IPO Prospectuses: Avoiding and Responding to Common SEC Comments

A Lexis Practice Advisor® Practice Note by
Anna Pinedo and Alexandra Perry, Mayer Brown LLP


Anna Pinedo


Alexandra Perry

This practice note examines some of the issues most commonly raised in initial Securities and Exchange Commission (SEC) comment letters on registration statement filed for initial public offering (IPOs). It is intended to guide you, as counsel to an IPO company, in assisting your client in efficiently navigating the SEC comment and review process.

This practice note discusses comments that apply to IPO prospectuses generally, including comments on plain English principles and expert consent requirements, and comments on specific sections of a prospectus, including the risk factors, management's discussion and analysis of financial condition and results of operations, and others. It provides excerpts from, and links to, representative SEC comment letters, and offers drafting and other tips to help issuers avoid receiving these types of comments or, failing that, to respond effectively to the SEC's concerns.

This practice note does not provide a comprehensive list of the types of comments that the staff of the SEC's Division of Corporation Finance (SEC staff or staff) can issue, and does not address SEC staff comments on executive compensation disclosure, which has become less important since the Jumpstart Our Business Startups Act of 2012 (JOBS Act) enabled emerging growth company (EGCs) to provide less detailed executive compensation disclosures in their registration statements, which most EGCs undertaking IPOs have done. It also does not discuss financial statement and related accounting issues, which are typically addressed by the issuer's chief financial officer and its outside auditor. SEC staff comments can vary widely from offering to offering and depend on the issuer's industry sector, the stage of the issuer's business, and the issuer's financial condition. Accordingly, each issuer must draft its IPO prospectus disclosures to accurately reflect its own unique facts and circumstances.

For information about preparing the registration statement and prospectus for an IPO, see Registration Statement and Preliminary Prospectus Preparations for an IPO, Top 10 Practice Tips: Drafting a Registration Statement, and Form S-1 Registration Statements. For information about the IPO process, see Initial Public Offering Process. For information generally on responding to SEC comment letters and the SEC staff review process, see SEC Comment Letter Responses and Understanding the SEC Review Process.

SEC REVIEW PROCESS

After a company files a registration statement on Form S-1 (or Form F-1 for foreign private issuer), the SEC staff will perform a cover-to-cover review of the document to ensure compliance with the applicable disclosure and accounting requirements under the Securities Act of 1933, as amended (Securities Act). The SEC staff does not

evaluate the merits of an investment in an IPO but rather focuses on whether the disclosures provided in the registration statement provide investors with enough information to make an informed investment decision.

The SEC Staff's Comment Letter

Virtually all IPO registration statements receive comments. The SEC staff will generally issue a comment letter within 30 days from the date the registration statement is filed (whether submitted confidentially or publicly on EDGAR). According to the SEC's Fiscal Year 2016 Annual Performance Report, available at https://www.sec.gov/files/secfy18congbudgjust.pdf, in 2016 the SEC staff issued initial comments within an average of 25.5 days.

The SEC staff's comments will include a description of any deficiencies identified in their review and may also include requests for supplemental information from the company if the staff believes the disclosures do not comply with SEC disclosure requirements or omit information that may be material to investors. Each comment letter is unique to the filing and may include comments that require substantial revisions to the registration statement. The number of comments in the SEC staff's initial comment letter can range from just a few to 70 or more. There may be several rounds of letters from the SEC staff and responses from the company until the issues identified in the staff's review are resolved.

Responding to SEC Staff Comment Letters

You should work with your client, underwriters' counsel, the company's auditor, and the other members of the IPO working group to carefully address each SEC staff comment in the company's response letter and in any amended registration statement filed with it.

When responding to the SEC, it is important to be mindful of your responses as they will eventually be made publicly available. If you do not fully understand a specific comment, you should contact the SEC staff reviewer for clarification so you can provide an appropriate response. Thoughtful, well-written response letters are crucial to resolve SEC staff comments efficiently. Responses should focus on the SEC staff's specific questions and cite the SEC's rules, guidance, and other authoritative sources (especially for accounting comments) wherever possible. Although it is helpful to review other registrants' response letters, a company's response letter should address its unique facts and circumstances. If an amendment to the registration statement is being filed with the response letter, the responses should indicate specifically where the revisions have been made to address the SEC staff's comments.

You should not assume that receiving a comment means that the SEC staff reviewer disagrees with the company's approach or disclosure. Often comments seek additional information and clarification to better understand the company's position. You should not, however, respond to a comment by adding disclosures to the registration statement that you believe to be immaterial. If you believe that a comment concerns an immaterial matter, you should communicate that to the SEC staff reviewer (legal or accounting) responsible for the comment as early as possible in the review process to avoid causing any delays in resolving the comment. The response letter should thoroughly explain the judgments the company applied in drafting such disclosure to assist the SEC staff in understanding why additional disclosure is not material to investors or necessary to comply with the disclosure requirements.

Generally, SEC comment letters request responses within 10 business days. However, if you believe more time is needed to respond to the comments, you should discuss this with the appropriate SEC staff reviewer.

Once all the SEC staff's comments on its registration statement have been resolved, the company can request that the SEC declare the registration statement effective, which allows it to proceed with the IPO. The SEC

staff will upload its comment letters and the company's responses to EDGAR within 20 days of declaring the registration statement effective.

For additional information about the SEC review process, see Understanding the SEC Review Process.

