance might take, attention should be paid to the fact that some potential partners may want to review any disclosures relating to the alliance before its inclusion in the prospectus.68

Customers. The most important strategic relationship which

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68. The terms and conditions of strategic partnerships are often the subject of confidential treatment requests under Rule 406 of Regulation C.
the issuer has is, of course, with its customers. The issuer may have entered into various types of arrangements with its customers, with respect to product requirements and co-development efforts, which are similar to those referred to above in the discussion of strategic partners. The explicit disclosure requirements regarding customers is contained in Item 101(c)(vii) of Regulation S-K. This Item requires a description of the dependence of any segment upon a single customer, or a few customers, when the loss of any one or more of which would have a materially adverse effect on the segment. However, as explained below, the discussion in the prospectus of customers and the relevant marketplace should go beyond that which is required by Item 101(c)(vii) to include an objective segmentation of relevant purchasing behavior in the marketplace and the various needs and requirements of the customers as they make their purchasing decisions.

**Competitors and Industry Participants.** Competitors certainly have a "stake" in the issuer's commercial activities, although the direction of that interest is quite different than that of the other stakeholders referred to herein. Moreover, beyond the various competitors in the issuer's industry, the characteristics of which are discussed in greater detail below, there exists an even broader environment in which the issuer must act and compete. Among the interested parties that must be considered are trade organizations and "lobbying" groups which attempt to articulate the interests of each of the competitive participants, including the issuer, in the marketplace and before regulatory agencies. As noted below in the discussion of the overall planning environment, the issuer's place and image within the broader industry context is relevant to marketing efforts prior to, and during, the IPO.

**Financial Community Representatives.** Financial community representatives include the issuer's commercial lenders, as well as any investment bankers who have managed prior private placement transactions for the issuer. Lending and secured leasing arrangements should be closely reviewed in light of any future fixed obligations that involve restrictions imposed upon the issuer's financial operations. The discussion in the MD&A should include references to these fixed obligations and the use of proceeds section should also include an explanation of how the offering relates to existing sources of bank liquidity and available credit lines.

As to investment banking relationships, the most important part of the IPO is the engagement of an appropriate managing underwriter to conduct the offering. High technology companies often
form relationships with "specialty" investment banking firms to manage private placement transactions. However, those firms may not always have the opportunity to manage the IPO. A review should be made of any understandings or agreements between the issuer and its previous investment bankers to insure that the issuer's ability to use a new investment banker to manage the offering is not impeded by any pre-existing right of first refusal.

Government Regulators. Securities regulators, health, safety and environmental regulators and "industry-specific" regulators, such as the Food and Drug Administration and the Federal Communications Commission, are all important parts of the issuer's operating environment. The only specific regulatory disclosures emanate from Item 101(c)(xii) of Regulation S-K. This Item requires appropriate disclosure of the material effects that compliance with Federal, State and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the issuer. However, high technology companies should also expect to provide a clear and concise summary of the effects of any other regulatory regime to which the delivery of its products and services may be subject, including one or more of the following elements:

1. Identification of those regulatory agencies that have jurisdiction over the proposed products and services of the issuer, the scope of their authority and the review and approval process to which the issuer's products and services may be subject prior to the commencement of sales and distribution activities.

2. A description of the specific criteria imposed by each of the regulatory agencies for review and approval, including any required disclosures, applications, testing and certifications. If useful, an assessment of the duration of each stage in the approval procedure should be specified, based on the issuer's own experience or the public experience of others in the industry.

3. Most importantly, each product and service of the issuer should be "placed" in the appropriate stage of the regulatory approval process in order to provide the reader with an accurate sense of when those products and services will be available in the marketplace and the risks associated with obtaining any future approvals.

4. Finally, any special relationship which the issuer may have
formed with a strategic partner which might facilitate completion of the regulatory process should be mentioned. For example, small companies involved in the life sciences area often develop marketing and distribution relationships with larger companies that include an undertaking by the larger company to move the products through the regulatory process. Such companies typically have a good deal of skill and experience in minimizing the time required for approvals to be obtained.

As part of the larger planning and industrial environment discussion, the issuer should attempt to posit its assessment as to the direction of future regulatory efforts, many of which might be affected by governmental policies regarding research and development and concerns regarding perceived competitive disadvantages created by domestic procedures in relation to comparable procedures in foreign jurisdictions. Also, if the issuer intends to undertake international sales and distribution of its goods and services, reference should be made to foreign regulatory procedures, perhaps with the assistance of local counsel in those areas.

Local Community Representatives. The specific disclosure requirements of Regulation S-K provide little opportunity for a discussion of the issuer's relationship with local governmental agencies, the local Chamber of Commerce, the business press and other elements of the community in its area of operation. However, each of these groups are essential components in the issuer's efforts to effectively conduct its business operations, recruit and motivate qualified employees and obtain concessions with regard to anticipated expansions of its business and properties. Accordingly, an effort should be made to calibrate the issuer's position within the community and any advantages or problems created for the issuer and its operations.

Professional Relationships. The IPO candidate will have developed a number of professional relationships with its legal counsel, its independent public accountants, management and marketing consultants and its public relations firm, to name a few. The existence and scope of these relationships are all important elements of the issuer's overall strategic planning effort and, in many cases, represents a decision on the part of management not to develop specified "in-house" capabilities. An effort should be made to understand the level of professional services provided by each firm or entity described above, including the costs thereof and any "on-site" use of personnel or services from those consultants.
There are a number of purposes to be served by identifying and describing the interests of the issuer’s various stakeholders. The information can provide each of the participants in the drafting and disclosure process with a broad map of the issuer’s significant business relationships that permits the parties to see how any specific business strategy must be implemented and the possible effect that such strategies might have in light of the pre-existing relationships. Also, to some extent, the identification of the stakeholder interests tends to explain the motivations behind the choice of the IPO as a financing vehicle, a topic which is covered in greater detail below.

5. What is the overall financial condition of the issuer?

Due to the importance placed on an issuer’s financial disclosures by the SEC and the investment community, great care must be taken in establishing the tenor and format of the issuer’s numerical and narrative disclosures that will appear in the IPO registration statement. The foregoing is necessary due to the fact that all subsequent filings under the Securities and Exchange Acts will build upon the initial filing. As such, these sections require a great deal of attention from all of the parties to the registration process, particularly from management and the issuer’s independent public accountants who are responsible for preparing the financial statements and opining on the IPO’s financial condition prior to and following the filing of the registration statement.

Assuming that Form S-18 is not utilized for the IPO, the financial reporting requirements of Form S-1, which are determined by reference to the specific items of Form S-1 and the cross-references to Regulation S-K set forth therein, become relevant. The requirements in Form S-1 are as follows:

1. Financial statements meeting the requirements of Regulation S-X, as well as any financial information required by Rule 3-05 and Article 11 of Regulation S-X.\(^{69}\)

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69. The involvement of the accountants is particularly important if the financial information is being subjected to audit for the first time in contemplation of the IPO. If this is the case, the issuer will have the opportunity to select and establish accounting principles which, consistent with GAAP, will permit its income statements to be arranged and presented in the most favorable light for the investment community. The elections to be made, all of which may have a significant impact on the issuer’s “profit and loss” picture, relate to matching of income and expense items, particularly when service commitments have been made, and the treatment of inventories (LIFO vs. FIFO). It is unlikely that changes will be made in accounting principles for an IPO candidate which has previously had its financial statements audited and certified due to the need to disclose the pro forma effects and the fact that certain changes will require restatement of prior period results. APB Opinion No. 20, “Accounting Changes” (July 1971) is relevant to the issues to be considered.

70. See Form S-1, Item 11(e).
2. Information required by Item 301 of Regulation S-K, selected financial data;\textsuperscript{71}

3. Information required by Item 302 of Regulation S-K, supplementary financial information;\textsuperscript{72}

4. Information required by Item 303 of Regulation S-K, the MD&A discussion;\textsuperscript{73}

5. Information required by Item 304 of Regulation S-K, disagreements with accountants on accounting and financial disclosure;\textsuperscript{74} and

6. Financial statement schedules required by Regulation S-X.\textsuperscript{75}

Of the requirements listed above, items (1), (4) and (6) raise the most substantial issues in the context of an IPO. Item 302 of Regulation S-K is, by its terms, not applicable to an issuer that has not previously registered a class of its securities under the Exchange Act. Item 304 of Regulation S-K is only relevant in the event of a dispute between the issuer and its principal accountant during a specified period prior to the filing of the registration statement.

Obviously, a careful review of the issuer's historical financial statements and financial condition should be undertaken and completed. A good number of the material assertions regarding the operation of the issuer's business can be verified through a close review of the financial statement disclosures. Interviews should be conducted with the issuer's independent public accountants and senior financial personnel. In addition to the particular items required by Regulation S-K, attention should be paid to the issuer's profit margins, working capital requirements and sources, cash flow projections and accounting principles and inventory policies. If necessary, a product-by-product financial profile also should be created in order to provide a picture of the cost accounting considerations for a particular product.

In the course of preparing the strategic business plan, as well as in the overall preparation of the financial portion of the prospectus for the IPO, an attempt should be made to assess the managerial competence of the issuer's financial personnel, particularly the issuer's chief financial officer. This not only entails an analysis of the issuer's budgetary and financial procedures, but also will focus upon

\textsuperscript{71.} See Form S-1, Item 11(f).
\textsuperscript{72.} See Form S-1, Item 11(g).
\textsuperscript{73.} See Form S-1, Item 11(h).
\textsuperscript{74.} See Form S-1, Item 11(i).
\textsuperscript{75.} See Form S-1, Items 11(e) and 16(b).
the manner in which the issuer may have designed and pursued financing alternatives other than equity, such as the use of bank financing, asset-based financing and leasing. Investors will scrutinize period-by-period changes in the issuer’s financial position to get a sense of the asset management skills of senior personnel.

As part of the review of the issuer’s financial condition, it is also important to describe and understand the issuer’s internal financial controls with respect to budgets, inventory, accounting and financial management. An issuer needs to be able to understand where its resources and assets are located and be able to analyze their utilization over time. For many potential investors, the presence of an experienced chief financial officer and controller is crucial for considering an investment in a company. Furthermore, the internal control systems should be consistent with the objective measures that are strategically significant in the given industry.

It is also important to interview the issuer’s independent public accountants and to focus on their assessment of the adequacy of the issuer’s internal accounting controls. Counsel should interview the issuer’s accountants with management present in order to get a sense of how the issuer may have responded to any of the accountant’s prior recommendations on these matters. Additionally, if the accountant has performed a periodic review of the issuer’s accounting systems and controls, any correspondence detailing the accountant’s recommendations should be reviewed and discussed with management in order to ascertain their response.

6. What considerations led the issuer and its various control persons to choose the IPO as its financing alternative?

For any issuer, the question of whether or not there are any real financing alternatives to an IPO depends upon its goals and objectives in undertaking any new financing transaction. Economic factors to be considered in connection with any financing include: the amount of funds required and the expected use of proceeds; potential capital providers (i.e., banks, individuals, institutions, public); the “price” of the offering and the relationship thereof to such tangible measures as book or market value; the timing of the offering; the manner of offering and use of an investment banking intermediary; and the risks involved with the offering.

If the issuer is seeking additional financing in order to expand operations or to repay outstanding indebtedness then, depending on the market’s perception of its future prospects, it might enjoy any number of opportunities to raise capital. This can be accomplished
either in the private placement market\textsuperscript{76} or by entering into one or more different types of strategic partnerships in the form of technology funding arrangements, research and development partnerships or licensing and marketing agreements.\textsuperscript{77} Any or all of these alternatives might be particularly attractive when the timing for an IPO is inappropriate, either due to marketing conditions or because the issuer stands at a particularly immature stage of development.

On the other hand, if the issuer's prime objective is to establish a means for its existing shareholders to liquidate their investment, then an IPO is probably the best vehicle to achieve that result. Other options often considered are finding an acquisition candidate or perhaps absorbing the burden of commercial debt financing to repurchase the shares of those holders wishing to "exit." Moreover, in addition to liquidity, there are a number of other significant advantages associated with an IPO that might motivate an issuer and its control persons to select it as a financing vehicle. Among the attractive characteristics are the following:

\textit{Prestige.} Any form of financing would provide the issuer with additional funds that can be utilized for the purposes stated above. However, creating a public market for the issuer's securities has certain special advantages in that it tends to provide the issuer with a new competitive advantage derived from the greater visibility, credibility, respect and prestige within the issuer's industry and community. This includes its relationships with its suppliers, employees, customers, lenders, competitors, and other components of the financial and business environment. Moreover, founding shareholders may derive intangible benefits from "taking the company public."\textsuperscript{77}

\textsuperscript{76} The market for private placements consists not only of equity securities but also can permit an issuer to secure adequate amounts of debt financing, depending upon the credit quality of the issuer. While the private placement market may be attractive, some issuers may be forced to accept significant future dilution, in the form of warrants, options or downward adjustment in the conversion price of previously issued securities, in order to complete a private placement financing when product development has not proceeded in accordance with the original expectations of management and key investors.

\textsuperscript{77} Care must be taken in these transactions to insure that the company does not give up the rights to significant future revenues that might be derived from further development and exploitation of specified technologies or products.

