A GUIDE FOR ISRAELI COMPANIES CONSIDERING A U.S. IPO

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Introduction

Financial market conditions in the United States have become wide open for underwritten initial public offerings by promising Israeli companies, particularly technology-based companies. Until recently, the predominant strategy for Israeli companies desiring to go public in the United States and gain a Nasdaq listing was a so-called reverse merger. A classic underwritten IPO was available only to large, well-established and profitable companies and a small number of biotech companies.

The underwritten IPO is a far superior path to going public than alternatives such as reverse mergers, which are needlessly complex, entail significant out-of-pocket expenses related to the structure and the implicit expense of the equity retained by the merger shell. Further, the resultant "public company" has a shareholder base with no real investment interest in the company and may saddle the successor with prior bad history, including substantial actual and contingent liabilities.

In an IPO underwritten by an investment bank, the company is marketed to investors who "buy in" to the company's prospects, and the underwriters orchestrate supply and demand for the company's equity, which optimizes the market capitalization and stability of the company's outstanding equity.

This is not to say that the going public process is easy or available to all technology companies. The classic underwritten IPO has become very expensive over the last decade, and investment banks are interested only in a credible and salable "growth story."

This guide will outline the key elements of the IPO process in the United States, followed by a discussion of the key elements of the required documentation and a list of key tasks to be performed by companies considering an IPO.

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IPO Process, Participants and Mechanics

Fundamentals

An underwritten IPO is a sale by a private company of its ordinary shares to the public. The sale takes place through the marketing efforts of an investment bank underwriter concurrently with the registration of the shares with the U.S. Securities and Exchange Commission (SEC). Optimally, the breadth and financial success of the offering will qualify the company for listing on a securities exchange, usually Nasdaq for Israeli technology companies. If the offering is completed and the company does not qualify for listing, the stock can be traded on the over-the-counter market (the Bulletin Board), although this market is not as deep and is therefore not as desirable. Occasionally, the private company's shareholders may sell a modest portion of their shares in the IPO (although this happens only in the strongest IPOs). After the IPO, the company's shareholders will own publicly traded stock that can be sold into the trading market, subject to certain restrictions such as lock-up agreements that are discussed below.

The IPO process, reduced to its most basic elements, entails completing a prescribed SEC form (in this case Form F-1 for "foreign private issuers") and filing it with the SEC. Unfortunately, this is an oversimplification. The "form" requires extensive and complex information about the company, and the written text must be at a very high level of composition, both from a legal and a marketing perspective.

The Registration Statement/Prospectus

The large majority of the time and expense of the IPO process involves the preparation of the registration statement and related prospectus that must be cleared by the SEC. This prospectus is also used to market the deal. The prospectus is often more than 100 pages, much of which is somewhat formulaic, but a significant portion needs detailed and original drafting. The task of the company and its advisors in drafting the prospectus is to thoroughly describe the company in a way that demonstrates why the company stands apart from competition, and what makes investment in the company attractive.

The "Business" section

The most difficult portion of the prospectus to prepare is the "Business" section. This section typically is 15 to 20 or more pages long. The content required is described in the SEC regulations in general terms, but the sequence and internal logic of this section are prescribed by long-standing custom and practice.

In essence, the internal logic/sequence asks the following questions:

- What is the societal need that is not currently being met (or not being met well enough)? For example, what task may be improved by new software, what medical condition may be improved by a new medical device, or what disease does not have an adequate pharmaceutical treatment.

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- What is the industry landscape? What is the size of the market for the company's actual or prospective product or service? All information of this nature needs to be supported by outside studies or research reports that must be made available to the company's and the underwriters' lawyers. No poetic license or exaggeration is advisable.
- What are the competitors / competitive products that are on the market now (if any), and what in particular is deficient about the current product offerings?
- What is the company's "solution" to overcome those deficiencies and meet the market need? How does the product work in a way that current products do not?
- How can the company's products be described in detail?
- What is the company's strategy to market and distribute its products?
- What is the company's strategy regarding its future product development and pipeline?
- What is the nature, strength and scope of the company's intellectual property protection?
- How is the product regulated, and what is the process and timing for obtaining any required regulatory approvals?