To minimize the number of SEC staff comments on your client's registration statement, you should review staff comment letters and company response letters from recently completed IPOs in the same industry to identify industry-specific issues that the SEC staff may have, as well as IPOs for companies that have adopted similar accounting principles to identify any accounting-specific issues that the SEC staff is focused on. Foreign private issuers should also review SEC comment letters and company response letters from recently completed IPOs for issuers with the same country of domicile. However, many comments tend to fall under the recurring themes discussed below.

COMMON SEC COMMENTS ON IPO PROSPECTUSES

The following types of comments apply to prospectuses generally.

Plain English

Rule 421 under the Securities Act (17 CFR 230.421) requires companies to use plain English writing principles in their prospectuses. Here are some examples of comments received by issuers that failed to do so:

> "Throughout the prospectus numerous statements in your disclosure are unclear because they are not written in plain English or the concept is not fully described. Please review your entire prospectus to ensure that your disclosure throughout is written in plain English and the concepts that you describe are fully explained. See Rule 421(b) of Regulation C." (SEC Comment Letter to Achison Inc. (Sept. 20, 2016), *Comment #1*).
> "Please note that the summary is subject to the plain English principles under Securities Act Rule 421(d). Revise to eliminate unnecessary redundancy. For example, the fourth paragraph in this section appears to repeat much of the information in the first paragraph." (SEC Comment Letter to UPAY, Inc. (Aug. 4, 2016), *Comment #1*).
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> "Throughout your registration statement you utilize industry jargon. For example purposes only, we note your reference to "commercial real estate CDOs" on page 6. Please concisely explain these terms where you first use them." (SEC Comment Letter to TPG RE Finance Trust, Inc. (May 24, 2017), *Comment #3*).
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> "Please revise to explain industry jargon to an investor not in your business, such as "technology white space," and eliminate marketing language." (SEC Comment Letter to Ameri Holdings, Inc. (Mar. 6, 2017), *Comment #9*).

To avoid this type of comment, you should write in short declarative sentences, use definite and concrete everyday language, use active voice, present complex information in tabular format, and avoid legal and industry jargon and double negatives. Descriptive headings and bullet lists are also recommended. If highly technical or legal jargon cannot be avoided, then you should include a glossary in the prospectus to facilitate the reader's understanding of the prospectus disclosure.

Eliminating Repetition

The SEC staff may comment if there is too much redundant information in the prospectus. The problem of repetitive disclosure most commonly arises in the summary section of the prospectus. Here is an example of this type of comment:

> "Please identify those aspects of the offering and your company that are most significant, and highlight these points in plain, clear language. The summary should not, and is not required to repeat the detailed information in the prospectus. The detailed description of your business, competitive strengths, and strategy is unnecessary since you repeat them verbatim in the business section of the prospectus." (SEC Comment Letter to Valvoline Inc. (Jun. 27, 2016), *Comment #2*).

In preparing the summary section, you should avoid repeating too much information from the business section. The summary should highlight the most significant aspects of the company's business, with a lengthier description reserved for the business section. Item 503(a) of Regulation S-K (17 CFR 229.503) provides that the prospectus summary should be brief and provide an overview of the key aspects of the offering, and the SEC staff will object if it is too long. When drafting the summary, you and your client should consider and identify those aspects of the offering that are most significant and determine how to best highlight those points in clear, plain language.

Clarifying the Basis for the Issuer's Statements

Although the prospectus is, in part, a marketing tool, companies should avoid hyperbolic statements and marketing language. Statements of belief should be clearly labeled as such and be accompanied by an explanation of the basis for each belief. Companies should also be cognizant of potential liability under the federal securities laws for misstatements or omissions in the registration statement. Here are some examples of this type of comment:

> "We note your statement that you believe Top Kontrol is "the most advanced anti-theft and personal safety automobile device of its kind currently available." Please expand here and in all applicable places in the document to disclose the nature of the Top Kontrol device, such as how it is installed and how it works. Please also better explain the basis for your belief that it is the "most advanced" of its kind currently available. In this regard, we note that on page 25 you compare Top Kontrol to Viper and LoJack. As each of Viper and LoJack offer multiple products with multiple features, please clarify to which of their products you are referring in making the comparison to Top Kontrol." (SEC Comment Letter to SecureTech Innovations, Inc. (Mar. 15, 2018), *Comment #2*).

> "Disclose the basis for your assertion that nervonic acid "is known to be beneficial to memory related brain health, anti-aging, blood lipid regulation, and anti-fatigue symptoms." Disclose whether this information is based upon management's belief, industry data, reports/articles or any other source. In this regard, you state on page 14 that the benefits are claimed by studies. Elaborate upon the nature of these studies and whether you or a third party commissioned such studies." (SEC Comment Letter to CAT9 Group Inc. (Jan. 23, 2018), Comment #*6*).

To avoid comments on statements about a company's relative position in the industry, such as being a leader in a field, the company should disclose the relevant metric used for making the assertion, such as industry-wide sales figures or, if possible, a third-party source. It should also be clear when a statement is made based on management's belief (i.e., "We believe that . . ."). Although phrasing a statement as a belief may weaken its impact, it can help companies avoid liability under federal securities laws for misstatements or omissions of material facts. If a company has a good faith basis for its belief or opinion, and does not omit any material facts necessary to make the statements not misleading, statements of belief and opinion should be insulated from liability under Section 11 of the Securities Act (15 U.S.C. § 77k). Additionally, a good faith belief can support a defense against claims asserted under Section 10(b) (15 U.S.C. § 78j) of the Securities Exchange Act of 1934, as amended (Exchange Act), and Rule 10b-5 thereunder (17 CFR 240.10b-5), which require proof of an intent to deceive, manipulate, or defraud to impose liability.

