<u>Public Without an IPO – Strategies and Considerations</u>

-- Part 1 of a Series of Articles --

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I've received numerous inquiries and had many discussions regarding which way is the best way to become a public company. As the title to this latest article plainly suggests, there are indeed many considerations – more than can be covered in one article. This first article is a step though and will be followed by additional articles building on the information here.

Bucking the IPO System

When I first expanded my securities practice years ago to include reverse mergers and shell company transactions, I occasionally encountered skepticism from entrepreneurs and their lawyers from time to time regarding various alternative methods that allowed a company to become public without the traditional Initial Public Offering filing with the SEC (I'll refer to these various methods and other going public strategies that don't rely on an IPO as "IPO Alternatives").

Even straightforward self-filings using an experienced securities attorney were considered out of the mainstream. This occasional skepticism and overly cautious view of IPO Alternatives was a result of several factors.

1. <u>Going Public Raises Money for Operations</u>. First, conventional wisdom had it that "going public" was to accomplish various goals – a primary one being the raising of money for operations and growth. Not only is the <u>company</u> registered with the SEC but <u>shares</u> of the company are also registered so that they may be legally sold to investors by one or more underwriters. IPO alternatives, like reverse mergers and self-filings, include the first element (the company is registered with the SEC) but financing is a separate element which, if needed, must be arranged. This may be a PIPE financing at the time of the transaction or shortly after, a Regulation D private offering beforehand (refer to my articles in the archive on Reg D) or market makers lined up and in place to handle the sale of shares following a self-filing.

2. <u>Shareholder Base</u>. In addition, a successful IPO creates a broad shareholder base as a result of the distribution of the shares by the syndicate of underwriters. This type of broad share distribution generally creates a diverse "float" of public shareholders and a healthy trading market. A self-filing or a reverse merger (which may also take the form of a share exchange or asset acquisition) doesn't create new shareholders. The company needs to have enough shareholders to have a float and trading market following completion of documentation and filing with the SEC. While the shareholder base can be grown over time, regulator preferences and market realities require a sufficient shareholder base to make your efforts worthwhile.

3. <u>IPO Legitimacy</u>. Finally, an IPO has always had legitimacy because that was the clear roadmap laid out and supported by the SEC and custom-made for the SEC's integrated disclosure and reporting framework. Further, it way it was done by the big players – the

large brokerage houses and investment bankers – and they earned huge fees along the way for underwriting a conventional IPO. Creative entrepreneurs who didn't have access to Wall Street, or whose businesses were not mature enough to justify even a "best efforts" commitment by underwriters, or didn't have adequate revenue or capital for the going-public process, had to find other ways to provide their investors with free trading stock.

Initial SEC Distrust

Unlike an IPO, the SEC had some real and often justified concerns with the way some IPO Alternatives were being implemented. Beginning in the 1970's and 1980's, entrepreneurs, investment bankers and their attorneys began using Rule 504 of Regulation D and/or various state and federal securities laws to sell stock that would be able to trade without restrictions. Even if there was no public market for the stock, the trading could eventually develop if a good company continued to have positive developments and it found support among market makers. Another strategy was to simply form a company with a basic business plan and attempt to raise money with a public offering (sometimes with every intention of continuing the business and sometimes with the intention to acquire a company with more substance to be identified in the future).

From the SEC's point of view, many of the transactions employing these under-regulated alternatives were used simply to avoid the SEC's securities registration requirements and they resulted in complaints from investors claiming securities fraud. A typical example might involve a promoter who raised money for a company, but since it was not underwritten it was not nearly enough for the company to truly carry out its business plan or to have a healthy public market. Over time, the money raised is depleted paying fees or salary to the promoter while he is seeking other sources of financing or has moved on to other deals.

Heightened SEC Regulation

Much to the chagrin of those companies who were trying to do things right, the SEC decided it needed to step in and regulate IPO Alternatives more directly. Among other things, the SEC's Rule 419 in 1992 required promoters of "blank check companies" to keep all money raised in escrow until a merger or acquisition was generally approved by the shareholders and appropriate filings were made with the SEC. (A "blank check company" was defined by the SEC as "a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company…") If no acquisition was found or approved within 18 months, the funds had to be returned to investors with interest. Some readers may note the resemblance to a modern day specific purpose acquisition company, or "SPAC", however SPACs, while structured generally in the same manner, raise well over $5 million dollars and are therefore outside the purview of Rule 419.