At the outset, it is the company's task to prepare the first draft of the Business section. Neither the bankers and certainly not the lawyers understand the company's business in the depth necessary to create a workable first draft. Also, since much of the other portions of the prospectus depend on and revolve around the Business section, the earlier the company completes the first draft, the faster the "form" will be filed with the SEC. This cannot be emphasized enough. Although the company prepares the first draft, only rarely is it written in a way that will satisfy regulatory or marketing standards. This part of the process is an art and not a science where experienced lawyers and bankers play a key role. Depending on how "apprehensive" the bankers and the bankers' lawyers are about the document, the process of drafting the Business section can take several weeks and usually <u>much</u> longer. It is therefore crucial for the company to prepare a comprehensive first draft early on.

Although the company needs to be described in a unique fashion, there are drafting models that are usually available as a starting point for the process. Before drafting begins, the company and its lawyers should find as many examples of reasonably similar public companies as possible. These companies' disclosure documents are publically available and free online on the SEC's website. It is important to identify strong examples, as this will expedite and simplify. The company would then analyze the content and internal logic of the models and use them as an aid to prepare the first draft.

The balance of the registration statement

The Business section typically runs 15 to 20 or more pages, but the registration statement itself often exceeds 100 pages. What's left?

- The risk factors of the business. The "Risk Factors" section describes in gruesome detail all of the risks facing the company and its investors. This section has suffered from "boilerplate creep" over the years and alone can run up to 20 pages. Usually, however, there are fairly good public company precedents that can serve as a starting point. Although the SEC specifically does not want boilerplate disclosure, in practice – this is largely what they get.

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Nevertheless, providing a more specific discussion of the "real" risks is conducive to avoiding SEC comments and delays (discussed below).

- Audited financial statements for the last two or three years.
- A discussion of what is really "going on" behind the numbers in the financials, constitutes the section known as MD&A (Management's Discussion and Analysis of Financial Condition and Results of Operations). The MD&A section addresses such matters as the reasons why the line items in the income statement increased or decreased from year to year, and the company's current financial condition and liquidity.
- Management biographies.
- Equity ownership of the company.
- Description of Articles of Association provisions, and related corporate law requirements.
- Description of the company's internal governance structure (Board committees, independence, committee charters and the like) that must comply with increasing Nasdaq complexity as a result of the Sarbanes-Oxley statute.
- Description of the underwriting arrangements.
- Multiple technical disclosure sections.

The SEC Registration Process

After the draft registration statement is satisfactory to the various deal participants, it is filed with the SEC. The SEC takes about a month to review it and then sends the company a letter describing all of the things that the SEC thinks the company should have done (but did not) and all of the things that the company should have done better in its disclosure. It is important to note that from the SEC's perspective, the philosophy of the registration process is *disclosure* – the SEC does not engage in a *merit* based analysis of the company. The SEC comments are prepared by a junior SEC staff member and are reviewed by more senior SEC lawyers. Accordingly, some comments are mere annoyances, but some require significant attention and discussion. Although sometimes company counsel can get the SEC to withdraw a comment or "soften" their position, the SEC really controls the process, and it is the company's (and the company's lawyer's) job to get the registration statement cleared and "declared effective" as soon as possible. The SEC review process usually takes a minimum of 60 days, and often takes much longer. Amendments to the registration statement that are responsive to the SEC's comments can number from a few to up to 10 or more.

Economic factors for the company and the founders/shareholders

Unfortunately, there is often a false promise for IPOs in the sense that there are a number of market and contractual factors that ultimately result in disappointing financial rewards for founders and shareholders. This consequence stems from contractual, legal and market limitations on the sale of

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secondary shares after the IPO. First, universally in IPOs, the underwriters require the shareholders of the company to sign what are called "lock-up" agreements by which the shareholders agree not to sell any of their shares for at least six months after the IPO. The initial success of the IPO is simply the product of the supply and demand for the company's shares, and the lock-up agreements serve to reduce supply. Next, SEC Rule 144 limits the number of shares that "affiliates" of the company – officers, directors and major shareholders – can sell into the market. Last, and most importantly, the trading market that develops after a relatively small company goes public is often too "thin" to support the sale of a substantial number of shares by affiliates. In a really strong IPO, however, the insiders may have the opportunity to sell shares in an underwritten secondary offering a few months after the IPO. In this sense, the IPO is the exact opposite of an M&A exit for the company – in that case, shareholders can get complete liquidity. The prevailing view is that company valuations are higher in an IPO than in a sale transaction, but for the foregoing reasons that doesn't necessarily translate into the realization of any incremental wealth by the shareholders.

Consequences of being a public company

Once a private company completes its public offering, it becomes a public company subject to a maze of ongoing SEC regulations governing public companies. Most importantly, these regulations take the form of reporting requirements, since the mandate of the SEC is to ensure fair disclosure and not to impose substantive legal requirements. These lines become blurred, however.