\textsuperscript{78} By no means is it necessary to be a public company in order to be a large and significant factor within a given industry. It has been estimated that private companies with more than 100 employees account for about 20\% of the United States economy, although the same source concedes that all public companies account for almost twice that amount. \textit{INC.} magazine, which publishes an annual list of America's 500 fastest-growing private companies, reported that only 17 of the 500 companies so ranked in 1985 took advantage of positive market conditions to "go public" in 1986 and that there existed a real reluctance on the part of many chief executives of profitable privately held companies to undertake an IPO, citing some or all of the disadvantages described in the text.
Increased Operational Flexibility. An issuer whose stock is traded publicly will be able to pursue more attractive merger or acquisition partners. The ability of the issuer to offer both cash and marketable securities in the context of future acquisitions may enable the issuer to vigorously pursue additional lines of business. In many cases, common stock is the best financial instrument to complete such acquisitions and its use may allow the issuer to utilize the more favorable "pooling of interests" accounting treatment. Furthermore, stock for stock exchanges can delay the recognition of capital gains for the selling shareholders, often an important consideration in the acquisition of a high growth company.

Future Financing Opportunities. Although not always true, IPOs tend to establish a higher valuation for the issuer upon completion of the offering due to the liquidity available to the shareholders. The issuance of equity securities, to the extent it improves the issuer's existing debt to equity ratio and establishes a market value for the going concern of the enterprise, can enhance the issuer's ability to pursue and obtain one or more of the alternative forms of financing, perhaps on terms that permit the issuer to obtain a greater deal of control over the operations of the business than would have otherwise been the case had an IPO not occurred.

Liquidity for Current Shareholders. An IPO creates a post-offering trading market for existing securities, thereby providing a source of liquidity to current shareholders of the issuer. Not only might existing shareholders participate in the offering through the means of a secondary offering of their own securities, but the issuer is also then able to permit its shareholders to avail themselves of Rule 144 for the purpose of subsequent resales into the newly created public market. Although rarely an important consideration

79. Particularly with respect to venture capital-backed companies, a good deal of pressure is brought to bear after a specified period of time by the venture capitalists to establish some means of "exiting" the investment in order to demonstrate profitability to their own institutional investors. Typically, depending upon the stage at which the investment is made, venture capitalists will have the ability to "demand" a registration of the issuer's securities beginning on a date which is two to three years after their original investment. Also, the failure of the company to attain levels of profitability such that an IPO can be successfully undertaken may trigger special rights for the investors with respect to control of the Board of Directors, payment of dividends and even required redemption of their equity interest in the issuer. While registration rights are heavily negotiated, it is extremely unlikely that investors will "force" an IPO which is not supported by the management group and which is not otherwise sustainable in light of market conditions.

80. Rule 144 is available immediately for non-affiliates of the issuer who satisfy the three-year holding period of Rule 144(k), and is available 90 days after the IPO for all other persons who satisfy the two-year holding period and observe the volume limitations. In addition, shares of "restricted stock" issued and sold prior to the IPO pursuant to certain em-
in the case of high technology IPOs, the creation of a public market may permit a better valuation of securities for estate tax purposes as well as for certain other contractual arrangements turning upon a precise valuation of the issuer's securities.

Attraction of Key Employees. As noted above, a public market for the issuer's securities, although substantially increasing the purchase price of the securities, usually provides an attractive means for recruiting and retaining key employees. The issuer is able to establish and maintain stock option and stock purchase plans which enable such employees to purchase securities at a discount from the public market price, or to receive options at a fixed price that are exercisable in the future when the underlying stock has increased in value, thereby providing an attractive recruiting tool for the issuer. The attractiveness is enhanced by the employee's ability to readily liquidate his investment in the securities, an advantage not readily offered by private company share ownership where value can only be realized through share redemptions of acquisition of the firm, which often carries with it the prospect of loss of control and security.

2. Products and Services of the Issuer

In drafting the prospectus, the issuer must be able not only to describe each of its basic products and services, but also must be able to identify the key strengths and advantages that the issuer pos-

employee benefit plans can be registered for resale to the public by use of a "reoffer" prospectus on Form S-3 which is included as part of a Form S-8 registration statement relating to the same plan (see General Instruction C to Form S-8). The advantage of this procedure is that a Form S-8, with its Form S-3 reoffer prospectus, can be filed 90 days following the completion of the IPO and will become effective immediately upon filing. In addition, the SEC's Rule 701 allows issuers to issue securities to employees in certain circumstances which would be eligible for resale 90 days following the IPO, without regard to the period of time such shares may have been held by the employee. The decision as to whether or not to permit a secondary offering of securities as part of the IPO is largely determined by the managing underwriter based on its perceptions of the market for the securities at the time of the offering. Excessive secondary sales by "insiders," either in the IPO or in the period immediately following, can be negatively perceived by the marketplace and may hamper the ability of the issuer to sell the entire offering at the price desired or the underwriter's capacity to stabilize trading activity after the IPO. Accordingly, underwriters usually require a "lockup" of existing shareholders' stock for a specified period of time following an IPO (typically from 90 to 270 days) in order to regulate aftermarket trading in the securities and significant restrictions on resales may also be imposed by state securities authorities.

81 Stock purchases and option grants to employees may come under extensive scrutiny under guidelines promulgated by various Blue Sky administrators. As described below, many issuers are called upon to explain the reason for what the administrator believes are "excessive" amounts of options and the issuer may be required to curtail future option grants for a specified period of time as a condition to qualification of the IPO in that jurisdiction.
sesses that will make the production and marketing of those products and services a profitable venture for the issuer's various managers, employees and shareholders. In addressing these items, care should be taken to cross-reference the perceived customer needs within the targeted markets as well as the competitive factors that operate within those markets and in related industries which might provide substitutes or alternatives for the issuer's products and services. Also, a candid expression of some of the weaknesses of the issuer's product and service portfolio is very important and appropriate, particularly in the context of understanding competitive offerings and, if necessary, in drafting appropriate "risk factors."

\[a. \textit{Describe each of the issuer's major products and services and identify any specific potential strategic advantages associated with such products and services.}\]

Item 101(c)(i) of Regulation S-K requires a description of the principal products produced and services rendered by the issuer in each industry segment and the principal markets for, and methods of distribution of, the segment's principal products and services. In addition, the issuer must state for each of the last three fiscal years the amount or percentage of total revenue contributed by any class of similar products or services that accounted for 10 percent or more of consolidated revenue in any of the last three fiscal years or 15 percent or more of consolidated revenue, if total revenue did not exceed $50,000,000 during any of such fiscal years.

The issuer should also provide a description of the status of any new product or industry segment (e.g., whether in the planning stage, whether prototypes exist, the degree to which product design has progressed or whether further engineering is necessary), if there has been a public announcement of, or if the issuer otherwise has made public information about, a new product or industry segment that would require the investment of a material amount of the assets of the issuer or that otherwise is material. However, this requirement, as set forth in Item 101(c)(ii) of Regulation S-K, is not intended to require disclosure of otherwise nonpublic corporate information, the disclosure of which would affect adversely the issuer's competitive position.

Once the issuer's products and services have been described, it is then important to identify any innovative features, potential applications or technological characteristics which might serve as a
basis for a particular strategic advantage. This means going beyond the narrative description of products and services which typically appears in the prospectus to examining, with respect to each major existing product and proposed product, the revenue and cost structure associated with the product, the actual and potential markets for the product, the distribution channels utilized for the product, and the assets and resources of the issuer which are, and will be, needed to support the product in the future, taking into account any proposed expansion of the product offering.

Still another perspective to the issuer's product portfolio would be to examine each of the products and services in light of their particular stage in the "product lifecycle" and any demographic trends that may provide an insight into the need to make further modifications in the characteristics of the product or the marketing efforts associated with the product or service. While many high technology companies have only a handful of basic products and services, other companies may have developed successive generations of products, each of which utilize increasingly more advanced technology and are suited for differential potential markets based on pricing and usage considerations.

b. Identify the institutional practices and internal and external arrangements that have been developed by the issuer with respect to the development, manufacture and distribution of its products and services.

There are a number of key questions that should be answered in order to understand how the issuer brings its ideas for products and services to the marketplace. For example: Were the issuer's existing products and services internally developed or acquired from third parties? Does the issuer have its own manufacturing capabilities or is it dependent upon third parties for key elements of its production process? As to distribution, does the issuer have its own sales force or is distribution primarily done through a network of sales and marketing agreements in domestic and international markets? Finally, does the issuer plan to make any material changes in the aforementioned practices in the future and, if so, how are such modifications to be funded?

The considerations regarding strategic partnering, particularly with respect to suppliers and distributors, have already been noted. Absent extraordinary access to significant amounts of financing prior to the IPO, most high technology issuers will need to make a
number of decisions regarding the allocation of relatively scarce resources to various elements of the so-called "value chain," those functional activities that lead from product conception to sale. Accordingly, the issuer must decide how it might effectively structure its capabilities with respect to research and development sales and distribution, customer service and field engineering.

For example, distribution typically presents a number of strategic dilemmas for the high technology issuer. In many cases, the cost of developing an internal marketing force which is capable of effective sales activities throughout the United States and overseas can be prohibitive. In those instances, the issuer looks to the formation of any number of OEM or distributor agreements to facilitate the introduction and sale of its products. If third party relationships have been formed, the issuer must attempt to identify whether or not the distributor has a legitimate and serious interest in the issuer's success and its products, the degree of dependence upon the services of the distributor and the long-term effect of these relationships on the issuer's overall development.

3. Managerial and Human Resource Strategies

Managerial and human resources are an important potential strategic advantage for an IPO candidate and the information included in the prospectus on that subject will be closely scrutinized by the investment community. As noted above, required disclosures are limited to information regarding the number of persons employed by the issuer and a description of various compensation and employee benefit programs. Therefore, the quality of the issuer's human resources is typically reflected in the "products" of their talents, such as a unique technology rights position or exceptional management experience.

a. Describe the experience and "motivational" factors with respect to members of the management team and key employees of the issuer.

The quality of the issuer's managerial and human resources is a function of the experience that such persons bring to the development of the issuer's business and strategic planning. However, another important factor in assessing the issuer's human resources is the manner in which such persons are motivated to use their best efforts to meet the overall business and financial objectives of the
issuer. The foregoing not only refers to the level of compensation received by management and employees, but also reflects the degree to which employees are able to participate in the key decision-making processes relating to the issuer.

While some believe that "good management" is the most important "people" issue with respect to a potential IPO candidate, others believe that long-term success is only insured if the issuer has a strong pool of human resources as well as a set of programs designed to continuously and positively motivate the employees to remain with the business. To that end, the business plan should describe the following elements:

1. Any internal organizational structures for communication between and amongst managers and employees regarding the anticipation of environmental changes and formulating strategic responses to changes in the competitive environment. Also, what is the process by which appropriate objectives are established for the issuer and what supporting measures have been established in order to monitor performance and award incentives amongst employees?

2. What programs and procedures have been developed to enhance and protect the issuer's human and technical skills, including programs to encourage future development and learning?

3. Any existing or projected compensation and or stock plans, including the basis for inclusion of management and employee personnel therein.83

Notice that "communication" and "participation" are emphasized prior to any compensation or equity ownership plans. The ability of employees to participate with management in setting the long-term strategic objectives of the issuer has been found to provide a sense of overall satisfaction that often exceeds that attainable through mere cash incentives. The ability of a person to "control" his own environment and to think and act independently and creatively within the confines of any overall competitive plan can, in

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82. Item 402 of Regulation S-K requires a good deal of detailed information regarding executive compensation. Item 402(a) covers cash compensation, bonuses and deferred compensation for (i) each of the registrant's five most highly compensated executive officers whose cash compensation required to be disclosed exceeds $60,000 and (ii) all executive officers as a group. Item 402(b) requires a description of all plans pursuant to which cash or non-cash compensation was paid or distributed to the executive group referred to above.

83. All stock option plans, bonus and profit-sharing plans, pension plans and other employee fringe benefits should be included in the description. Once again, the degree and manner of disclosure regarding these matters is closely regulated by the SEC's guidelines.
and of itself, be a significant strategic advantage. Hopefully, the issuer can develop internal measurements of "creativity," be it in the form of new product development ideas or the like, to support this type of overall environment.

b. Describe the issuer’s organizational structure with respect to recruitment, promotion and employee relations.

A high technology company involved in a growing and rapidly changing industry must give a great deal of attention to its institutional ability to recruit, assess and reward a strong team of dedicated and talented managers and employees. Particularly in those cases where an issuer is involved in an industry that is experiencing tremendous competitive pressures due to the perceived availability of market opportunities, employees with specialized talents and skills will be likely targets for the recruitment efforts of other firms which might offer higher salaries and greater relative equity compensation packages.

An effort should be made to analyze the growth and effectiveness of the issuer’s human resources function. In many cases, an IPO candidate will not have had the opportunity to develop a sophisticated human relations or personnel department. Also, the size of the entire workforce may not justify the expenditure of great amounts of time or effort on the subject. Moreover, in those cases where the issuer is not manufacturing or producing most of its own products, it is likely that the size of the workforce will be small enough so that each employee already has some equity participation in the issuer’s overall business successes.

