



# INVESTOR RELATIONS

FOR THE

# EMERGING COMPANY

SECOND EDITION

RALPH RIEVES

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FOR THE  
EMERGING  
COMPANY**

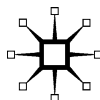
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SECOND EDITION

RALPH A. RIEVES  
AND  
JOHN LEFEBVRE

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# PREFACE

Like the first edition, this revision is intended for directors and executives of small capitalization public companies, their legal counsel, and other advisors. This book is not about burnishing image or equivocation. Moreover, this book is not about selecting the most efficient or effective channels and media for reaching investors. The rate at which communications technology changes precludes any discussion of media choices.

This book is about what to communicate about the company's commitment to growing the market value of its common stock and to whom to communicate that commitment.

There are new trading platforms, such as *Second Market*, that create private markets for the stocks of emerging companies not yet publicly traded. These platforms evolved so as to let insiders/founders monetize their illiquid holdings by selling them to accredited investors and institutions through regular auctions. The strategies and tactics discussed in this book are not likely to be appropriate for these private

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communications. But our suggested approaches to disclosure will facilitate closing some of the private placement deals.

This book is also intended for individual and institutional investors who can use the advice and recommendations offered here as benchmarks for measuring the degree of a corporation's commitment to increasing the value of its common stock.

A company's common stock remains the most viable method of financing the company's growth. The market value of a company's stock is critical. That value is based on how the company's commitment to sustained growth is perceived. The main element dictating that perception is the manner in which the company is governed and managed. The practice of investor relations is to let investors understand how a company is governed and managed.

Regardless of economic and financial market cycles, an investor relations program is a critical component of a company's strategy. It follows, then, that the responsibility for an investor relations program rests with top management. Implementing appropriate tactics within the program can be delegated, just as any corporate function can be. However, the board and the CEO are responsible for the strategy and tactics employed in the company's investor relations program.

The concerns of entrepreneurs and their business associates are first focused on survival of the enterprise; hence, there is an undercurrent of anxiety. We have learned that personal consulting or written advice is most effective if delivered in an informal and personalized manner. Therefore, the second person dialogue "you" seemed to be the most appropriate mode in which to write this book and address readers.

**PART I**  
**THE INVESTOR UNIVERSE**

# **CHAPTER 1**

## **PEP TALK**

All emerging public companies share a common goal: rapid and sustainable growth in shareholder equity. This book is intended to describe to emerging public companies how to communicate their commitment to that goal in a manner that is honest, ethical, and legal.

Honesty isn't just about accurate financial reporting and ethical business practices. It is also about admitting mistakes and taking responsibility. Doing so publicly is the courageous

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part of the investor relations process—and you will have the opportunity to demonstrate that courage to investors.

No matter what precautions and controls you have set up to forestall situations that impede your growth, your company is going to get whacked by events beyond your control. Experienced investors in new companies understand this. They have owned stocks in companies that have experienced recalls, sabotages, strikes, environmental suits, embezzlements, natural disasters, and the threat of technological obsolescence, among other things.

Experienced microcap investors expect the unexpected. They want the companies they own to confront and deal with the unexpected and to deal with all the challenges emerging companies will face. They expect your company to be able to communicate your actions and responses to any challenge you encounter. When your actions and responses are communicated in a way that demonstrates responsibility, prudence, and good judgment, your experienced investors will stay the course.

More likely, they will be buying more of your stock when the trepid are selling.

**CHAPTER 2**  
**THE GROWTH**  
**CHALLENGE**

**W**e were reluctant to revise the first edition of this book. The Sarbanes-Oxley Act (SOX) has been studied and critiqued as extensively as any legislative act that has impacted business practices. We felt that we couldn't add any comments of consequence to what had been written about SOX. However, in 2012, TD Ameritrade introduced a smart phone app that allows investors to scan UPC bar codes on any product and instantly get stock information about the

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company that made it. After learning that, we were no longer ambivalent about undertaking this revision.

That announcement reminded us that information technology has changed investor relations practices almost as extensively as SOX has. In addition to SOX compliance and ongoing technological changes, investment managers reminded us that the funding commitments of defined benefit plans are no longer tomorrow's challenges. The time has now arrived to meet these commitments.

Investment managers are eager to find companies, of any capitalization, whose market value is increasing. They now have a higher degree of sensitivity to a corporation's commitment to sustained growth.

As a publicly held company you face that "growth challenge." This book describes the practices and procedures for telling investors about your company's commitment to meeting the growth challenge: legally, honestly, and ethically.

Once your company becomes publicly owned, its activities must be focused on increasing its net worth, not just on meeting the payroll or paying the bills. A major aspect of the growth challenge is increased competition. A privately owned company's actions are, in most respects, dictated by its market competition. A public company's strategy is dictated by other firms competing for capital as well as by other firms competing for customers.

The market price of your company's stock determines your ability to raise capital. Capital is always scarce. The global capital markets will allocate scarce capital only to companies perceived as focused on increasing value for shareholders.

## THE GROWTH CHALLENGE

It follows that those companies effectively communicating that focus will enjoy a competitive advantage in raising capital.

Always be aware that a public company is under constant scrutiny. A public company confronts another set of regulators, more business reporters, and more attention from the public at large than does a private company. The manner in which your newly public company is governed might be as crucial to its sustained success as the manner in which your company competes for customers. Your business is now conducted in an environment more complex than the one in which you did business as a private company, and the rapid advances in communications technology only increase this complexity.

This book is intended to serve as one of your guides to operating in your new environment. Descriptions, explanations, and anecdotes are discussed so that you can put suggested policies and practices into a business perspective.

Prior to and during your IPO process, no time was available for addressing what would follow. It was difficult enough to sustain just the daily routines of business while undergoing all the preparation necessary to bring your company public. Your investment bankers offered some counsel and advice, but their main responsibility was to take your company public. Accountants and attorneys were appropriately focused on the minutiae of compliance. It's a very different scene the morning after the IPO. Now the focus is on those parties who bought shares in your company—and on those who might buy shares in the future.

What distinguishes this book from others on investor relations is our target audience: the directors and executives

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of emerging growth companies such as yours. We have kept in mind the problems, opportunities, and unexpected events unique to a newly public company. Every suggestion has roots in real-life experience or in the empirical research of highly qualified academics.

The most viable method of financing a company's growth is its common stock. Regardless of financial market cycles, an investor relations (IR) program is a critical component of a company's growth strategy. While the implementation of appropriate tactics in the IR program can be delegated, communicating how that growth will be sustained is the responsibility of the CEO. And that responsibility has been recognized in recently enacted federal legislation. Those mandated rules of compliance and disclosure are discussed at length in later chapters.

The next two chapters are descriptive and are included for background knowledge. If you are familiar with all the players in the global capital markets, you may skip these chapters.

**CHAPTER 3**  
**MODERN INVESTING**  
**THEORIES AND**  
**PRACTICES**

*[Note to the reader: This chapter is included as background for the descriptions and prescriptions detailed in the next chapter. Readers with a basic understanding of portfolio management and principles may choose to skip this chapter.]*

**T**he eminent financial historian Peter L. Bernstein once stated with his customary elegance:

Investing is a process of making decisions today whose results will not be known until tomorrow. Nobody knows what tomorrow will bring, because nobody can control

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everything that is going to happen tomorrow. The overarching reality, the launching pad from which investment theory takes off, is that being wrong on occasion is inescapable, even for people who are very smart. The subject matter of investment theory, then, is about how best to manage our affairs in the face of that disagreeable reality.<sup>1</sup>

Bernstein also could have pointed out that there is significant disagreement among “people who are very smart” about how “best to manage” large pools of money. There is also agreement. We will look at the areas of agreement first.

### **RISK AND RETURN**

Rational investors are primarily concerned with risk. An accepted definition of risk is the possibility that an asset will be sold at a price that is lower than the purchase price. Stocks of emerging companies are correctly perceived as riskier investments than stocks with higher capitalization: There is less history about the issuer, a thinner float, and fewer company assets to assign value to.

The most effective way your company can mitigate that perception is by demonstrating a fierce commitment to full disclosure. Moreover, you and your board should understand the responses and reflexes of the investment professionals who choose to invest in riskier stocks. There has been much academic research about investors’ levels of risk tolerance, that is, the desire for gain relative to their aversion to loss.

The proven manner in which investment risk is controlled is by diversifying among selected stocks in an investment portfolio. The remainder of this chapter is about the theory

of managing investment portfolios. What is the relevance for you of the following discussion? The relevance of this discussion is to confirm that there are many professional investors who will never be interested in your company's stock, regardless of its market cap.

### ***The Capital Asset Pricing Model***

Picking the right stocks for an investment portfolio is the obvious challenge for any investment manager. Harry Markowitz was awarded the 1990 Nobel Prize for Economics for developing a statistical approach to dealing with that challenge. William F. Sharpe shared the 1990 Nobel Prize because he took Markowitz's theory further.

Markowitz developed the means to study how investors choose among risky assets. Sharpe's contribution was the division of investment (portfolio) risk into two parts: systematic and unsystematic. Systematic risk is market-related risk. It is the risk of being in the market (the system). Systematic risk cannot be diversified away. The systematic (market) risk of a stock is the variation of its price due to changes in the overall securities market(s). Unsystematic risk is the risk specific to a single stock: an unexpected decrease in earnings, a product recall, a strike, etc. This specific risk can be reduced by holding other different (diverse) stocks.

The specific risks of different stocks in an investment portfolio can be reduced by diversification strategies. These observations are part of the basis for what is known as the capital asset pricing model (CAPM). How these risks relate to your investor-relations activities is discussed in length in

chapter 6. There are controversies surrounding the CAPM; however, they deal with refinements and anomalies that academics get paid to study and that portfolio managers attempt to arbitrage.

### ***Is the Market Efficient?***

An argument exists in the world of finance that may have some effect on the market value of your company's stock. Some very smart people argue that "you can't beat the market." Some other very smart people say that "yes, you can."

The ongoing dispute is about a theory known as the efficient market hypothesis (EMH). The EMH consists of the following four propositions:

1. Successive stock prices are mostly unrelated and tend to move within the market in a random fashion.
2. There are many participants in the market, and they have access to all relevant information affecting stock prices.
3. Market prices fully reflect and discount all information available to the public and investment professionals.
4. New information is quickly disseminated throughout the market.

### ***What Market?***

What does *market* mean in the context of EMH? In the general framework of the theory, it means all exchanges and systems whose listing requirements include disclosure of relevant information about a listed company's stock. In practice,

market means the arena in which company stocks of like market capitalization are traded.

### **BENCHMARKS**

EMH holds that all information about all stocks, in a defined market, is reflected in the current market prices of those stocks. According to the EMH argument, it follows then that no single investor can consistently beat the market. This argument requires a market benchmark, or proxy, against which a given investor's performance can be measured. Each benchmark is an aggregation of carefully selected stocks that mirror a specific universe of stocks. There are several of these benchmarks computed every trading day as indexes or averages. The best known benchmarks are those against which large-market-cap investors are measured, such as the Dow Jones Averages and the Standard & Poor's (S&P) 500. Small-cap stocks are usually measured against the Russell 2000. This is an index calculated by Russell Investments, a Seattle investment management and research firm that develops and refines global investment data products and sources.

#### ***Passive Investing***

Proponents of the EMH argue that because all investors are part of the market, their collective actions will cancel each other out. The EMH adherents think that any investment return will, over time, revert to the mean best represented by a benchmark. The extension of that argument is that a portfolio should hold only those stocks in the benchmark aggregate.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

This portfolio strategy is called indexing or passive investing. Over 30 percent of institutional stock portfolios are passively managed. This means that about one-third of all institutional investment managers will never be interested in your company's stock, regardless of its market cap.

### ***Active Investing***

There are a lot of portfolio managers who think their respective investment strategies can outperform the market and that they can sustain this performance. They think that they can beat the market. They argue that when one-third of investment managers invest in index funds, it leaves opportunities for those who really know how to research companies and stocks. If someone's efforts can determine whether a stock's price is really an indication of its value, then that someone can make investors a lot of money and is adding value to the investment process. "*C'est moi!*"

## **INVESTMENT STYLES**

How an active investment manager tries to add value to portfolios of stocks is the major concern present and prospective clients. This concern is not just about returns besting the indexers but also about diversification.

Professional investors believe that the market prices of different assets (stocks, bonds, real estate, commodities, etc.) move in different directions, depending on the overall economic climate. Fiduciaries of pension funds, foundations, and

## MODERN INVESTING THEORIES AND PRACTICES

endowments, therefore, want diversification among different asset classes as well as among different stocks. They want to diversify their “stock” money among investment managers specializing in stocks of a certain type (such as microcap stocks). That specialization is referred to in the financial world as *style*.

Some managers focus on particular industries and are referred to as sector-style managers. Others focus on stocks whose growth in earnings has exceeded the average growth rate of all stocks—hence, they are called growth-stock managers. Portfolio managers investing in stocks they believe are presently undervalued are known as value stock managers. Growth and value are the most common style categories.

### **Value Investors**

Value investors focus on a company’s book value, which in its simplest form is calculated as total assets minus total liabilities and intangibles. The other commonly accepted terms for this value are net tangible value and liquidating value.

After value managers have calculated the book value of selected stocks, they compare those respective values to their present market prices. If the market price of a stock is significantly lower than the computed book value, that particular stock is a candidate for the portfolio. The managers would search for the reasons why a particular stock appears to be undervalued. The rationale for the value style of investing is the assumption that, at some time, other investors will recognize that the stock is undervalued. Those other investors’

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

subsequent purchases would raise the prices of the shares already in our prescient investment manager's portfolio.

You may correctly infer that there are no value managers for emerging companies, because they are looking for the stocks of reemerging companies.

The purpose of the foregoing was to explain how value managers act. If you encounter one, you now know not to waste your time discussing the merits of your company.