As reverse mergers increased in popularity, further problem areas inherent in the use of IPO Alternatives were addressed by the SEC. On January 21, 2000, Richard Wulff of the SEC wrote a letter in response to an earlier letter from Ken Worm of the NASD (now known as the "Worm-Wulff letters") advising that Rule 144 was not available for the resale of securities initially issued by companies that are, or previously were, "blank check" companies. Since 2000, therefore, no resales of shares issued in connection with a reverse merger have been permitted without registration of the shares (as opposed to registration of the company) with the SEC. This became applicable to all holders of restricted and non-restricted shares of trading shells and non-trading shells, regardless of whether they were reporting or non-reporting (although see my recent article on Rule 144 - with recent changes to Rule 144 in 2008, holders of shares issued in shell transactions have a very narrow way out of the Worm-Wulff restrictions if the company is no longer a shell and files its required reports for 12 months).

Following the Worm-Wulff letters of 2000, the SEC adopted much more detailed filing requirements for reverse mergers in 2005 and prohibited shells from using Form S-8 (which had become commonly used in shell transactions as another form of compensation for insiders instead of its intended purpose related to employee-director stock grants).(See http://www.sec.gov/rules/final/33-8587.pdf.)

Finally Respectable

Even given the various limitations on IPO Alternatives which have been imposed along the way by the SEC, it is important to note that the SEC never prohibited shell company transactions – for the most part they have made promoters more forthcoming regarding transaction details. In its 2005 rulemaking, the SEC actually acknowledged there were legitimate purposes for the use of shells:

> "The rules and rule amendments we are adopting today do not address the relative merits of shell companies. We recognize that companies and their professional advisors often use shell companies for many legitimate corporate structuring purposes. Similarly, our definition and use of the term "shell company" is not intended to imply that shell companies are inherently fraudulent. Rather, these rules target regulatory problems that we have identified where shell companies have been used as vehicles to commit fraud and abuse our regulatory processes."

SEC respectability has accompanied acknowledgement from the big players on Wall Street that IPO Alternatives should be considered along with the traditional IPO approach. The term "reverse merger" gained new respect when the venerable 215 year-old New York Stock Exchange concluded a reverse merger with the registered upstart Archipelago Holdings rather than select a traditional IPO. While not perfect, Google's "Dutch Auction" strategy worked impressively despite an initial push towards going the traditional IPO route. There have been a multitude of successful self-filings and transactions using IPO Alternatives that have firmly established that a conventional IPO is not the only way to go.

Choosing the best IPO Alternative

If you can get an underwriter's commitment to take you public going the IPO route, you should seriously consider it and its costs. If you don't have the luxury of a major brokerage house waiting to underwrite your deal, how do you choose the best IPO Alternative? These transactions are all complex and not for the faint of heart. You need experienced legal and financial professionals to discuss the multiple pros and cons of the different IPO Alternatives before you even start to consider those alternative ways for your company to become public. Regardless of what anyone says, this is not a situation where there are a couple of quick documents you can sign and then you are on your way.

Your company might be ideal for a straightforward self-filing. This is clearly the SEC's most favored IPO Alternative because you are taking your company public "through the front door." Your company might also be offered opportunities to merge with an existing public company. (Just be conscious of the numerous restrictions applicable if the merger partner is, or was ever, a shell.) There are a various IPO Alternatives that can be used to accomplish your objectives and with the cost ranging from under $100,000 for self-filings to up to $1 Million or more for other options, there is ample reason to consider the pros and cons of each alternative suitable to your company. (As an example, the fact that a company already has a trading symbol is only one aspect to consider – but clearly not enough upon which to base a decision on how you will achieve your objectives for your company.)

In follow-up articles, I hope to explore some of those various considerations with you. Be sure to send me an e-mail and let me know if this article was helpful to you or if you have other questions before continuing further in your own ventures.

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