However, given the ambitious expectations of the investment community regarding future growth of the IPO candidate, it will be necessary to examine several significant questions regarding historical and projected human resource development, including some of the following:

1. Has the issuer experienced any difficulties in obtaining qualified personnel, due to location or otherwise, and has the issuer suffered any material problems with respect to personnel turnover? If a problem does exist, has the issuer developed any plans to improve the personnel situation in the future?

2. Does the issuer prefer to hire and train its own people, or has the issuer engaged in acquisitions of other companies, assets or personnel to expand and develop its business?

3. Does the human resource profile of the issuer reflect experi-
1. Has the issuer engaged in significant divestitures of parts of its business, or has the issuer significantly modified its business plans regarding product development? If so, what effect have these changes had upon morale amongst the issuer's personnel?

2. Has the issuer experienced a management change, and if so, how does that experience impact the overall culture of the issuer?

3. What are the personnel practices of the issuer's competitors and how are they perceived amongst the industry and the issuer's own employees? Also, has an effort been made to understand the needs and motivations of the issuer's employees?

4. Technology Rights of the Issuer

Item 101(c)(iv) of Regulation S-K requires a description of the importance of trademarks, patents and franchises to segments of the issuer's business. It is important to get a sense of the importance of the issuer's technology rights by contacting outside experts, such as current or potential distributors or customers. By doing so, counsel will get a fuller appreciation of the significance of the issuer's technology rights, and will also get an idea of whether or not the issuer's technology rights are state of the art or are likely to be made obsolete by the activities of potential competitors.

The importance of technology to a business enterprise may vary depending upon its purpose, mode of operations and the environment and markets in which it competes. For example, the growth and development of a high technology firm clearly depends upon its ability to build and maintain a strong portfolio of technology "assets" in the form of patents, trade secrets, trademarks and copyrights. On the other hand, the strength of other firms may lie not in technology or research, but in its skills in production, marketing and distribution. Even in those cases, technical assets such as production "know how," trade secrets (e.g., customer lists and informational databases) and trademarks may play an important role in the success of the firm. In examining the technology position of the IPO candidate, counsel must carefully understand the

84. A detailed description of the various statutory and nonstatutory technology rights referred to in the text is beyond the scope of this article. In addition to taking advantage of the specialized skills of experts in each of these areas, counsel may also wish to consult one or more of the treatises that have been written in each of the substantive areas, including Nimmer, Nimmer On Copyright (1984); Chisum, Patents (1984); McCarthy, Trademarks and Unfair Competition (2d ed. 1984); Gilson, Trademark Protection and Practice (1984); and Milgrim, Milgrim On Trade Secrets (1984).
role that the technology rights play in the competitive environment of the issuer.

It is important to make a complete assessment of the issuer's existing technology rights: how they were obtained; how the technology and information is being protected and, to the extent regulatory filings have not been made, on what basis statutory protection is not being pursued; how and to what extent the technology and productive use of the information depends upon the skills of key employees or licenses obtained from third parties; what technology is being utilized by current and prospective competitors; how new and supplemental technology will be obtained and developed; and what, if any, future agreements might result in a technology transfer, by license or otherwise, to third parties. From this, the answers to three key questions should be obtained:

a. Will the issuer be free to use its technology rights for the commercial development of products and services that can be sold and distributed in its target markets?

Sometimes referred to as "infringement analysis," the inquiry at this point assumes that the technology rights will not be improved or further developed and asks whether or not they will, in their present state, infringe upon the rights of third parties or be subject to claims of ownership from any former employer due to an alleged theft of trade secrets by an employee of the company. Counsel must analyze the manner in which each material piece of technology and confidential information was developed or acquired by the issuer in order to anticipate any future problems. Also, the issuer should identify any actual or known potential competitors who may have perfected rights which might create an infringement issue.

If the patent position of a competitor appears to cover the issuer's technology or other confidential information, it may be precluded from using the technology until the term of the underlying patent expires. A similar situation may occur if concerns exist regarding a key employee's activities with a former employer. In those situations, thought should be given to entering into a license

85. The prospect of litigation with a former employer of one of the company's key employees can, and should, cause great concerns on the eve of any financing including an IPO. Counsel should clearly understand the procedures followed by the company during the course of any employee's "move" from the old to the new employer. In this regard, reference should be made to the discussion in Bunker, "A Trade Secrets Checklist for Hiring Employees From Competitors," 1 CEB CALIFORNIA BUSINESS LAW PRACTITIONER 18 (Spring 1986).
or other appropriate agreement with the other party, even if the subject technology is not currently being used or exploited by such party. Also, if a portion of the technology has been acquired under the terms of any license or similar agreement with third parties, a review should be made of any provisions which might restrict the use or transfer of the technology, as well as any provisions dealing with the ownership of rights to any improvements, enhancements or modifications.

b. Assuming that the issuer will be free to use the technology rights without fear of adverse claims by third parties, do the technology rights, in their current form, provide the issuer with a satisfactory level of protection from competition by third parties?

Answering this question involves an analysis of the quality of the technology rights as well as the strength of the procedures which have been implemented to insure that the technology and confidential information has been adequately protected by appropriate statutory filings and internal practices calculated to maintain the integrity and confidential nature of any trade secrets. Obviously, even well protected and documented technology may be of little value if it does not provide the owner with a unique competitive advantage. Correspondingly, the most creative research and development plans may fail to bring the desired return to the owner if the technology and resultant products are not eligible for, or do not receive, adequate protection.

The quality of a given technology package will depend upon its composition. For example, the commercial value of a patent will depend upon the breadth of its claims and the relation of those claims to the key technical components of the subject product. Therefore, a fairly narrow or weak patent may have a high commercial value because of the particular feature that it covers, its utility in supporting a defense against a third-party patent infringement claim or otherwise blocking a competitor's attempt to obtain a patent on its own technology, or because it forces a competitor to make costly design changes, which reduce the competitiveness of the product, in order to avoid a claim of infringement.

If the technology rights consist mainly of trade secrets, which may be the case because the owner does not wish to disclose sensi-
tive information in a patent application, the analysis must take into account the fact that actions with respect to trade secrets generally lie only in the case of theft or misappropriation. Thus, a real risk exists that competition may arise from third parties who independently develop similar products or acquire the information through lawful means. In such cases, great care should be given to evaluating the internal procedures which have been implemented to protect the trade secret information. Also, some analysis should be done as to whether some limited form of patent protection might actually be useful for prolonging the life of the competitive advantage and otherwise dissuading the independent development efforts of competitors.

86. Patent protection may not be pursued in instances where the technology is moving so fast that the patent claims will become outdated before the patent issues. Also, trade secret protection may be preferred if the patent that would be issued is so "weak" that others would simply "invent around" the claims contained therein.

87. As noted in the text, "independent development" operates as a defense to a claim of trade secret misappropriation. It has been suggested that trade secret protection can be circumvented by product development efforts that are done in a manner that does not infringe upon the rights of others yet takes advantage of careful analysis of innovative techniques embodied in existing products. See Davidson, "Reverse Engineering and the Development of Compatible and Competitive Products Under United States Law," 5 SANTA CLARA COMPUTER AND HIGH TECH. L. J. 399 (1989), which provides a useful introduction to some of the things that must be borne in mind with respect to "reverse engineering" activities. But see Lake, Harwood and Olson, "Tampering with Fundamentals: A Critique Of Proposed Changes in EC Software Protection," 6 THE COMPUTER LAW. 12:1 (Dec. 1989), where the authors argue vigorously against any modifications to European Community copyright protection which would have the effect of facilitating reverse engineering activities. The article also contains a number of annotations on the subject.

88. See Slaby, Chapman and O'Hara, Trade Secret Protection: An Analysis of the Concept "Efforts Reasonable Under the Circumstances to Maintain Secrecy," 5 SANTA CLARA COMPUTER AND HIGH TECH. L. J. 321 (1989), which contains a summary of case law and commentaries on the subject of trade secret protection. A trade secret protection program directed at maintaining the confidentiality of specified information should include a practice of identifying the trade secret and specifically marking it as "confidential" or "proprietary"; restricting access to the information on a "need-to-know" basis and maintaining documentation with regard to such procedures; specific instructions to employees as to the restrictions on disclosure of the information; consistent use of detailed confidentiality agreements with employees, vendors, purchasers or licensees; and the use of security measures calculated not only to maintain the confidentiality of the information, but also to put outsiders on notice that the information is to be treated as a confidential trade secret of the company.

89. In many cases, patent protection may not be available for trade secrets because of prior art or the failure to make a timely filing of the patent application. When it is anticipated that patent protection will be sought for a particular invention, the inventor should take certain steps to document the development process. Also, once an invention has been conceived, it may make sense to conduct a patentability search with the assistance of patent counsel in order to assess whether or not the invention will satisfy the "novelty" requirements necessary to obtain patent protection. See Calvey, "Proprietary Protection of Product or Service," in Start-Up Companies: Planning, Financing and Operating the Successful Business (Law Journal Seminars-Press 1985, revised 1988).
The strength of the issuer's technology rights really depends upon whether or not the various components thereof have been properly maintained. An investigation should be done to insure that patents remain valid. Also, patent, trademark and copyright registrations should be maintained and, if necessary, renewed. Contractual restrictions and covenants in third party technology agreements, such as licenses, should be reviewed to insure that no defaults exist and any prior "transfer" or assignment documents from third parties should be reviewed to insure that they effectively conveyed title to the relevant technology or confidential information to the issuer. Also, if possible, an independent search should be conducted to ascertain whether any liens or mortgages have been imposed on the technology.

c. What steps can be taken to enhance the issuer's technology rights portfolio by improvement or development of its technology or by strengthening the degree of protection for the existing technology?

Based on the aforementioned business and legal analysis, the issuer should have reached an understanding regarding the state of development of its technology rights, the likelihood that a patent will issue with respect to an important piece of technology, the feasibility of the technology, the availability of any competing products that may undermine the value and utility of the technology as it presently exists and the likelihood that significant trade secret information will be lawfully disseminated into the public domain. At some point, it may be determined that the ultimate long-term viability of the issuer really depends upon certain improvements being made to the technology itself or the protection program that surrounds it.

The desire of the investment community to invest in an IPO candidate when the proceeds will be utilized primarily for the development and improvement of its technology rights, rather than for the current production and sale of products and services, really de-

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90. For example, a license agreement may contain options, reversions, durational limitations, territorial limitations and other restrictions on the rights granted to the company.

91. Item 101(c)(x) of Regulation S-K requires disclosure of the amount, if material, spent during each of the last three fiscal years on issuer sponsored research and development activities, and, if applicable, similar information for the same periods relating to customer sponsored research activities. A research and development plan should be developed, including dollar amounts and the amount of human and facilities resources to be devoted to the projects.
PENDS ON AN ASSESSMENT OF THE AMOUNT AND TYPE OF WORK THAT REMAINS TO BE DONE TO BRING THE TECHNOLOGY TO THE DESIRED LEVEL AND, MOST IMPORTANTLY, A BELIEF THAT THE COMPLETED WORK WILL CREATE A TECHNICAL POSITION THAT JUSTIFIES THE RISK OF AN INVESTMENT IN THE ISSUER AND WHICH CAN REASONABLY BE EXPECTED TO BRING AN APPROPRIATE RETURN ON THE INVESTED CAPITAL OVER TIME.

IF, AS A RESULT OF THE DUE DILIGENCE INVESTIGATION, A CONCLUSION IS REACHED THAT THE ISSUER HAS NOT TAKEN APPROPRIATE STEPS TO EFFECTIVELY PROTECT ITS TECHNOLOGY RIGHTS, YET THOSE RIGHTS DO NOT APPEAR TO INFRINGE UPON THE KNOWN RIGHTS OF OTHERS, IT MAY BE APPROPRIATE TO DESIGN A PROGRAM TO STRENGTHEN THE TECHNOLOGY RIGHTS POSITION. FOR EXAMPLE, A NUMBER OF PATENT APPLICATIONS CAN BE PREPARED AND FILED IN MULTIPLE JURISDICTIONS IN A MATTER OF MONTHS, WITH THE RESULT BEING THAT THE VALUE OF THE RIGHTS THEMSELVES WOULD BE SIGNIFICANTLY HIGHER. THIS STRATEGY MAY BE PARTICULARLY VALUABLE WHEN THE ISSUER'S BUSINESS PLAN CONTEMPLATES OPERATIONS, THROUGH LICENSING OR OTHERWISE, IN FOREIGN JURISDICTIONS.92 THE CONTENT AND DEVELOPMENT OF THE ISSUER'S TECHNOLOGY RIGHTS ALSO MUST TAKE INTO ACCOUNT A NUMBER OF ADDITIONAL ENVIRONMENTAL FACTORS. FOR EXAMPLE, AS NOTED ABOVE, DUE REGARD SHOULD BE GIVEN TO THE IMPACT OF GOVERNMENTAL REGULATION IN THE AREA (I.E., HEALTH AND ENVIRONMENTAL CONSIDERATIONS, AS WELL AS THE EFFECT OF ANTITRUST LAWS UPON JOINT RESEARCH AND DEVELOPMENT RELATIONSHIPS). ALSO, PRODUCTS WHICH DEPEND UPON THE PERFORMANCE OF NEW AND RELATIVELY UNTESTED TECHNOLOGY, OR WHICH ADDRESS PROBLEMS WHICH ARISE IN RELATIVELY "HIGH RISK" AREAS (E.G., HEALTH CARE), RAISE QUESTIONS AS TO THE NEED FOR PRODUCT LIABILITY INSURANCE AND ITS AVAILABILITY. IF INSURANCE IS INADEQUATE, UNAVAILABLE OR UNUSUALLY EXPENSIVE, APPROPRIATE DISCLOSURES SHOULD BE MADE IN THE PROSPECTUS.