For more information about the liability under the federal securities laws of participants in IPOs, see Liability under the Federal Securities Laws for Securities Offerings and Liability for Securities Offerings Checklist.

The SEC staff may, nonetheless, ask for the company's basis for a statement of belief. When responding to such comments, the company should carefully review how the statement of belief is phrased and provide support where possible, as in this example:

SEC Comment:

> "Please tell us the basis for your belief that your company is 'the only service available which is a patented methodology to effectively safeguard an individual's personal rights.'" (SEC Comment Letter to Right of Reply Ltd (Nov. 27, 2017), *Comment #2*).

Company response:

> "We have amended our disclosure to state that the Company is "one of the only…" in lieu of "the only…". We have also attached as Exhibits A and B to this letter opinions of counsel for the Company which we believe supports the statement highlighted in your comment." (Response to SEC Comment Letter to Right of Reply Ltd. (Jan. 3, 2018), *Response #2*).

The SEC staff will also typically ask the company to provide copies of all sources cited in the prospectus:

> "Please supplementally provide the report by the National Institute of Health Research in the United Kingdom referred to in this section." (SEC Comment Letter to OncoGenex Pharmaceuticals, Inc. (May 17, 2017), *Comment #7*).

> "Please provide us with supplemental support for the factual assertions made throughout your prospectus. To the extent you do not have independent support for a statement, please revise the language to clarify the basis for the statement. In addition, to the extent that some of these statements are intended to be qualified to your belief, please revise your disclosure to state the basis, to the extent material, for your belief." (SEC Comment Letter to FTS International, Inc. (Jan. 31, 2017), *Comment #7*).

To facilitate a timely response, you should prepare copies of all relevant third-party reports in advance and clearly highlight the relevant portions of the reports that support the statements included in the prospectus. Third-party reports and other supplemental information submitted in response to SEC staff comments are generally not filed on EDGAR and thus will not be made publicly available.

Experts' Consents

Rule 436 under the Securities Act (17 CFR 230.436) requires that the written consent of any expert (e.g., the issuer's independent auditor) or counsel whose report is quoted or summarized in the prospectus be filed as an exhibit to the registration statement. Here are some examples of this type of comment:

> "We note your response to comment 5 and your revised disclosure on page 12. It appears that this disclosure is being attributed to Savills PLC. Please provide an analysis as to why this third-party attributed disclosure is not expertized disclosure requiring a consent. Refer to Rule 436 of the Securities Act and Securities Act Compliance and Disclosure Interpretation Question 233.02." (SEC Comment Letter to Majulah Investment, Inc. (Oct. 23, 2017), *Comment #2*).

> "We note your disclosure throughout that Egan-Jones has rated the CM Loan at "A+" and that you have rated the loan an "A." Please file the consent for the Egan-Jones Ratings Company, as required by Securities Act Rule 436. Alternatively, please remove the references to the credit rating. For further guidance, please consider our Securities Act Rules Compliance and Disclosure Interpretations Questions 233.04 and 233.05." (SEC Comment Letter to Korth Direct Mortgage, LLC (Sep. 8, 2017), *Comment #13*).

> "We note references throughout your prospectus to third-party sources, such as Notch Consulting and ACT Research, for statistical, qualitative and comparative statements contained in your prospectus. Please provide us with copies of any materials that support third-party statements, appropriately marked to highlight the sections relied upon. Please also tell us if any reports were commissioned by you for use in connection with this registration statement and, if so, please file the consent as an exhibit. See Rule 436 of Regulation C of the Securities Act of 1933." (SEC Comment Letter to PQ Group Holdings Inc. (Jul. 7, 2017), *Comment #4*).

The SEC staff will not require a consent when the prospectus cites a publicly available report, but will require a consent when the report or other information was prepared by a third party at the company's request. Third parties may be reluctant to be deemed to be "experts" because experts are subject to liability under Section 11 of the Securities Act for any material misrepresentations in or omissions from their reports or other information included in the prospectus. Therefore, before filing your client's initial registration statement, you should determine whether any third-party information included in the prospectus will require a consent and whether the third party(ies) would be willing to deliver a consent.

If the company believes that an expert's consent is not required, it should explain its position in its response to the SEC:

SEC comment:

> "We note your reference to a study commissioned by you and conducted by Millward Brown regarding your brand awareness among women in the United States. Please file the consent of the named researchers as an exhibit to your registration statement or provide us with your analysis as to why you do not believe you are required to do so. Refer to Rule 436 under the Securities Act." (SEC Comment Letter to Stitch Fix, Inc. (Nov. 1, 2017), *Comment #2*).

Company response:

> "The Company respectfully submits that Millward Brown is not an "expert" under Rule 436. Rule 436 requires that a consent be filed if any portion of a report or opinion of an expert is quoted or summarized as such in a registration statement. Section 7 of the Securities Act of 1933, as amended, provides that an expert is "any accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him." The Company respectfully submits that Millward Brown, the third party provider of this study, is not among the class of persons subject to Section 7 and Rule 436 as "experts" unless the Company expressly identifies such provider as an expert or the statements are purported to be made on the authority of such provider as an "expert." Accordingly, the Company believes that Millward Brown should not be considered an "expert" within the meaning of Rule 436 and the federal securities laws.
>
> In addition, the Company notes that the consent requirements of Section 7 and Rule 436 are generally directed at circumstances in which an issuer has engaged a third party expert or counsel to prepare a valuation, opinion or other report specifically for use in connection with a registration statement. The information from this study included in the Amended Registration Statement was not prepared in connection

> with the Registration Statement or the Amended Registration Statement. In fact, the study was commissioned in November 2016, at which time the methodology, study details, key deliverables and price were set. As a result of the foregoing, the Company respectfully submits that the third party provider of this study is not an expert of the kind whose consent is required to be filed pursuant to Rule 436." (Response to SEC Comment Letter to Stitch Fix, Inc. (Nov. 6, 2017), *Response #2*).

