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Technology Industry Practice Guide

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Overview

Question 1: Please describe the technology industry and briefly discuss various types of companies and major players.

The technology industry is focused around companies that primarily sell technology or technology services. Major players in the technology industry include:

- Hardware companies, such as Apple, Dell, HP, and Lenovo, which generate revenue by building and selling physical products
- Software companies, such as Alphabet (Google), Adobe Systems, Microsoft, and Oracle, which generate revenue by developing and selling software
- Information technology (IT) services companies, such as IBM, which generate revenue by providing services related to either hardware or software
- Companies that provide critical components to the technology industry, such as Intel and Applied Materials, which generate revenue by providing software or hardware to other technology companies
- Peer-to-peer companies, such as Uber, Airbnb, Snapchat, Facebook, and Lyft, which generate revenue by connecting individuals or businesses together online to deal with each other directly
- Biotechnology and medical device companies, such as Amgen and Medtronic, which generate revenue by developing and selling products or services used in the medical industry

The technology industry is also often defined to include companies that rely on technological innovation to disrupt existing business models, such as Amazon and Tesla.

In addition to competing in the technology industry, many technology companies also impact other industries. For example, Apple has established a presence in media with iTunes, and its Apple TV product, Alphabet, is a pioneer in the car industry, launching a self-driving car project in 2014. Uber and Lyft's online services are similarly disrupting the transportation industry.

Applicable Securities Laws and Regulations

Question 2: What are the relevant statutes and regulations governing securities offerings by technology companies?

Securities offerings by technology companies, including private and public equity and debt offerings, are subject to the same general set of securities laws and regulations that govern securities offerings by companies in other industries. This includes the Securities Act of 1933, as amended (the Securities Act), the Securities Exchange Act of 1934, as amended (the Exchange Act), the Sarbanes-Oxley Act

of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the Trust Indenture Act of 1939, as amended, and state securities or blue sky laws. In particular, the issuance of options, restricted shares, and other forms of equity incentives, which many technology companies rely on heavily to incentivize their employees, requires compliance with the Securities Act and state blue sky laws. For private technology companies, Rule 701 (17 C.F.R. § 230.70) under the Securities Act is an important exemption from the registration requirements of the Securities Act for issuances of equity to employees, officers, directors, consultants, and advisors. For a further discussion of these provisions, see U.S. Securities Laws: An Overview, Whistleblower Protections under Dodd-Frank and Sarbanes-Oxley (SOX), Addressing Internal Control over Financial Reporting, Introduction to Corporate Governance Requirements for Public Companies, How to Comply with SOX's Prohibition Against Loans To Directors and Officers, The Dodd-Frank Wall Street Reform and Consumer Protection Act: Road Map to Key Provisions, Trust Indenture Act of 1939, and Employee Incentive Compensation and Rule 701.

Technology companies that qualify as emerging growth companies (principally, technology companies with less than $1 billion of revenues) under the Jumpstart Our Business Startups Act (the JOBS Act) may also benefit from accommodations under the JOBS Act that are designed to facilitate the initial public offering (IPO) process. See Emerging Growth Company versus Smaller Reporting Company Comparison Chart and IPO Requirements for Emerging Growth Companies Checklist.

Non-securities related laws and regulations may also impact a securities offering by a technology company. For example, many technology companies are potentially disruptive of heavily regulated industries, such as Airbnb in the housing and rental industry, Uber and Lyft in the labor and transportation industry, and financial technologies (fin-tech) companies that use technology and innovation to compete against traditional financial institutions in the delivery of financial services. These technology companies will need to provide an overview of the laws and regulations applicable to their business in the offering document and also evaluate their compliance with these laws and regulations in the context of securities offerings and their disclosure obligations under the Securities Act. If a technology company is in the process of seeking a significant government approval, such as Food and Drug Administration (FDA) approval of a new drug in the case of a biotechnology company, the technology company will also need to consider the applicable approval process and related laws and regulations in determining what is material to an investor and needs to be disclosed under the Securities Act. See, e.g., Development-Stage Pharmaceutical Company Due Diligence Questions.