### ***Growth Investors***

Growth investment managers focus on sustained growth in earnings. They look for companies whose annual earnings increase at a rate greater than the market as a whole. These pros spend a lot of time and money searching for those companies whose growth rates, current and projected, are not fully reflected in the price of their stock. Their opportunities to discover a stock before other investors do are fewer than those of value investors. There are more investors in the hunt for growth stocks.

Growth investors have a heightened sense of urgency; hence, they spend a lot of time and money to get the earliest position in a stock. They usually restrict their investing within a specific market-capitalization group, categorizing themselves as medium-cap growth, small-cap growth, or microcap growth. The latter is a very distinct group in which you can find portfolio managers who are most willing to talk with you about your stock. For obvious reasons, growth investors are discussed in great detail in this book.

## MODERN INVESTING THEORIES AND PRACTICES

The next chapter is about the structures of the markets in which your company's stock trades as well as about that feature of your company's stock about which you should be most mindful: liquidity!

### Note

1. *The Portable MBA in Investment* (New York: Wiley, 1995).

**CHAPTER 4**  
**THE SECURITIES**  
**MARKETS**

**T**he structures of the markets in which securities trade has changed and is changing—for the better. These changes facilitate the movement of capital and speed up the movement of information, thus enhancing the measurement of risk. The numeric term 24/7 was introduced just in the past century. It is understood throughout the global markets as the new paradigm for the capital markets: 24 hours of trading, 7 days a week. All these changes have created wider

## INVESTOR RELATIONS FOR THE EMERGING COMPANY

opportunity for price transparency and better execution of transactions. Better execution enhances that feature of capital markets about which you should be most mindful: *liquidity*.

To be viable, capital markets must perform orderly and efficiently so as to ensure fair and competitive prices at all times. The liquid feature of any specific stock is the amount of shares of that stock readily available for sale or purchase. Regardless of how dramatically the capital markets are changing, they will never accommodate an issue that cannot be readily traded.

Despite the impact of technology and changes *on* the capital markets, transactions are still conducted *in* one of two ways: by auction or by negotiation. Both types are now conducted with greater precision and dispatch, but the basic modes of interaction for each remain as *they have* been for centuries. Each requires *a* type of market center for execution. Auction transactions and negotiated transactions are distinguished from each other by the operations of their respective market centers.

Generally, established companies have their seasoned stocks traded by auction, the market center for which is a stock exchange, and the best known is the New York Stock Exchange (NYSE). Stocks of emerging companies are traded in negotiated markets; therefore, the greater part of this chapter is devoted to discussing negotiated markets.

### THE NEGOTIATED MARKET

Negotiated markets are conducted in telecommunications market centers. The centers were once referred to as the

## **THE SECURITIES MARKETS**

wire markets or the over-the-counter markets bulletin board market (OTCBB), with the latter term the most common and also most inaccurate.

Negotiated markets are market-making systems without a central matching agent, a central element of auction markets. The advances in telecommunication technology have affected capital markets as radically as any other area of commerce. The National Association of Securities Dealers (NASD) regulates the negotiated markets. The NASD was created in 1938 by an amendment to the Securities and Exchange Act of 1934. The NASD is a nationwide membership group of securities dealers and brokers. It is not a government agency but does operate under the supervision of the Securities and Exchange Commission (SEC).

Originally, the NASD was intended to function as a self-regulating organization to establish and enforce codes of practice in the trading and brokering of securities. The NASD regulates three categories of negotiated markets: the Over-the-Counter Bulletin Board (OTCBB), the National Association of Securities Dealers Automated Quotations Board (NASDAQOMX), and all electronic communication networks (ECNs) over which securities are traded.

### ***The OTCBB***

This market is regulated by the NASD. The OTCBB is separate from the NASDAQ market. Bulletin Board stocks are characterized by their stock symbols, consisting of either four or five letters followed by the designator "OB." Bulletin Board stocks do not meet the various listing requirements

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

of the broader securities exchanges. OB stocks, therefore, are considered a greater investment risk due to their volatility, lack of liquidity, and larger bid-ask spreads. As a result, OB stocks have very little appeal to professional/institutional investors.

The only requirement for your company's stock to be included on the OTCBB is that your company must file periodic financial reports required by the SEC (10-Ks and 10-Qs), the IRS, and other federal and state agencies. There need be no business relationship between your company and the participants in the OTCBB. If a broker/dealer chooses to be a market maker for your company's stock, then that broker/dealer must file form 15c-2-11 with the NASD after consulting with your company's counsel and CFO. By filing the 15c-2-11, the broker/dealer agrees to keep and maintain due diligence files about your company for as long as it acts as a market maker for your company.

The NASD has no enforcement authority regarding OTCBB companies. If an OTCBB company fails to file a required report to a regulatory agency, it is the SEC's responsibility to deal with filing delinquencies. If your company is delinquent, the NASD appends an "E" as a fifth letter to your trading symbol. When you notify the NASD that your company again meets all listing requirements, the listing reverts to four letters. However, if the NASD has not been notified that a company is again in full compliance within 60 days of being given the "E," the stock is removed from the OTCBB listing.

## THE SECURITIES MARKETS

The primary advantage for having your company listed on the OTCBB system is to make it feasible for investors to trade your company's stock. Another advantage is the inference that your company is complying with all reporting requirements. Institutional investors are reluctant to hold OTCBB stocks because the OTCBB provides the least degree of market discipline regarding stock prices. OTCBB price quotes are posted electronically, but not negotiated electronically.

The time to complete an OTCBB transaction can be lengthy, and prices of OTCBB stocks can be very volatile within time spans of only a few minutes. There are two NASD rules to protect investors from some of the consequences of the volatility of microcap stock.

*The Firm Quote Rule:* A dealer cannot post "intent" to buy or sell your stock at a stated price, unless that trader fully intends to honor the price under conditions specified at the time of the bid or offer.

*The Best Execution Rule:* The broker-dealer must prove to have exercised "reasonable diligence" in getting the best possible price.

Technological developments and ongoing refinements to market structures preclude detailed descriptions of trading rules in this book; you should visit the relevant NASD websites for details on current stipulations and regulations.

Investors in OTCBB stocks generally look for the stocks that have the largest trading volume. The consequences of

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large volume are generally several market makers, tighter spreads, and better liquidity.

### ***Move Up***

Our first recommendation to clients is: Focus intently on attaining sufficient financial viability so that your common stock can be listed for trading on a market other than the OTCBB.

### **NASDAQ OMX**

Even with the above-mentioned strictly enforced rules, there are enough limitations inherent in the OTCBB process to aspire to a more inclusive listing on NASDAQ OMX. Technological developments and changes to market structure preclude detailed descriptions in the book. Readers should visit the relevant NASD websites for current stipulations and regulations.

Stocks accepted for listing on NASDAQ are divided into three tiers based on total market capitalization:

1. *The NASDAQ Global Select Market* has the highest initial listing standards of any stock market in the world. A company must meet specific financial and liquidity requirements for initial listing and must continue to meet standards to maintain its listing.
2. *The NASDAQ Global Market*, formerly the NASDAQ National Market, has a new name. The listing requirements are somewhat less than those of the Global Select Market. A company must meet all initial listing criteria and continue to meet those standards to maintain its listing.

## THE SECURITIES MARKETS

3. *The NASDAQ Capital Market*, formerly the NASDAQ Small Cap Market, was renamed in 2005 to reflect the core purpose of this market, capital formation. This is the tier market appropriate for emerging companies and will be discussed at length.

### ***Listing Requirements for the NASDAQ Capital Market***

Emerging companies aspiring to become listed as a NASDAQ Capital Market issue must initially meet the following criteria:

- Have a minimum bid price of \$4 a share
- Have a net income of \$750,000 in the most recent fiscal year or in two of the last three fiscal years
- Have a total of one million publicly held shares
- Have a total market valuation of publicly held shares of \$15 million
- Have at least 300 shareholders, each of whom must purchased at least 100 shares or more in the open market
- Have at least three market makers, and many portfolio managers prefer more
- Must comply with all corporate governance requirements as set forth in NASDAQ's Rule 5600 series

Once listed, any NASDAQ small-cap stock whose minimum bid remains below \$1 per share for 30 consecutive days will be issued a 90-day warning that the company is in danger of being delisted. Immediately upon being so warned, a company must let NASDAQ listing officials know what action and/or circumstances will raise the share price back above

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

\$1 within 90 days. If the company cannot rectify the situation within that 90-day period, NASDAQ can move to delist the company. The same danger of delisting applies to falling below the minimum standards for the other listing requirements.

Obtaining and retaining a NASDAQ listing is evidence that your company is financially viable and that it has some liquidity, and it makes your stock appealing to some institutional investors.

### ***Market Makers***

A market maker is any broker/dealer firm that has posted its willingness to trade in round lots at the prevailing price. To retain a NASDAQ small-cap listing your company must have at least three dealers who are willing to make a market in your stock. There are two categories of market makers: wholesalers and retailers. NASDAQ's listing staff has no rule about whether the market makers "sponsoring" your company's stock should be retailers or wholesalers. The retail market maker's sales staff will be promoting your stock to prospective investors who are likely to hold your company's stock for a reasonable period of time. Your company's stock, therefore, must be more appealing in terms of liquidity and future prospects than the other thousands of issues.

## **THE AUCTION MARKET: STOCK EXCHANGES**

Earlier in this chapter, we explained that the stocks of most emerging companies are traded in the negotiated markets

## THE SECURITIES MARKETS

and that the auction markets trade in the seasoned stocks with higher capitalization. However, some exchanges (most notably the American Stock Exchange) are recruiting emerging companies to list with them. Thus, it is possible that your company's stock could be listed and traded on an exchange.

The auction market, or more accurately the open-outcry market, is composed of the stock exchanges. The most familiar of these is the New York Stock Exchange (NYSE); another familiar auction marketplace is the American Stock Exchange (AMEX). The listing requirements of the AMEX are less stringent than those of the NYSE, since the former is actively recruiting emerging companies to list. However, keep in mind that the AMEX listing requirements are related to capital structure and are in no way more permissive with respect to reporting and disclosure requirements.

There is, however, another viable auction market exchange that can accommodate the trading of smaller cap stocks. It is the BATS exchange.

### **BATS**

BATS is an acronym for "Better Alternative Trading Systems." BATS ([batstradingystems.com](http://batstradingystems.com)) is headquartered in Kansas City and has offices in New York City. BATS operates e-markets where broker-dealers and financial firms connect to execute trades. It is a registered US securities exchange and now accounts for about 12 percent of stock trading volume in the United States. Stocks trading on BATS are commonly listed on other exchanges. BATS operates two exchanges BZX and BYX. The degrees of volume and

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liquidity among the listed issues are what determines whether a BATS listing is traded on BZX or BYX.

Emerging companies aspiring to become traded on BATS initially must meet the following criteria:

- A minimum bid price of \$4 a share
- At least 1 million publicly held shares
- At least 400 shareholders, each owning at least 100 shares
- Annual revenue from continuing operations of at least \$1,000,000
- in the most recently completed fiscal year OR in two of the past three years
- Stockholders' equity of at least \$15 million
- Market value of publicly held shares of at least \$8 million
- At least three registered and active market makers

## **LIQUIDITY, LIQUIDITY, LIQUIDITY**

Again, float size is a major concern. Whether a stock is traded within a negotiated market or on an exchange, the number of shares available for trading must be large enough to permit those shares to be converted into cash without significant loss of value.

In the next two chapters we describe the behavior of those investors whose activities determine the price levels at which the stock of your company trades.

**CHAPTER 5**  
**REACHING THE**  
**INDIVIDUAL INVESTOR**

There are fewer and fewer individual shareholders among the prospective investors in your company. That is because people have become more aware of *specific risk* ([chapter 2](#)) and of the wisdom of diversification through mutual funds. There are, however, some individuals who still want to manage all aspects of their financial activities. These individual investors buy stocks in small lots and generally are

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less sophisticated than institutional investors. They are the most likely shareholders to generate complaints.

What, then, is the appeal of having a core group of individual shareholders? First, they tend to hold their shares for a longer time; therefore, they may make up the most stable portion of your shareholder base. If your company demonstrates its ability to grow value for shareholders, those individual shareholders will be among the first to buy more of your stock. A solid cadre of individual stockholders can be evidence to brokers, traders, and institutions that your company's stock is a viable investment.

There is a direct way and an indirect way of reaching new individual investors.

### **THE DIRECT APPROACH IS NOT RECOMMENDED**

You run several risks if you promote your stock directly to new individual investors. First, this can be very expensive because the retail audience is broad, to qualify and reach appropriate investor prospects takes money and time. Second, and more important, you will lose the service of brokers. The major service of brokers is that of filtering out inappropriate investors. There are some investors who do not share your goal of building an enduring company. That sort of investor may be inadvertently solicited through your company's direct campaign.

In addition, shareholders acquired directly are most likely to come *directly to you* for information and reports. They should be receiving those from their investment advisor, so as

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to avoid an unnecessary workload on your staff. More important, by directly soliciting purchases of your stock, you are likely to be in violation of one of hundreds of state, federal, or exchange rules that govern securities transactions.

Demonstrate your commitment to growth with innovation, energy, and good judgment. Actions do speak louder than words. All activities of your company should be directed toward enhancing its appeal to investors. This includes your sales, your marketing, your advertising, the quality of your product or service, and your reputation; you and your employees should be occupied with these challenges.

The only action we recommend for you toward directly soliciting new investors is to include in your advertising and press releases the fact that you are a public company, to list your trading symbol, and to provide information about where your stock trades.

The activities associated with communicating the present and prospective values of your company should be left to parties trained to analyze the elements of those values as well as to parties able to identify those who want to profit from the increase of your company's value. This is the function of securities brokers.

## **THE BROKERS**

Retail brokers provide a proven means of reaching individual investors. A broker provides the opportunity to tell your story—many times, if necessary. Moreover, brokers are your compliance shield. They know securities law; they know what

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can and cannot be said. Brokers can insulate your company from disclosure problems.