AS NOTED BELOW, THE ISSUER'S TECHNOLOGICAL POSITION IS A KEY ELEMENT OF THE VALUE CHAIN AND MAY, IN SOME INSTANCES, FORM ONE OF THE ISSUER'S STRATEGIC ADVANTAGES. INTERESTINGLY, IN THE CASE OF SOME HIGH TECHNOLOGY COMPANIES, MANAGERS TEND TO DISMISS THE SUSTAINABILITY OF LONG-TERM TECHNICAL ADVANTAGES, ANTICIPATING THE ABILITY OF COMPETITORS TO RAPIDLY DEVELOP NEW OR COMPARABLE TECHNOLOGIES. AC-

92. A NUMBER OF ALTERNATIVE FORMS EXIST FOR A "PRESENCE" IN A FOREIGN MARKET, INCLUDING SALES THROUGH DOMESTIC AGENTS OR DISTRIBUTORS, AN INTERNAL PROGRAM OF EXPORT TO THE FOREIGN MARKET, LOCAL AGENTS IN THE FOREIGN MARKET OR A "REGISTERED" PRESENCE, SUCH AS A BRANCH OFFICE, JOINT VENTURE COMPANY OR WHOLLY-OWNED SUBSIDIARY. THE FORM IN WHICH THE COMPANY Chooses TO DO BUSINESS IN THE FOREIGN JURISDICTION DEPENDS UPON PERCEPTIONS OF SUCH THINGS AS POLITICAL RISK, LOCAL CONTROL POLICIES, DISCRIMINATORY PRACTICES AIMED AT FOREIGN BUSINESS ENTITIES, CURRENCY CONSIDERATIONS, EXPORT-IMPORT RESTRICTIONS, THE AVAILABILITY OF SKILLED LABOR AND THE COMPETITIVE ENVIRONMENT WITHIN THE MARKET. COUNSEL'S JOB IS TO UNDERSTAND THE POTENTIAL RESTRICTIONS IMPOSED ON THE DESIRED FOREIGN PRESENCE PARTICULARLY, IN THE CONTEXT OF THIS SECTION, ANY IMPEDIMENTS TO THE DESIRED DEVELOPMENT AND PROTECTION OF TECHNOLOGY RIGHTS.
accordingly, if the issuer's key strategic strength at the time of the IPO is its technology rights position, an explanation should be provided of any plans to develop complementary skills, such as production and marketing capabilities, that can sustain growth and expansion after the initial technical advantage has been reduced by the lawful actions of competitors.

5. Physical Assets of the Issuer

The description of an issuer's physical assets in the IPO prospectus is usually limited to a brief elaboration on the site and size of its business and manufacturing facilities. However, an assessment of the physical assets of an issuer should not be limited to a description of its facilities. Instead, an examination should be made of the effect that the location and capabilities of the issuer's facilities will have on its becomes quite important, not only for cost-effectiveness, but also in relation to the issuer's ability to recruit and retain appropriate human resources and to move its products and services quickly into the appropriate distribution channels and manufacture and package its products and services on a cost-effective basis.

   a. Provide a physical description of all offices, plants, laboratories, warehouses, stores, outlets, studios, or other facilities of the issuer, including the size of the plots, square footage of enclosed space and other relevant physical characteristics.93

The information should include a list of all real estate owned by the issuer, including, without limitation, the following: (a) the improvements on the property, (b) the assessed valuation and amount of current real estate taxes, (c) any mortgages, including amount, rate of interest and due date, (d) any liens or encumbrances, and (e) the estimated present value of the property. Also, a description of all real estate leased by the issuer should be listed along with a description of (a) the amount of space, (b) the rent

93. Item 102 of Regulation S-K requires that the registrant "[s]tate briefly the location and general character of the principal plants, mines and other materially important physical properties of the registrant and its subsidiaries. In addition, identify the industry segment(s) that use the properties described. If any such property is not held in fee or is held subject to any major encumbrance, so state and describe briefly how held." The instructions to Item 102 state that what is required is such information as reasonably will inform investors as to the suitability, adequacy, productive capacity and extent of utilization of the facilities by the registrant. Detailed descriptions of the physical characteristics of individual properties or legal descriptions by metes and bounds are not required.
(fixed and contingent), (c) the term of the lease, (d) the renewal options, if any, (e) the purchase options, if any, (f) the minimum amount of annual gross rentals, and (g) the minimum total gross rental obligation to expiration of all leases in force. Due diligence in this regard would include an inspection and review of the properties of the issuer, including an examination of title, title insurance policies, mortgages, tax and judgment liens and financing statements.

b. Does the issuer intend to enlarge its present areas of distribution or service and, if so, what effect will such expansion have on the adequacy of existing physical resources?

A review should be made of the issuer's control over its production facilities and distribution systems. Particular attention should be paid to the ability of the issuer to inject new and innovative production technologies and ideas into its production and distribution systems in order to facilitate the cost-effective development and production of new products. In a sense, an issuer can compete on the basis of its ability to adapt assembly line facilities and expand its distribution structures over time. However, an issuer's ability to make such changes and adaptations really depends upon its rights under existing agreements relating to its facilities, its ability to expand its facilities and the amount of financial resources which are available for such purposes.

c. Are raw materials important to the issuer and its industry? If so, what sources are available to the issuer and to its competitors and what restrictions might arise with respect to such resources?

Item 101 of Regulation S-K requires that the issuer make certain disclosures regarding the sources and availability of raw materials. As noted above, supplier relationships are a key strategic partnering issue for any IPO candidate and any analysis should take into account not only the requirements of the issuer, but those of other industry participants. Obviously, any physical or volume limitations will be highly relevant. The existence of any governmental regulations or overall policy considerations that effect supply relationships, perhaps with regard to export or trade objectives, should also be factored into the analysis.
6. “Value-Chain” Analysis

Once the overall analysis of the issuer’s products and services, managerial and human resources, technology rights, and physical assets has been completed, an attempt should be made to isolate those specific strategic advantages which the issuer might possess that are relevant to competing in its chosen markets. “Value-chain analysis” recognizes the process by which a firm develops, produces and distributes its products and services and consists of a series of questions designed to highlight the issuer’s specific strategic advantages. In essence, the exercise is designed to establish the basis upon which the issuer will compete in the future and, to some extent, to identify those areas in which the issuer’s skills fail to match the expertise of competitors. In any event, the following questions should be considered, both for the issuer and each of its competitors:

1. Is the issuer able to compete on the basis of its strengths in procurement, processing or manufacturing?
2. Is the issuer able to compete on the basis of its practices with respect to inventories, packaging or production flexibility?
3. Is the issuer able to compete on the basis of its strengths with respect to sales, distribution, customer service, delivery, promotion, maintenance or field engineering?
4. Is the issuer able to compete on the basis of the characteristics and capabilities of its products and services?
5. Is the issuer able to compete on the basis of its operational flexibility to accept its products to meet the needs of different customer “niches”?
6. Is the issuer able to compete on the basis of its human resources strategies?
7. Is the issuer able to compete on the basis of its strengths in the area of research and development?
8. Is the issuer able to compete on the basis of a unique technological advantage, which is either embodied in its product line or is utilized in the course of its manufacturing?
9. Is the issuer able to compete on the basis of its financial assets or strategic business relationships?
10. Is the issuer able to compete on the basis of its managerial skills, internal controls or innovative business goals and philosophies?

Once the key components of the relevant value chain for the issuer’s products and services are identified, and the issuer gains
some sense of the industry’s key success factors, the issuer can choose the basis upon which it wishes to compete and can also understand the manner in which the competition will seek to enter the marketplace. For example, a product that is technically “inferior” may flourish in the marketplace due to the exceptional distribution capabilities of the manufacturer. In other cases, pricing advantages may be available by virtue of the manufacturer's ability to use low-cost production facilities in an offshore location. The key is to identify the crucial point in the value chain where a strategic advantage is available, make that advantage an essential element of the issuer’s strategic mission, and emphasize that advantage in the disclosure documents relating to the IPO.

C. The Customers

Once the prospective strategic advantages of the issuer are identified, the relevant marketplace for the issuer’s products and services must be analyzed and an effort should be made to understand customer needs and the function that the issuer’s products and services might play in satisfying those needs in a manner that differentiates the issuer from its competitors. Once determined, the issuer must select a market entry strategy that complements the strategic advantages identified in the analysis of the issuer, addresses the known success factors within the industry, and that is capable of being supported by coherent pricing, distribution and promotion strategies.

1. Describe the issuer’s potential markets and industry segments, including a market analysis and forecast, a summary of industry trends and the place of the issuer’s products within the industry and market frameworks.

This general introduction may, to some extent, reflect the issuer’s “hopes” as opposed to its realistic expectations based on current capabilities. However, an accurate market analysis will be useful and will help focus the search for the important strategic factors within the marketplace, at least in the eyes of the customers. Specifically, each target market should be segmented by size and volume, the products and services used, the sophistication of the customers, the amount of innovation required to meet the needs of the customers, the amount of customizing required in order to penetrate a specified market and the importance of producing a “standardized” product.
2. Provide a three-year history of the names, addresses and volume of purchases of major customers or outlets for the issuer's products and services.

After describing the issuer's market objectives, it is important to understand the historical and existing market for the issuer's specific products and services. Item 101(c) of Regulation S-K requires that if the sales to one customer are in the aggregate equal to ten percent or more of consolidated revenues, the name of the customer must be disclosed if the loss of that customer would have a material adverse effect on the issuer. However, a listing of each of the issuer's material customer relationships, even though not required under Item 101(c), will facilitate an analysis of the issuer's products and services in the broader context of the marketplace.

3. Analyze the needs and requirements of the marketplace and the manner in which they might be satisfied.

The most important step in understanding the needs of the marketplace is to examine the issuer's relationship with each of its major customers. In doing so, a number of key questions can be asked and answered, such as:

1. Has the issuer, through contractual arrangements or long-term loyalty, established a relationship with each of its major customers such that those customers are unlikely to "switch," either to another vendor or to self-production?

2. What economic factors face the "decision-makers" at each of the issuer's major customers; what incentives might there be to switch or use substitute products?

3. How important is the issuer's product or service in the customer's ultimate product or service, both technically and in terms of cost? Is the customer a licensee of certain technology rights owned or controlled by the issuer?

4. How sophisticated is customer information regarding the product or service offered by the issuer and the marketplace for such products or services?

5. How might the customer be viewing overall trends in the

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94. Due diligence on this matter requires a review of the terms of sale contracts for the products and services of the issuer in order to analyze any warranties or other contingent obligations of the issuer as seller after the sale, including ongoing maintenance and repair obligations and financing arrangements extended by the issuer to its customers. Disclosures are required regarding extended payment privileges and return policies, particularly as they effect the issuer's working capital requirements. In addition, great care should be taken in disclosing potential warranty obligations, particularly when the products do not have a proven record of warranty claims.
issuer's own industry and in the customer's own business. How might these trends differ and what might the consequences be for future dependence and reliance upon the issuer's products and services?

In analyzing the various relationships between the issuer and its major customers, it is important to take note of whether or not the issuer has established and maintained its own internal infrastructure dedicated to motivating employees to seek, meet and understand the needs of the customer base. Among the questions to be answered in this regard are "How does the issuer 'interact' with customers in order to understand their needs and requirements?", "Is the issuer perceived by customers to be 'responsive' in that regard?" and "Is the issuer committed to customer service?"

While an issuer may be doing a good job in anticipating and meeting the perceived needs of its existing customer base, it is important to gain a sense of how customer needs are defined in the industry and how competitors may be meeting the needs of their customers in a manner that differs from the focus of the issuer. Accordingly, important competitor-customer relationships should be examined in the same manner as described above, thereby creating a means for understanding the strategic advantages of each of the issuer's competitors and the types of strategies that might be successful in permitting the issuer to enhance its market share at the expense of competitors.

For example, it is often said that customers seek "quality" as the most important factor in a vendor relationship. If that is the case, an effort should be made to describe the quality dimensions in the particular industry in which the issuer is competing. This includes the manner in which quality is measured, the customers' perceptions of the quality component of different businesses and how those perceptions were developed and altered over time. Quality is defined by the expectations of the customer, not by the producers. As such, the issuer will need to be cognizant of such things as durability, lack of defects, reliability and serviceability, special features or an overall "quality name" which is a function of historical customer satisfaction and promotional activities.

4. What channels of communication exist between the issuer and its potential customers?

Communication between buyer and seller can occur on a number of formal and informal levels. Obviously, promotion and advertising play an important part in the selling effort associated
with the issuer's products and services. Thus, a review should be made of all brochures, catalogues, mailers, publicity releases, newspaper or magazine articles, and other selling literature which is distributed by or concerning the issuer, its products, personnel or services. Also, an understanding should be achieved regarding the incentives and compensation available to the issuer's sales representatives and distributors in the area of promotion.

