SEC
Office of Investor Education and Advocacy

INVESTOR BULLETIN

Investing in an IPO

The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to provide investors with information they should consider when investing in the shares of a new public company.

What is an IPO?

Historically, an initial public offering, or IPO, has referred to the first time a company offers its shares of capital stock to the general public. Under the federal securities laws, a company may not lawfully offer or sell shares unless the transaction has been registered with the SEC or an exemption applies.

To register an offering, a company files a registration statement with the SEC, typically using Form S-1. Some offerings may involve other registration statement forms. An important part of this registration statement is the "prospectus" that will be used by the company to solicit investors. The prospectus is the offering document describing the company, the IPO terms and other information that an investor may use when deciding whether to invest. ***It is important to read the prospectus because it provides information regarding the terms of the securities being offered as well as disclosure regarding the company's business, financial condition, management and other matters that are key to deciding whether the offering is a good investment.***

Registration statements for IPOs are subject to review by the SEC's staff to monitor compliance with applicable disclosure requirements. In such reviews, the staff concentrates on disclosures that appear to conflict with SEC rules or the applicable accounting standards and on disclosure that appears to be materially deficient in explanation or clarity. The staff's review often results in revisions to the prospectus. However, the review process is not a guarantee that a company's disclosure is complete or accurate, and the staff does not evaluate the merits of any IPO or determine whether an investment is appropriate for any investor. Rather, responsibility for complete and accurate disclosure lies with the company and others involved in the preparation of the company's registration statement and prospectus.

Once any staff comments have been addressed, the staff will issue an order declaring the registration statement effective, which means the company may proceed to consummate its IPO. ***Although the staff will not declare a registration statement effective if the staff has reason to believe that the disclosure is incomplete or inaccurate in any material respect, the SEC's declaration of effectiveness does not represent an approval of the merits of the IPO or an indication that the information disclosed is complete or accurate.***

The underwriters of the IPO typically will have obtained "indications of interest" from prospective investors prior to effectiveness and will use this information to recommend a price for the shares to the issuer, who ultimately determines the price of the IPO. Underwriters are the investment banks that manage and sell the IPO for the company.

An IPO helps to establish a trading market for the company's shares. In conjunction with an IPO, a company usually applies to list its shares on an established stock exchange, such as the New York Stock Exchange or NASDAQ. Any planned exchange listing will typically be disclosed in the prospectus for the IPO. The new public company will also be required on a going-forward basis to disclose certain information to the public, including its quarterly and annual financial statements on Forms 10-Q and 10-K.

How do I invest in an IPO?

An IPO gives the investing public an opportunity to own and participate in the growth of a formerly private company. ***By their nature, however, IPOs can be risky and speculative investments.***

- There are two ways the general public can invest in a new public company. First, if you are a client of an underwriter involved in the IPO, you may be offered the opportunity to directly participate in the IPO. In this instance, you will be able to purchase the shares at the offering price. It is often the case that underwriters and dealers will distribute most of the shares in the IPO to their institutional and high net-worth clients, such as mutual funds, hedge funds, pension funds, insurance companies and high net-worth individuals. For the typical investor, being able to directly buy in a popular IPO is a unique opportunity.
- The other way, which is more common in the case of individual investors, is to purchase the shares when they are resold in the public market in the days following the IPO. An investor could place an order with his or her broker to purchase shares in this manner.

How do I learn about the company?

A company undertaking an IPO discloses required information in the registration statement, typically on Form S-1. Form S-1 and its amendments, which are denoted as S-1/A, are filed with the SEC and publicly available through the SEC's EDGAR database at www.sec.gov/edgar/searchedgar/webusers.htm. Comment letters issued by the staff during the course of an IPO filing review are also made available on EDGAR, but they are not posted until at least 20 business days after the registration statement is declared effective.

Most of a Form S-1 is comprised of the prospectus, which contains important information about the company. A new public company typically has no prior reporting history, and the information that can inform a decision to invest often can only be found in the prospectus, although, if it has sold securities in reliance on an exemption, the company may have filed one or more notices on Form D.