Brokers convinced that your stock's price represents value will encourage investors to purchase it every trading day. Daily volume for emerging company stocks is created by retail brokers and their customers. Without this daily volume, you are less likely to attract the attention of institutional investors.

Occasionally, clients ask: "How many of your broker friends will start selling our stock now?" The implication here is that brokers that are good investor relations firms must know other brokers that will follow their recommendations. However, it doesn't work that way. The approach to working with brokers cannot be based on "favors." You must be as deliberate and systematic in reaching out to brokers as you are in reaching out to institutional investors.

In our chapter on institutional investors, we recommend bypassing the broker/dealer and communicating directly with institutional investment managers. However, it is inefficient to bypass brokers when promoting your stock to individual investors. You have to work with those brokers who sell to individuals, but you must be selective in dealing with the many retail brokers out there. Employing a selection process requires knowledge of the present state of the retail stockbroker market.

### ***Making the Cuts***

The overriding fact about retail stockbrokers is that their number is decreasing because of internet trading. Moreover,

## REACHING THE INDIVIDUAL INVESTOR

there has been a change in the way many retail brokers now conduct their business. Half of the brokers who work with individual investors don't generate their income from commissions on stock transactions. Rather, their compensation is based on fees earned on the amount of their clients' assets that are directed to investment management enterprises, including mutual funds and hedge funds. These individuals are commonly known as fee-based consultants, financial planners, or wrap-account brokers. The foregoing individuals are easily identified as candidates for your first cut.

Brokers whose clients have a low tolerance for risks should be excluded. Demographics dictate that this is the largest subset of retail brokers, because the largest group of these investors is over 50 years old. Hence, their focus is on preservation of capital. Keep in mind the disagreeable reality that your company's stock is perceived as a high-risk investment.

### ***The Best Broker Prospects***

The best target profile is a broker with at least 10 years of successful experience dealing with high-net-worth clients. These clients have usually designated some percentage of their capital for alternative investments. These alternative investments include hedge funds, venture capital funds, LBO funds, leveraged strategies involving derivatives, *and* stocks of emerging companies. (Yes, many brokers and/or financial planners characterize emerging company stocks as alternative investments.)

Veteran retail brokers are also likely to maintain a list of clients who have an asset management strategy of investing in

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some emerging company's stocks. Even though these clients are willing to assume a higher level of risk, they shouldn't be characterized as speculators or gamblers. They are aware that they could lose most of their investments in *some* companies, but they expect commensurate rewards from the stocks of other emerging companies. Moreover, these investors derive great pleasure from being part of a growing company.

### ***The Worst Broker Prospects***

An investor relations policy should dictate that a company should avoid brokers who cater to speculators or those who "flip stocks." Those clients are gamblers hoping for a quick profit before they go on to the next hot deal. This is impatient money and is soon gone.

## **"PUMP-AND-DUMP" AND OTHER CHICANERY**

Hot deal money has no value for the emerging company with the deliberate goal of increasing shareholder equity. There are financial advisors for emerging companies who propose campaigns guaranteed to dramatically increase the price of your company's stock.

Benjamin Mark Cole, in his cogent book, *The Pied Pipers of Wall Street*, calls these advisors the "Pied Pipers with Brass Flutes."<sup>1</sup> Companies like yours are in the telescopic crosshairs of these bad guys. Your company should maintain constant vigilance about these financial advisors.

## REACHING THE INDIVIDUAL INVESTOR

On your worst days, you can be aggravated about the prospects of your company's stock. Understandably, this state of mind can make you susceptible to the pitch of some so-called Wall Street pro who has surefire plans for increasing the price of your company's stock. The most common of these plans is a game often referred to as "pump-and-dump." Here is Cole's concise description of this scheme:

The pump-and-dump scheme is when a group of traders [and like-minded brokers] artificially boost the share price of a selected stock...and then sell out before reality hits and the price of the stock plummets. They usually do this by coordinating timed purchases with a wildly positive public relations campaign, the centerpiece of which is generally an analyst's glowing report—the enthusiastic analyst being a hired accomplice.<sup>2</sup>

As Cole points out, stocks of companies like yours are most often the targets of schemes such as these. One reason is small floats. A small float is the cause of less liquidity, which translates into volatility. Cole further states: "As a result, even a small amount of buying pressure—artificially induced—can send stocks soaring. The pumpers can then dump."<sup>3</sup>

If you are approached by a broker or analyst with a plan to increase the price of your company's stock within a few weeks, be very wary. Ask for the names and affiliations of those who will be working on the campaign.

Pay particular attention to what the campaign proponent is focusing on with respect to your company. If that person is indifferent to the details of your business strategy, your cost

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controls, your competitive analysis, and the profiles of your customers, how can that Wall Street pro be sincere about the long-term prospects of your company. Make a point to get the names of the other companies the so-called pro has worked with and call them.

Once your company has been the subject of a pump-and-dump scheme, its reputation within the investment community has been besmirched—that is always the aftermath. Restoring the appeal of your company is most likely impossible.

### ***Web Chat Rooms***

Cyberspace offers unlimited opportunities for creativity for renegade brokers and their associates. The problems associated with this activity are discussed at length in [chapter 16](#).

### ***The Less Than Gifted Broker***

The SEC explicitly prohibits any broker from accepting a direct payment (bribe) from a company in exchange for agreeing to make a market in that company's stock. Such an arrangement is illegal. In addition to these practices being illegal, there is another reason to decline any such arrangement. Who would want to do business with a broker stupid enough to make such a proposal?

## **TARGETING THE BEST RETAIL BROKERS**

The brokers you should target have learned that real success is sustained success. The key to that sustained success is in

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their retention of clients. Successful retail brokers work hard to find stocks that will make their clients money within the clients' given circumstances and risk tolerance. These brokers are careful and deliberate. They reflect on what they hear at initial presentations. They do their own research as a way of augmenting and checking other research reports.

Gifted brokers may work at a small brokerage firm or at a large financial services firm. The size of the company for which they work may dictate how they work and what they are allowed to do.

### ***Megafirm Brokers***

Megafirms are the full-service broker-dealers with extensive research and investment banking divisions. They have offices throughout the world. Their research divisions employ scores of analysts who cover a large number of securities within many sectors. Their primary focus is on companies with market capitalizations of more than \$1 billion.

These firms have a large overhead of administrative costs. To operate profitably they need high commission and fee revenues. Transactions in higher-priced securities generate higher revenues; therefore, these firms generally will have policies that prevent brokers from transactions in stocks priced below \$5 a share. These firms are not likely targets for your IR outreach.

### ***Regional Brokers***

Regional firms run full-service operations, but they generally do not have a national presence. They are likely to have

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a multistate presence. Like the megafirms, they structure their operations in a manner that discourages low-revenue transactions.

Their distinctive appeal is that they may have some brokers who specialize in stocks of emerging companies within their respective regions. Their aim of having their brokers focus on companies like yours is to cultivate a relationship from which will come investment banking opportunities.

### ***Independent Brokers***

There are a few independently owned brokerage firms, and their activities are as closely monitored by regulators as are the activities of larger firms. They are no more likely to be involved in any chicanery than any other broker/dealer.

### ***Microcap Brokers***

Regardless of the size of the local office or the size of the firm, there are some experienced brokers who have established good track records with all types of securities including microcap stocks. Among their clients are institutions as well as individuals with high net worth. Their record of success allows them some anonymity in stock selection. They may do their own research and focus on corporations in the communities where they work. They may be familiar with your company.

If you are contacted by a local broker, make time to talk. An enterprising local broker will want to visit and observe your company's operations. If one visits your company, be alert to disclosure strictures. Don't provide any information

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about revenues or earnings that has not been disclosed publicly. You are free to talk about your competitive advantage, your plans for growth, and your cost-control process. Be careful that neither you nor anyone else on site talk specifically about revenues, order backlogs, new products, or new services unless that same information has been published.

It is onerous and time-consuming to determine where the brokers in your area are who have a sustained interest in emerging companies. You could call regional brokerage offices and ask the branch manager: “Are there any brokers on your staff who specialize in microcap stocks?” Here is an alternative approach: retain an experienced investor relations firm that has already developed a list of qualified stockbrokers.

## COMMUNICATING WITH BROKERS

Whatever messages your company intends to send to its corps of selected brokers, they must always be in the following context:

How is this meaningful to the owners and potential owners of my company’s stock?

How will it affect the market value of my company’s stock?

### *The Telephone*

Brokers are accustomed to dealing with people by phone. When you have brokers on the phone who say they do have clients who invest in companies like yours, you already have their attention. Thus, your answers should be concise. Give

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the name of the company and its trading symbol. Describe your product or service in no more than two sentences. Explain who your intended customers are and avoid discussing complicated technical features or concepts. Tell them how long you have been in business and then shut up. Let the broker ask the questions. Remember not to disclose any information that has not been made public. Offer to send more information and refer the broker to your website. Give the date of your most recent 10-Q and 10-K filings.

### ***The Web***

Of course, web-based services continue to evolve, and most of them have very large opt-in databases of retail investors, brokers, and day traders who subscribe to get information on companies in certain industries and sectors. A diligent and focused IR advisor will stay abreast of those services and should be able to advise you on whether or not to retain one of them and also assist you in selecting the most appropriate for your sector and your strategy. Don't confuse these legitimate web-based services with the "pump-and-dump" gangsters we have described elsewhere in this book (p. 45 above).

Again, diligence and focus are the attributes of a sustained and effective IR operation. According to Don Markley, an esteemed and experienced IR professional, the keys to having a retail following are as follows:

1. Make sure information about your company is easily available on your website; this includes all news releases, a fact sheet, and slides from presentations.

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2. Maintain a database of investors and brokers who have expressed interest in your company.
3. Continue to update the database on all company news, making sure that such updates are released simultaneously to all addressees.

### ***Following Up***

Keep in mind that you are competing with thousands of other public companies vying for stockbrokers' attention. The key to building an effective IR program is sustaining your relationship with retail brokers. Never assume that the brokers with whom you have relationships will take the initiative to stay abreast of your company's activities. Put a system in place that assures that the brokers you have cultivated stay informed about events and circumstances that could affect the price of your company's stock.

## **RETAIL RESEARCH: THE QUID PRO QUO**

We advise against approaching sell-side research analysts. There may be occasions when one of the brokers you have cultivated will refer an analyst from the firm to you. In that case, sit down with the analyst, keeping in mind that you are a source of new business. Don't be surprised that in addition to asking for your investment bank business, the firm offers to run your ESOP, profit-sharing, and 401(k) plan.

Don't agree to any arrangement to manage your ESOP or retirement programs without first clearing the arrangement with your legal counsel. Federal regulations prohibit

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certain related-party agreements between brokers and plan sponsors.

### **CONCLUSION**

A base of individual investors is necessary to provide your company's stock with liquidity and a stable trading range. The time involved to cultivate and recruit appropriate retail brokers is a necessary IR investment. A seasoned cadre of responsible brokers can be one of your best lines of defense when economic events or a poor quarter depresses share prices.

### **Notes**

1. Benjamin Mark Cole, *The Pied Pipers of Wall Street* (Princeton, NJ: Blomberg Press, 2001), 132.
2. Ibid.
3. Ibid.

**CHAPTER 6**  
**TARGETING INSTITUTIONAL  
INVESTORS: THE MICROCAP  
FUNDS**

Chapter 5 describes some of the theories and practices that experienced individual investors use in developing an investment strategy. The purpose of this chapter is to describe investors who have the objective of buying thousands of shares of emerging companies' stocks. This selectively targeted group is part of the largest and most important segment of the investing world, the institutional investor community.

Institutional investors are persons or organizations that assume the responsibility of investing or overseeing the

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investment of large pools of money. The institutional investor community includes all the fiduciary parties and the parties providing services to fiduciaries. This includes investment managers, brokers, custodians, researchers, software vendors, consultants, accountants, and attorneys.

### **YOUR COMPANY MUST BE LISTED**

If your company's stock is not listed for trading on an exchange or on the NASDAQ system, it is not considered a viable investment by institutional investors. A listed stock's value is openly negotiated, and the most recent price at which the stock trades is available immediately. A major concern of institutions is liquidity. Listed stocks should have a minimum float of 1 million public shares, thus ensuring liquidity. Stocks listed on an exchange or the Nasdaq system and OTCBB stocks are all subject to strictly defined financial reporting and disclosure requirements. The reporting and disclosure requirements for listed stocks likely qualify them as securities approved for inclusion in most portfolios. However, these securities must have the three essential features necessary for institutional appeal: Liquidity, liquidity, and liquidity. Unless your company meets the requirements for public listing and attains that status, do not expect any interest from institutional investors.

### **THE INSTITUTIONAL "SIDES"**

Two-thirds of institutionally managed money is composed of retirement funds (defined benefit and defined-contribution

## TARGETING INSTITUTIONAL INVESTORS

plans) and the assets of individuals with high net worth. The professional organizations aspiring to invest those pools of money, for a fee, are insurance companies, brokerage firms, independent money managers, bank trust departments, and mutual funds.

These investment professionals are known collectively as the buy side. They in turn are the customers for professionals, such as stockbrokers, who provide transaction services. Those third parties are known collectively as the sell side.

Most of this chapter will be devoted to the buy side. The reason for this will become apparent after we briefly discuss the sell side.

### THE SELL SIDE

As discussed earlier, broker-dealers and investment banking firms make up the sell-side segment of the institutional investment community. They sell their intermediary services and research services to investment decision makers for commissions and fees.

#### *Sell-Side Research*

Broker-dealer and investment banking firms maintain extensive research departments composed of economists, technical analysts, and company financial analysts. Technical analysts watch security price movements and the movement of selected indexes to forecast the direction in which these values might move.