In the example above, the company, through its outside counsel, responded to the SEC staff's comment citing the applicable rules to explain why an expert's consent was not needed.

Signatures, Exhibits, and Material Agreements

The SEC staff may question the completeness and adequacy of exhibits, audit reports, and management signatures included in or omitted from the registration statement. In particular, the staff often inquires about seemingly material contracts that have not been filed as exhibits to the registration statement, and a company may need to amend its filing to resolve these questions. Here are some examples of this type of comment:

> "We note your disclosure that Dr. O'Neill currently has a consulting agreement with the company. Please file this agreement as an exhibit or tell us why you believe that you are not required to pursuant to Item 601(b)(10) of Regulation S-K and disclose the material terms of this agreement in this section." (SEC Comment Letter to BioXcel Therapeutics, Inc. (Feb. 23, 2018), *Comment #2*).

> "We note that on August 22, 2017, you received an in-process research and development product candidate from a related party together with an agreement with a third party for the development, manufacturing, and commercialization of the product. Please expand your disclosure, here and elsewhere, to identify the product and collaborative partner. Additionally, disclose the material terms of the agreement, such as the duration, termination provisions, and each party's rights and obligations. File the agreement as an exhibit or provide an analysis supporting your determination that you are not required to file it pursuant to Item 601(b)(10) of Regulation S-K." (SEC Comment Letter to Sol-Gel Technologies Ltd. (Jan. 12, 2018), *Comment #1*).

In determining which contracts to file as exhibits to the registration statement, you should apply the definition of "material" in Securities Act Rule 405 (17 CFR 230.405), which provides that information is material if "there is a substantial likelihood that a reasonable investor would consider it important in determining whether to purchase the security registered." You should also carefully review Item 601(b)(10) of Regulation S-K (17 CFR 229.601), which lists the types of contracts that are considered to be material, including contracts not made in the ordinary course of business; contracts with directors, officers, or shareholders other than contracts involving the purchase or sale of securities at market price; contracts on which the company's business is substantially dependent; contracts for acquisition or sale of substantial amounts of property, plant, or equipment; and leases for property held by the company.

See the SEC's Compliance & Disclosure Interpretations for Regulation S-K, available at https://www.sec.gov/divisions/corpfin/guidance/regs-kinterp.htm, for the SEC staff's views on what may be required to be filed as an exhibit to the registration statement.

For further guidance on making materiality determinations, see Materiality Determination Guidelines, Materiality: Relevant Laws and Guidance, and Determining Materiality for Disclosure Checklist.

Emerging Growth Companies

The JOBS Act created a new category of issuer, called an EGC, to encourage public offerings by small and developing companies. EGCs are subject to less stringent SEC disclosure and reporting requirements, including

scaled (reduced) disclosures in their IPO registration statements. In its comment letters, the SEC staff has primarily asked EGCs to discuss: (1) their EGC status and their elections under the EGC provisions of the JOBS Act; (2) how and when they may lose EGC status; and (3) their qualification for an exemption from Section 404(b) of the Sarbanes-Oxley Act of 2002 (i.e., the requirement to provide an auditor's attestation report on the issuer's internal control over financial reporting). These are some examples:

> "Please update your disclosure throughout the prospectus describing how you may lose emerging growth company status. In this regard, we note that the gross revenue threshold is $1,070,000,000 and the non-convertible debt limit is $1,000,000,000. Refer to the definition of Emerging Growth Company found in Rule 405 of the Securities Act of 1933." (SEC Comment Letter to Atlantic Acquisition II, Inc. (Dec. 5, 2017), *Comment #4*).
>
> "We note your response to our prior comment 2 and your revised disclosure that you are 'an emerging growth company' as defined in the Jumpstart Our Business Startups Act. Please revise your registration statement to:

- Describe how and when a company may lose emerging growth company status
- Briefly describe the various exemptions that are available to you, such as exemptions from Section 404(b) of the Sarbanes-Oxley Act of 2002 and Section 14A(a) and (b) of the Exchange Act; and
- State your election under Section 107(b) of the JOBS Act:
  - If you have elected to opt out of the extended transition period for complying with new or revised accounting standards pursuant to Section 107(b), include a statement that the election is irrevocable; or
  - If you have elected to use the extended transition period for complying with new or revised accounting standards under Section 102(b)(2), provide a risk factor explaining that this election allows you to delay the adoption of new or revised accounting standards that have different effective dates for public and private companies until those standards apply to private companies. Please state in your risk factor that, as a result of this election, your financial statements may not be comparable to companies that comply with public company effective dates. Include a similar statement in your critical accounting policy disclosures."

(SEC Comment Letter to Achison Inc. (Oct. 19, 2016), *Comment #1*).

To avoid these types of comments, a company should include in its prospectus:

- If it has elected to be an EGC
- How it qualifies for EGC status
- How and when it may lose its EGC status
- The elections it has made under the EGC provisions
- Any related risk factors

For more information about EGCs, see IPO Requirements for Emerging Growth Companies Checklist, Emerging Growth Company Practice Guide, and Top 10 Practice Tips: Emerging Growth Companies.