Being well informed is critical in deciding whether to invest. Therefore, it is important to review the prospectus and ask questions when researching an IPO. Whenever possible, verifying the information you are given against independent sources is also recommended. If you buy directly in an IPO you will receive a copy of the prospectus before your broker confirms your sale, but you can also read the prospectus before then by reviewing the prospectus included in the company's most recent registration statement on

EDGAR. When you read a prospectus, you should check to make sure you are referring to the company's most recent filing, because the contents of the prospectus may be revised during the course of the registration process. In addition to reading the prospectus, be sure to ask questions if the information is not clear.

After a company's IPO registration statement has been declared effective, the company will typically file a final prospectus—usually identified as a 424B3 or 424B4 filing in the EDGAR database. The final prospectus generally includes information related to the final offering price that is not available at the time the preliminary prospectus is distributed.

Highlighted below are some of the sections of an IPO prospectus that an investor should consider. Of course, other or additional sections may contain information that is important to an investment decision in the context of a particular IPO.

- Prospectus Summary briefly summarizes information that is disclosed in greater detail throughout the prospectus, including the company's business, strategy, plans for using the funds raised in the IPO and financial condition, as well as the terms of the IPO itself.
- Risk Factors identifies risks that the company's management feels could significantly impact the company's business, operations or performance, or an investment in the securities being offered.
- Use of Proceeds specifies what the company plans to do with the money it raises in the offering.
- Dividend Policy describes the company's history of paying, and possibly its plans to pay, dividends to shareholders.
- Dilution illustrates the usually significant disparity between the price that investors are paying for shares in the company's IPO to both (1) the book value of such shares and (2) the average price paid by existing shareholders that include founders, officers and early investors.
- Selected Financial Data discloses certain key financial and other data in a summarized column format. The information and presentation can highlight significant trends in the company's financial condition and results of operations. Companies are generally required to disclose selected financial data for the prior five years. However, if the company is an "emerging growth company" (as described in a section below), this disclosure can be limited to the prior two years. "Smaller reporting companies" (generally those expected to have less than $75 million in publicly held common stock following the IPO) are not required to provide selected financial data.
- Management's Discussion and Analysis gives management an opportunity to discuss in narrative form management's perspective on the company's financial condition, changes in financial condition and results of operations. This narrative section should provide investors with information to help them understand how and why the company's financial results have changed over the time period covered by the financial statements and factors that management thinks might affect the company's future financial condition or operating results.
- Business describes the company's lines of business, its principal products or services and their markets, any significant suppliers and customers on whom the company's business depends, and its competitive landscape and principal methods of competition, among other matters. This section may also provide

information regarding the relative contribution to the company's financial results from different significant lines of business or operations in foreign countries. In addition, *Legal Proceedings*, which is usually located at the end of *Business*, discloses the significant litigation involving the company.

- Management offers biographical information regarding the directors and executive officers of the company.
- Financial Statements and Notes provides standardized financial reports on the company's financial condition and performance. Emerging growth companies and smaller reporting companies are required to include two years of audited financial statements in their IPO prospectuses (compared to three years for other companies conducting IPOs). In addition, immediately prior to the financial statements is the *auditor's opinion* that sets forth the independent auditor's opinion of the financial statements it audited.

What else should I consider?

Following are some things to consider when making an investment decision involving shares of a new public company.

Offering price

The company and the underwriters make the decision on where to set the offering price. The factors they will consider in setting the price, as well as the terms of the underwriting agreement between the company and the underwriters, are discussed in the prospectus, usually under the caption *Underwriting* or *Plan of Distribution*. It is important to understand that the offering price is determined by a mix of market conditions, analysis and negotiation. Competing interests affect the determination of the offering price.

From the perspective of the company offering its shares in the IPO, the higher the offering price, the more capital the company can raise. The underwriters also have an interest in a high price not only to meet the company's objectives, but also because their compensation is typically a percentage of the offering price.

At the same time, the underwriters are responsible for selling the IPO and will want a price that is attractive to the client-investors to whom they will be selling. Underpricing an IPO creates a discount for the initial investors, increases the demand for the IPO and helps the underwriters sell all of the available shares. Underpricing may also affect how much, if at all, the stock's price rises on its first trading day. If there is a large increase, or "bump," from the offering price during the initial trading, the underwriter's client-investors may be satisfied because the value of their investment will have increased. However, the company may be unsatisfied in that case, as it might have been able to sell its shares at a higher initial offering price and thereby raise more capital.