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Company financial analysts (or securities analysts) and their support staffs account for most of the people employed in a research department. These analysts conduct research and recommend the purchase or sale of securities. They specialize in specific industries and sectors. They are supposed to provide the brokerage firm's clients with informed opinions about the present and future market prices of a company's stocks. Sell-side analysts with reputations for good calls are among the highest paid people in the investment business.

### ***The Sell-Side Dilemma***

Recent events have had a severe impact on the full-service broker/dealer houses in the United States and Western Europe. Full-service firms could depend on dense profits from five areas of revenue: brokerage commissions, dealer (trading) profits, derivatives activities, money management fees, and investment banking fees.

Competition among established firms, the emergence of discount houses, and online trading services have all reduced revenue streams and the associated high profit margins. The advent of decimal pricing has further narrowed the bid-ask spreads on traded securities, thus making it more difficult for the dealer side of the firms to earn large profits on spreads. Firms have shifted to order flow strategies in an attempt to gain profits on momentum volume.

The staffing of derivatives strategy departments with bright and talented employees has diluted the competitive advantage that any one firm may have had in the trading or

## **TARGETING INSTITUTIONAL INVESTORS**

development of synthetic securities. The pressure of earning profits in the money management business has evolved into a challenge of achieving economies of scale. Merger activities continue among sell-side and buy-side players.

The remaining activity for dense profit revenues might be investment banking, that is, corporate finance and merger-acquisition activities. Not surprisingly, investment banking is very competitive. Success is dependent on the quality of relationships a firm maintains with corporate management. However, this does not mean that a close relationship between banker X and company Y's CEO will ensure that X will be Y's investment banker of choice. It can, however, give X the opportunity to be the first to learn about Y's corporate strategy and promote X's capabilities in implementing the financial aspects of that strategy.

So, it should not be surprising that within broker-dealer firms, there is a symbiotic relationship among the analysts and the bankers.

Do not underestimate the importance of the sell side as you can benefit from having the sell side know your story. An analyst with a sell-side firm can arrange for you to present at a conference, as well as mention you in an overall industry roundup report.

## **SELECTED TARGETING WITHIN THE BUY SIDE**

A major concern of any business is the efficient use of resources and the elimination of wasteful practices. Your investor relations program should be subject to process discipline. You

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

made the first step by not focusing on the sell side. Additionally, there are some easy exclusions to implement among the buy-side players. Two obvious categories are funds that specialize in foreign securities and the indexers (passive investors). Because your company is an emerging company and not a reemerging company, you can also eliminate investment managers who restrict their activities to value strategies.

Using your knowledge about institutional investing, you have just eliminated all of the sell side, all the indexers, all managers who focus on foreign stocks, and all the value players. Now you can begin the winnowing of buy-side growth investors.

### ***Growth Investors***

Growth companies are companies with annual earnings that increase at a rate greater than that of the market as a whole. Growth investment managers look for companies whose earnings growth rates are not fully reflected in the price of their stocks. They will look even further among such companies to find those that fit one of four subcategories. Each of these categories is defined based on a given range of market-capitalization values:

1. Large cap: More than \$5 billion
2. Medium cap: Between \$1.5 billion and \$5 billion
3. Small cap: Between \$300 million and \$1.5 billion
4. Microcap: Less than \$300 million

The market capitalization of your company is likely to be in the microcap category. So, let's talk about how you can

## TARGETING INSTITUTIONAL INVESTORS

get the attention and support of microcap investment managers, more specifically of microcap mutual funds. These funds remain a nimble group of competitors for large pools of money. They are ready buyers for emerging company stocks that meet their selection criteria.

### ***Selling to the Microcap Funds***

We have said that an IR program should be as subject to process discipline as any other business function. Selling is the business function that is most like microcap IR. The overriding rule of selling is that you must know your customer. Microcap investment managers are part of your customer base. They may be working in a mutual fund company, or they may be independent money managers. Knowledge of how these professionals do business is essential to your effective and sustained IR program. Keep in mind that investment managers are running a business, just as you are. You share the same overriding concerns: controlling costs and increasing revenues.

### ***The Killer Costs of Managing a Microcap Portfolio***

Most of the operating costs that a microcap investment manager has are similar to those of any other business: facilities, personnel, marketing, communications, etc. These can be managed with prudent attention to purchasing, hiring, and compensation practices. The costs that override the degree of success that any institutional investor has are the costs associated with the buying and selling of securities. These costs are

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referred to in the aggregate as transaction costs. Growth managers who invest in small companies encounter higher transaction costs than investment managers of any other style, and microcap growth managers face the highest costs of all.

Other than brokerage commissions, what other transaction costs are there? Wayne H. Wagner and Steven Glass of the Plexus Consulting Group defined them in detail in an issue of the *Journal of Investment Consulting*: market impact costs, delay costs, and opportunity costs.<sup>1</sup>

*Market impact costs* are measured by taking the difference between the quoted price of a stock when the investment manager placed an order and the price when the order was executed. Because microcap stocks have relatively small floats and volume, large buy orders will have a significant effect on the share price.

*Delay costs* can be incurred because a microcap portfolio manager may wait for the best price to make a trade with a market maker who is closely monitoring the stock. The odds are about even that neither will get a better price.

*Opportunity costs* are the extreme of delay costs. These are the costs of missing out or only partially completing an order.

### ***An Aggressive and Expensive Investment Style***

The common factor that governs these costs is the size of the float. A quick quiz follows:

Name the three features of a microcap stock that appeal to an investment manager?

The answer is: Liquidity, liquidity, and liquidity.

## **TARGETING INSTITUTIONAL INVESTORS**

A growth style of investing is an aggressive style. Growth managers are “tracking” hunters. Value managers are “sit-and-wait” hunters or shoppers. Tracking, by nature, is a more expensive activity than sitting. Wagner and Glass measured the aggregate transaction costs across four styles of portfolio managers: large cap value, small cap value, large cap growth, and small cap growth. The costs for a small cap growth manager were more than four times those of a large cap value manager and two times more than the costs incurred by a large cap growth manager or a small cap value manager.

### ***Bad News and Good News***

Some investment managers can be compared to pilots of commercial jumbo jets, not microcap managers. Microcap investors are like test pilots, the same as founders and principals of emerging companies. They are your kin.

For you, here is some bad news—and some good news. The bad news is that it is very expensive for an institutional investor to buy your stock. The good news is that it is very expensive for an institutional investor to sell your stock. When you finish reading this chapter, you might conclude that the good news is even better than you thought it was.

### ***The Profit Challenge for Microcap Investment Managers***

The burden of high transaction costs borne by buyers of your stock must be offset by superior investment returns, which in turn attracts more money into microcap growth funds.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

Always remember that microcap growth investors have to significantly outperform other portfolio managers just to remain even within comparative cost ratios. You must understand how these professional investors operate as they attempt to outperform all other managers in the institutional investment universe.

### ***Microcap Investment Managers Don't Delegate Their Research***

The buck starts and stops at the microcap portfolio manager's console. There is almost no sell-side research available. Analysts capable of selecting outperforming stocks are very expensive to hire, train, and retain. There are only two staffing models in microcap investment managers' offices: very lean or none.

You have to make it easy for the managers interested in your company to get the answers they need. These pros don't have time to stay on hold. You need to organize your IR team and communications systems so that investment managers can reach you directly. If you can't take a call, make sure that you or one of your senior people gets back to the caller within an hour.

### ***Investment Disciplines Can Vary among Microcap Investment Managers***

Investment managers have different selection criteria and search patterns. All want a high rate of earnings growth (20 percent or more), but they will look at that in the context of another operating measure. Some favor high rates of revenue growth,

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some will look at annual increases in free cash flow, and others want a pattern of increasing operating margins.

Don't approach a manager until you understand that manager's selection criteria. Read the manager's prospectus and sales literature. Search the web for transcripts or videos of interviews with the target manager. Several managers only use computer-based screening models to select stocks. They rely on statistical data about some feature that they use to select stocks. They search among data on thousands of stocks for that feature. In their marketing, those investment managers will be very specific about their proprietary screening models. Don't waste time contacting these managers. Your company's stock will either pop up within a model or it won't.

### ***Now What?***

Attaining the goal of institutional ownership is an important step in enhancing the viability of an emerging company. That achievement isn't an investor-relations accomplishment in the literal sense. Prior to the investment manager's purchase of your company's stock, you were just a suitor. Now you and the investment manager are married. How can you manage this relationship so that you can remain married?

### ***Truly Understanding the Microcap Investment Manager***

The relationship with your institutional investors depends not just on the continued success and growth of your company but also on your company's policies, practices, and behavior.

## INVESTOR RELATIONS FOR THE EMERGING COMPANY

All of which should be based on a deep understanding of the risks encountered by microcap investment managers.

All investment managers work in an environment influenced by three types of risk. Two of these types of risks are discussed in [chapter 3](#): systemic (market) risk and nonsystemic (specific) risk. Investment managers are also susceptible to what can be termed consensus risk.

Consensus risk is a branch of specific risk. It is the risk due to the fact that a stock's market value is determined not by fundamental measures but by the collective (and perhaps capricious) opinions of some analysts and their investing peers. The remainder of this chapter discusses these three types of risk with respect to your company's stock. These risks are the elements that constitute Peter L. Bernstein's "disagreeable reality" (introduction to [chapter 3](#)).

### ECONOMIC NEWS AND MARKET RISK

Those who run microcap investment portfolios are intrepid. They believe that, contrary to academic theory, they can outperform the overall market even against the prevailing headwind of high transaction costs.

Bad economic news always drives down the market values of small company stocks first. Your payroll is a bigger portion of your company's operating expenses than the payroll costs of a large corporation. Accordingly, news of rising wages is not good news about your company. Any news of inflation is worse news for your company because the perception is that your company has less wiggle room in the face

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of higher costs. But microcap investors are contrarians; they make money buying on dips. Look for buying patterns in a down market. If you discern some buying activity in stocks like yours, crank up the IR activity.

### **THE RISKS SPECIFIC TO OWNING YOUR COMPANY'S STOCK**

Vigorous debates about the valuations of emerging companies are common in the business news. When reviewing these comments by market professionals and academics, you will have come to one of two conclusions: each person has a responsible point of view or that nobody has a clue. This section's focus is on those operating, financial, and accounting measures that are the practical day-to-day concerns in connection with the specific risks of owning stock in an emerging company.

The valuation measure that is most frequently mentioned in the popular media is the ratio of share price to earnings—the P/E ratio. Your target institutional investor will never accept the size of a P/E ratio as even an initial selection variable. Is your company with a trailing P/E ratio of 20 a better value than company X with a 30? Probably not, if your company's earnings have been growing at an annual rate of 25 percent and X's have been growing at an annual rate of 30 percent.

All portfolio managers want a high rate of earnings growth, but they will also look closely at other operating measures. With respect to microcap investors, there are three other operating measures: the rate of revenue growth, the increase in operating margins, and the increase in free cash flow.

### ***Growth in Revenues***

Some investment managers believe so strongly that growth in revenues is the guiding measure of value that they pay close attention to the ratio of price to sales. These managers cite their focus on growth in revenues as the major reason. They prefer that your company reinvest a major portion of operating margins into furthering growth. They also reason that a well-managed company continues to operate more cost-effectively; therefore, increasing revenues ensure proportionately greater margins.

These higher leveraged revenues can be critical to how these managers value your company. A couple of quarters of increased earnings with flat revenues might be acceptable to some portfolio managers, but flat revenues are a major source of concern for those who focus on the top line. They want increasing annual rates of growth in customers, unit volume, and billings. These professionals are also wary about companies that have just a few customers who account for a major percentage of sales.

### ***Operating Margins***

Some investment managers look closer at the other side of the revenue/expense ratio. At some point, they want clear evidence of a return on expenses. They begin looking for productivity gains relative to your personnel costs (payroll). They expect higher sales resulting from your increased advertising expenditures. They will be paying particular attention to how your research and development costs are amortized. These portfolio managers may be characterized as very thrifty. If

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you have a year or two when expenses have increased at a higher rate than revenues, they perceive that condition as an unacceptable risk. As one of these microcap portfolio managers put it: “I am very partial to inverted burn rates.”

### *Free Cash Flow*

Managers of microcap portfolios can hardly be characterized as being averse to risk; however, some of them are more cautious than others. Investors who are more cautious look only at companies that have been in business long enough to have generated free cash flow.

This measure is computed by first identifying earnings before any noncash deductions, such as depreciation. From these cash earnings, the investment manager subtracts your capital investments, such as equipment, buildings, and other debt payments. These investors are, in effect, treating all your capitalization entries as expenses. Some investors, however, won't deduct certain amortizations. How they compute is not as important as understanding their risk mind-set. They focus on cash: where it is, where it comes from, and where it is going. What does this mind-set mean for you? It means that if the average of your receivables increases or your inventory begins inflating, these investors will sell your stock.

### *The Balance Sheet*

The risk measures described above are items reported in two of the three corporate reporting documents: the profit and loss statement and the statement of cash flows.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

The descriptions above concerned operating measures. Microcap investment managers also look at the balance sheet. The debt-to-equity ratio is one of the first items they focus on. They get concerned about companies that have more than 50 percent of their capital in the form of debt. Interest expense is a very specific risk.

Another item of primary interest is working capital. This is computed by subtracting current liabilities from current assets. Working capital is closely related to cash flow. The more conservative portfolio managers want to see at least one-and-a-half times as many current assets as current liabilities.

Of course, the most important balance sheet item is often overlooked: Do your company's sequential balance sheets show sustained increases in shareholder equity?

### **THE QUALITATIVE CONSIDERATIONS**

Of course, experienced money managers won't rely solely on operating and accounting measures. Here are some investor prejudices and preferences you should keep in mind. Your targeted investors will always favor companies in which management has a large ownership stake. One portfolio manager with whom we talked was unambiguous: "If they ain't owners, we ain't buyers."