Foreign Private Issuers

The SEC staff's comments to foreign private issuers have included financial accounting and other disclosure topics, many of which are generally like those issued to domestic filers and relate to issues discussed in other

sections of this practice note (although SEC staff comments to foreign private issuers on financial statement issues may refer to international financial reporting standards (IFRS) rather than U.S. generally accepted accounting principles (GAAP)).

COMMENTS THAT APPLY TO SPECIFIC SECTIONS OF THE PROSPECTUS

The following types of comments relate to the disclosure included in specific sections of an IPO prospectus.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

SEC staff comments on MD&A are common and tend to focus on results of operations, critical accounting policies and estimates, and liquidity matters. Additionally, the SEC staff often comments on the use of financial measures not presented in accordance with U.S. (or IFRS) GAAP (non-GAAP financial measures), which, if included in the prospectus, typically appear in the MD&A section.

Results of Operations

The SEC staff often requests that companies explain the results of their operations with greater specificity, including identifying underlying drivers for each material factor that has affected their earnings or that is reasonably likely to have a material effect on future earnings. Here are some examples of these type of comments:

> "Please note that the purpose of Management's Discussion and Analysis (MD&A) is to provide information necessary to a reader's understanding of the registrant's financial condition, changes in financial condition and results of operations, as required by Item 303(a) of Regulation S-K. Specifically, where the consolidated financial statements reveal material changes from year to year in one or more line items, the registrant shall discuss the underlying reason(s) for the changes to assist in understanding their business. In this regard, please revise your MD&A to provide a robust discussion of your financial statements as previously requested." (SEC Comment Letter to International Land Alliance, Inc. (Feb. 17, 2017), *Comment #1*).

> "We refer to your discussion of regulatory changes in Brazil affecting higher education. You state that these program changes had an adverse impact on you in 2015 and are likely to have an adverse impact on you in 2016. It is not clear how and to what extent these changes impacted your results of operations in 2015 and how you expect them to affect you in 2016. Accordingly, please expand your disclosures in Management's Discussion and Analysis of Financial Condition and Results of Operations to provide a more informative analysis and discussion of the effect on your results of operations in 2015 and how you expect these changes to impact your revenue and related income in 2016. Refer to Item 303(a)(3) of Regulation S-K and Section III of SEC Release No. 33-8350." (SEC Comment Letter to Laureate Education, Inc. (May 26, 2016), *Comment #1*).

> "We note your September 29, 2015 acquisition, from an entity under common control, of what appears to be a substantial custom design on-line educational platform. Tell us and include in management's discussion a description of the operating history of this educational platform. Address those financial and non-financial metrics you use to assess its operating performance. Identify any known trends and uncertainties arising from the platform's historic operations that you expect to have a material impact on your prospects for future revenues." (SEC Comment Letter to British Cambridge, Inc. (Dec. 4, 2015), *Comment #5*).

To avoid these types of comments, you should carefully review the instructions to Item 303(a)(3) of Regulation S-K (17 CFR 229.303) for preparing disclosure about an issuer's results of operations. The disclosure should

include the key metrics that are monitored by management and how those metrics correlate to material changes in the company's results of operations. The company should also describe any:

- Unusual or infrequent events or transactions that may materially affect its operations
- Significant components of its revenues and expenses necessary to understand the results of operations
- Known trends that have or are expected to have a material effect on its operations
- Material changes to revenues resulting from a business combination or introduction of a new product/service line
- Segment information needed to understand the company's operations

The SEC staff often requests that companies provide a more granular quantification and discussion of specific factors, including any material offsetting factors, that contribute to material changes in the results of operations period over period, as well as the business or economic reasons that contributed to those factors.

Critical Accounting Policies and Estimates

The SEC staff often requests discussion and analysis of critical accounting policies and estimates, and criticizes companies that merely repeat the disclosure provided in the financial statement footnotes. Here are some examples:

> "Please revise your filing to include a robust discussion and analysis of the critical accounting policies you name here. This disclosure should supplement, not duplicate, the description of accounting policies in the notes to the financial statements, and should provide greater insight into the quality and variability of information regarding financial condition and operating performance. The discussion here should present your analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time. Refer to the guidance in FR-72." (SEC Comment Letter to X Rail Enterprises, Inc. (Jul. 3, 2017), *Comment #8*).

> "Please disclose and discuss the critical accounting policies and estimates that required significant management judgement. It appears to us, at a minimum, you should enhance disclosures related to business combination, intangible assets, taxes, and stock compensation." (SEC Comment Letter to PQ Group Holdings Inc. (Jul. 7, 2017), *Comment #25*).

> "Your disclosure should supplement, not duplicate, the description of accounting policies that are already disclosed in the notes to the financial statements. Please revise to limit your disclosure to significant accounting estimates and assumptions. Your disclosure should address accounting estimates and assumptions where the nature of which is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change or where the impact of the estimates and assumptions on financial condition or operating performance is material. Refer to Item 5 of Form 20-F and Section V of SEC Release 33-8350." (SEC Comment Letter to AGM Group Holdings Inc. (Jun. 9, 2017), *Comment #16*).

To avoid this type of comment, companies should focus their MD&A discussion of critical accounting estimates on the quality and variability of management's most significant judgments and assumptions. The SEC staff's comments have frequently targeted repetitive discussions about critical accounting estimates in MD&A, and the SEC staff has reminded companies that MD&A should supplement but not repeat the disclosures in the significant accounting policies note of the financial statements.

