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Know Before You IPO: Governance Best Practices That Drive Shareholder Value

The past year, 2021, was a banner year for IPOs. Initial public offerings hit 1,000 for the first time ever, and the fourth quarter of 2021 was the most active fourth quarter for global IPO deals since 2007.

Some of this growth — and many of the headlines — is due to SPACs, special purpose acquisition companies set up by investors solely to raise money through an IPO for an acquisition. But whether a company's journey to the public markets involves an IPO or a de-SPAC, the formula for safeguarding stakeholder interests and unlocking long-term shareholder value is the same: good governance.

This means private companies need to prepare themselves with fundamental systems of corporate governance. "There's no better time for companies than when they're small to be able to start these things, to get the right fundamentals and building blocks in place so that the foundation is there," said Diligent President and COO Lisa Edwards. "It may feel a little weird when you're pretty small and nimble," Edwards explained, but "things are happening earlier than you may have seen five years ago. Building the right processes, the right governance, the right systems in advance is always a good idea, and it's a particularly good idea in this environment."

Where to begin? Public listing changes the game in terms of compliance, governance and investor expectations in seven key areas. All are important for strengthening a company's position and improving the chances of a smooth public offering and a compliant, well-governed future. Read on for why these areas are critical and learn next steps for getting ready for a public listing.

1. Board Composition

The path to a successful IPO starts with an effective board, a high-performing team of directors capable of guiding the company through the challenging road ahead.

Private companies, particularly fast-growing ones, may be tempted to populate board roles with existing senior executives. Resist this temptation. Such a route risks over-familiarity and hampers independence. Instead, companies on the complicated journey to an IPO need a board with the right mixture of expertise, independence and diversity: in tenure, age, gender and beyond. In fact, some regulatory bodies require one or more independent non-executive directors (NEDs).

Board diversity requirements have started entering the mix as well. As of August 2021, for example, Nasdaq-listed companies will be required to publicly disclose that they have at least two diverse board members or disclose why this is not the case.

When evaluating your potential NEDs and expanding the diversity of your board, look for candidates who understand the investment landscape and your stakeholders' expectations, as the selection will have to stand up to investors' heightened scrutiny. Look for literacy in both finance and the relevant corporate standards, like those for Nasdaq-listed companies. You'll need knowledgeable members for your board's audit committee — also a requirement of many regulatory bodies.

"It can take a while to recruit really talented people to be on the board and find the right people. Starting that process early is absolutely a good thing."

Lisa Edwards
President & COO,
Diligent Corporation

Next Steps:

- ☐ Research the board diversity and independence requirements of relevant regulatory bodies
- ☐ Create a skills matrix to evaluate your current and desired board composition and identify gaps
- ☐ Tap established networks and new resources for candidates, including NEDs

2. ESG Disclosures

Companies with a potential IPO in their future also need to start thinking about environmental, social and governance (ESG) reporting — and think of it in the same fashion as they do financial reporting.

Many private companies do some sort of tracking and sharing of their ESG actions and impact in today's world. Now is the time to get serious about these efforts with formalized measures and increased knowledge of SASB, TCFD, WEF, and other standards and frameworks.

Meanwhile, the regulatory landscape is evolving, with governing bodies like the Securities and Exchange Commission (SEC) beginning to mandate that companies disclose their policies on climate change and diversity targets.

"It should be an expectation that ESG is going to be a part of your future if you are a publicly traded company," Edwards said. She added, "What you're doing to move the needle forward as a corporate citizen" is vital to attracting great employees and positive investor attention. "If you want to attract investor capital, all of these things are going to come into play, and having an ESG strategy is the right thing to do."

According to Gartner:

- 85% of investors considered ESG factors in their investments in 2020
- 91% of banks, 71% of fixed-income investors and over 90% of insurers monitor ESG, as well as 24 global credit rating agencies
- In 2020, media mentions of ESG data, ratings or scores grew by 303% year over year

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3. Executive Compensation

For employees, particularly top executives, an IPO brings the exciting potential for lucrative compensation packages: options, stock-based compensation and more. For those in oversight and administrative roles, however, an IPO introduces a host of complications to manage, from the macro to the micro.

At a high level, pre-IPO companies must design a sound compensation framework that rewards sustainable value creation. Compensation policies must reflect the company's philosophy and objectives and be overseen by a 100% independent compensation committee at the board level.

For administration, the devil is in the details: managing options grants and board approvals, modeling exit scenarios and mastering ASC 718 reporting, the standard way to expense employee stock-based compensation on an income statement.

Next Steps:

- ☐ Form an executive compensation committee with directors who understand both compensation practices and your company's philosophy and directives
- ☐ Make sure members are equipped to provide independent oversight — and implement controls, such as D&O questionnaires, to confirm this independence
- ☐ Explore technology solutions for sharpening visibility and streamlining oversight

4. Security

When a company goes public, and even in the time leading up to the IPO, boards face heightened demands to share and store data — much of it highly sensitive and confidential. Meanwhile, the risks — and repercussions — of a breach or data leak increase exponentially.