Securities Offering Process

Question 3: What is the typical process for securities offerings by technology companies, including general steps, timeline, key transaction documents, due diligence process and required regulatory and stock exchange filings?

Similar to companies in other industries, technology companies may offer securities both on a registered basis as well as by private placement, and may issue various types of securities (debt, equity, convertible or hybrid securities). Based on recent market practice, private technology companies typically issue preferred equity or convertible debt, which converts to common equity upon an IPO. As technology companies mature, however, they are more likely to issue straight debt.

The process for an offering of securities by a technology company is generally the same as the process for offerings by companies in other industries. Whether a technology company is offering debt or equity securities will have an impact on the overall offering process and the extent of documentation required. In addition, whether the securities are offered publicly or privately will have an impact on the overall offering process, the extent of documentation required, and the investor base to which the securities may be offered and sold.

For venture financings (principally, private acquisitions of preferred equity or convertible debt by a venture capital firm), counsel will often start with the model legal documents prepared by the National Venture Capital Association (NVCA). These forms are available at www.nvca.org and are designed to reduce the time and effort spent by investors, management teams, and attorneys on negotiating legal documentation. Venture capital firms are often unwilling to negotiate or deviate from the forms for standard provisions due to the number of financing rounds completed each year. Among the tailored provisions that are often heavily negotiated are liquidation preferences, forced conversion thresholds, governance provisions, potential vesting of founder stock, employee equity pool, and anti-dilution provisions, including ratchet provisions in connection with an IPO. IPO ratchet provisions are designed to protect pre-IPO investors by granting them more shares upon automatic conversion if the public offering price is below a certain threshold. These provisions can apply to one or more series of financings and may have different threshold IPO prices. If a venture capital investor does not receive an IPO ratchet provision in connection with its investment, it may negotiate for a different type of protection, such as a minimum IPO price below which their preferred equity or convertible debt will not convert to common equity.

While preferred equity and convertible debt typically convert automatically to common equity upon an IPO, private technology companies looking to consummate an IPO will still need to discuss their capitalization structure post-IPO with their advisors, as well as

the underwriters and their counsel. In particular, a growing number of private technology companies have dual class stock structures with one class of super-voting shares designed to enable founders and other critical members of management to maintain control of the company post-IPO. While technology companies such as Square Inc., Facebook, Alibaba, LinkedIn, Yelp, Groupon, and FitBit have completed IPOs with dual class stock structures, this structure is subject to criticism from stockholder and corporate governance advocates and may impact pricing in an IPO. As a result, underwriters may advise against a dual class structure.

In public offerings, the Securities Act requires that a company file a registration statement with the Securities and Exchange Commission (the SEC) before securities may be offered or sold. The registration statement contains a prospectus, exhibits of material documents, and other required information. The prospectus, which is distributed to investors, provides an overview of the company, including its products and services, financial statements, management, and other material information. The prospectus will also include a description of the terms of the securities offered and the use of proceeds of such offering.

In some private transactions exempt from registration under the Securities Act, companies provide investors with an offering circular, offering memorandum, or private placement memorandum. A private offering document is similar to a prospectus and typically includes much of the same information required by the SEC in a prospectus. However, the issuer is not required to publicly file a private offering document. Venture capital financings with institutional venture capital investors and accredited investors often do not involve such a circular.

In order to prepare the prospectus or private offering document, counsel will need to complete due diligence on the issuer. For technology companies, due diligence requests will likely cover intellectual property (IP) related matters in addition to traditional corporate requests, such as copies of material contracts, corporate records, and minutes. Depending on the scope and significance of the issuer's IP, counsel for the underwriters or initial purchasers may also request a separate IP due diligence call or updated patent searches. Counsel for the underwriters or initial purchasers may also request legal opinions covering certain statements in the prospectus or private offering document. If the technology company operates in a heavily regulated industry, counsel will also need to diligence compliance with applicable rules and regulations, as well as risks associated with non-compliance.