Yet another element of selling and communications activities is the day-to-day informal interaction between the issuer and its customers, which takes the form of routine inquiries and discussions regarding the terms of purchase and sale, warranties, returns and shipping dates. These informal contacts are just as important in insuring customer loyalties as are more formal contacts and great attention should be paid to the manner in which customer relationships are formed and maintained through special promotions, dedicated sales representatives and attention from top management to important accounts and distribution relationships.

As noted below, the issuer's public profile is also a function of its participation in industry trade group activities, conferences and trade journals. Each of these activities provides a means for the issuer and its personnel to convey its strengths to a relevant interest group within the industry which, if not customers themselves, are in a position to form and direct a consensus within the industry regarding the issuer and the capabilities and characteristics of products, services and management capabilities. Accordingly, management should be encouraged to participate in those trade shows and industry conferences which are designed to insure broad, yet controlled, exposure of the issuer to the investment community and other aspects of the "planning environment" referred to below.

D. The Competition

Although the issuer may have a significant strategic advantage in its chosen market, perhaps in the form of innovative and proprietary technology, it can be expected that a properly chosen market niche that is expected to expand in the future will attract competition from a number of disparate firms. Accordingly, an understanding of the forces driving industry competition should be developed that takes into account the actions and skills of existing participants and potential competitors, each analyzed in the same manner as was done with respect to the issuer; any barriers to entry which might be faced by new competitors; potential "substitutes" in the form of products or services which provide either a better an-
answer for or, in some cases change, the needs of the customer; and the potential actions of parties who are already involved in the relevant value chain which might materially impact the issuer's market strategies.

1. **List the issuer's major competitors and describe the nature and area of their competition, be it direct or indirect. What is the issuer's rank within the industry, both in terms of sales volume and with respect to the characteristics upon which the needs of the customer are satisfied?**

   Item 101(c)(x) of Regulation S-K requires a description of competitive conditions in the issuer's business including, where material, the identity of the particular markets in which the issuer competes, and an estimate of the number of competitors and the issuer's competitive position, if known or reasonably available to the issuer. The principal methods of competition (e.g., price, service, warranty or product performance) also should be identified, and positive and negative factors pertaining to the competitive position of the issuer, to the extent that they exist, should be explained if known or reasonably available to the issuer.

   Issuers tend to respond to Item 101(c)(x) by simply listing one or more competitive factors without any serious attempt to discuss the issuer's strategies within the context of the overall competitive environment. Moreover, issuers sometimes dwell upon an analysis of the actions of competitors while forgetting to concentrate on the needs of current and potential customers. The most important product of investigating various competitive factors is an understanding of the strengths and weaknesses of the competitors as well as those strategies which appear to have been successful in satisfying customer needs. Not only may the issuer seek to replicate the strategies of others, provided that they are consistent with the issuer's own strengths and weaknesses, but the information is also helpful in anticipating the reactions of competitors to the strategic actions of the issuer.

2. **How difficult is it for new competitors to enter the industry?**

   High technology companies are often involved in the formation of new and innovative industries. As such, the risk of new competition is particularly high, especially when it is anticipated that significant profit margins can be realized and that the market will be
expanding over the next few years. Factors to be taken into account in determining the risk of new competition include economies of scale achieved by existing competitors and the amount of capital required to effectively achieve the needed level of scale economies; the proprietary nature of any products or technology, as well as the importance of brand identification; “switching costs” for the customer base; the availability of appropriate distribution channels; the existence of any absolute cost advantages; and any regulatory barriers to entry into the industry.

"Barriers to entry" come into play in at least two ways. First, an issuer may wish to construct barriers making it difficult for competitors to enter the market. Alternatively, entry barriers present strategic problems when the issuer is itself looking to enter new markets. Barriers appear to arise when an industry participant has a broad product line, an installed base of satisfied customers, is a pioneer in the industry and has established a known “name” and reputation, or has a technology rights position which is superior and not easily duplicated by competitors. In order to construct one of the aforementioned barriers, it is important for a high technology company to meet all known and announced expectations of its customers or other competitors with respect to product introduction, quality and development.

Failure to adequately and candidly assess and describe the competitive aspects of the issuer’s industry is a common fault in IPO disclosure and one which increasingly exposes issuers and their underwriters to potential liability in shareholder litigation, particularly if the poor performance of the issuer’s securities can be attributed to “unforeseen” or, at least, “undisclosed” trends in the competitive marketplace. As noted above, issuers tend to comply only with the minimum disclosure requirements of Item 101(b) of Regulation S-K relating to “competition.” However, it should be clear that a thorough analysis of the issuer’s business and prospects is not possible without an integrated discussion of competition, customer needs and the issuer’s own strategic advantages.

E. The Planning Environment

Clearly, it is not enough to simply understand the issuer, the customers and the competition in isolation. It is necessary to integrate that knowledge into a cohesive process aimed at successful decision-making. This typically requires an analysis of the dynamics and future of the business and social environment in which the issuer, its potential customers and its competitors will be operating,
the critical choice of the strategic business factor(s) which tend to segregate "winners" and "losers" within the marketplace, the establishment of realistic goals and objectives and a timetable setting forth the future financial and market milestones for the issuer, and the ability to build an organizational structure with the requisite flexibility to respond to environmental changes.

Environmental changes can come from a number of directions. First, there is technological uncertainty which affects the issuer's product designs and its manufacturing processes. Second, there is market uncertainty reflected by changes in customer needs and in the manner in which the products and services might be most effectively distributed. Third, there is competitive uncertainty due to the formation of new business and strategic alliances between competitors or related firms. Finally, industrial and market characteristics may change quite rapidly as new industry standards emerge or competitive technologies begin to intrude into market opportunities. Whatever the case, the issuer must develop institutional structures and articulate appropriate strategies which have the capacity for rapid adaptation, continuous learning and assimilation and understanding of environmental trends.

1. In addition to customers and competitors, identify the other significant "players" in the issuer's industry environment.

The first step in understanding the broader planning environment in which the issuer operates is identifying some of the other "interested parties." These would include trade organizations, "lobbying groups," stock analysts and researchers, marketing consultants and government regulators. Once identified, the relationship, if any, between these parties and the issuer should be described and some idea of the relative importance of these relationships should be determined. For example, do trade groups operate in a manner that establishes industry standards for each of the industry's participants? If so, how active are the issuer's competitors in these organizations?

2. What is the reputation of the industry and its participants in the overall business community? What is the specific reputation of the issuer amongst its competitors and potential customers and employees?

A good deal of attention has been paid to the issuer and its
competitors. At this point, it is necessary to take one step back and look at the industry in the context of the more general business environment. For example, what role does the industry play in the general domestic economy? What is the reputation of the industry in political, economic and social circles? How are firms in the industry typically funded (i.e., are they larger public companies with a great deal of visibility or are they smaller companies, either "stand-alones" or divisions of larger enterprises)?

A similar view should be taken of the issuer itself. What is the issuer's reputation with respect to its own unique business culture, its manner of operations, its business ethics, its announced "strategic mission," its reputation amongst its employees and its reputation within the communities in which it operates. Are the managers of the issuer among industry leaders and have they assumed a high profile with respect to political and economic issues relating to the current and future structure and vitality of the industry? In short, the issuer's public "profile" prior to the IPO is an important consideration.

3. **Is the issuer's industry vulnerable to competition from foreign firms, and how have firms within the industry reacted to such challenges?**

Technology has become a global enterprise and high technology firms must take into account the effect of competitive practices in foreign countries, many of which differ in substance and effect from those which operate in the United States. The existence of international competition should have been noted in the analysis of competition described above. Moreover, the basis upon which international firms may compete with the issuer and its domestic colleagues should be clearly understood in the context of international trade and import and export concerns.

In many cases, the perceived threat of international competition is so acute that labor or governmental lobbying groups may be formed for the purpose of advocating specific governmental trade actions aimed at regulating the entry of foreign products into domestic markets. The issuer's involvement in, and attitude toward, these activities should be examined and the expected effect of governmental action should be analyzed. The impact of international competition is also felt when those firms seek to make acquisitions of, and alliances with, domestic firms or serve as a means for international distribution of domestically developed products and services.
4. How do regulatory standards influence the industry and to what extent is the issuer and its competitors involved with defining and influencing those regulatory standards and the manner in which they are enforced?

High technology firms, particularly those active in the medical and life sciences, may be subject to a good deal of regulation regarding the development and ultimate sale of their products and services. If this is the case, the attitudes and objectives of the various regulatory bodies should be clearly understood, as is the case when the issuer is subject to environmental regulation. To the extent that the issuer, or the industry as a whole, is engaged in an ongoing and meaningful dialogue with regulators and relevant policymakers, the content of those discussions should be assessed in light of the overall competitive pressures and the time and financing required to complete any regulatory approval procedures.

5. How has management reacted to significant changes and difficulties during the development of the business and how, based on their experience and history, can they be expected to react to environmental changes in the future?

As suggested elsewhere, an IPO represents a very drastic environmental change in the manner in which the issuer and its managers have conducted business operations in the past. For all the advantages of a public offering of securities, there are a number of significant potential disadvantages which management and current controlling shareholders must consider in the course of deciding whether to pursue an IPO, including the following:

_Fiduciary Obligations._ To an even greater extent than was the case with the closely-held enterprise, management, directors and controlling shareholders owe fiduciary duties to their new "outside" shareholders. Officers, directors and 10% shareholders are likely to become subject to the short-swing profit provisions of Section 16(b) of the Exchange Act and also must be cognizant of the potential civil and criminal liability associated with trading in the issuer's securities on the basis of material information not otherwise disclosed to the broader trading public. Although officers and directors may have insurance or indemnification agreements, either by contract or

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95. Item 101(b) of Regulation S-K requires detailed disclosures regarding the effects on capital expenditures, earnings, and competitive position of the issuer resulting from environmental regulations.
statute, which protected them from a number of shareholder actions, those provisions will, in most cases, be inapplicable to the new liabilities created by the decision to undertake the IPO.

_Loss of Managerial Control and Discretion._ At or immediately prior to the time of the IPO, it is likely that outside directors and new management members will be added to the firm, thereby diluting the control previously enjoyed by the existing management group. In addition, shareholder approval of basic organizational changes, including amendments to the issuer's charter documents and the adoption of employee stock purchase and stock option plans will be made more difficult due to the time-consuming and expensive process of approval required by the proxy rules and regulations of the Exchange Act and the greater number of shareholders. It is for this reason that many of these "corporate housekeeping" matters are attended to by the smaller shareholder group prior to the offering.

As a public company, management's business judgment will be increasingly subject to evaluation and analysis by the investment community and, as a result, management may unwisely focus on short-term profitability at the expense of implementing programs designed to enhance the long-term viability of the issuer's operations. For example, while a private company could decide to absorb large losses over a multiple year period in order to develop a substantial market share, this is often unacceptable to public shareholders seeking current and consistent earnings. Furthermore, while cash flow may be of primary importance to the owners of a private company, earnings per share is more important for public companies. In light of the pressures created by public ownership, it is not surprising that analysis of successful IPO candidates places a premium upon managerial strength and experience in the "public environment."

_Disclosure._ The disclosure requirements imposed upon a public company may result in the publication of sensitive information regarding management compensation and related transactions, and may significantly impact the preexisting salaries, fringe benefits and

96. Obviously, the ability of non-affiliated persons to purchase shares of the issuer in the public market leads to the possibility of an unwanted, or "hostile," acquisition of a controlling interest in the issuer. It is possible to insert so-called "shark repellent" measures in the issuer's charter documents prior to the IPO (e.g., "supermajority" voting provisions, "staggered" board of directors and "blank check" preferred stock, to name a few), but many underwriters will discourage this apparent "hurdle" to full liquidity for the non-affiliated investor community and some state securities administrators will seek to prohibit or limit the offering of securities in their states by an issuer which has adopted such provisions.
other arrangements between the issuer and insiders. In addition, the issuer will be required to disclose proprietary information regarding key customers and marketing and operating methods. Many companies believe that information about their gross margins, sales and earnings by product lines in geographic regions, and research and development expenses, all of which is required under the SEC's financial disclosure requirements, may provide competitors with important and potentially damaging information.97

Financial and Other Costs of Administrative Compliance. Assuming that the offering is completed, the issuer will be exposed to significantly higher administrative costs relating to SEC reporting requirements, including the preparation of audited financial statements, as well as the new relationships that must be formed and maintained with public shareholders, regulatory staff and the investment community. These costs include ongoing transfer agent services, increased legal and accounting services, and expenses relating to larger shareholder meetings, public relations and administration fees. Also, in the event that the enterprise must undergo a change in organizational structure—e.g., from partnership to corporate form—in preparation for the IPO, additional reorganization expenses may be incurred which may also involve a loss of certain tax benefits previously available to equity investors.

In addition to the financial costs, management will be required to devote a significant amount of its time to public relations and relationships with analysts, investment bankers and shareholders, which time will decrease the resources available to operating the business of the issuer. For example, management will need to allow time to review the periodic financial filings that must be made with the SEC and which are widely disseminated in the financial press. Also, it will be necessary to prepare for interviews and presentations to the investment community during the year, particularly at research analyst sessions where questions will be posed by those professionals charged with assessing the near-term earnings performance of the issuer.