Obviously, investors don't like companies with products or services that might become obsolete. They prefer companies that operate in an industry with high barriers of entry. They will verify that you are complying with all applicable laws and regulations. Employee turnover rates are always

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of interest. They will also long remember people who have burned them with inaccurate information or who mismanaged other enterprises. Microcap investment managers are nice people, but they are not very forgiving.

### M&A CONSIDERATIONS

Mergers and acquisitions are always in the forefront of experienced investors' minds. There is an estimate among financial professionals that for every company that goes public, six other companies are merged. Confront another fact of public life: individual and institutional shareholders own your stock in part because they think your company is an attractive acquisition target.

What if your strategy consists of plans to grow by acquisition? Professional investors are skeptical about that path to growth. One of the reasons for their skepticism is that they want to know who conceived that strategy, you or an investment banker. Investors want to understand the expected benefits of this action, specifically they want to know the answers to the following questions:

1. What are the economies of scale?
2. Will there be increased market share?
3. Will there be synergy-driven increases in revenues, earnings, and free cash flow?
4. Will you overpay?
5. Will you lose focus on the activities that really drive your company's growth?

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

6. Do you have the depth of executive talent to manage a larger company?

If you intend to disclose acquisition plans to your shareholders, you should be prepared to answer these questions in considerable detail. When acquisitions are publicly announced, the market price of the acquirer usually drops. You want your institutions to stay on board, and that is why you should assure them that you and your board of directors have been deliberate and careful in developing the strategy and tactics.

If you are in an industry with many small companies, you may have plans to acquire your competitors. This strategy is commonly known as a roll-up. Portfolio managers are very skeptical about this approach to growth.

## **CONCLUSION**

This discussion of market risk and the specific risks of owning stock in your company has been based on concepts and practices easily understood by institutional investors and business advisors. You may already have known all of the above. The challenge here was to make clear how those risks are relevant to your concerns. The challenge in writing the next chapter was to explain some perplexing behavior and activities of individual and institutional investors.

## **Note**

1. *Journal of Investment Consulting* 2, no. 1 (November 1999): 30.

**CHAPTER 7**  
**ABOUT CONSENSUS RISK**

**C**onsensus risk refers to the risk of the market value of your company's stock being determined by the collective, and sometimes capricious, opinion of a majority of analysts and institutional investors. Our discussion of consensus risk can best be followed if you keep in mind the fact that when you are wrong about something and so is everybody else, you won't get much blame.

## **THE SIGNALING MODEL OF INVESTOR BEHAVIOR**

Risk, by definition, can be priced. Uncertainty, by definition, cannot be priced. When investors are uncertain about the prospects of a stock, they are likely to use other investors' actions as credible signals about that stock's risk-value profile. This type of behavior is referred to by academics as the *signaling model* of investor behavior.

One of the objectives of this book is to show you how to reduce the uncertainty regarding the prospects for your company's stock. One function of disclosure policies, practices, and behavior is avoiding being the subject of the signaling model. Part II of this book describes regulations, including SEC Regulation FD (fair disclosure). What follows in this chapter is a guide to recommended behavior in the context of consensus risk.

### ***Herding***

When there is scant precise information about the future of a company, professional investors are subject to the signaling model. An observable effect of signaling behavior is the tendency of investment managers to move in tandem or to *herd*. That herding behavior actually exists was confirmed in a study of mutual funds by Professor Russ Wermers of the University of Maryland.<sup>1</sup> He broke his study down into subgroups of funds and subgroups of stocks. He found that growth funds have the highest incidence of herding and

## ABOUT CONSENSUS RISK

that small-cap stocks were most likely to be traded by the herds.

However, the small floats of microcap stocks might preclude their being subject to herding activity. Again, it's very expensive for a portfolio manager to sell a microcap stock. As your company grows its float and its market cap increases, its stock is more likely to be subject to signaling behavior and herding transactions. Get ready.

### *The Cockroach Signal*

“If you see one cockroach in a room, that means there are a lot more.” This coarse observation has achieved axiom status among institutional investors. They firmly believe that one disappointing quarter indicates that a company is in trouble. As one expert on small stocks put it: “More often than not, an earnings shock in a small stock is the beginning of a long period of underperformance and may be the beginning of the end. It is wiser for investors not to wait around for things to improve.”

That no one points to any empirical study for confirmation is immaterial. Wall Street has bought the so-called cockroach signal. Regulation FD has not affected herding or acceptance of the cockroach signal. What if all pros had run for the exit, and then the dumped company's share value significantly increased over subsequent quarters? So what? If everybody was wrong, who's to blame? We know it takes guts to be a microcap stock investment manager. To be a contrarian microcap stock investment manager takes even more guts.

## **THE FORECASTING GAME**

“Vicious circle” is a trite but appropriate term for the cockroach dilemma. Realizing that investment managers can overreact to earnings surprises, companies attempt to manage their earnings on a quarterly basis. *Go slow here!* Managing earnings could be considered an attempt to manipulate the figures. Such practice(s) can create a perception of accounting fraud. Financial reporting scandals receive major news coverage because they are infrequent among the thousands of accounting reports issued every quarter.

More commonly, companies try to steer analysts’ expectations with the companies own forecasts in the hope of avoiding surprises. Regulation FD permits doing so as long as these forecasts are first made public. This behavior has attracted the attention of academics, and there is published research about forecasts. Here are a few of the findings:

1. Companies that forecast have greater percentage changes in earnings than those that do not.
2. Company forecasts are not systematically higher than analysts’ forecasts or than the subsequent actual earnings.
3. Analysts will respond to company forecasts, and their responses are greater when a forecast yields a surprise.
4. Surprise announcements tend to come from small companies.

It appears that there are no surprises when it comes to studying financial reporting surprises.

## ABOUT CONSENSUS RISK

Forecasting for the analysts is a distraction from running the business; in a sense, it is putting the focus on the wrong task. Don't do it. The result of this "misfocusing" might be some real surprises. Your inattention to running the business could impede the company's progress. After all, you are the boss—or were.

The risk of making forecasts is too great for an emerging company, and it was so already before the enactment of regulation FD. There is nothing that will repulse professional investors more than being told something different than what you subsequently include in your 10-K! Your steering attempts will have compounded the consequences of some unexpected news.

Your best approach is to disclose, via press releases, any material change that could impact earnings and/or shareholder equity. The timing of the press release should be after you and your financial staff have agreed that there is a material change that will impact earnings. This announcement should be released before any other mention of the circumstances is disclosed to anyone.

Regulation FD mandates protection for investors, *not for companies*. Some companies made the mistake of prematurely announcing to the public a new product, a new sales contract, or an R&D breakthrough that subsequently didn't work out. This can charitably be called enthusiastic behavior. It can be less charitably called stupid behavior. Stay in the safe harbor. When in doubt about what you can or cannot disclose, keep your mouth shut (KYMS).

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

### ***Our Advice (Besides KYMS)***

Again, do not play the game of forecasting earnings. Conduct your activities for what's right for shareholders over the long term. One CEO, frustrated about this advice, responded caustically: "We won't have any shareholders in the long term!" Our view is that, sooner or later, intelligent people will realize that Wall Street cannot price every stock, every day. Smart money gets smarter. We believe that overreaction leads to underreaction. The number of informed players in the equity markets of the United States continues to increase. Most important, many players are pension managers with imminent funding liabilities. They will structure their investment practices to act and react according to consensus risk.

Companies with higher market caps than your company's market cap can buy back some of their stock and wait. You, however, have a float problem.

Hang in there with sound and prudent business practices. Revisit your business plan and revise it as needed. Meet the challenges you encounter in the investment world in the same way you confront the challenges in your market. Face the realities of life in a public company. One reality will be that the share price of your company's stock approximates the intrinsic worth and the near-term prospects of your company.

Regulators, the media, investors, and fiduciaries are most vigilant about what represents appropriate accounting and classification of revenue and expenses. There are thousands

## **ABOUT CONSENSUS RISK**

of companies in which they can invest. Why risk investing in a company with dubious financial reporting?

At this point, some of you may be disappointed that we have not prescribed any surefire and easily implemented solutions to the challenges inherent in consensus risk. We don't know any—except for KYMS.

## **OTHER PLAYERS**

Mutual funds, foundations, and banks account for over 75 percent of institutional investing activity. They are some other managers of large portfolios whose transactions can influence the stock price of your company.

### ***Independent Investment Managers***

In addition to the managers of microcap growth mutual funds, there are some independent investment managers who specialize in stocks like those of your company. There are other independents that are not wed to any investment style. They will include microcap stocks in their investment mix for diversification and return enhancement. Market values of these portfolios usually total less than \$50 million. The practices and selection criteria of these managers are similar to those used by other managers as discussed in this chapter.

### ***Local Institutional Investment Managers***

In addition to local pension plans, your close-to-home IR activities are best directed to unions, state and local foundations, and endowments. Is there a place for your company's

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

stock in the portfolio of your local college or hospital? Maybe the trust department of a local bank has a policy of carrying securities of local/regional companies. Don't overlook these institutional investors. Again, their practices and selection criteria are similar to those we have discussed in this chapter.

### ***Technicians and Their Charts***

There are some investment professionals who do not rely on fundamentals and accounting measures to value stocks. These professionals focus on the direction of market price changes and transaction volume. These market participants are known as technicians, technical analysts, chartists, or momentum investors. This group of investors believes that by graphing (charting) patterns of price changes, they can forecast share prices over the short term. Because of the light trading volume of stocks like those of your company, these technicians have little interest in your company.

## **CONCLUSION**

Institutional investors, managers of microcap growth portfolios, and some independent money managers are the institutional investors that will be interested in the stocks of emerging companies such as yours. Attracting microcap growth portfolio managers requires a deep understanding of their risk management practices as well as their selection criteria. An understanding of the environment in which these managers operate is also critical to attracting them as investors. The actions, reactions, or inaction of these atypical

## **ABOUT CONSENSUS RISK**

investment professionals are major factors affecting the market value of your company's stock.

Your company's stock is correctly perceived by investors as riskier than stocks of larger-cap companies. The two primary ways to mitigate that perception is effective governance and a fierce commitment to full disclosure.

### **Note**

1. Russ Wermers, "Mutual Fund Herding and the Impact on Stock Prices," *Journal of Finance* (April 1999).

**PART II**  
**GOVERNANCE AND**  
**DISCLOSURE**

**CHAPTER 8**  
**GOVERNANCE: THE**  
**INVESTMENT MANAGER'S**  
**PERSPECTIVE**

Governance is leadership. It is not just about compliance. Professional investors presuppose your compliance with SEC rules, just as they presuppose your compliance with the laws of other agencies and regulatory bodies. If your company is not in compliance with any regulations, it won't have any appeal to professional investors.

With respect to compliance, professional investors focus on the spirit of the law, not the letter. When you appoint

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board members to the audit committee, as far as the SEC is concerned your company is complying as specified. But experienced investors want more than just “certified bodies” on the audit committee. Investment professionals demand that all members of the board of directors conduct their oversight duties with shareholders’ interest always in the forefront. Directors are to govern as leaders.

The oversight of audits and financial reporting are discussed at length in other chapters. The objective of this chapter is to describe how board members should govern so as to assure that they are protecting shareholder interests. Most notably, they are concerned with the company’s use of shareholders’ money, not with how the company reports its use after the fact.

Again, governance is not just about compliance; rather, it includes oversight practices that assure a systematic increase in shareholders’ equity.

The following four areas of governance are of major concern to experienced investors:

1. Qualifications of the board of directors
2. Compensation practices
3. M&A considerations
4. The capital structure of the company

## **THE BOARD OF DIRECTORS**

Recruiting competent, qualified independent directors is an exacting task. Candidates are asking for higher fees, wider indemnification, and higher amounts of director insurance. The recruiting challenge is compounded by uncertainty

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about what qualifications are necessary for board members to have, especially members of the audit committee.

The SEC provides little guidance on what those qualifications should be. Again, this dilemma is best approached from the perspective of professional investors. They want governance to be conducted within the context of your industry's best practices. It follows, then, that a board member should know what those best practices are. Even board members with the least industry experience should have an understanding of the comparative measures by which experienced investors evaluate companies in your industry.

### ***Members of the Audit Committee***

Many leaders of public companies think that every member of the audit committee should have a background in accounting or corporate finance. There is no such official stipulation. The SEC does encourage public companies to have “at least one financial expert” on the audit committee, and it defines a financial expert as someone with an understanding of financial statement auditing, financial reporting, and the Generally Accepted Accounting Principles (GAAP). If there is no financial expert on the audit committee, the company is required to report to the SEC why there isn't one.

Accordingly, at least one member of the audit committee should have experience in the preparation, auditing, and reporting of financial information, and not just to avoid having to report to the SEC about the lack of a qualified person on the board. Rather, the real value of having such a person on the board is that he or she can act as a coach and guide

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for the other members who are responsible for ratifying the accounting systems, procedures, and control measures.

Thus, at least one member of the audit committee should know the business of your company. Competitive circumstances will dictate from where that person is recruited. Of course, recruiting someone currently engaged with another company in the same business sector is not prudent. However, recruiting someone within the same industry group makes sense if that person understands the organizational reflexes and responses characteristic of the top performers in your specific sector. In any case, the person joining your company's audit committee should have a refined sense of smell, so to speak, and have a nose for mistakes and shenanigans, such as misreported billings and channel stuffing, that can result in audit violations.

In [chapter 12](#) we have included the Charter of the Audit Committee of the Board of Directors of the Boeing Company (appendix 12) as a model from which you can craft a financial reporting strategy and a policy for an audit committee.

### ***Leadership Experience for all Members***

Experienced investors all agree that the most important attribute of independent members of a board of directors is their leadership experience. The most effective members will have successfully managed organizations that consistently exceeded performance benchmarks in their respective area, whether business, education, or government. These members know how to ask tough and probing questions and have

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developed a feel for the dynamics that have the most impact on a company. They can direct their fellow board members' focus to those critical activities that enhance the company's value for shareholders.