For additional information about the typical process for securities offering by all types of companies (including technology companies), see Understanding the Initial Public Offering Process, Understanding the SEC Review Process, Preparing the Registration Statement and Preliminary Prospectus for an IPO, Parties to a Securities Offering Checklist, Understanding Registered Securities Offerings Post-IPO, Follow-On Offerings Resource Kit, Private Placements Resource Kit, Managing the Due Diligence Process for an IPO, Conducting Due Diligence for a Private Offering, and Due Diligence for Securities Offerings Resource Kit.

Disclosure Obligations

Question 4: What information must be made available to potential investors in connection with securities offerings by technology companies?

The SEC instructs issuers to file a registration statement with information about the company and to provide the prospectus to investors, unless an exemption is available. Issuers conducting private placements are exempt from making specific disclosures, but market practice is to comply closely with the SEC requirements for comparable public offerings. For further information, see Comparison of Types of Equity Offerings Chart and Considerations When Conducting a Private Placement of Securities.

The tension between what investors and the Securities Act require in terms of disclosure and the historical secrecy of the technology industry can result in disclosure issues for technology companies. Technology companies may not want to disclose much information about their technologies, products, and engineers in a public registration statement or private offering document because they may be concerned about competitors using this information to duplicate technology or identify potential engineers to hire. This is especially an issue in venture financings as venture capital firms often refuse to sign non-disclosure agreements. To resolve this conflict, counsel for the issuer and the potential investor (or underwriter or initial purchaser) will need to weigh the value of the information to the potential investor against the competitive or market risk to the technology company. For sophisticated technology companies with highly confidential trade secrets (such as biotechnology and medical device companies), venture capital firms may be more willing to sign non-disclosure agreements or designate certain information as accessible only by the attorneys on the offering. For less technical information, counsel may be able to address the tension through qualitative or aggregate disclosure that meets the requirements of investors and the Securities Act, but is of minimal value to competitors.

A. Risk Factors

Risk Factors: Please describe the common risk factors that are specific or unique to issuers in this industry. Have there been any recent developments or changes that counsel should be aware of when preparing these risk factors?

Risks Related to Competition and Growth

Because the technology industry is rapidly changing and highly competitive with the constant introduction of new products and services, there will be a focus on risks related to growth and competition. Technology companies should consider the risk that their products may become obsolete due to innovation by their competitors or market focus on an alternative platform or software. For example, peer-to-peer companies may want to highlight the risk of a decline in user growth or user engagement as a result of influential users endorsing an alternative product, a perceived decrease in quality, a negative reaction to new advertising methods, or other negative publicity.

Technology companies should also consider the risk that they miss the applicable product cycle for a new product offering. For example, hardware and software companies may want to highlight the risk that bugs or compatibility issues delay the release of a new product, making it unavailable when purchases of that type of product peak.

Finally, technology companies should consider the risks associated with high levels of growth. For example, technology companies that have experienced or expect to experience rapid growth in headcount and operations may want to highlight the risk that they are unable to innovate or execute as quickly as a smaller organization and the risk that they are unable to effectively manage a larger organization.

Risks Related to Financial Results

Because many technology companies have a limited operating history, there should be a focus on risks related to the company's future financial performance. For example, early stage companies that generate limited or volatile revenue may want to highlight the risk that their operating results may fluctuate and that they may be unable to achieve or subsequently maintain profitability. Technology companies that operate in new or unproven markets may want to highlight the risk that the applicable market may not develop as expected.

Technology companies should also consider whether their financial performance presents any liquidity concerns. For example, a technology company that generates limited revenue may want to highlight its cash flow needs, including any debt service obligations, and the risk that it may be unable to generate sufficient cash flow to satisfy its obligations.

Risks Related to Innovation and Research and Development

Since technology companies often spend heavily on research and development, including to attract talented engineers, they should also consider the risks associated with those investments. Potential risks include dependence on key personnel, ability to attract and hire skilled personnel, and ability to integrate acquired products or services.

Risks Related to Governmental Action, Regulation, and Litigation

The operations of technology companies can involve numerous laws and regulations. As a result, technology companies should evaluate their risk factors in light of the relevant regulatory regimes. Counsel should pay special attention to risks or uncertainties associated with accounting, such as transfer pricing, international taxes, IP, and general regulatory compliance.