Dilution of Control andRedirection of Firm Objectives. An IPO will result in immediate dilution of the shareholdings of management and current shareholders and may, in the long run, expose management to an enhanced risk of losing control of the enterprise or even an unfriendly takeover from third parties. Any antitake-

over devices utilized by public companies will be subject to the scrutiny and review of the investment community, which typically is more interested in their ability to realize the benefits to their financial investment of an attractive outside offer than in preserving existing management. The foregoing also demarks a change in the stakeholder focus of the issuer, in that the interests of employee groups and the community within which the business is operated are transformed by the demands for consistently improving financial performance from the public shareholders.

**Conditions to the Offering.** The registration process in various merit review states may require that insiders agree to the imposition of significant restraints upon the issuer and/or its prior shareholders, especially if there have been significant issuances of securities at a price far below that of the proposed IPO price; if management and the managing underwriter have entered into an agreement whereby the managing underwriter is to receive warrants or options for significant amounts of shares; if the selling expenses are deemed to be excessive; if the public shareholders will be subjected to significant dilution; or if past management practices (such as loans and favorable transactions) are disclosed in the course of the registration process. Also, “promoters’ shares” or “cheap stock” may be subjected to escrow conditions, future issuances of options may be circumscribed and various “insider transactions,” such as loans, will be “undone” (i.e., repaid or rescheduled) as a condition to qualifying the offering.

6. **Finally, what elements of the broader political, legal, regulatory, social, economic and technological environments are likely to impact the formulation of the issuer’s business strategies in the years to come?**

A good deal of the analysis regarding the issuer takes the form of a microeconomic assessment of demand, supply and competitive pressures within a given industry or set of markets. However, the issuer’s strategies must operate within a variety of “macrosystems,” each of which can have a significant impact on the manner in which firms compete and customers make their purchasing decisions. Accordingly, the issuer should “search” each of the aforementioned environments to identify any significant policy issues which, in some respect, may affect its business decisions.

For example, social and political attitudes regarding the level of health care costs in the United States certainly play an important
role in assessing the prospects for future profit and growth in the pharmaceutical area. Also, general economic conditions will dictate the level of disposable income and the ability of potential consumers to purchase the goods and services to be made available by the issuer. Finally, catastrophic events, such as the outbreak of hostilities in the Middle East, will materially impact the domestic economy as well as potential markets overseas.

VI. UTILIZING THE ISSUER'S STRATEGIC ADVANTAGES IN THE IPO MARKETING PROCESS

Once the issuer has organized all of the information necessary to properly describe its own beliefs about itself, its customers, its competitors and the planning environment in which it operates, management should seek the assistance of the managing underwriter in developing a statement of the issuer's strategic mission for inclusion in the prospectus. The four main elements of the plan identified above should be the focus of discussions between management and any prospective managing underwriter which occur prior to the commencement of the preparation of the offering documents. Any lapse or "problem" uncovered during the course of those discussions should be the subject of intense scrutiny and may, in fact, be an indication that the offering should be delayed until such time as appropriate remedial measures have been taken.98 Assuming that management and the managing underwriter are reasonably satisfied with the potential viability of the IPO following the completion of the issuer's business plan, it is then time to turn to the formulation and use of the contents of the plan in the drafting of the prospectus and the overall marketing of the issuer and the offering. The first part of this section describes the process of developing the business strategy statement to be included in the prospectus. Thereafter, attention turns to the presentation of potential risk factors and, finally, to the drafting of the MD&A, that portion of the prospectus which provides the best opportunity for integrating a discussion of the financial and non-financial aspects of the operation of the issuer's business.

98. Requiring that the issuer develop a strategic business plan will provide the managing underwriter with a good sense of the capabilities and temperament of management, including their ability to explain their function and the roles of other key managers, the presence or absence of a consensus amongst management with regard to the significant risks associated with the issuer's business and prospects, the timing of significant product and marketing milestones and any other factors that are necessary for the issuer to establish the appropriate niche in the marketplace.
A. Development of the Description of the Issuer's Business

The most important non-financial element of the IPO prospectus is the detailed description of the issuer's business. The issuer is not only required to address the requirements with respect to disclosure which are set forth in the registration forms and in Regulation S-K, it must also be able to formulate and communicate to the investment community a coherent statement of the issuer's business strategy, including a recognition of the issuer's strategic advantages, a knowledge of the proven needs of the issuer's customer base for its products and services, an understanding of the basis upon which other companies will seek to compete with the issuer in the marketplace and, finally, a statement of the manner in which the issuer's strategic advantage will be utilized to insure sufficient profitability for the issuer to satisfy the needs of the issuer's new customer base: the members of the investment community.

Using the information gathered in the due diligence process and in the course of preparing the issuer's strategic plan, management, the managing underwriter, legal counsel and the accountants should be able to piece together the story of the issuer's business and prospects in substantially the following manner and order:

**Introduction.** The first paragraph in the business description in the prospectus should briefly describe the activities of the issuer and the major industry segments in which the issuer competes or proposes to compete in the future. Reference should be made to the current products and services of the issuer, including the manner in which such products and services are delivered to the relevant markets, and any plans for future development and expansion of the business. If possible, reference should be made to the issuer's own particular strategic advantage with respect to the manufacture and distribution of its products. Finally, any significant financial milestones should also be mentioned, such as a material increase in dollar or unit sales.

**Industry Overview.** It is important to provide the prospective investor with the issuer's own sense of the industry in which it operates, its historical evolution and perceived future trends, as well as the role that the issuer is expected to play within the industry.

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99. It is particularly important to describe the issuer's overall business strategy, particularly when the operating history of the issuer is especially brief or significant future developments are necessary for the ultimate realization of its long-term business objectives.

100. For example, a company engaged in a technology-driven industry characterized by rapid changes may provide a description of key technological milestones in the course of industry development.
Accordingly, the issuer should provide a general overview of each of its industry segments and the various business, commercial and social problems which the industry, and the issuer in particular, is seeking to address in the conduct of its business activities. For example, a health care company might attempt to describe the breadth and severity of the particular health problems which the issuer feels will support a market for its products. Also, with respect to each market "problem," reference should be made to the various "solutions" that may have been offered by existing products and services.

If necessary, significant industry definitions and classifications should be introduced to the reader at this point, and the reader should be given a sense of the development of the industry and its technology, the needs and demands of the base of customers, pricing and costing characteristics in the industry, future trends regarding the overall size of the industry and any changes in the markets and applications for the issuer's products and technology. Finally, even though it may otherwise be covered in the discussion of "competition," it is important to state initially the "basis for competition" within the industry and the various factors (e.g., cost, manufacturing efficiencies, product reliability, technology, breadth of products, capacity, capital, distribution or service) which the issuer believes may influence competition within the industry in the future.

Manner of Competition. Following the brief introduction to the issuer's industry, it is then necessary to concentrate upon a careful explanation of the various functional activities that must be completed in order to achieve profitability in the industry and, most importantly, the relative competence of the issuer in each of the specified areas. Key functional activities include research and development, product and process technology, procurement and suppliers, production and manufacturing, sales and distribution, service and support, human resources, finance and general management expertise.

101. If possible, the issuer should attempt to identify any external factors which may impact the businesses of the issuer, its customers or its competitors in the future. For example, an attempt should be made to anticipate sudden "shocks" with regard to natural resource availability or regional political changes which might impact the supply of labor or the availability of markets. In those cases, even when the direct impact on the issuer is slight, such changes may significantly alter the manner in which competitors seek to market their products and services.

102. For the high technology issuer, it is often appropriate to provide a general explanation of the relevant technology in the product area, including a summary of past developments and the manner in which the issuer seeks to differentiate its efforts in the technology
Products and Product Strategy. In this section, the issuer should clearly and concisely articulate its strategies regarding the development of specified products and services. In particular, the issuer's disclosures should focus upon material aspects of its products and services, characteristics which distinguish the issuer's products and services from those offered by its competitors and, if appropriate, a historical description of the development and introduction of the issuer's products and services. Also, reference should be made to the issuer's research and development projects, including the manner in which the issuer's products were developed or acquired.

The product strategy statement should clearly state the issuer's business objectives and the manner in which they will be pursued in the marketplace. If possible, the description of the strategies with respect to the pursuit of those objectives should be linked to the issuer's overall financial condition and the use of proceeds from the offering. In addition, any significant risks associated with the strategy should be referenced in the discussion of risk factors which appears in the prospectus. Finally, the various "strategic success factors" within the market should be clearly explained and, hopefully, related to the issuer's own product strategies.

103. The issuer should describe each of its principal products, perhaps utilizing some form of tabular presentation which reflects various applications, models, marketing status and the percentage of revenues in the most recent fiscal year. Key competitive characteristics of each of the current products should be presented in great detail, as well as facts pertinent to an understanding of the prior evolution and development of such products. Product listings can be subdivided by application or market focus, provided that the presentation does not unnecessarily duplicate prior disclosures, and include appropriate financial segment information. Proposed products should be consistent with the issuer product strategy. Developmental efforts should be clearly explained, including the various technical, distribution and regulatory "hurdles" that must be overcome for the proposed products to be brought to market. Also, a description of the proposed markets and applications for the new products, and their effect upon existing products, should be included. Finally, separate service offerings of the issuer should be described, including the effect that such offerings have upon the issuer's requirements regarding human resources and facilities.
Several different approaches can be used in the course of describing the issuer's product strategies. For example, an issuer may be seeking development through new technologies, the improvement of production efficiencies, cost reductions, quality enhancements or the creation of reliable documentation. While these strategies focus on the production process, another issuer may be focusing upon extending its existing product lines and developing new distribution channels through joint ventures, reciprocal development agreements and other strategies which are designed to facilitate the acquisition and distribution of new products. Allied strategies might also include enhancements to existing products, warranties and service capabilities.

Manufacturing and Production. Depending upon the nature of its business, manufacturing and production can be an important component of the issuer's ability to promptly bring its products to market and fulfill the demands of the customers. The section should begin with an explanation of the manufacturing process and the definition of the crucial components thereof. In particular, attention should be paid to the following matters: facilities, testing production line arrangements, packaging, raw materials and government regulations with respect to environmental and quality control matters. Also, research and development relating to manufacturing processes and technologies should be explained, as well as any dependence on vendors or suppliers.

If "backlog" is important in the context of the issuer's industry and production processes, appropriate disclosures should be made. The amount of the backlog, and any significant customers included in the backlog, should be discussed and any plans which the issuer might have to correct the situation should also be set forth. If the backlog may not be representative of actual sales for any succeeding period due to customer changes in delivery schedules or cancellations, disclosure should be made regarding scheduling and booking practices within the industry. In many cases, the rate of booking new orders varies from month to month and the release of shipping dates and quantities against purchase orders may also fluctuate over time.\(^{104}\)

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104. The discussion of backlog in the prospectus presents a number of difficult issues regarding the appropriate definition of backlog and the internal accounting procedures that should be used in calculating the amount of any backlog figures. Given the uncertainties involved, issuers should proceed with caution in this area, although in those cases where the value of the issuer lies in its future orders and prospects, as opposed to historical sales trends, it will be quite tempting to include favorable estimates of future sales as reflected in various orders. Although it is preferable from a securities law perspective to only include firm orders
Marketing, Distribution and Customers. The issuer's ability to identify the markets and customers for its products, and to develop the proper distribution channels for introducing those products to those markets, is the focus of the description in this section. A typical introductory paragraph would include a listing of those markets which the issuer has identified as targets for the sale of their products; the significant "needs," in terms of product and service characteristics and the manner of delivery, of the projected customers; the appropriate "uses" for the issuer's products; and the various applications for the issuer's products. Clearly, significant customer relationships should be identified, including all customers which account for 10% or more of net product sales. Thereafter, reference should be made to the distribution channels, be they direct sales or indirect sales through OEMs, VARs and systems integrators. Sale commissions and compensation should also be discussed.

Significant sales and distribution agreements should be discussed in detail, including the term of the agreement, any minimum quantity of products that must be purchased, the number of products purchased to date under the agreement, ordering procedures, any agreement with respect to scheduling, increasing or decreasing the amount of orders, charges for changes in delivery and product mix, and any agreement whereby the distributor could acquire the right to manufacture products. In the event that distributors meet significant competition themselves, this should be discussed, as should any factors which might effect the distributor's own customer base or product strategies.

Finally, the issuer's own internal sales and marketing organization should be described, including such things as the number of members of the issuer's sales force, the location and coverage of the issuer's sales offices, trade show and print advertising strategies, service and technical support capability and warranty terms and coverage. Should the issuer be planning any significant modification in its marketing strategies, perhaps through the engagement of a third-party marketing partner, it should be discussed in this section.

Competition. Disclosures regarding competition begin a series of sections dealing with the issuer's external environment and non-product related resources. Typically, the registrant should discuss the following items:

as part of the backlog figure, other issues to be addressed include time of shipment, cancellation and product return experience, the differences between released and non-released backlog, concentration of backlog among certain products or customers, and concentration of backlog among business segments.
1. The historical development of competition within the industry, including any cyclical variations and pricing factors, in order to provide the reader with a sense of the environment in which the issuer must develop, produce and distribute its products or services.

2. The identity of specific competitors should be disclosed, as well as the basis upon which such entities compete with the issuer. If competition exists with respect to specific products, it should be identified in that manner. Remember that competition may come from specialized firms, as well as from larger companies with divisions capable of competing in the industry.

