

# **Government-Business Forum on Small Business Capital Formation**

Washington, D.C.  
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**Small business capital formation issues not  
addressed by the JOBS Act**

# Alternative Paths to the Public Markets

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# Background

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- The market for traditional IPOs is “broken” and continues to deliver largely disappointing results and mixed after-market performance
- The market for IPOs is characterized by the following dynamics:
  - **Fewer sponsoring firms:** due to consolidation and shrinkage in the brokerage industry, there are far fewer firms willing to/capable of effecting IPO transactions
  - **Execution risk:** given that the preparation phase of an IPO can take 4 to 6 months, there is significant risk that market conditions will have changed by the time a company is ready to market its IPO story to investors
  - **Costs precede capital:** a company should anticipate spending over \$2 million in legal, accounting and other fees to prepare for an IPO– all before marketing the story and raising any IPO proceeds
  - **Marketing dynamics:** traditional IPOs are sold in a condensed two-week roadshow consisting of a series of one-on-one meetings - this is clearly a sub-optimal format for conveying the merits and risks of many businesses
  - **Pricing dynamics:** few companies have been able to price within their original filing range and often price at a discount to the target price
  - **Mixed after-market performance:** on average, traditional IPOs are trading flat, but there is a wide variation from the mean and after-market support is often spotty

# Alternatives to a Traditional IPO

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*In response to the challenging and unpredictable IPO environment, there are alternative paths for companies to consider - Until recently, most of these alternatives were focused on various forms of reverse mergers*

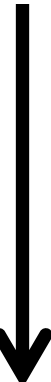
- The reverse merger, in various forms, has been the primary alternative to an IPO
- While reverse merger structures have historically been widely used as a way for a company to become public, there have also been structural and other concerns associated with them that have discouraged their use:
  - Lack of market liquidity post merger
  - Lack of broad institutional investor sponsorship
  - Lack of the transparency provided, and due diligence performed by, accountants, attorneys and underwriters in an IPO
  - Stigma often experienced by reverse merger companies by not doing an IPO-especially since the controversies associated with many Chinese reverse merger transactions erupted
  - Recent rule making covering exchange listing which makes it more difficult to attain exchange listing and associated benefits
- The new rules which toughen the listing standards for reverse merger companies have lead some companies seeking to become public to seek alternatives

# Change in Market Structure

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## The Market Has Moved to Confidentially Marketed Offerings

*The confidential format for marketing equity capital markets transaction has emerged as the preferred mechanism for marketing a follow-on financing - Some market participants believe that the IPO market will follow a similar path and that the confidentially marketed IPO (“CM-IPO”) will become a more frequently used alternative for companies seeking to become public*

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- Publicly announced, fully-marketed underwritten follow-on’s are predominant; Unregistered private placements (PIPEs) are uncommon and viewed less favorably
    - PIPEs emerge as a common and more accepted financing vehicle
      - Shelf registration filings become more common and accepted
        - Registered private offerings (RDs) and confidentially marketed public offerings (CMPOs) emerge as a preferred financing alternatives vs. PIPEs
          - Reverse mergers into cash and trading shells emerge as viable alternative
            - Form 10 reverse mergers gain recognition with the Cougar Biotechnology and Puma Biotechnology transactions
              - Form 10 self-registration
                - Future: Confidentially marketed IPO – Self Registration Resale S-1

# Historical Context

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## Form 10 Reverse Mergers

- The Form 10 path to the public markets gained significant attention with the success of Cougar Biotechnology
  - Strong institutional investor sponsorship
  - Sale to Johnson & Johnson for ~\$1 billion (May 2009)
- Most of the initial Form 10 transactions were executed as reverse mergers into Form 10 shells (*e.g.*, Cougar, Radius, Puma)
- The new rules which toughen listing standards for reverse merger companies have made the Form 10 reverse merger pathway significantly less attractive due to the time required to “up-list”
- In response, the focus has turned to the Form 10 self-registration approach

# Direct Registration Alternative

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- Coronado Biosciences entered the public markets via the self-registration pathway in a fast and efficient manner:
  - Form 10 review period: 67 days
  - Form S-1 review period: 48 days
  - Total process – private financing to public trading: 139 days
  - Days trading on OTCBB before up-listing to NASDAQ: 21 trading days- Exchange “seasoning” rules do not apply because the transaction is not a reverse merger

*The CM-IPO is a modest revision to the Form 10 self-registration path that saves significant time and meaningful expense*

- Follows same process as the Form 10 self-registration path but removes the Form 10 registration step
- After closing a private placement, a company can proceed directly to filing a Form S-1 Resale Registration Statement with the SEC
- Filing a Form 8-A concurrent with the effectiveness of the Form S-1 achieves the same result as the Form 10 filing (*i.e.*, registers the company under the '34 Act)