### ***War Story***

One of the major corporate blowups of this young century can be attributed in part to fraudulent accounting. The ramifications reverberated throughout the financial world even though the corporation in question had a prominent accounting academic with a deservedly high reputation on its board. This person was a pioneer in the development of accounting for costs, often referred to as managerial accounting, an area of accounting separate from the practice of auditing and reporting. This distinction wasn't apparent to the most experienced professional investors until it was too late.

The moral of the story is that academic credentials by themselves do not guarantee qualification to oversee, govern, and lead.

## **COMPENSATION PRACTICES**

One of the first questions an experienced investor will ask about your company is how closely the top management's goals are aligned with his or her investment goals. Thus, you may want to ask what those investment goals are. Experienced investors may then tell you that they are looking for a return in excess of the S & P 500 that will compensate them for the higher levels of risks and transaction costs they will assume.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

For this reason, they need to be sure that your pay and incentives appropriately compensate your managers for the risks they take working for an emerging company. Your compensation plan must be structured to hire and retain the kind of people who will grow your market capitalization at a rate appropriate to the risks and costs the investors are assuming.

Thus, executive compensation should be tied to financial performance in general and to share value in particular. This policy is not as easily implemented as inexperienced investors may think. Experienced investors want your board to devote a significant amount of time to establishing executive compensation policies that link short-term performance with a sustained long-term increase in shareholder value.

Excluding benefits, executive compensation generally consists of:

1. Base salary
2. Short-term benefits
3. Purchase options on listed stock

### ***Base Salary***

Base salary should be a reflection of the executive's experience and sustained performance. Experienced investors expect the salaries of your top executives to be set on the basis of the going market rate for similar positions in your company's industry sector. The turnover rate of key executives is a major concern of experienced investors. Annual raises must be based as much on the goal of retention as on short-term performance.

## **GOVERNANCE: THE INVESTMENT MANAGER'S PERSPECTIVE**

The issue of salaries for your top executives can be a source of contention between them and two of your most important groups of stakeholders: your employees and your shareholders. A high degree of discontent within these two constituencies will complicate your path to greater share value. This is why experienced investors want the salary portion of your top executives' total compensation to provide, over time, the least amount of total compensation.

### ***Annual Bonuses***

Conventional wisdom holds that the danger of awarding performance bonuses on an annual basis is that your executives will focus on short-term goals at the expense of long-term objectives. This is a legitimate concern of established companies; however, the long-term objectives of an emerging company are less complicated than those of large-cap companies. Basically, your long-term goal is to be around. In order for your company to survive, you need to keep your team on board and focused on sustained performance. Here again, bonus plans are as necessary for retention as they are for motivation.

Most experienced investors in emerging companies will focus on short-term performance measures. But what distinguishes successful investors is which short-term performance measures they focus on. These investors understand your industry sector and the measures most likely to build long-term value in that particular area of business activity. You have to tie your bonus program to what successful investors

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

are monitoring. Some of the more obvious measures are growth in revenues, operating margins, free cash flow, and balance sheet ratios. You should structure some of your bonus criteria around those investor concerns.

You should tie most of your bonuses to functional performance, a measure of how well a specific activity contributes to share value. For example, if your company is a manufacturing company, the bonuses in the purchasing department would be based on how well staff manages the costs and delivery of materials.

### ***Stock Options***

The practice of granting stock purchase options is no longer as popular as it used to be. Many experienced investors have been concerned about the contingent expenses' impact on earnings when the options are exercised. Their concern has been exacerbated by some well-publicized accounting and executive compensation incidents that impacted share prices directly and had a dampening effect on the overall market. This collective concern prompted the Financial Accounting Standards Board to revise its 1995 standard (FAS 123) so as to require companies to specifically expense stock options and detail the valuation method employed. This requirement stipulates that the valuation method must be described prominently and in detail in companies' financial statements.

The bewildering aspect of this requirement was how to compute the value of unexercised options. There are at least a half-dozen variables to consider in the valuation methods of the least complicated mathematical models. None of these

## **GOVERNANCE: THE INVESTMENT MANAGER'S PERSPECTIVE**

models will yield anything more than an approximation of the expense impact (see “War Story” below).

Despite the additional accounting burden, many companies still offer stock purchase options as part of their executive compensation. These companies think retaining a stock option program demonstrates a commitment to increasing shareholder value. The expensing requirements increase the scrutiny these programs undergo; therefore, if a company grants stock options that scrutiny is important. Investors in emerging companies want a return commensurate with the risks and transaction costs they assumed when they bought the company's stock. Thus, the return on your company's stock has to exceed any return investors could earn by investing in a portfolio indexed to a broad market measure. That return should also exceed any returns investors would have received over similar holding periods from owning the stock of one of your competitors. A stock option plan, granting a strike (exercise) price of \$20 at the end of four years to acquire shares now trading at \$25 gives the grantee an immediate 25 percent return.

Shareholders who bought the stock four years ago at \$20 have earned a compounded annual return of about 5 percent, assuming no dividends have been paid out. A plan such as this is considered unfair by shareholders who could have earned more annually by holding another stock over the same period. Your company's stock option plan should be linked to a market index.

Investors in emerging companies encounter acquisition/transaction costs that can be higher than the costs of

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

buying large-cap stocks. A generally accepted risk premium for microcap stocks is about 6 percent. We recommend that your stock option price be stipulated as at least 8 percent higher than that of a selected market index.

The conditions described above make the option process more complicated, but your company has already assumed a significant oversight task in offering the options. When you offer stock purchase options, there will always be someone to challenge the investment measure benchmark and the return premium; however, no one can challenge the strategic objective for introducing these elements into your stock option program: it is intended to promote a higher share price.

### ***The Big No-No***

It is possible that the price of your company's stock won't increase to a level that exceeds the option plan strike price or that it will recede below the strike price before an exercise date. That is, the stock price will be "out of the money" "underwater." In some cases, the stock price of companies with underwater options was lowered (reset), which leads to an even lower trading price because experienced investors will respond to this action by dropping the stock.

Determining the value (expense) of an unexercised option requires a mathematical model that can accommodate several variables. The Financial Accounting Standards Board (FASB) requires corporations to implement some process for computing the contingent liability of their unexercised stock options. Any of the accepted processes compute at best an

## **GOVERNANCE: THE INVESTMENT MANAGER'S PERSPECTIVE**

approximation of the contingent costs. Professional investors will be skeptical about the reliability of the reported valuations because of one infamous incident.

### ***War Story***

A number of highly experienced and exceptionally well-educated Wall Street veterans established a hedge fund, the strategy of which was built on complex mathematical models. One of the fund's founding principals was the codeveloper of a commonly used stock option valuation model.

Despite employing validated models to leverage all foreseeable market contingencies, the fund imploded with such force that it upended capital markets around the globe. The whole world learned that there are no models that can value a financial instrument with precision. The moral of the story is that the imprecise dictate of the market trumps methodology every time. Experienced investors make allowances for this fact and will discount their valuations in relation to the number of unexercised options on the books.

## **M&A CONSIDERATIONS**

Experienced investors, investment bankers, attorneys, accountants, consultants, and experienced business leaders are hardly ever in unanimous accord about any aspect of corporate strategy. But they all agree that mergers and acquisitions are the most demanding, exacting, and perilous of all corporate activities.

Your shareholders will scrutinize every action and response once you become engaged in mergers and acquisitions. The

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

road to an effective M&A strategy is strewn with the bones of CEOs who thought they were engineering a great strategic fit.

Think about the fees your company will pay to investment bankers, accountants, tax experts, and attorneys. Think about the additional compliance and disclosure issues. More than a few agencies could get involved. There are antitrust issues. There can be pollution credit issues. Everybody wants to get into the act. The Department of Labor (DOL) can express concern about arbitrating conflicting union agreements among the merging companies, and the trustees of your pension fund may have to defend their votes to the DOL's Pension and Welfare Benefits Administration.

You also should consider what the current market values of the stock of the two companies really represent. Over what time period should incremental cash flows be projected? What criteria do you use to discharge or retain members of the combined work force? What about enhancing your competitive position? Will that position prevail tomorrow in the face of unforeseen changes?

If your board is set on acquiring or merging with another company, all members of the board must agree that there is no such thing as too much due diligence. Ugly surprises often are not the result of chicanery or subterfuge on the part of the tainted party. Most often, discoveries come too late because of the acquirer's cursory attitude that "we know these guys as well as we know our own company." Do not take shortcuts. Private equity firms hardly ever get burned on the dozens of deals they do every year because their due diligence staffs are very conscientious. They take nothing for granted. Nothing

## **GOVERNANCE: THE INVESTMENT MANAGER'S PERSPECTIVE**

will provide your directors with a better opportunity to demonstrate their worth than the trying circumstances of mergers and acquisitions. Here, more than anywhere else, inattention to the smallest detail can break your company.

### ***War Story***

A company representing manufacturers and specializing in robotic machines was the dominant player in a six-state region in the Midwest. Its ROI (return on investment) and ROE (return on equity) were significantly higher than those of most other companies in its sector nationwide, and earnings were growing at a rate of about 10 percent a year over its past six years of operations. The company's financial advantage was the manner in which it was organized. It was divided operationally by how revenues were generated: sales of new machines, brokering of used machines, and leasing of machines. There were three separate sales staffs focusing on each of the contracts. All sales staff was trained extensively in the technological aspects of the machinery. All salespeople were also taught how each division contributed to the growth of the company. Compensation was based on the overall performance of the company. Team spirit was instilled among salespeople, and communications among divisions were mandated.

The mandate was bolstered by biweekly meetings of the managers of each division and by semiannual resort outings. The interdivisional relationships were further reinforced by the nature of the outings, which were mostly recreational with a focus on team competition.

Another company in an adjacent region was privately held and focused exclusively on brokering used equipment. The

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founder and CEO died in an accident. In settling his estate a decision was made to sell the company. The three-prong company acquired it.

Ample due diligence confirmed that the acquired company had no contingent liabilities and that the financial and operational systems could easily be integrated. However, the compensation of the acquired company's sales staff was strictly commissioned-based. The clash of cultures was wounding. The extra costs of retraining and/or replacing salespeople combined with a loss of business associated with the dismissal of the most recalcitrant of the acquired sales staff reduced sales and earnings. The costs of prolonged legal settlements with the former salespeople exacerbated the decline in earnings. Moreover, the machine tools industry was undergoing a cyclical slump. The market value of the stock decreased by 40 percent. It was three years before the company achieved the same capital market grades it had before the acquisition.

The moral of this story is that due diligence must address human resource compatibility as thoroughly as financial and infrastructure aspects. Moreover, company leaders need to recognize that this issue is more difficult and more time-consuming to assess than other functions.

## **CORPORATE FINANCE**

Ever since money was introduced, people have been saying that you can never have too much money. Ready cash or assets that can be leveraged are essential to maintaining corporate nimbleness. The money from stock issues and long-term debt

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can be used up quickly by investments in R&D, plant, and human resources.

Short-term bank financing is limited. Emerging companies often need to raise money with special securities. Experienced investors in emerging companies tolerate these situations. However, there are only a few arrangements they consider acceptable based on the extent that the financing will affect the capital structure of the company.

### ***Warrants***

A stock warrant is similar in its provisions to a call option on a stock. A warrant gives its owner the right to purchase company stock direct from the company at a fixed price for a given period of time. A warrant is sold by the company. The proceeds of the sales go to the company. There is a significant difference between a warrant and an option. Company stock options are given to employees in lieu of compensation, and there are no charges to the grantee. The company receives no income from employee stock option plans. Nor does a company receive any money from the trading of listed options on its stock. The other way that a warrant differs from an option is that a warrant usually has a longer time from issue to expiration.

Warrants are used in two ways in corporate finance. Warrants are sometimes attached to an issue of a security to enhance the appeal of that security. Your company's IPO or secondary offering could have warrants appended to them. The other use of warrants in raising capital is to issue them separately. There are two concerns about issuing warrants

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separately: how to price them and the impact a warrant will have on your company's financial structure.

There is no need to undergo the aggravation and cost of issuing stand-alone warrants unless the money raised is sufficient to meet funding needs for a considerable length of time. Obviously, the two factors that determine how money is raised are the price of each warrant and the number of warrants to be issued. The price will be governed by the trading price of the underlying stock, but not necessarily the price at which the stock is trading shortly before the warrants are offered. Warrants are usually priced after a review of the price range within which the stock has been trading over the past 12 months.

In addition to heeding the advice in the numerous articles and books on the subject, companies must structure warrants with a concern for existing stockholders. They are the first people to be offered a chance to buy the warrants. They have stayed on board when operating capital was tight. They deserve the right of first refusal regarding the opportunity of leveraging their existing investment. The terms of the warrant issue should balance shareholder appeal with a rigorous appraisal of the exercise/redemption effects upon the overall capital structure of your corporation.

Giving your loyal stockholders a "sweetener" won't mitigate their concerns about the firm's financial stability. You need to demonstrate that you are restructuring your operations to ensure redemption at exercise time (without diminishing critical assets). Redemption will increase shares in the float.

### ***Convertible Bonds***

The redemption effect on shares in the float is often experienced when convertible securities are exchanged for authorized shares. The most commonly used instrument in this category is the convertible bond. What follows is an extensive description of convertible bonds.

Convertible bonds are issued under provisions that they can be exchanged for a fixed number of common stock shares up to the date that the bond matures. Investment bankers give the following two reasons why issuing convertible bond provisions to a specified number of shares is a good strategy.

1. The company is getting credit on the cheap. The coupon rates on a convertible bond can be set below the market rates for straight bonds.
2. At some point in the future, the company can issue a stock at a share price higher than the price at which the existing stock traded when the convertible bond was issued.