3. Future competitors, and the resources which they will bring to the marketplace, should be identified.

4. The principal elements of competition, including price, performance, product quality and reliability, financial stability, adherence to standards, marketing, distribution, technical resources, production capacity and manufacturing efficiencies and production yields.

5. The issuer should explain how effectively it is able to compete with respect to the elements of competition referred to above, and any plans to improve the issuer's performance should be explained. Any competitive disadvantage with respect to the issuer due to the lack of breadth in its product line or otherwise should also be explained.

6. If the issuer expects significant changes in the competitive environment in the future, the nature of those changes should be explained and any plans for remaining competitive should be discussed. These might include additional plans to lower manufacturing costs, introduce new products and improve production yields.

The issuer should consider appropriate cross-references to "Risk Factors" within the "Competition" discussion.

Government Regulation. The development, testing and marketing of an issuer's products may be subject to regulation by a variety of federal, state, local and foreign agencies. Such agencies, including the Food and Drug Administration and the U. S. Department of Health and Human Services in the case of pharmaceutical and biotechnology companies, regulate the product introduction, advertising, manufacturing, labeling, distribution and record-keeping activities and practices of industry participants. Typically, before a product can be marketed it must go through a number of stages of preclinical studies and testing. The issuer should describe the stages of premarketing development and identify where each of the issuer's current and developing products stand in the process.
An attempt should also be made to describe the issuer's views as to how the regulatory process will evolve over time and the effect that any transition might have on the issuer.

Intellectual Property. The "Competition" section will indicate whether or not patents and trademarks, copyrights or other forms of proprietary technology are considered to be important factors in the issuer's industry. Important factors with respect to disclosures relating to intellectual property would include the following:

1. Does the issuer possess any significant patent, trademark or copyright rights? How important will these rights be in providing future competitive protection? In some cases, the issuer will indicate that it believes that intellectual property rights are of less significance in its industry than such factors as innovative skill and the technological experience of its personnel. If that is the case, a description of the issuer's unique human resources in the technology area is appropriate, as well as the issuer strategies to protect its proprietary technologies.

2. What licensing arrangements have been made by the issuer, on what terms, and how important are they to the technical position of the registrant? In particular, a description of the scope of the license in terms of exclusivity, geographic area and scope of products and technology should be included.

Technology licenses from and to the issuer normally play a significant role in the early development of an issuer involved in a technology-driven business. Licensing may provide an appropriate vehicle for introducing the issuer's products into new geographic and vertical markets, however the issuer must be prepared to sacrifice a portion of its autonomy with respect to future decisions regarding the sale and distribution of its products. Pertinent issues include the stream of royalties from the license, the ability of the issuer to grant a series of non-exclusive licenses to insure proper coverage of a particular market and any obligation that the issuer might have to extend additional rights to one or more of its historical licensees.

Research and Development. Research and development activities may have been discussed in the context of the issuer's future products. Disclosures should cover the following items:

1. The amount of technological change which has occurred within the industry in the past and the direction of emerging technology which the issuer believes will dominate competition within the industry in the future.

2. The issuer's principal research and development activities
and the type of product development efforts which have been undertaken in the past.

3. Any research and development activities devoted to improving the issuer's process technology.

4. Any research and development activities aimed at enhancing existing product offerings and developing new offerings based on advanced technologies.

5. The amount of research and development expenses and any independently financed research and development contracts, including research and development partnerships.

Properties and Facilities. As noted above, disclosures regarding the issuer's properties and facilities are specifically required under Regulation S-K. Typical descriptions will refer to the issuer's principal business and manufacturing facilities, the amount of square footage and degree of utilization, plans for future expansion and a statement as to whether or not such facilities are properly maintained and adequate for their purposes. Significant lease arrangements should also be included. Once again, the location of the issuer's properties and facilities may have an effect its ability to attract and maintain its pool of human resources, utilize university research facilities and rapidly move its finished goods and products into the distribution channel.

Human Resources. The issuer's human resources may have already been discussed in the context of "Competition," "Intellectual Property," and "Research and Development." Basic disclosure will include the number of employees, including a breakdown of the number of employees active in the areas of marketing and sales, research and development, engineering, manufacturing, production and facilities support and general management, including finance and administration. Any plans for hiring additional personnel in particular areas should be disclosed, particularly as they relate to strategic plans for product development and distribution which might have already been discussed. Significant factors relating to the recruitment and retention of key personnel should also be included in the discussion.

A significant aspect of an issuer's human resources are the skills and experience of its management team. However, the prospectus typically contains very little information that can provide the investment community with a sense of the specific characteristics that tend to lead to a performance advantage. Accordingly, the issuer should look to other avenues to "market" the capabilities of its managers. For example, preoffering marketing should include wide exposure of the issuer's executives in the relevant business and
trade publications. Moreover, the road show presentations during the waiting period provide a good opportunity to showcase the ability of the issuer’s managers to articulate a sound and focused business strategy with regard to the issuer.

**Legal Proceedings.** The issuer is to disclose with respect to any material pending legal proceeding, other than routine litigation incidental to its business, the date on which the proceeding was initiated, the court or agency in which it is pending, the principal parties thereto, the factual basis alleged to underlie the proceeding, and the relief sought. There is no express requirement that threatened litigation be disclosed other than with respect to proceedings known to be contemplated by governmental authorities. It is, nonetheless, necessary in many instances to disclose threatened litigation and, possibly, unasserted claims.

Once the initial draft of the business section has been completed, the participants should ensure that it contains a clear and concise description of the manner in which the issuer will satisfy customer needs by using its own strategic advantages such that its products and services are differentiated from those of its competitors in a manner that is favorably perceived by the marketplace and which sustains sufficient levels of profitability for the issuer. In addition to the description of the business, the issuer should relate its strategies to the management and financial characteristics which are perceived to be of importance to the investment community.105

**B. Focusing on “Risk Factors”**

Having completed a description of the issuer’s business strategy and its own unique strengths within the competitive environment, it should now be a relatively easy task to turn to a consideration of the “risk factors” that may be relevant to the issuer and its ability to attain its business objectives. Specifically, some or all of the following items should be considered for further explanation in the prospectus:

**Financial Risks.** One of the most typical risks for the IPO candidate arises from the issuer’s limited operating history, which may include a prior record of operating losses or recent adverse trends in sales, earnings, margins and backlog. In such cases, the prospectus

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105. In particular, the participants should carefully review the characteristics of a “suitable” IPO candidate and attempt to relate the strengths of the issuer to the identified needs of the investment community. For example, characteristics of the issuer’s business and industry should be compared to those factors cited by investors as indicative of future growth and profitability.
should discuss whether or not the issuer’s historical financial results are relevant to a consideration of its future prospects. Moreover, as discussed below in the context of preparing the MD&A, risks associated with the issuer’s future liquidity\textsuperscript{106} and ability to meet its obligations with respect to any fixed obligations should also be described, as should the effect of any covenants under existing credit arrangements which might inhibit the issuer’s future operations and flexibility.

**Product Development Risks.** The IPO candidate may not yet have a “track-record” of commercially accepted products and services. Accordingly, an effort should be made to identify any market and/or product development uncertainties, including the time period and costs required to achieve commercial success. For example, are the needs of the marketplace sufficiently defined so as to insure acceptance of the issuer’s new products? Alternatively, is the issuer’s success dependent upon its ability to develop or acquire new products in the future? In those cases where the issuer has already completed the development of one product, attention must be paid to whether or not that product can fully support the issuer as it seeks to develop new and additional products.

**Technological Risks.** Technological uncertainties can affect the issuer’s ability to complete its product development efforts on a timely basis\textsuperscript{107} as well as the likelihood that the issuer can achieve and maintain an advantage based on its research activities and obtain legal protection with respect to its technology and related intellectual property rights. Moreover, research can often prove to be very costly, particularly in those industries which are subject to significant government regulations and approvals, and the issuer must be certain of its ability to obtain the funds necessary to complete any required projects.

**Production and Distribution Risks.** A significant risk associated with the actual distribution of the issuer’s products is its reliance upon one or more customers, since the loss of a major customer may have a material adverse effect upon the issuer’s financial situation as well as its overall image and perception in the mar-

\textsuperscript{106} Particular risks might include poor cash flow from operations, high “debt-equity” ratio, substantial near-term debt and/or lease obligations, substantial near-term capital expenditure requirements, the need for future financing to fund acquisitions and working capital requirements, significant contingent liabilities, and the issuer’s ability to obtain financing through credit facilities.

\textsuperscript{107} For example, significant risks may exist with respect to the obsolescence of the issuer’s products due to new or competing technologies.
Also, as noted above, the issuer may be dependent upon one or more key suppliers, licensors, researchers or distributors with respect to its products and, therefore, attention should be paid to the consequences of any disruption or termination of those relationships. Finally, to the extent that the issuer is involved in foreign distribution activities, any particular risks associated with activities in foreign markets should be discussed.

**Regulatory Risks.** Is the issuer subject to regulatory risks which could affect its products, marketing efforts, pricing strategies, service routes or areas and the timing of product introduction? Antitrust considerations are certainly important in those situations where the issuer is expected to be a dominant firm in a definable market area or may wish to conduct cooperative research and development activities. However, more importantly with respect to IPO candidates in the health care and biotechnology industries is the effect of the various regulatory approvals necessary to commence testing and distribution of various products. As noted above, an effort should be made to explain any relevant regulatory procedures in the business section of the prospectus. Also, to the extent that foreign firms which might compete with the issuer are subject to different regulatory procedures which might impact the time required to bring their products to market, these procedures should be noted.

**Competitive Risks.** Competitive uncertainties are of tremendous importance in analyzing the prospects of any IPO candidate. The issuer should candidly assess whether or not it lacks one or more significant production functions or support services which might be necessary to effectively compete in the marketplace or to realize the expected breadth and volume of distribution of its products. Moreover, it is no longer sufficient for the emerging IPO candidate to merely take note of the uncertainties with respect to

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108. For example, many IPO candidates in the high technology area will enter into long-term sales agreements with larger customers. However, in those cases where there are no minimum purchase requirements, the customer is in a position to make certain product strategies, including the acquisition of competing product lines or businesses, which might adversely impact the issuer. Moreover, the existence of a large customer may affect the overall seasonal and periodic trends with respect to sales and revenues of the issuer.

109. The concentrated use of indirect sales agents, such as OEMs and VARs, will make the issuer heavily dependent upon the resale efforts of such agents and may impede the issuer's ability to generate sales to new customers.

110. Also, even in those cases where the issuer is not dependent upon the services of others with respect to production of its products, attention must be given to the adequacy of the issuer's own production factors: aging of its plant and equipment, excess production capacities, expansion/obsolescence factors and the issuer's continuing ability to compete on the basis of cost.
competition from "larger" competitors. The IPO issuers should carefully analyze the direction from which competition might come and any plans that it might have to establish a countervailing advantage.

Management and Employee Risks. A number of key risks and uncertainties are associated with the issuer's dependence on the skills and availability of one or more key managers and employees, the issuer's ability to recruit and retain qualified employees and the operational experience of the issuer's current management to provide the leadership necessary to manage a growing company in the issuer's industry. Again, this risk factor tends to be included without a great deal of thought to the issuer's own plans regarding recruitment of key employees. An attempt should be made to understand the issuer's future plans with regard to available cash and equity compensation for new employees, including the effect of future financing and expansion efforts.

Litigation Risks. For the high technology IPO candidate, actual or threatened litigation regarding material elements of its technology portfolio or asserted intellectual property rights can be disastrous, severely impairing the viability of the proposed offering and significantly depleting its financial assets. For example, competitors may assert that rights used by the issuer infringe upon their technology rights or, alternatively, that the technology actually arose out of the activities of current employees of the issuer who

111. Among the various risks factors are industry dominance by one or more competitors, which might impede the ability of smaller firms to establish pricing factors or the mode of competition; recent changes in industry characteristics, such as deregulation, consolidation or a reduction in the number of competitors; and the impact of pending legislation with respect to such things as taxes, trade laws or removal of competitive barriers.

112. Also, the effect that new competition might have on existing competitors should be taken into account.

113. An unusual phenomenon amongst some high technology firms relates to the aversion that many employees and managers might have to working for a company that they believe to be too "big." Often the IPO brings uncertainties to entrepreneurial scientists and engineers if it is accompanied by expansion that dilutes the attraction of the small or "incubator-sized" firm. The due diligence process can provide participants with a sense of employee attitudes toward growth and expansion, as well as management plans to avert any significant defections. Objective measures regarding the possibility of losing key employees include a review of vesting schedules and key employee agreements.

114. Other risk factors associated with human resources include such things as the age of management personnel, the lack of employment contracts, significant recent changes in management, other time commitments of management, adverse background factors (e.g., prior business failures, pending litigation and securities law violations), and potential conflicts of interest, many of which must be disclosed pursuant to the disclosure requirements of Regulation S-K.
had previously worked at the competitive firm.\textsuperscript{115}

\textit{Environmental Risks}. Consistent with the notion that the issuer should conduct an overall “scanning” of its competitive environment, no risk factor section would be complete without an attempt to discern those uncertainties which might arise out of general social, political and economic conditions. For example, long-term trends with respect to the nation’s health care payment system might have a significant effect upon the pricing structure for issuers involved in the health care industry. Also, political uncertainties in foreign markets might adversely affect the issuer’s ability to obtain reliable low-cost labor for its future manufacturing activities. If these risks are known and have been factored into overall business planning, consideration must be given to mentioning them in the prospectus.