Reporting requirements are *technically* more relaxed for Israeli companies that qualify as "foreign private issuers" (FPIs). For instance, some of the SEC regulations, such as proxy regulation and the "short-swing" profits rules, do not apply to FPIs. Note, that for an Israeli company to qualify as an FPI, it must be incorporated outside the U.S. and not have over a specified percentage of U.S. shareholders. FPI status must be checked at the outset of the process and periodically thereafter.

Tasks to Prepare for an IPO other than Document Preparation.

Because the public markets are fickle, and favorable markets can change suddenly, a private company contemplating an IPO should begin its preparation well in advance of the expected SEC filing date. In fact, many pre-IPO steps and practices should be kept in mind beginning with the founding of the company. Most early-stage mistakes can be fixed, but some cannot.

Among the preparatory steps that a private company should take before the IPO are the following:

Task 1. Establish a relationship with one or more investment banks.

An underwritten IPO, as its name suggests, requires an underwriter. So, the first step for any company contemplating an IPO is to identify one or more U.S. investment banks that are interested in taking the company public. Years ago, there were several "tiers" of investment banks – the top-tier firms like Goldman Sachs or Morgan Stanley; the mid-level firms specializing in technology company IPOs; and then the bottom-tier firms, most of which had bad reputations—often well deserved. Over the last decade this lineup has completely changed. The technology banks were almost all acquired by larger firms that subsequently became uninterested in the smaller deals. There are still middle market firms, but

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that vacuum was mostly filled by smaller and reputable firms that found the economics of smaller technology IPOs to be a lucrative niche. There are a large handful of those firms today, mostly operating in New York, that are currently having great success in bringing to market small promising biotech, medical device and other technology-based companies. Before a company does anything else, it should obtain introductions to these firms through U.S. counsel and others to assess the interest of the banks in doing an IPO for the company.

Task 2. Retention of experienced U.S. securities counsel.

To shepherd the company through the morass of complex legal and practical issues involved in the IPO process, the company needs to retain sophisticated and experienced U.S. securities lawyers. There are many competent IPO lawyers in the United States. The problem for smaller companies is that the fees of the more prominent firms have exploded over the last ten years. Company counsel fees for a technology company IPO 15 years ago were rarely more than $250,000 to $350,000, except for the large New York firms. For reasons that are unclear, many securities law firms now typically charge $1 million or even $2 million or more for an IPO. If the company successfully raises $50 million in its IPO, that pain goes away quickly. But there is no guarantee that an offering will be concluded successfully. For that reason, many large law firms will not take on smaller IPOs, and most of the remaining firms that will take them on are less than entirely competent, and sometimes worse. As a practical matter, smaller IPO prospects must seek out competent and more efficient securities lawyers.

Task 3. Prepare SEC-compliant audited financial statements and enact and maintain adequate internal financial controls.

The SEC has prescribed rigid rules for the financial statement content of registration statements. Beyond the requirements of U.S. GAAP or IFRS, the SEC has its own separate requirements. Most importantly, the registration statement requires two or three years of audited financial statements. FPIs must file audited financials annually, and in almost all cases publish and file with the SEC also unaudited quarterly financial statements. There are strict deadlines for these filings. So, if it hasn't already done so, the company must engage an accounting firm that is experienced in SEC financial statement compliance. This function in Israel is accomplished in most cases by the Israeli affiliates of the large international accounting firms.

As mentioned above, the IPO prospectus also contains a section where management discusses its past financial performance and the behind-the-numbers story of the income statement and balance sheet. The section also requires disclosure of "known trends and uncertainties" regarding the company's prospective financial performance. Although the company technically is not required to furnish projections, this somewhat nebulous standard is meant to elicit disclosure that will eliminate surprises in the company's future operating results that are already known or easily foreseen. An early start on the preparation of this section by the company is always very helpful.

Beyond the financial statement requirements, the company must have in place the internal systems and controls that are sufficient to generate the financial statements required going forward on a timely basis. A chief financial officer who is familiar with U.S. reporting requirements is essential, but also essential are the internal systems that support prompt generation of quarterly financial

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statements (even if not technically required) and provide the needed back-up for an audit. Generally speaking, of all the pitfalls associated with the IPO process and public company status, inaccurate or otherwise non-compliant financial statements are by far the most common source of trouble and liability.

Task 4. Strengthen the management team, if necessary.