Informing these competing interests are valuation analyses of the company's business and the "order book." Valuation analyses, which can be conducted by underwriters or potential investors, attempt to value a company based on its revenues, customers, financial results and other metrics. The "order book" is the compilation of indications of interest that the underwriters have obtained from the client-investors they solicited regarding the IPO. The order book lists how many shares each client-investor would like to purchase and at what price.

All of the foregoing factor into the determination of the offering price. Whether you have an opportunity to participate directly in an IPO or are buying shares in the open market, it is important to realize that the offering price reflects a negotiated estimate as to the value of the company. ***The offering price may bear***

little relationship to the trading price of the securities, and it is not uncommon for the closing price of the shares shortly after the IPO to be well above or below the offering price.

In addition, purchasing shares in the market immediately following an IPO can be risky. Underwriters can support the trading price of the new issue in its first few days of trading with certain trading activities, including purchasing shares of the company. This is often done to keep the trading price from falling too far below the offering price. Once this support ends, the stock price may decline significantly below the offering price.

Selling shareholders

Existing shareholders can sell their shares in the IPO if their shares are included in and registered as part of the offering. Most large IPOs include only new shares that the company sells in order to raise capital. However, in some cases, shares held by existing shareholders are included in the IPO and the shareholders are called "selling shareholders." The proceeds from the sales by selling shareholders do not go to the company and instead go to the selling shareholders.

The cover page of the prospectus details how many shares are being sold by selling shareholders, if any. The company will also disclose the number of shares each selling shareholder currently owns, plans to sell in the offering, and will retain following the offering under *Principal and Selling Shareholders* or a similarly captioned section. Selling shareholders may include, in addition to early investors seeking liquidity on their investment, the company's founders and management. Companies must disclose any position, office or other material relationship each selling shareholder has had with the company within the past three years. It may be worthwhile to discern the relationships the selling shareholders have had with the company and what proportion of their respective holdings is being sold.

Limited trading volume

The trading price of a new issue may be affected by a limited supply of shares in the market immediately following an IPO. The shares being traded on the first day are generally only shares that were sold in the IPO. All other outstanding shares, such as those held by founders, early investors and employees that have not been included in the IPO, may often not be sold in the public market so soon after the IPO, either because they are "restricted securities" under the federal securities laws that can only be resold without registration under certain circumstances, or because the existing shareholders have entered into a "lock-up agreement" in which they agree not to sell their shares for a certain period of time, typically 180 days.

Moreover, underwriter policies that discourage "flipping" also limit the number of shares sold in the IPO that may trade on the public market in the first few days or weeks of trading. "Flipping" is the term used to describe the act of immediately reselling the shares acquired in an IPO through the open market. Underwriters may discourage flipping by refusing to allocate IPO shares to customers who have flipped shares in the past, but the practice of flipping, alone, is not prohibited under the federal securities laws.

These restrictions, lock-up arrangements and underwriter flipping policies all serve to limit the number of shares that trade in the public market immediately following an IPO. ***The resulting limited trading volume, particularly in the case of a highly sought-after IPO, can operate to drive the trading price of an issue steeply up because of the limited supply to meet the high demand.***

Market overhang

The number of shares that are outstanding but cannot be traded at the time of the IPO is sometimes referred to as the "market overhang." The share price after an

IPO may decline over time as shares that were previously restricted become available for sale. In addition, when lock-up agreements expire, the share price may decline significantly if a large number of shares become available for sale all at once. ***Early investors and shareholders in a company often view an IPO as an exit strategy—a way to realize a profit on their investment by being able to sell shares to the public. The lock-up expirations give these early investors the opportunity to sell their shares to the extent they weren't able to do so as selling shareholders in the IPO.***

An investor can discover the extent of a company's market overhang in the IPO prospectus. A company must discuss the shares that it has agreed to register for sale or that will be available for sale without registration following the IPO. This disclosure can typically be found under *Shares Eligible for Future Sale* or a similar caption.

Dual-class common stock

An increasing number of companies engaging in IPOs have created separate classes of common stock with one class having greater voting power than the class being sold in the IPO. This dual-class common stock structure is often used by companies that are family-controlled or will continue to be led by their founders, with the "super-voting" common stock held by the founders or controlling family. With this structure, the holder of the super-voting common stock has a much greater percentage of the voting rights in the company than his or her equity stake would otherwise provide and can control the company without owning a majority of its shares. Generally, the super-voting common stock converts to the lesser-voting class of common stock when sold by its initial holder. ***While many successful companies maintain a dual-class common stock structure, investors should be aware that such a structure may make it more difficult, if not impossible, for public shareholders to exert any influence or control over corporate matters***.