For the IPO candidate in the high technology area, it is most common to find risk factor concerns with respect to the dependence on one or more key customers or suppliers, fluctuating revenues, dependence upon outside distribution channels, product development risks, competitive and technological uncertainties and dependence on key personnel. However, the foregoing list is not intended to be all-inclusive and while reference should be made to disclosures of issuers involved in the same industry, it remains important to focus upon those factors which will provide the most “balanced” presentation with respect to the specific issuer in the context of preparing the prospectus.

\textbf{C. Management’s Discussion and Analysis}

Perhaps the most meaningful portion of the prospectus other than the financial statements, the business summary and the description of any risk factors, is the MD&A, which includes a narrative discussion of such things as the results of operations, liquidity, capital resources, and the impact of inflation.\textsuperscript{116} The MD&A brings the financial and non-financial portions of the registration statement together, and the SEC has stated: “The management discussion gives the registrant an unusual opportunity to articulate its objec-

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\item[115.] In some cases, the issuer will simply state that participants in a given industry are subject to a good deal of uncertainty regarding litigation with respect to claims of ownership over new or emerging technologies, particularly in those areas, such as biotechnology, where the state of the law regarding the legal rights of various commercial firms is far from settled. However, such a general disclaimer may no longer be sufficient given the significant risks associated with litigation regarding infringement of existing rights or misappropriation of technology.
\item[116.] Regulation S-K, Item 303.
\end{enumerate}
\end{footnotesize}
tives and financial policies; to describe where it is headed and how it hopes to get there; and to establish and maintain credibility. Included in the management discussion should be factors about the particular business which management is in the best position to know. For each business, there is a limited set of critical variables which presents the pulse of the business."

Interestingly, the approach which the SEC advocates for the preparation of the MD&A is most similar to the overall strategic business planning framework described in this article. For example, the issuer is admonished to focus upon its overall business objectives and manner in which it hopes to attain those objectives. Moreover, the "critical variables" refer not so much to the elements of the value chain but to those measures of performance that provide the investment community with an objective means of assessing the issuer's ability to meet its stated business goals. While the instructions for preparation of the MD&A in Item 303 of Regulation S-K are somewhat self-explanatory, care must be taken to insure that the following items have been considered and adequately explored:

1. Will the issuer be able to generate sufficient cash or other working capital to fund the ongoing operations of the business, including known material fixed commitments for capital expenditures or any future plans with regard to debt repayments, capital expansion or acquisitions and divestitures?

The issuer should identify any trends, demands, commitments, events or uncertainties that are both presently known to management and reasonably likely to have a material effect on the issuer's short-term and long-term liquidity. Obviously, this discussion should reference to all of the issuer's sources of cash following the offering, including the proceeds of the offering itself and any working capital that might be available under banking arrangements. In the case of an IPO issuer, specific comment should be made on the issuer's ability to adequately meet its cash needs over the first 12 to 24 months following the offering. Also, any material covenants which continue to exist under banking arrangements after the IPO should be referenced.

In those cases where the issuer has made a commitment with respect to capital expenditures, the issuer should identify the gen-

eral purpose of the commitment, the anticipated source of funds to fulfill the commitment, significant balloon payments or other payments due on longterm obligations arising out of the commitment and any off-balance-sheet financing items. Most importantly, if a material deficiency is identified due to the inability of the issuer to generate sufficient liquidity to meet its fixed commitment obligations, the deficiency should be disclosed and the issuer should indicate the course of action that has been taken, or is proposed to be taken, to remedy the deficiency or, if no remedial action has been taken, the issuer should indicate that it either has not decided on a remedy or that it is currently unable to address the deficiency.

If the description of the issuer’s business includes a reference to any future plans relating to the acquisition of new businesses or other assets, the MD&A should refer to the manner in which the issuer proposes to fund such an acquisition. It may be that the issuer expects adequate funding to be available through cash generated from operations and existing credit lines. However, if it may be necessary for the issuer to undertake still another offering of its securities in the foreseeable future, such information will be important to the investment community in assessing the future value of its commitment.

2. Identify the key performance indicators relating to the issuer’s overall financial condition and results of operation and explain, to the extent necessary, the reasons for any material changes in those indicators from year-to-year.

Each industry, as well as every firm therein, has one or more financial indicators that are considered important measures of overall performance. The issuer should carefully analyze its historical performance with respect to those items. Moreover, each material financial statement line item, such as net sales or revenues, should be analyzed in light of any changes which might have oc-

118. Note that where disclosure is not otherwise required or has not yet been made, the MD&A need not contain a discussion of the impact of preliminary merger negotiations when, in the issuer’s view, inclusion of such information would jeopardize the completion of the transaction. However, an IPO issuer should seriously consider whether or not the offering should be undertaken if it contemplates being involved in serious merger discussions during the period prior to the expected offering date.

119. The issuer should include a discussion of any expected adverse trends that might impact performance within the entire industry, such as changes in material, labor and energy costs, and the manner in which such changes might affect the issuer in a manner that differs from the experience of its competitors.
occurred on a year-to-year basis and during any interim periods.\textsuperscript{120} For example, if there has been an increase in the level of revenues, the issuer should indicate whether such changes are attributable to changes in prices and, if so, the effect of inflation thereon, to increases in the volume of sales or to the introduction of new products.

3. \textit{Identify and describe any unusual or infrequent events or transactions with respect to the issuer which may not be indicative of future operations.}

For example, the issuer should discuss the impact of discontinued operations and extraordinary gains and losses when these items have had, or are reasonably likely to have, a material effect on the issuer's reported or future financial condition or results of operations. Correspondingly, an attempt should be made to provide forward looking information and to disclose events known to management which, although not specifically required as part of the disclosure, will materially affect future operating results of the issuer. The emphasis in this discussion should be upon events that have not regularly occurred in the past or events which, if they happen, will materially alter some aspect of the issuer upon which prior financial results have been based (e.g., loss of a major customer).

4. \textit{Consider what, if any, aspects of the issuer's own internal forecasts with respect to future financial results might be relevant for inclusion in the MD&A.}

Concerns regarding the use of projections and forecasts in the prospectus have already been noted. However, it will be extremely useful to consider the issuer's own internal forecasts regarding future trends with respect to revenues, expenses, cash flow and other key indicators of performance, particularly if they are expected to differ significantly from any historical measures. In addition, it will be helpful to analyze the issuer's assumptions regarding such things as the projected average annual real growth in GNP and average rate of inflation, foreign exchange rates, acquisitions and divest-

\textsuperscript{120} Interim disclosures are particularly important when the issuer is in its rapid growth phase and has just recently turned profitable. In those situations, it may be appropriate to break the narrative discussion in the MD&A into quarterly segments in order to assist investors in examining the various trends that might continue into future quarters after the offering. Interim disclosures also permit the issuer to identify any seasonal aspects to its financial performance.
tures, financing strategies, dividends, tax rates and the timing of such dilutive events as the exercise of stock options or the conversion of outstanding debentures.

The MD&A is, along with the brief description of the issuer's business which appears on the summary page of the prospectus, the most difficult part of the prospectus to draft. The issuer must concern itself with intense scrutiny of the disclosures by the SEC, as well as the exceptional interest of members of the investment community. Narrative comparisons of line items in the financial statements are no longer an appropriate response to Item 303 of Regulation S-K and management, counsel, underwriters and accountants should insure that the MD&A is properly drafted and reflects a strategic planning outlook which is consistent with past practice and the balance of the disclosures in the prospectus.

VII. Conclusion

The exercise of preparing a strategic business plan at the time of the IPO is clearly intended to facilitate the drafting of the prospectus in a manner that conveys the strategic advantages which the issuer brings to its day-to-day marketplace and which, if successful, will bring growth and profitability to the issuer and appreciation in the value of the offered securities. However, the process of "positioning" the issuer and creating and enhancing its public image should begin well in advance of the IPO. Moreover, the issuer is probably better able to effectively "market" those strategic advantages which are most valued by the investment community, such as the skills and experience of management, outside of the constraints of the prospectus, provided that the distinction drawn by Section 5 of the Securities Act between information and solicitation is respected.

Obviously, an issuer which is intent on eventually undertaking an IPO must remain cognizant of the various restrictions, as explained above, which are placed upon public relations activities

121. In Release No. 33-6349 (Sept. 28, 1981), Fed. Sec. L. Rep. (CCH) ¶ 72,321, the SEC extensively discussed the MD&A and included a number of useful examples of acceptable presentations in a variety of areas. While a review of these examples, as well as the presentations made by other companies in the same industry, can be useful in identifying important matters for inclusion in the MD&A, the SEC has also noted that "good MD&A disclosure for one registrant is not necessarily good MD&A disclosure for another." Release Nos. 33-6835; 34-26831; IC, 16961; FR-36, an extensive release on the MD&A issued in May 1989, should also be carefully reviewed by an issuer preparing its initial registration statement, and includes still another admonition on the part of the SEC for issuers to include "prospective information."
under the federal securities laws. To that end, counsel should continuously advise management on the subject of “gun-jumping,” including the judicial interpretations and interpretative releases on the subject which have been released over the years. However, nothing contained therein should prohibit the issuer from seeking to develop and manage its image within the general business community; provided that such activities remain compatible with the ultimate timetable for the public offering.122

For example, through product advertising and various other types of promotion, the issuer should try to develop significant name recognition amongst editors in the business press, industry analysts, brokers and various specialty publications well in advance of the IPO. This type of recognition usually complements parallel efforts aimed at customers, suppliers and potential employees. Management may also consult and retain a professional financial public relations firm and almost certainly should attend various trade shows, technical conferences and trade association meetings and develop a mailing network for press releases and other pertinent information about the issuer.

Moreover, assuming that the issuer is able to identify one or more strategic advantages in the course of preparing its strategic business plan, the following additional steps would appear to be consistent with the manner in which the investment community will otherwise assess the issuer:

1. Develop a pre-offering marketing campaign, including one or more of the components referred to above, designed to build the issuer’s image around the perceived strategic advantages.123 Make sure that the issuer is already “positioned” before the prospectus is drafted and distributed, since it might then be too late to overcome other “externals.” In

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122. Naturally, it is difficult to identify the precise moment when an issuer has seriously begun consideration of a prospective public offering. Once the issuer is "in registration," that period which begins when serious negotiations have been completed with the prospective managing underwriters, material increases in public relations activities should be avoided. However, existing levels of advertising may be continued, so long as no reference is made to the offering. Therefore, a gradual “ramp-up” of advertising expenditures in the period before serious consideration of the offering begins may be useful.

123. The content of the preoffering marketing campaign should be designed in consultation with counsel to insure that the activities are not deemed to be solicitation activities. As noted above, any reference to the offering should be avoided and the focus should be on providing an appropriate level of factual information regarding the issuer to the general business community. With regard to the marketing aspects of the IPO, see Howard D. Sterling, “Deciding to Go Public: The Importance of the Intangible Factors,” “Going and Being Public As A Marketing Tool,” and “Capital Raising: Modern Graphics Are Necessary” in How to Prepare An Initial Public Offering 1989, P.L.I. No. 656 (1989).
drafting the prospectus, discuss the issuer's strategic advantages in light of the known areas of concern of the investment community concerning the business of the issuer.

2. Understand the significance of "comparables" and past financial performance, but work hard to overcome any "downside" which those variables might create by distinguishing the issuer and its future prospects and illustrating how past performance may have fit within the issuer's original strategic objectives and timetable. Use the exercise of identifying the issuer's strategic advantages as an opportunity to understand the overall industry framework and to anticipate market characteristics which might influence the investment community's perception thereof.

3. Attempt to market the issuer's management and investment backers. Like it or not, the ability and willingness of those persons to communicate an aura of competence and confidence to the investment community is often far more important than product or technical concepts, which can only be explained to investors with great difficulty. The actual disclosures regarding management and current shareholders in the prospectus will be relatively summary in nature, thus it is important for an image to be formed prior to, and outside of, the offering process.

4. Insist that the managing underwriter demonstrate its ability to understand the issuer and its industry. Shy away from investment bankers who insist that selling is a matter of timing and "connections"; those factors are just too ephemeral. Investors do look to the stature and reputation of the managing underwriter.

5. Finally, recognize that the best disclosure is "full disclosure." Litigation arises when the prospectus is less than candid as to uncertainties and risks, and suits are usually filed after the event in question has already otherwise deterred the issuer from its operational progress. The preparation of the IPO prospectus is part of a long-term marketing effort and the developing public company will have the opportunity to continue to address in the business environment changes through its future Exchange Act reports. The purpose of the initial disclosure is to establish the framework for effectively communicating with the business community for years to come.

The IPO marks the beginning of a drastic and largely irreversible change in the manner in which the prospective public company conducts its internal affairs and formulates its external business strategies. As such, the tendency of the securities bar to focus upon
potential risks and liabilities with respect to compliance with regulatory disclosure requirements is to be understood. However, this article is intended to suggest that what is often considered to be a regulatory “nightmare” can actually be completed in a manner which complements the issuer's underlying skills and strategic business plan and its ability to devise appropriate marketing information for the competitive securities market.