Stakeholders from investors to regulators want to see strong security practices, starting at the board level. It's more than data protection and cyber awareness: It's an indicator that your leaders are equipped to put up guardrails, hold themselves accountable, communicate priorities and face the scrutiny of operating as a public company, even under deadline pressures and remote and hybrid meeting environments.

Next Steps:

- ☐ Evaluate and improve how board members store information and consider implementing a secure board portal or dedicated data room
- ☐ Evaluate and improve how board members communicate and share information, and consider implementing a secure messaging app
- ☐ Train your board on the latest security best practices

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5. D&O Questionnaires

Under the Securities Exchange Act of 1934, publicly registered companies must periodically disclose material information such as the business relationships of board members, officers and principal shareholders. The goal: to eliminate conflicts of interest and ensure director independence.

The resulting directors' and officers' (D&O) questionnaires can be very detailed, with steep penalties for incomplete and/or inaccurate submissions, including fines, the loss of directors and risk to the companies' reputation.

If you're a private company considering an IPO, now is the time to get up to speed on D&O questionnaires — possibly in tandem with forming your board and screening potential candidates.

Next Steps:

- ☐ Identify the directors and officers who will need to complete D&O questionnaires.
- ☐ Develop your question list based on the requirements of the exchanges under which you plan to list and the jurisdictions where you plan to operate.
- ☐ Create a process for distributing, storing and compiling questionnaires in a timely fashion. For increased security, efficiency and accuracy, consider a software solution over paper-based forms.

6. Sarbanes-Oxley (SOX) Compliance

An IPO, and subsequent listing on public stock exchanges, puts a range of new compliance mandates on a company's radar, and few are more challenging than those related to the Sarbanes-Oxley Act of 2002, affectionately (or not so affectionately) known as SOX.

This multifaceted U.S. federal law stipulates several legal and compliance requirements, from Section 401 for periodic disclosures to Section 302 establishing CEO and CFO responsibility for financial reports. Section 404, which requires management and auditors to report the accuracy and adequacy of their internal controls, is one of the more involved mandates and may come as a surprise. For example, has your company undergone changes in management or lost a major client? These are routine events that, under Section 404, now require an 8-K report.

If your company hasn't started getting up to speed on SOX and implementing a strong framework of internal controls, now is the time to begin. Waiting until the IPO countdown to tackle SOX compliance will cause major delays and create a huge burden on staff.

Next Steps:

- ☐ Assemble your SOX compliance team — including chief compliance officers, audit executives, auditors, information officers and risk management teams — and account for the roles of clients and external reviewers

- ☐ Develop a structured program for SOX 404: controls, processes, systems, assurance and more

- ☐ Put Section 302 certifications on your radar for quarterly reporting, from who needs to sign them to how you'll manage the process: activities, automation and beyond

7. Entity Management

Joint ventures, limited liability companies, mergers, acquisitions and more: All of these give private companies the power to grow — fast. But a burgeoning array of business entities, especially across international borders, adds layers of complexity to data collection, management and reporting, before and after the IPO.

Entity management encompasses a range of data, governance areas and standards, including board compensation and appointments, matters requiring shareholder approval, financial reporting and more. You'll need to ensure compliance with relevant regulatory bodies and regulations, like the Office of Foreign Assets Control (OFAC) and the Foreign Corrupt Practices Act for companies listing in the United States. If you do business within the EU, you'll need to ensure GDPR compliance for all data.

Because even one noncompliance incident in one jurisdiction can result in a big fine, reputational damage or other negative consequences, you'll want to vet your entities' finance, accounting and compliance data well in advance of an IPO. And you'll want to establish a robust data collection and management system for maintaining future compliance.

Next Steps:

- ☐ Arrange your entity management team, including an external auditor and an internal audit committee, which are IPO requirements in most jurisdictions
- ☐ Research the entity data requirements for the exchanges you plan to list on and the jurisdictions in which you operate
- ☐ Put systems and controls in place for collecting, reviewing and reporting all required entity data, including contractual obligations and outstanding litigation

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In Closing

At first glance, these seven critical pre-IPO milestones can seem complex and labor-intensive. Yet the rewards for executing them are high. Strong governance practices, from board composition to entity management, have positive market implications before, during and after a company's IPO.

By positioning your company now to meet investor expectations and regulatory standards, you can stand out from peers, receive higher valuations and be positioned for long-term success in the public markets.

Set up a meeting with Diligent to get your company IPO- or de-SPAC-ready. You'll learn about common requirements, best practices and technology solutions that can help.

REQUEST A MEETING

About Diligent Corporation

Diligent is the leading governance, risk and compliance (GRC) SaaS provider, serving more than 1 million users from over 25,000 organizations around the globe. Our modern GRC platform ensures boards, executives and other leaders have a holistic, integrated view of audit, risk, information security, ethics and compliance across the organization. Diligent brings technology, insights and confidence to leaders so they can build more effective, equitable and successful organizations.

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