Liquidity Matters

SEC staff comments on liquidity focus on disclosure and analysis of the drivers of an issuer's cash flow. Here is an example:

> "In addition to the disclosures provided, your discussion and analysis of operating, investing, and financing activities should focus on the primary drivers of and other material factors necessary to understand your cash flows and the indicative value of historical cash flows. Please revise to provide disclosure and analysis of the underlying drivers that affect your cash flows that are not readily apparent from your cash flow statements. Ensure that your discussion includes an explanation of the cash received from deposit payable and the investment in transaction monetary assets. In this regard, clarify whether transaction monetary assets are available to fund your operations, or whether they are considered restricted solely for repayment to your clients. Refer to Item 5.B of Form 20-F and Section IV.B of SEC Release No. 33-8350." (SEC Comment Letter to AGM Group Holdings Inc. (Jun. 9, 2017), *Comment #14*).

To avoid this type of comment, you should carefully review Items 303(a)(1) and (2) of Regulation S-K, which require discussion of known material trends, demands, commitments, events, or uncertainties that are reasonably likely to affect (either favorably or unfavorably) liquidity or capital resources. The MD&A section should therefore include a meaningful analysis and discussion of the material components that explain the variability of cash flows, including the underlying drivers for material changes. Especially when there are trends or uncertainties affecting liquidity, the MD&A section should focus on sources and uses of cash and the availability of cash to fund liquidity needs. For example, if there is an elevated risk of default on a company's contractual obligations, or if management believes that is reasonably likely that the company may not continue to comply with its debt covenants, the company should include comprehensive disclosures on the potential risks and effects of covenant noncompliance and whether there are any possible waivers or covenant modifications available to the company to cure or prevent such covenant violations.

For information about preparing or reviewing MD&A, see Management's Discussion and Analysis of Financial Condition and Results of Operations and Management's Discussion and Analysis Section Drafting Checklist.

Non-GAAP Financial Measures

In recent years, the SEC staff has increased its focus on compliance with the presentation and disclosure requirements for the use of non-GAAP financial measures. All public companies are prohibited from presenting non-GAAP financial measures in ways that are misleading or give them greater prominence than GAAP measures. These prohibitions apply to both the order of presentation and the degree of emphasis given to these measures. In April 2018, the SEC staff updated its guidance on the use of non-GAAP financial measures, available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm, and identified certain uses that the SEC staff considers misleading or providing undue prominence. Here are some examples of comments on the use of non-GAAP financial measures:

> "To the extent you provide the non-GAAP financial measure, total segment adjusted EBITDA, please reconcile it to the most directly comparable GAAP measure, net income, as required by Item 10(e) of Regulation S-K." (SEC Comment Letter to PQ Group Holdings Inc. (Jul. 7, 2017), *Comment #23*).

> "We note your presentation on page 15 of the non-GAAP measures "Gross Merchandise Volume (GMV)" and "SPE Revenue". We also note you define GMV "as the total of uSell revenue plus revenue generated by the SPE," an entity whose revenues are neither reportable in your financial statements nor in accordance with GAAP. Your presentation of these non-GAAP measures is inconsistent with Question 100.04 of the

> Compliance and Disclosure Interpretations guidance on non-GAAP measures issued on May 17, 2016. Accordingly, please revise your presentation to remove these non GAAP measures or tell us why you believe it is not necessary to do so." (SEC Comment Letter to uSell.com (Dec. 14, 2017), *Comment #1*).

> "Please balance your presentation by showing a GAAP gross profit percentage with equal or greater prominence to the incremental contribution margin percentage. In addition, please revise your reconciliation of the non-GAAP measure, incremental contribution, to begin with consolidated gross profit, the most directly comparable GAAP financial measure. Refer to Question 102.10 of the updated Compliance and Disclosure Interpretation Guidance on non-GAAP financial measures issued on May 17, 2016. Furthermore, expand your disclosure on page 65 to disclose why the presentation of this non-GAAP measure is useful to investors." (SEC Comment Letter to WideOpenWest, Inc. (May 12, 2017), *Comment #6*).

> "Your measure of adjusted net income includes an adjustment to exclude the loss from discontinued operations. This measure appears to use an individually tailored measurement method substituted for one in GAAP. Please revise to exclude this adjustment or advise. Refer to Question 100.04 of the Non-GAAP Compliance and Disclosure Interpretations." (SEC Comment Letter to Bandwidth, Inc. (Oct. 19, 2017), *Comment #3*).

To avoid SEC staff comments about non-GAAP financial measures, companies should include clear and specific disclosure of why each non-GAAP measure is useful for investors and how management uses it. The statements a company makes about non-GAAP measures in its IPO prospectus may signal how it plans to communicate with investors in the future; therefore, it is important that you carefully review any non-GAAP disclosures in the registration statement. When disclosing non-GAAP financial measures, companies must include a reconciliation of such measures to the most directly comparable GAAP financial measures. Non-GAAP financial measures must also not use individually tailored measurement methods instead of GAAP methods, which could be viewed as misleading and violative of Rule 100(b) of SEC Regulation G (17 CFR 244.100). You and the other members of the IPO working group should carefully review Regulation G, Item 10(e) of Regulation S-K (17 CFR 229.10), and the SEC staff's guidance for any non-GAAP disclosures included in the prospectus.

For guidance in preparing compliant non-GAAP financial measures, and for more information about the SEC's regulation of non-GAAP financial measures generally, see SEC Regulation of Non-GAAP Financial Measures.