To the extent there are weaknesses in the company's management team, additional personnel should be hired prior to the IPO. Part of the assessment that underwriters make in determining whether the company is ready for an IPO is the quality and depth of the management team. Frequently, the existing chief financial officer is replaced if he or she does not have public company/IPO experience. Usually the CFO manages the IPO process on behalf of the company. The CFO must also prepare financial projections for the investment bankers to review; the bankers need to have a significant degree of comfort into the company's future financial performance even if no near-term profits are anticipated, particular in the fiscal quarters immediately following the IPO. Surprises in the numbers can cause a disastrous drop in the company's stock price and expose the company and the underwriters to legal liability and investor wrath. Further, companies may never recover from this kind of drop in stock price.

It is also useful to have one or more members of the Board of Directors with experience as a director or officer of a U.S. public company. An experienced board will provide the company with valuable, but low cost advice. Most importantly, a strong board builds investor confidence.

Task 5. Address corporate governance requirements dictated by Israeli law and put in place SEC/Nasdaq-compliant corporate governance provisions and Board and committee structures.

FPIs are required to comply with provisions of the Israeli Companies Law that relate to corporate governance. In addition, one of the principal features of the Sarbanes-Oxley Act and related Nasdaq requirements was to require stringent new corporate governance standards for public companies and companies that file to go public. Compliance with certain of these requirements can be delayed and some are not applicable to FPIs if their home country practice differs, but the company nevertheless must be aware of the applicable requirements and have a plan in place for compliance. Among the principal requirements are:

- The board of directors must have a majority of members who are "independent" under applicable SEC/Nasdaq/stock exchange rules.
- The board must include two 'External Directors', as such term is defined in the Companies Law.
- The board must have an independent audit committee of the board of directors with at least three members. One of the members should be a so-called financial expert—someone like a CFO of a public company, who has had responsibility for public company financial reporting in the past.
- The board must also have an independent compensation committee with at least three members.

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- The board must, or in certain cases should, approve policies and procedures such as a pre-approval policy for non-audit services, whistleblower procedures, code of ethics, insider trading policy and disclosure policy.

Task 6. Prepare in advance for underwriters' business and legal due diligence.

Both the underwriters and their counsel do a “due diligence” investigation of the company's business and legal affairs. Underwriters' counsel prepares a lengthy due diligence checklist of all of the legal documents that they need to review. The underwriters prepare their own list of required business information. These lists are largely all the same, so the company and its lawyers can expedite the process by assembling the documents that are likely to be on the list. In order to make the process a smooth one, these documents should be uploaded to an online data room. It is surprising how this mundane task can save a lot of time in the end.

Task 7. Review existing legal documentation.

The company's corporate lawyers should do a comprehensive review of the legal affairs of the company to make sure everything is in perfect order. The investment bankers will advise whether the company needs to do a forward or reverse stock split (to bring the price per share in the IPO into the customary range: $10 to $15, more or less). The company will also adopt, contingent on the success of the IPO, a new public company Articles of Association that, among other things, authorize sufficient shares to do the IPO, make additional public offerings and/or share exchanges or mergers for stock, and allow room to do a future stock split if the stock price significantly rises. Further, public company Articles of Association sometimes contain anti-takeover provisions, such as a staggered board, prohibition on shareholder written consents, advance notice of shareholder proposals, and the like. Underwriters typically don’t like these provisions because of investor perception issues. Prior to the IPO, many companies adopt new equity incentive plans or add additional shares to existing plans; also, public company plans usually contain additional provisions, such as those permitting cashless exercises, that may not be contained in the company's existing plans.

Task 8. Consider settling troublesome disputes.

Because the IPO will generate significant cash for the company, the company will find it more difficult to settle disputes and litigation after the IPO because of its deeper pockets. Also, announcement of a pending IPO often brings “vulture" claims forward. To the extent prudent, the company should try to dispose of these claims in advance.

Task 9. Pay off insider loans.

Loans to insiders are no longer permitted for public companies, and a quirk of the SEC rules requires that insider loans be repaid before the filing of the IPO registration statement, even though the deal may not proceed to pricing and closing.

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Task 10. Analyze the company's financing needs.

Companies can conduct private placements prior to an IPO and even, in certain circumstances, concurrently with the IPO. But there are significant limitations on the company's ability to do so. The company's financing plans must be shared with its advisors to make sure that they are not inconsistent with the IPO rules.

Conclusion

We recognize that every company is different, and every IPO is different. Acknowledging the challenge of summarizing the entire IPO process in a concise guide, we have focused our attention on the points we consider to be most generally applicable and most beneficial for Israeli companies contemplating a U.S. IPO.

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