Investors in new public companies can determine whether a company maintains a dual-class common stock structure and the rights they will have as shareholders by reviewing the first page of the prospectus as well as the section entitled *Description of Capital Stock*.

Stage of the company

An IPO is a significant milestone for a company, and high-profile IPOs frequently include companies that have exhibited recent tremendous growth and development. However, companies at different stages of development engage in IPOs for various reasons. Often, a company is seeking to access the capital markets in order to fund future growth and expansion. In other instances, a large and mature business may be returning to the public market after a successful reorganization under bankruptcy. ***It is important to keep in mind that an IPO does not always represent an opportunity to invest at an early stage with a fast-growing company.***

Emerging growth companies

One thing to keep in mind before investing in an IPO is that many disclosure and other requirements that now apply to public companies are phased in over time for what are called "emerging growth companies." Emerging growth companies generally have less than $1 billion in revenue. A company will remain an emerging growth company for up to five years after becoming a public company, unless its revenue exceeds $1 billion or it exceeds certain other thresholds.

- Emerging growth companies may elect to have the same extended periods of compliance that may be available for private companies to implement any new or revised accounting standards. This means that other public companies may have to implement new or revised accounting standards before emerging growth companies do. Emerging growth companies will have to disclose whether or not they are electing

to take advantage of the extended compliance periods. When you compare an emerging growth company's financial statements to those of other companies, you should keep this potential difference in mind.

- Emerging growth companies are not required to have their auditors annually assess their internal controls over financial reporting. Other public companies that are not emerging growth companies have up to two years after their IPO before they are required to have their auditors assess their internal controls, and smaller reporting companies are exempt from this requirement. After the IPO, management of emerging growth companies will have to assess the effectiveness of internal controls, like other public companies, but a separate auditor's assessment of such controls is not required.

- Emerging growth companies do not have to disclose as much about executive compensation as other public companies.

- Emerging growth companies do not have to conduct shareholder advisory votes on executive compensation arrangements, such as "say-on-pay" and "say-on-golden parachutes" votes.

- Brokers and dealers, including underwriters who are participating in an emerging growth company's IPO, are allowed to provide research reports regarding emerging growth companies prior to, during and after the IPO registration process. These research reports may not present all the information required in a prospectus filed with the SEC and are not subject to the stricter liability standards for a prospectus. ***Investors should keep in mind that brokers and dealers participating in the offering may face a conflict of interest between their obligation to provide their research clients with a balanced research report on a company and their desire to facilitate a successful offering on behalf of the company, which is their investment banking client or potential client.***

- A research report can provide useful information, but as a general matter, you should never rely solely on a research report. You should also do your own research—such as reading the prospectus—to determine whether a particular investment is appropriate in light of your own financial circumstances.

Additional Information

For information on how to search for company documents, such as prospectuses and registration statements, in the SEC's EDGAR database, visit investor.gov/researching-managing-investments/researching-investments/using-edgar-researching-public-companies and www.sec.gov/investor/pubs/edgarguide.htm.

For our investor alert about Pre-IPO Investment Scams, visit www.investor.gov/news-alerts/investor-alerts/investor-alert-pre-ipo-investment-scams-updated.

For information about Analyzing Analyst Recommendations, visit www.sec.gov/investor/pubs/analysts.htm.

For information about being able to directly participate in an IPO, visit www.sec.gov/answers/ipodiff.htm and www.sec.gov/answers/ipoelig.htm.

For more information about IPO lock-up agreements, visit www.sec.gov/answers/lockup.htm.

For more information about IPO and post-IPO pricing disparities, visit www.sec.gov/answers/ipopricing.htm.

For our investor bulletin about Say-on-Pay and Golden Parachute Votes, visit www.investor.gov/news-alerts/investor-bulletins/say-pay-golden-parachute-votes.

For our investor bulletin on How to Read a 10-K, which summarizes information that companies provide in annual reports on Form 10-K, visit www.investor.gov/news-alerts/investor-bulletins/how-read-10-k.

For additional educational information for investors, see the SEC's Office of Investor Education and Advocacy's website for investors, www.investor.gov.

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

SEC Pub. No. 133 (2/13)