As a result of high profile data security breaches, there has also been increased focus on risks related to cybersecurity for any technology company that processes or stores customer data. For a form of cybersecurity risk factor and examples, see Cybersecurity Risk Factor. Technology companies with international operations or that expect to expand internationally may also want to highlight the risks associated with complying with foreign laws and foreign currency regulations, double taxation of international earnings, and potentially adverse tax consequences due to changes in tax laws.

B. MD&A and Business

MD&A and Business Sections: Please provide the key discussion points that counsel should consider when preparing the business and MD&A sections for issuers in this industry.

The MD&A section of a prospectus or private offering document is the management's analysis of its financial statements and prospects for the business. See Management's Discussion and Analysis Section Drafting Checklist. In addition to discussing historical results, technology companies should include a discussion of key factors that impact their business and could cause historical results to not be indicative of future results. For example, a technology company with limited revenue generation should consider including a discussion of other non-financial metrics that would help an investor evaluate its business and prospects for future revenue. For some technology companies, it may also be appropriate to include a detailed discussion of accounting policies with respect to revenue recognition and capitalization or expense of development costs. In addition to traditional financial metrics, many technology companies regularly report user metrics, such as daily active users, k-value (a measure of virality that quantifies the growth rate of websites, apps, or a customer base), portion of mobile traffic, and total addressable market (TAM). TAM is a term that typically refers to the revenue opportunity available for a product or service. TAM can be calculated either as a global total (representing the entire market that a technology company could hypothetically reach) or as a target market (representing the market that the technology company could reasonably serve based on certain constraints).

Some technology companies also quantify traffic acquisition costs (TAC), which consists of payments made by Internet companies to affiliates and online firms that direct consumer and business traffic to their websites. TAC is a critical cost of revenue for Internet search firms such as Alphabet and Yahoo, and is watched closely by investors and analysts. By quantifying TAC, technology companies are able to report revenues on both a gross basis and net basis that excludes TAC. Some technology companies also quantify TAC as a percentage of advertising and search revenue, which can be used to evaluate cost pressures on profitability.

User metrics (including daily active users, k-value, portion of mobile traffic, and TAM) and TAC are not considered non-GAAP financial measures for purposes of Regulation G or Item 10(e) of Regulation S-K. As a result, they are not required to be reconciled to the most directly comparable GAAP financial measure. Revenue excluding TAC (or revenue ex-TAC) would typically be considered a non-GAAP financial measure for purposes of Regulation G (17 C.F.R. §§ 244.100-102) or Item 10(e) (17 C.F.R. § 229.10) of Regulation S-K, however, and should be reconciled to revenue calculated in accordance with GAAP. For a further discussion of these regulations, see Understanding SEC Regulation of Non-GAAP Financial Measures and Drafting Regulation G Compliant Disclosure.

C. Other Prospectus Disclosure

Other Prospectus Disclosure: Is there any other additional or special disclosure that should be included in the prospectus or registration statement for issuers in this industry, either required by the SEC or from market practice?

In 2011 the SEC Division of Corporation Finance released CF Disclosure Guidance: Topic No. 2 – Cybersecurity (October 13, 2011), which is available at https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm. This guidance made it clear that material cybersecurity risks and incidents should be disclosed to investors. As a result, any technology company that experiences a data breach will need to evaluate whether that data breach is material and required to be disclosed. Whether or not a data breach is material and required to be disclosed is a judgment call that will need to be made based on the severity of the data breach and its potential impact on the issuer.

Technology companies that offer social media services should also consider the legal and reputational risks associated with their services in the context of a securities offering. For example, there are unique IP issues associated with social media sites, including policies on ownership and sourcing of IP generated by users, compliance with the Digital Millennium Copyright Act, inadvertent disclosure of confidential information, and trademark infringement via third-party registration of user names in social media. There can also be reputational risks associated with social media services. For example, a social media site could lose customers if it censors its users or if it cooperates with governmental requests for customer data.