Risk Factors

Item 503(c) of Regulation S-K (17 CFR 229.503) requires the disclosure of the most significant factors that make the IPO speculative or risky. Risk factors should be specific to the company's facts and circumstances, and the SEC staff commonly questions risk factor disclosures that could apply generally to any public company. It also may question the completeness of a company's risk factor disclosures based on information included elsewhere in the document or other public information. Here are some examples:

> "This risk factor is overly generic in nature. Please remove the risk factor or address the specific risks posed to the Company." (SEC Comment Letter to Franklin Hill Acquisition Corp (Jan. 11, 2017), *Comment #9*).

> "We note that the Chief Executive Officer, Lin Yi-Hsiu, will be offering the company's securities to the public while simultaneously offering his own shares for sale. Please add a risk factor that addresses this potential conflict of interest." (SEC Comment Letter to Leader Capital Holdings Corp. (Dec. 11, 2017), *Comment #4*).

> "We note your disclosure on page 18 that your Chief Executive Officer resides in Canada. Please provide a risk factor pertaining to the difficulty that U.S. stockholders would face in effecting service of process against

> your sole officer. This risk factor should address the risk U.S. stockholders face in: effecting service of process within the U.S. on your officer; enforcing judgments obtained in U.S. courts based on the civil liability provisions of the U.S. federal securities laws against the officer; enforcing judgments of U.S. courts based on civil liability provisions of the U.S. federal securities laws in foreign courts against your officer; and bringing an original action in foreign courts to enforce liabilities based on the U.S. federal securities laws against your officer. Alternatively, please advise as to why you believe such a risk factor is unnecessary." (SEC Comment Letter to Hoops Scouting USA (Nov. 21, 2017), *Comment #4*).
>
> "Given your disclosure on page 2 and elsewhere that you intend to focus on companies in the senior housing and care industry in the United States, please add risk factors that highlight the materials risks concerning companies in that industry." (SEC Comment Letter to Big Rock Partners Acquisition Corp. (Nov. 9, 2017), *Comment #5*).

To avoid comments such as these, you should carefully draft the risk factors to:

- Concisely summarize the major risks facing the company's business or industry.
- Provide sufficient information to place each risk in context and allow investors to assess the magnitude of the risk.

Each risk factor should have a clear heading and identify the risk facing the company, rather than simply stating facts about the company and its industry. For example, see the following SEC comment and resulting revisions made by the company to address the comment:

SEC comment:

> "We acknowledge your response that you are unclear on the DEA's position on CBD. Please expand your risk factor disclosure to discuss why this uncertainty exists and the potential impact on your business if your products are considered by the DEA to be Schedule I controlled substances, and highlight this possibility in your risk factor header." (SEC Comment Letter to LBC Bioscience Inc. (Jul. 31, 2017), *Comment #4*).

Original risk factor:

> ***We are subject to numerous potential regulatory matters*.**
>
> The Drug Enforcement Administration ("DEA") which enforces the controlled substances laws of the United States has issued various rules and announcements concerning various items considered to be marihuana extracts which may encompass Cannabinoids. The uncertainty involves the extent to which the DEA will try to restrict the marketing or distribution of any CBD product. If the DEA were to take any aggressive action against CBD products, it would likely result in LBC ceasing operations.
>
> (LBC Bioscience Inc. Registration Statement on Form S-1 (Apr. 20, 2017))

Revised risk factor:

> ***We are subject to numerous potential regulatory matters. If the DEA were to take actions against CBD products as Schedule 1 controlled substances, it could cause LBC to cease operations.***

> The Drug Enforcement Administration ("DEA") which enforces the controlled substances laws of the United States has issued various rules and announcements concerning various items considered to be marihuana extracts which may encompass Cannabinoids. The DEA created a separate Administration Controlled Substances Code number for marijuana extract earlier this year, defined to cover an extract containing one or more cannabinoids, and stated that such extracts will continue to be treated as Schedule I controlled substances.
>
> If the DEA were to take actions against CBD products as Schedule 1 controlled substances or restrict the marketing or distribution of any CBD product, it would likely result in LBC ceasing operations.
>
> (LBC Bioscience Inc. Prospectus on Form 424(b)(3) (Sep. 28, 2017))

Additionally, risk factors should not include any mitigating language, as noted in this SEC comment:

> "Please revise to eliminate the last two sentences of the second paragraph of this risk factor, as they mitigate the risk you discuss." (SEC Comment Letter to Nine Energy Service, Inc. (May 15, 2017), *Comment #2*).

Accordingly, you should not include (or should delete) any language in a risk factor that appears to mitigate or otherwise lessen the impact of the identified risk, even statements of objective fact. However, mitigating language may be used in the business and MD&A sections of the prospectus.

Issuers must disclose all material risks. As shown in the following example, the SEC staff will object to any language in the prospectus disclaiming a company's responsibility to do so:

> "The second and third sentences in the introductory paragraph suggest that the risk factor disclosure is not complete because you may not be disclosing all material risks. Please revise or remove this language and disclose all material risks." (SEC Comment Letter to NPQ Holdings Limited (Aug. 10, 2016), *Comment #7*).