# Direct Registration Alternative #2

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- OvaScience Inc. entered the public markets via the self-registration pathway in a fast and efficient manner:
  - Form 10 filed April 11, 2012 after an institutional private placement.
  - Form S-1 filed August 29, 2012 after retail private placement; review period: 15 days from filing to effectiveness on September 13, 2012
  - Total process – last private financing to public trading: 91 days-OTCBB trading as of November 12, 2012. Opening price \$7.50/ share vs. private placement price of \$5.50/ share (a “step-up” of 36%)
  - Days trading on OTCBB before up-listing to NASDAQ: Not yet up-listed-Exchange “seasoning” rules should not apply because the transaction is not a reverse merger

*This just another, more recent, example which shows less uncertainty and with a timeline comparable-and maybe- substantially shorter than that for an IPO for the same company*



# CM-IPO Overview

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- The CM-IPO essentially turns the traditional IPO process upside-down
- Unlike a traditional IPO, where the registration process with the SEC precedes the funding event, the CM-IPO is a process whereby a company completes a private placement that is followed by the going-public process
- The CM-IPO process allows a company to take an alternative path to the public markets while avoiding the onerous restrictions imposed by the SEC, the stock exchanges and FINRA that are associated with reverse mergers

## Process and Timeline

- **Step 1** ( $T = 0$ ): Execute private placement
- **Step 2** ( $T + 15$ ): Form S-1 filed with the SEC
- **Step 3** ( $T + 50$ ): Investment bank to file Form 211 with FINRA to apply for trading on OTCBB
- **Step 4** ( $T + 90$ ): Form S-1 reviewed and declared effective by the SEC (~75 day process)
- **Step 5** ( $T + 95$ ): Form 211 cleared for trading
- **Step 6** ( $T + 96$ ): Begin trading

# Traditional IPO Challenges/ CM-IPO Solutions

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**Execution Risk / Costs:** the typical IPO process takes approximately 5-6 months. There is a significant risk that market conditions will change by the time a company is ready to go to market. Furthermore, the costs approximate \$1 MM before any capital is raised, vs.

- **Upfront Funding / Back-end Costs:** the process to go public begins with a financing. Only upon successful completion of the private placement will a company invest the time and expense of going public.

**Compressed Marketing Time-line:** an IPO is typically marketed over 8-12 business days that are filled with a condensed roster of one-hour meetings. Given the complexities of a typical emerging or growth story, this is a sub-optimal format to market a transaction, vs.

- **Privately Marketed, Extended Diligence:** the CM-IPO allows for more a more deliberate marketing process that can be conducted under confidentiality, vs.

**Pricing Dynamics:** on average, IPOs are pricing below the mid-point of the initial filed price range and may trade down in the aftermarket, vs.

- **Pre-established Pricing / Trading:** pricing is established upfront. Investors will be aligned in seeing initial public trading at prices equal to or better than the deal price.

# Challenges

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## **The Challenges of the CM-IPO**

- Execution of the upfront private placement may be difficult without a broad-based public marketing effort
- Aftermarket trading may be thin if the private placement was sold to a narrow group of investors
- Lack of an underwritten offering with a syndicate of banks may pose a challenge for reaching broad-based Wall Street sponsorship
- There can be uncertainty over meeting the timing and requirements for the transition from OTCBB to a securities exchange

## **A Traditional IPO May be Preferable for the Following Companies:**

- Companies with predictable revenues and earnings
- Companies for which the story is intuitive and has broad appeal to generalist and growth investors who can easily grasp the investment thesis in a traditional IPO marketing structure
- Situations where retail investors are the target audience

# Exchange Seasoning Rules

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*On November 9, 2011, the Securities and Exchange Commission approved new rules of the New York Stock Exchange, the NYSE MKT and NASDAQ that toughen the standards that companies which have gone public through a reverse merger must meet to become listed on those exchanges*

## **The main listing requirement changes consist of:**

- The company has completed a one-year “seasoning period” by trading in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following the reverse merger
- The company has timely filed all required reports with the SEC, including at least one annual report containing audited financial statements for a full fiscal year commencing on a date that is after the date of filing all information required to be filed about the reverse merger
- The company has maintained the requisite minimum share price (i.e., \$4 for NYSE and NASDAQ, and either \$2 or \$3 for Amex, depending on the applicable standard under which listing is sought) for a sustained period, but in no event less than 30 of the last 60 trading days, immediately prior to its listing application and the exchange’s decision to list the company’s shares

# Exchange Seasoning Rules (continued)

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- In addition, the NYSE and Amex rules give those exchanges the discretion to impose more stringent listing requirements in the case of a particular company if there is an:
  - Inactive trading market in the company's securities, there is a low number of publicly held shares that are not subject to transfer restrictions
  - The company has not had a Securities Act registration statement subject to a comprehensive SEC review, or the company has disclosed that it has material weakness in its internal controls that have been identified by management
  - The company has disclosed that it has material weakness in its internal controls that have been identified by management and/or the company's independent auditors but the company has not yet implemented an appropriate corrective action plan
- A reverse merger company generally would be exempt from these special requirements if it is listing in connection with a substantial firm commitment underwritten public offering with proceeds to the company of at least \$40 million, or if it has filed with the SEC at least four annual reports with audited financial information as of the application for listing

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