The SEC has also considered requiring more specific, uniform IP disclosures. Currently, biotechnology and pharmaceutical companies provide more extensive disclosure of their IP than information technology and service companies. See Section IV.A.3. Technology and Intellectual Property Rights (Item 101(c)(1)(iv)) of the SEC's Concept Release: Business and Financial Disclosure Required by Regulation S-K (Release Nos. 33-10064, 34-77599; File No. S7-06-16).

In addition to the foregoing disclosure, technology companies (like all companies) should disclose any information that is reasonably likely to influence a buyer's decision to invest in the company. For companies that are subject to regulatory regimes, market practice is to disclose any issues or developments in obtaining required approvals. Moreover, technology companies should focus on IP rights, including exclusivity assurances and plans for development of inventions.

D. Additional Disclosure Issues

Additional Disclosure Issues: Please discuss any other special disclosure issues or advice applicable to issuers in this industry.

As discussed above, it is important to understand the laws and regulations governing technology companies in different sectors. For example, fintech companies are subject to numerous U.S. and foreign regulatory regimes, including relating to anti-money laundering, consumer protection, privacy and protection of data, bank secrecy, and similar regulations. These regulatory regimes are typically jurisdiction specific and complex, and affect disclosure under the Securities Act because a technology company's compliance or failure to comply is generally considered material information.

While not specific to the technology industry, it is more common for technology companies to issue a low-vote or no-vote class of common equity in their IPOs. Examples include Google, Facebook, Zynga, Groupon, and most recently, Snap, Inc. As such, these issuers would include risk factors and disclosure about the ability of the (typically) founders to continue to control the outcome of all matters submitted to shareholder vote. Moreover, as many technology companies are heavily associated with their founders (e.g., Elon Musk with Tesla), additional disclosure may be warranted regarding the issuer's reliance on such founder and his or her time commitment to the issuer.

Underwriting Agreements

Question 5: What types of underwriting arrangements are commonly used? What are some of the standard clauses and clauses that are heavily negotiated in an underwriting agreement in connection with an offering by a technology company?

The underwriting agreement (or purchase agreement in a private offering) is a contract between the issuer and the underwriter (or initial purchaser in a private offering) to buy and sell securities and then resell them to the public. The common arrangement is for the underwriter to make a firm commitment to purchase the securities, though some arrangements will only bind the underwriter to use its best efforts to sell the securities.

In addition to including the terms of the purchase and sale, the underwriting or purchase agreement will include representations and warranties, conditions to closing, and standard indemnification clauses for misstatements or omissions in the offering materials, including any roadshow materials. IP representations and warranties are generally more extensive in underwriting or purchase agreements for technology companies, including, for example, assurances that the company owns and may use the IP rights, that it does not have knowledge of any third party infringements or violations with respect to the IP, and that the company will keep the IP confidential. For a form of underwriting agreement, see Underwriting Agreement.

Continuous Disclosure and Corporate Governance

Question 6: What specific continuous disclosure and corporate governance requirements apply to technology companies?

The continuous disclosure and corporate governance requirements applicable to technology companies are the same as those applicable to companies in other industries. As discussed above, technology companies often rely more heavily on equity compensation to incentivize their employees than companies in other industries. As a result, providing an annual Compensation Discussion and Analysis (CD&A) may be more burdensome for a technology company than a company in another industry. For additional information about the continuous disclosure and corporate governance requirements applicable to all companies (including technology companies), see Periodic and Current Reporting Resource Kit and Introduction to Corporate Governance Requirements for Public Companies.

Stock Exchange Requirements

Question 7: Are there any special listing or corporate governance standards required by major stock exchanges, including NYSE and NASDAQ?

The listing and corporate governance standards imposed by major stock exchanges on technology companies are the same as those imposed on companies in other industries. This includes the prohibition on dual-class recapitalizations by the NYSE and NASDAQ. As a result, a technology company desiring to use a dual-class capital structure will need to adopt this structure prior to listing on the NYSE and NASDAQ. Technology companies with existing dual-class capital structures will generally be permitted to issue additional shares of either class of stock in compliance with the corporate governance standards of the NYSE and NASDAQ.