### ***What a Deal!***

In the support of the two above-mentioned reasons investment bankers often argue that they will underwrite an issue of convertible bonds (e.g., \$1, 000 standard face value) at X percent, with X percent currently being 150 basis points below what you would pay out on a straight bond. The conversion provision will be set at 50 shares of your common stock. For example, if your common stock now trades at \$15, investors buy this convertible bond with a current embedded

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value of \$750 (50 x \$15) for \$1,000—and you have borrowed at a rate below the prevailing interest rate!

However, if your stock trades below \$15 during the months before the bonds' maturity, the holders of these bonds won't convert. As a result, you have added to your capital structure at terms below the prevailing interest rate. If the stock trades higher than \$15 during the time before the bonds mature, the bond holders will convert. You will issue 50 shares of stock to redeem a bond with a face value of \$1,000. This computes to selling stock at \$20 per share. You have effectively issued stock for one-third more than the \$15 it traded at when the bond was issued.

### ***This Is a Deal?***

Of course, experienced investors have a problem with the above-described scenario. They hear the investment banker saying after the bond is issued that it's good if the stock price falls. Experienced shareholders then want to know why more common stock was not issued as soon as possible if the company and the banker thought that the price of the stock would decrease in the near future. That way they could have made a profit. And, if the stock moves up substantially, there are now some new shareholders from the conversion who make out better than those who have been aboard for the long haul.

### ***The Need for Deliberation***

Both sets of shareholders' observations are legitimate and fitting, and the banker's rationale is also justified. There are

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many corporations that have implemented convertible bond strategies that raised needed capital and subsequently increased shareholder value. Be deliberate in structuring the deal and be diligent in how you communicate your strategy to your current shareholders. There are, however, some convertible deals that can annihilate the shareholder base and existing management at the same time. They are appropriately referred to as toxic.

### ***Toxic Deals***

Emerging companies often have fewer shares in their float (and treasury) than large-cap companies. This lesser degree of liquidity has its disadvantages. The most significant one is that investors incur large transaction costs when trading the shares.

However, having too large of a float can create overdilution, and the dynamics of supply and demand substantially reduce the share price. Certain kinds of convertible financing have an inherent potential for fatal overdilution. These deals have the common feature of a conversion formula based on share price instead of a finite number of shares. The toxicity aspect is that there is no floor on how low the conversion price can go. The lower the market price of the stock falls, the more shares the bondholder can get, thus gaining control of the company. This raider strategy is accurately referred to as putting the company into a death spiral.

### ***War Story***

ABC Corporation developed a more efficient and less expensive way to install and maintain HVAC (heating, ventilation,

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and air conditioning) systems in commercial buildings and apartment houses. To confirm and validate the extraordinary features of their system, the corporation installed it in a multi-story, newly constructed office building at no charge. The HVAC system operated as expected. However, the costs of materials, controls, and labor were significantly over budget. As a consequence, operating capital was significantly reduced.

The directors decided that bank funding was not sufficient to fund the operation. Someone referred the board to a PIPE (private investing in public equity) specialist who was experienced at helping companies just like this one. Not bothering to do any extensive background checking on this particular funding source, the company let the PIPE advisors structure a convertible deal tied to the market price of the underlying stock. Less than a year after the convertible bonds were issued, some associates of the underwriter were able to get control of the company. The new shareholders discharged the founder and most of the management with nominal severance packages.

The moral of the story is that you should script all the scenarios that could occur in the course of your stock's market moves before committing to a funding using convertible bonds. And do not ever tie conversion to a specified floorless price of the shares in your float.

## **CONCLUSION**

Governance is not just about assuring that your company is in compliance with regulations and laws. Governance is

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leadership and overseeing practices that assure a systematic increase in shareholder value. There are four areas to which experienced investors pay close attention: the board of directors, compensation practices, M&A activities, and corporate finance.

There is no PR spin and no IR campaign that will communicate your commitment to increasing shareholder value if you do not effectively govern the above-mentioned four critical areas. Your actions speak louder than your words. Your disciplined approach to meeting the challenges described in this chapter will have an impact on your company's growth—and share price.

**CHAPTER 9**  
**GOVERNANCE:**  
**REGULATION FD**

**O**ne more time: Governance is leadership. One important characteristic of corporate leadership is the manner in which management discloses financial information. Emerging companies are correctly perceived as riskier than larger-cap stocks. The only way for your company to mitigate that perception is to demonstrate a fierce commitment to full disclosure.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

Complying with the regulations and practices governing the disclosure of material information is among a corporation's biggest challenges. This disclosure challenge can be compounded by the imprecise nature of materiality.

Moreover, disclosure occurs within several contexts. First, there are public disclosures required by the SEC. Second, there are the substantive reports required by relatively recent federal acts. The most important of these are the Regulation FD (2000), the Sarbanes-Oxley Act (2002), and the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010). The exacting stipulations of these acts have heightened the sensibilities of directors, top management, shareholders—and regulators. We will consider the provisions of Reg FD in this chapter. The other two acts will be discussed in the next chapter.

The third context in which disclosure occurs is less formal but no less stringent. It comprises press releases and other broadly disseminated materials, most often about current developments. Always keep in mind that broadly disseminated can include word of mouth, and all informal disclosures are subject to the general antifraud requirement of the Securities Exchange Act of 1934: "That there will not be untrue statements of material fact or misleading omission of material fact." Obviously, trading with material but nonpublic information is also governed by the same general antifraud requirement.

### **MATERIALITY**

The notion of materiality is imprecise because governing bodies are reluctant to establish firm rules about materiality.

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The position of the Financial Accounting Standards Board (FASB) is as follows: “No general standards of materiality can be formulated to take into account all the considerations that enter into an experienced human judgment.”

Regarding the definition of *material*, the SEC has deferred to some definitions in case law. The general consensus of these definitions is that information is material

when there is substantial likelihood that a reasonable shareholder would consider it important, and that the information would have been viewed by the reasonable shareholder as having significantly altered the total mix of information made available.

Some of the obvious events “altering the mix of information available” are the following:

- Changes in earnings
- Significant changes in shareholder equity
- Mergers or acquisitions
- Joint ventures
- Tender offers
- Changes in control or management
- Changes in an audit or changes of an auditor
- New products and services
- Changes in capital structure

### ***Some Perspective***

It can be difficult to ascertain materiality in any context. A new product or service may be material to your company,

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but it may not be that material to investors or potential investors because they may have different analytical criteria. Thus, with respect to materiality in the context of your business, ask yourself whether the omission or misstatement of particular information about our company will change the way investors value your company. If the answer is yes, then that information is material. When in doubt, consider the matter material.

### **REGULATION FD**

The SEC instituted Regulation FD (fair disclosure) in 2000 in response to the practice of sell-side analysts sharing information they had received from companies with selected investors. Those analysts were disclosing this information to their institutional clients before they disseminated their findings to the public at large. This egregious behavior was euphemistically termed “selective disclosure.” Regulation FD was instituted to ensure that investors would not lose faith and confidence in the fairness and transparency of the securities markets. According to the SEC’s press release, “[the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets.”

The above-described circumstances reinforce one of our major recommendations in this book: Don’t disclose any material information selectively, but disclose all material information (and associated observations/interpretations) in writing through all media channels at the same time.

In the language of Regulation FD, the SEC did not try to define “material” or “nonpublic.” Information is nonpublic

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for purposes of Reg FD if it has not been disseminated in a manner that makes it available to all investors. Materiality is a question of “What.” “When?” is the question begged by the nonpublic issue. “What” and “when” are the key words characterizing disclosure practices and policies.

### ***Reg FD Stipulations***

The objective of Reg FD is simply to ensure that *all* market participants have access to material news at the same time. To repeat: A public company is prohibited from intentionally disclosing material information to any securities markets professionals and stockholders unless that company discloses the same information simultaneously through fully accessible, non-exclusionary media.

If a company unintentionally discloses material information to any persons trading securities as set forth in Reg FD, then that company must publicly disclose that same information within 24 hours and must also file a Form 8-K with the SEC before the opening of the next day’s trading session.

### ***It Is about You***

Regulation FD was not intended primarily to govern the behavior of broker/dealers, analysts, or investors. It speaks directly to issuers. According to an SEC press release, “Reg FD places the responsibility of avoiding selective disclosure and the risks of engaging in it squarely on the issuer.” Thus, be vigilant and don’t wink or nod or give any other kind of response intended to convey information that should

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be disclosed directly to everyone. If you have a practice of reviewing or commenting on drafts of analysts' reports or forecasts, stop doing so. You are running the risk of inadvertent selective disclosure.

### ***And It Is about Your Associates***

Your company needs a published set of practices and procedures governing disclosure. Publish for everyone in your company which employees are subject to Reg FD:

1. Executives, managers, and directors,
2. People responsible for investor relations or public relations,
3. Employees and agents who regularly communicate with shareholders or investment professionals.

### ***The Real Challenge of Reg FD***

We have discussed our concerns about broker/dealer research in an earlier chapter. Portfolio managers who are interested in your company conduct their own research about it. They will collect data and information from sources other than broker/dealer research departments. They will talk to your customers, suppliers, creditors, and competitors. None of those parties are subject to Reg FD when they are queried about your company.

Thus, your real challenge in complying with Reg FD is in responding to informed questions from enterprising buy-side analysts, giving them answers they have already discerned from other sources. When you are asked a question based on

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some data or information, it will be most likely couched as an inference, for example: “Since you have purchased 100 more boxcars of adaptable widgets than you bought at this same time last year, can I infer that you are ramping up production?”

You might respond to the manner in which the inference was reached by saying, “Some people might think so, if they thought an increase in such inventory was evidence enough to make such an inference.” This is not being cute or clever, but you should take your counsel’s advice about responding to questions from diligent analysts. And here is your counsel’s likely answer: “Our answer to that question could be considered a material disclosure. We have no comment at this time.” You must have a firm policy about the way you answer informed, inferential questions about your company.

There was a time, prior to Reg FD, when analysts relied on extensive guidance from a target company. Now analysts have no choice but to spend time and effort doing research without any guidance from you.

Always remember that Reg FD is intended to regulate your and your company spokespersons’ behavior. The burden of FD compliance rests squarely on your shoulders. There are only few sanctions for analysts and investors when they misuse company information, except in the context of violating the rules of insider trading. What are those rules?

## **INSIDER TRADING**

Many people have the right to possess inside information, which is information that is material but nonpublic. These

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people are not permitted to use the inside information for an investment advantage until that information is publicly disclosed. If they do otherwise, they are likely to have violated regulations about insider trading. Reg FD augments but does not replace SEC regulations prohibiting insider trading. The SEC instituted Reg FD because in the commission's opinion selective disclosure was essentially "the legal twin" of insider trading. The SEC's position is that it will not permit investors to profit from material, nonpublic information instead of applying their skill, acumen, and diligence.

The distinction between a violation of Reg FD and a violation of insider trading provisions is whether someone acts on the nonpublic (confidential) disclosure. The prohibition against insider trading is a major aspect of the Securities and Exchange Act of 1934. Indeed, with respect to insider trading violations, the SEC carries a big stick and neither speaks nor walks softly.

### ***Who Is an Insider?***

According to the act of 1934, an insider is an officer or director of a public company. An insider is also any person or entity owning 10 percent or more of any class of a company's share. In the appendix to this chapter we describe which one of three SEC forms should be filed at the time of an insider's transactions. The trading of a company's stock by an insider must be registered with the SEC. When you qualify as an insider, the SEC requires you to file Form 3. Form 4 must be filed each time you buy or sell the company stock, and

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at the end of the year a Form 5 must be filed by any person or entity who qualified as an insider at any time during that year. Anyone who possesses material, nonpublic information is also considered an insider.

Moreover, persons trading stock based on material, non-public information obtained from an insider are also likely in violation of the regulations against insider trading. If an investment professional breaches an agreement to keep information confidential by disclosing it to a client who trades on that information, then the analyst and the client both have violated insider trading regulations. The analyst is guilty of illegal tipping; the client is guilty of insider trading.

The SEC employs very sophisticated surveillance systems to ensure compliance with its insider trading dictates. These systems track transactions across all markets, 24 hours, 7 days a week. The system that tracks data from all sources all over the world is known as the Automatic Search and Match System (ASAM). Its capabilities are remarkable and should not be underestimated. ASAM has linked seemingly unconnected people and uncovered insider trading.

### ***Rules 10b-5-1 and 10b-5-2***

At the same time the SEC instituted Reg FD, it also introduced two other new rules: 10b-5-1 and 10b-5-2. These rules are intended to clarify when persons have violated prohibitions against insider trading.

Yes, it is illegal for someone who works for or advises your company to trade your company's stock based on material,

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nonpublic information. There was some question about whether the SEC had to prove that an insider actually acted on the knowledge or just knew about it when the trade in your company's stock was made. Rule 10b-5-1 removes any such questions. Now if somebody has material, nonpublic information about a stock and trades that stock, the SEC does not have to prove that the trader/investor acted on the basis of that information. It only needs to prove that the accused was aware of material, nonpublic information at the time of the stock transaction(s).

Rule 10b-5-2 specifies the concept of "misappropriation of knowledge." This rule expressly forbids anyone who learns about material, nonpublic information on the basis of a relationship with your company to trade on that information. This includes family members and other nonbusiness relationships as well as attorneys, accountants, employees, and consultants.

The tangential issue of privileged communications between spouses is an area into which the SEC is not afraid to venture.

### ***My Wife, the Tipster***

*[Upon learning that we were revising this book, readers of the previous edition wanted assurance that this anecdote would be left in just as it appeared in the first edition.]*

One of the attorneys we interviewed for this book shared his favorite insider story with us:

The CEO of a midcap company explained to his wife why he was so busy and so preoccupied. He was dealing with

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a tender offer for his company. His wife remarked about the tender offer to her brother. The brother, who lived in a trailer park, related this news to several people in the trailer park. The brother and several of his neighbors bought shares of the stock. The tender offer was consummated. The brother and those neighbors made substantial trading profits from transactions in that stock, which they spent. The SEC discovered all the facts and proved in court that there had been an infraction of insider trading regulations. The court ordered penalties equal to three times the gains from the trades made by the wife's brother and neighbors.