An emerging area of SEC focus is cybersecurity risk. In February 2018, the SEC issued interpretative guidance on cybersecurity disclosures, providing a framework to assist companies in preparing disclosure about cybersecurity risks and incidents involving cybersecurity in registration statements filed under the Securities Act and registration statements and current and periodic reports filed under the Exchange Act, which is available at: https://www.sec.gov/rules/interp/2018/33-10459.pdf. With the increase in frequency and severity of cyberattacks and data breaches, you should carefully consider what, if any, material cybersecurity risks or incidents should be disclosed in the prospectus, as this is likely to be an area of continued staff focus in reviewing IPO filings.

For information about drafting risk factors, see Risk Factor Drafting for a Registration Statement, Top 10 Practice Tips: Risk Factors, and Market Trends 2016/17: Risk Factors. For a form of cybersecurity risk factor, see Cybersecurity Risk Factor.

Use of Proceeds

Item 504 of Regulation S-K (17 CFR 229.504) requires companies to describe their planned uses and amounts of offering proceeds, including whether any proceeds will be used to discharge debt, complete an acquisition, or provide working capital. The SEC staff may request additional information or clarification, particularly if the disclosure is general or vague or the issuer states or implies elsewhere in the prospectus that it will use the proceeds in a manner inconsistent with, or not included in, the use of proceeds section disclosure. Here are some examples of these types of comments:

> "Please clarify your specific plans for the proceeds of the offering or if you have no such plans discuss the principal reasons for the offering. Refer to Item 3.C.1 of Form 20-F." (SEC Comment Letter to Jinxuan Coking Coal Limited (Feb. 9, 2018), *Comment #3*).

> "In addition to the table on page 13, please provide a narrative summary of your expected use of proceeds, including how each level will or will not advance your planned operations. To the extent you provide this detailed disclosure elsewhere in the prospectus, you may provide a descriptive cross-reference to that disclosure." (SEC Comment Letter to SigmaRenoPro, Inc. (Nov. 28, 2017), *Comment #10*).

> "Please revise your Use of Proceeds table to quantify, at each level of gross proceeds received, how much you will spend for your major categories of expenditures, such as advertising, officer compensation, new personnel, platform expansion and the development of the CCMP software. Please also clarify whether you will use any offering proceeds to repay related party debt pursuant to Instruction 4 of Item 504 of Regulation S-K." (SEC Comment Letter to Yappa World Incorporated (Sep. 28, 2017), *Comment #5*).

> "We refer to your statement that you intend to use the net proceeds for 'general and administrative expenses and the remainder for working capital and other general corporate purposes.' Please clarify whether the 'general and administrative expenses' will cover costs related to the development of your nasal and/or oral Lorazepam spray, and state the approximate amount intended to be used for each such purpose. Refer to Item 504 of Regulation S-K for guidance." (SEC Comment Letter to Axium Pharmaceuticals, Inc. (Sep. 15, 2017), *Comment #18*).

To avoid these types of comments, you should review Item 504 of Regulation S-K carefully when drafting the use of proceeds section. The instructions to Item 504 provide useful guidance and detailed requirements that apply to specified uses of proceeds, including to discharge debt and to acquire businesses or other assets. You should also make sure that disclosures elsewhere in the prospectus are consistent with that in the use of proceeds section.

Industry and Market Data

Prospectuses that include industry and market data taken from industry publications or other third-party sources sometimes include cautionary language that the third-party information has not been independently verified and may not be reliable. The SEC staff will object to such cautionary language because a company is responsible for all the information in its registration statement. Even if the company files the consent of a third party as an exhibit to the registration statement (making the information provided by that person an expertized disclosure), the accuracy and completeness of the information remains the company's responsibility under the federal securities laws. Here are some examples of this type of comment:

> "We note your statements, "However, we have not independently verified any of the data from third-party sources. Similarly, our internal research is based on upon our understanding of industry conditions, and such information has not been verified by any independent sources." It is not appropriate to infer that you are not liable for information included in your registration statement. Accordingly, please delete the statements referenced above or state specifically that you are liable for the disclosure included in the registration statement that is based on third-party sources." (SEC Comment Letter to Immuron Limited (Jan. 18, 2017), *Comment #2*).

> "We note your statement that "the accuracy and completeness of the [industry and market data included in the prospectus] cannot be guaranteed." Please delete such statement or revise as necessary, so that you do

> not suggest that you could lack a reasonable belief as to the accuracy and completeness of the market data that you elect to include in the filing." (SEC Comment Letter to Global Water Resources, Inc. (Feb. 11, 2016), *Comment #14*).

To avoid this type of comment, you should carefully consider whether any cautionary language in the prospectus could be viewed by the SEC staff as disclaiming liability. Including this type of language could prompt the SEC staff to request that the company include an affirmative statement regarding its liability for all the information in the prospectus, which, although accurate, is disclosure that most companies would prefer not to include in their IPO prospectuses.

Anna Pinedo
Partner at Mayer Brown LLP

Anna Pinedo is a partner in Mayer Brown's New York office and a member of the Corporate & Securities practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing experience in certain industries, including technology, telecommunications, healthcare, financial institutions, REITs and consumer finance. Anna has worked closely with foreign private issuers in their securities offerings in the United States and in the Euro markets. She also works with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium term note and other continuous offering programs.

In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.

Alexandra Perry
Associate at Mayer Brown LLP

Alexandra (Ali) Perry is an associate in Mayer Brown's New York office and a member of the Capital Markets practice.

Ali earned her JD from the University of Pennsylvania Law School where she was the managing editor of the Journal of Business Law and a member of the Entrepreneurship Legal Clinic. She also received a Certificate of Management from The Wharton School of Business. She received her BBA in Accounting and Finance from Emory University's Goizueta School of Business and is a certified public accountant.