In addition, if an individual or group of stockholders control more than 50% of the voting power for the election of a company's directors, either as a result of a dual-class capital structure or otherwise, the company will qualify for, and may rely on, exemptions from certain corporate governance requirements of the NYSE and Nasdaq, including (1) the requirement that a majority of the board of directors consist of independent directors as defined under the rules of the stock exchange, (2) the requirement that the technology company have a compensation committee that is composed entirely of independent directors, and (3) the requirement that the technology company have a nominating and corporate governance committee that is composed entirely of independent directors.

For additional information about the listing and corporate governance standards imposed by the NYSE and NASDAQ on all listed companies (including listed technology companies), see Complying with NYSE and Nasdaq Listing Requirements, Meeting the Exchange Independence Requirements for Boards and Committees, NYSE Corporate Governance Listing Requirements Table and NASDAQ Corporate Governance Listing Requirements Table.

Other Key Laws and Regulations

Question 8: What are other key laws and regulations that a securities lawyer working with a technology company needs to be aware of?

As discussed above, the operations of technology companies can raise complex legal issues, including issues involving tax laws, antitrust laws, privacy laws, and IP laws. It is important for a securities lawyer to be aware of these potential legal issues and engage appropriate specialists early on in the process to help them evaluate the potential implications for a securities offering.

Regulatory Trends

Question 9: What are the major regulatory trends affecting technology companies?

As technology companies transform the way people communicate, share information, and do business, there is friction with existing laws and regulations that have not caught up with existing technology. For example, Uber has been banned in certain cities and countries for not complying with laws on the carriage of passengers that were originally intended to apply to taxis. Some also argue that outdated tax laws and regulations have permitted many technology companies to use complicated tax strategies to avoid paying corporate taxes. Finally, as wage and hour lawsuits against technology companies increase, technology companies are focused on regulations related to employee classifications, with many technology companies advocating for a new classification (other than independent contractor or employee).

Since technology companies often operate worldwide, there are also regulatory compliance issues associated with complying with laws and regulations on a country-by-country basis, especially privacy and data security regulations. Different privacy and data security laws and regulations may apply depending on where data is stored or transferred. For example, complying with a request from the U.S. government for data that is hosted internationally can breach foreign data protection laws. As a result of high profile data security breaches, there is also increased focus on regulatory risks in the cybersecurity realm.

Commercial Trends

Question 10: What are the major commercial trends affecting technology companies?

As discussed above, the technology industry is fast paced with constant innovation and short product cycles. As a result, technology companies are under pressure to constantly introduce new products and respond to changes in the industry. For example, Apple has historically introduced a redesigned iPhone every two years. Software and app developers are also constantly updating their products to introduce new features or improve compatibility with changes in related hardware or software. Technology companies that are unable to keep up with their competitors' innovation, or that miss the applicable product cycle for a new product, face the risk of becoming obsolete, which has continued to drive large investments in research and development, as well as acquisitions of smaller technology companies by larger technology companies.

Another trend in the technology industry is that technology companies are staying private longer. An increasing number of technology companies are reaching high valuations in private markets and choosing not to undertake IPOs. This trend has increased the number of private funding rounds that many technology companies complete (including potential down rounds where investors purchase

securities at a lower valuation than the preceding round), increased private market activity by employees and investors, and increased focus on sale processes as a means of achieving liquidity. There are several reasons that technology companies may be deciding to stay private longer, including increased availability of private capital and a view that public markets prefer larger technology companies. The JOBS Act also increased the maximum number of stockholders a private company can have before it must disclose financial statements, which provides additional flexibility to private companies.

Practice Tips

Question 11: What practice points can you give to lawyers working with technology companies?

Since the technology industry is constantly evolving and expanding, it is important for lawyers working with technology companies to stay current on emerging legal issues and trends in the technology industry. For lawyers working with technology companies that are looking to disrupt other industries, it is also important to stay current on emerging legal issues and trends in those industries. Finally, it is important to understand your client's attitude towards risk as some technology companies will have a larger appetite for risk than others.

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