Guess who was judgment proof?

Guess who had to cough up, even though she didn't act on the information?

Guess who is not coming to dinner?

## **SAFE HARBOR PROVISIONS**

Public companies are very reluctant to share information with investors. The reluctance has been increased by instances of shareholders suing companies for allegedly making misleading public statements about future prospects. These suits have charged that management had made misleading statements so as to intentionally or recklessly raise investors' expectations. Most of these suits were without merit.

Legislators and regulators became aware that a lot of these lawsuits were brought by people who refused to face the consequences of their own bad judgment. Moreover, the costs of defending these suits were financially crippling to emerging companies. In 1995, the Private Securities Litigation Reform Act was instituted to discourage these lawsuits.

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The 1995 act provides a “safe harbor” for your company when it makes public projections or statements about the future. One of the practices resulting from the act is the addition of a disclaimer when announcing or discussing news that may be considered a forward-looking statement. This extra verbiage is referred to as the safe harbor statement. Some suggested wordings for a safe harbor statement are included in appendix 9-A.

There are some issues with respect to safe harbor statements that should be discussed further.

### ***Avoid Blanket Statements***

A boilerplate statement intended as a blanket cover for an accompanying webcast, press release, or conference is not an inoculation. Experienced investors (and the courts) expect companies to be conscientious about their disclosure practices. When informing your audiences about the nature of your disclosure practices, be precise. In each forward-looking statement, point out the specific items that are characterized by opportunity, risk, or financial changes. The safe harbor statement should identify important factors or circumstances that could cause actual results to differ materially from those described in a forward-looking statement.

### ***Don't Refer to Separate Documents***

We have observed instances when a company spokesperson has referred to a separate document when making a forward-looking statement, for example, saying something like the

following: “We expect to extend our coverage to four other countries, subject to risks disclosed in our most recent 10-K.” Such a reference does not provide safe harbor protection. The risks must be disclosed at the time a designated spokesperson is imparting this information. The risks also should be pointed out in a press release. With respect to written statements, the safe harbor provisions and cautionary statements accompany the written disclosure about risks.

### ***Avoid Qualifying Words***

Take care to eliminate words that make a disclosure seem so conditional that it is meaningless with respect to evaluating your company’s prospects, for example, words such as “maybe,” “perhaps,” “possibly,” “if conceivably,” “feasibly,” or “imaginably.”

### ***Don’t Fall Silent***

Early in this book, we advised (somewhat rudely perhaps) that sometimes you should keep your mouth shut. We think that is good advice in general, but it does not apply when there is a change in your operations that can be considered material. Not disclosing that change would violate the letter and spirit of disclosure regulations. Remaining silent about something that can adversely affect the company could provide grounds for shareholder suits. Forms 10-K, 10-Q, and 8-K provide means of disclosing a significant change; in fact, forms 10-K and 10-Q have sections that require such disclosure statements.

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In their watershed book *The Value Reporting Revolution*, Robert G. Eccles, Robert H. Herz, E. Mary Keegan, and David M. H. Phillips address and refute the 10 most common reasons or excuses company executives give for limiting disclosure. Here is a brief summary of those reasons/excuses:

### ***Reason/Excuse 1: The Market Cares Only about Earnings***

That is true, but closely on the heels of earnings are five other measures: R&D investments, cash, cash flow, capital expenditures, and segment performance. Four nonfinancial measures rank high: market growth, new product development, market share, and stated strategic goals. The market clearly cares about a wide range of performance measures.

### ***Reason/Excuse 2: We Already Report a Lot of Information***

It is not a question of how much information is being reported but whether the right information is being reported, such as customer retention, customer penetration, risk management practices, market risk exposure, performance relative to business segment, and economic profit.

### ***Reason/Excuse 3: Once We Start Reporting Something, We Can't Stop***

If the market finds a certain piece of performance information useful, it will certainly want more details. Responding to that desire for more information will serve management's

best interest because progress on that measure will have a positive effect on the company's stock price. If, however, a particular measure becomes irrelevant, or a more appropriate measure comes along, the company has no reason to continue reporting on it. But management needs to explain why it has ceased reporting on that measure.

***Reason/Excuse 4: Producing and Reporting Information Cost a Lot***

The cost of generating the information is the issue, not the reporting of it. New measurement methodology can be expensive. Management has to decide whether having this information for internal decision making justifies the costs of generating it. If you think that this information is critical to management, then the cost is justified. The cost of making that information available to the market is negligible.

***Reason/Excuse 5: No Matter How Much We Report, the Market Always Wants More***

This is not true. Most analysts are generally satisfied with the information they get. The SEC and FASB mandates are very inclusive with respect to financial reporting.

***Reason/Excuse 6: Bad Numbers Will Hurt Our Stock***

Yes, they will. However, improvements on the respective bad numbers can have a positive effect on your company's stock price even if earnings are weak.

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### ***Reason/Excuse 7: Some of These Measures Aren't Very Reliable***

This is true, because some emerging companies haven't developed adequate internal measurement systems for some key performance dimensions, particularly the non-financial ones. [Author's note: This is especially true with respect to emerging companies.]

### ***Reason/Excuse 8: Our Competitors Will Use This Information to Our Disadvantage***

This is always a possibility but not highly likely. Even if reporting to the market gave your competitors information they didn't already have, using that information for competitive purposes is not as easy as it seems.

### ***Reason/Excuse 9: Our Customers and Suppliers Could Learn How Much Money We're Making***

So what? They probably have a pretty good idea anyway. If they see a real benefit to sustaining a business relationship with your company, they will stay in that relationship.

### ***Reason/Excuse 10: We'll Get Sued***

The risk of litigation is a fact of life for public corporations. Emerging public companies are most vulnerable to the tactics of tort attorneys, even if your company releases forward-looking statements with all the proper disclaimers. The safe

harbor provisions of litigation reform laws were intended to reduce that risk.

You cannot be too vigilant with respect to disclosure and reporting compliance.

### THE PROXY PROCESS

A proxy form is a document that permits your shareholders to confer upon another person their respective rights to vote their stock on corporate matters and shareholder proposals at shareholder meetings. The proxy form must be accompanied by a proxy statement. This form is an explanation of the material information that will be voted upon. It must be filed with the SEC for examination prior to being distributed to your stockholders.

The SEC does not require that you file in advance proxy materials dealing with the election of directors without opposition, the selection of accountants, or the approval of any stock plan for employees. However, the SEC will be reviewing the proxy statement to see that it includes all the material facts about the matter to be voted on. SEC Regulation 14A governs the issues on which proxies must be solicited.

The SEC rules permit any holder of your voting stock or any group holding your voting stock to make an independent proxy solicitation without your or your board's permission or concurrence. Proxies will be discussed further in [chapter 11](#) in the context of social and shareholder activism.

## **Appendix 9-A: Sample Safe Harbor Statements**

### **ALTERNATIVE 1**

Here is a safe harbor statement in accordance with the Private Securities Litigation Reform Act of 1995; this is an all-inclusive form suitable for any business:

In accordance with the safe harbor provisions of the Private Securities Reform Act of 1995, this company notes that statements in this news release and elsewhere that look forward in time involve risks and uncertainties that may affect the company's actual results from operations. The following factors (among others that are discussed in company filings with the SEC) could cause actual results to differ materially from those set forth in the following forward-looking statements:

- a. Competition may cause our company to lose projects or result in decreased revenues.
- b. We may not be able to hire qualified technical personnel.
- c. The highly competitive market for technical personnel may increase our costs.
- d. Our operating results may fluctuate significantly.
- e. Acquisitions involve numerous risks, including
  - difficulties in integrating personnel, operations, and technology of an acquired company;
  - the risk of diverting management's attention from normal daily operations;

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- the risks of entering markets in which the company has no or limited experience, and where companies in such markets have stronger market positions; and
- the potential loss of key employees of acquired companies.

### **ALTERNATIVE 2 FOR ORAL STATEMENTS**

This presentation contains forward-looking statements in the sense of Section 21A of the Securities Act of 1933 as amended and Section 21E of the Securities Exchange Act of 1934 as amended, and these statements are subject to the safe harbors created thereby.

Such statements involve certain risks and uncertainties associated with an emerging company. Actual results could differ materially from those projected in the forward-looking statements as a result of risk factors discussed in this company's reports that will be on file with SEC (including but not limited to the information on Form 10-K).

### **ALTERNATIVE 3 FOR DOING BUSINESS IN COUNTRIES OTHER THAN THE UNITED STATES**

The following (presentation, news release, broadcast, etc.) contains forward-looking statements in accordance with Section 21A of the Securities Act of 1933 as amended and Section 21E of the Securities Exchange Act of 1934 as amended. Such statements are subject to risks and uncertainties that could cause actual results to vary materially from those projected in these forward-looking statements. The company may

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

experience significant fluctuations in future operating results due to a number of economic, competitive, and other factors, including the size and timing of customer orders, changes in laws, new or increased competition, delays in new products, production problems, changes in market demand, market acceptance of new products, seasonal product purchases, and changes in currency exchange rates. These factors and other factors that could affect the company and its operations are included in the company's filings with the SEC and are incorporated herein.

**CHAPTER 10**  
**GOVERNANCE: SARBANES-  
OXLEY AND DODD-FRANK**

**I**n the previous chapter we discussed two Reg FD issues in the context of interrogatives: The issue of materiality was characterized as a question of *what*. The issue of timely public dissemination was characterized as a question of *when*.

This chapter will address the question of *why* the Sarbanes-Oxley Act and the Dodd-Frank Wall Street Reform Act were introduced on the heels of Reg FD. This chapter will also

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

explain *how* a company should comply with all three of these onerous mandates.

Again, the objective of Reg FD was to ensure that all market participants have access to material news at the same time. It stipulates that a company will not intentionally disclose material information to any investors, broker-dealers, or stockholders, unless that company discloses the same information simultaneously through fully accessible, nonexclusionary media.

So, everyone had access to material news at the same time. How “material” was some of that news? Materiality implies accuracy, responsibility, and relevance. Some alleged miscreants (among whom were some of the world’s largest corporations) needed further encouragement to be accurate, responsible, and relevant.

## **THE SARBANES-OXLEY ACT OF 2002**

In less than three years since the passage of Reg FD, there were enough public companies accused of inaccurate, irresponsible, and misleading financial reporting to incite congress and the G. W. Bush administration to pass the Sarbanes-Oxley Act (SOX). SOX has been designed to oversee the financial reporting landscape for investors. Its purpose is to review audit requirements and enhance the reliability of corporate disclosures, that is, that all those disclosures are accurate, responsible, and relevant (as prescribed by Reg FD).

The provisions of SOX are extensive and the burden is on the CEO to understand and to comply with those provisions.

## **GOVERNANCE: SARBANES-OXLEY AND DODD-FRANK**

You must consult your accountants and attorneys about instituting all provisions so as to be in full compliance. We will just touch here on some of the main provisions with which you must comply.

### ***Stipulations for Executive and Managers***

There are some severe penalties prescribed for the manipulation, destruction, or alterations of financial reports and records. A code of conduct is mandated for analysts that requires them to disclose any knowledge of any conflicts of interest among corporate executives, or auditors, or other analysts. SOX established a federal entity to govern auditing practices: the Public Company Accounting Oversight Board (PACOB). However, the most important provision is the one regarding the CEO's accountability: "The CEO is individually responsible for the accuracy, validity, and completeness of all corporate financial reports. And the CEO is the only person in the corporation authorized to sign off on the corporate annual tax return."

### ***Section 404***

In 2003, the SEC implemented Section 404 of SOX. Section 404 requires companies to set up and periodically test procedures that monitor their financial control systems. That is, Section 404 requires that those designated to monitor your internal systems must report their findings in writing to auditors and management. Section 404 also requires that an outside auditor attest to the accuracy and reliability of the company's monitoring and controls.

***SOX in Perspective***

Yes, SOX has heightened any CEO's appreciation of and sensitivity to the work of the company's accounting and financial staff. Thus, the act has heightened the focus and the diligence of the accounting and financial staff.

Moreover, SOX has led to heightened awareness of accountability standards for all directors and all operating officers of your company, and it has increased the appreciation for the need of highly competent legal counsel.

**THE DODD-FRANK WALL STREET REFORM ACT (2010)**

Regulation FD (2000) is intended to assure that your corporation makes public disclosure of all relevant company information that may change the way investors or shareholders might value your company. SOX (2003) is intended to ensure that company information is accurate and reliable.

When global securities lost over half of their value in the first quarter of 2009, Congress, the administration, and the financial industry created a tidal wave of new regulations. The most important and far-reaching was the Dodd-Frank Wall Street Reform and Consumer Protection Act. It includes the following main provisions with respect to investing practices:

1. It further enhanced modern corporate transparency by giving shareholders greater power to influence the composition of the board.

## **GOVERNANCE: SARBANES-OXLEY AND DODD-FRANK**

2. It enabled directors to root out underperforming management.
3. It allowed shareholders to play a more important role in defining the ground rules of management.

### ***Dodd-Frank in Perspective***

Dodd-Frank has increased the focus on the interaction between IR and the board of directors. Directors are scrutinizing IR policies and strategy more intensely now.

Describing the full impact of Dodd-Frank's many facets would require volumes of discourse, analysis, and interpretations. You should know above all that it is powerful legislation and is here to stay. It establishes the Consumer Financial Practices Bureau (CFPB) to oversee agencies such as the CFTC and the FDIC. It also established the Financial Stability Oversight Council (FSOC). That entity comprises of representatives from a number of financial regulatory agencies and is chaired by the secretary of the treasury.

Another of the provisions of Dodd-Frank that might affect you is that stockholders who have held a 3 percent portion or more of your company's stock can nominate board candidates on proxy statements. In addition, directors can have a direct input on executive compensation practices and policies. There are provisions for more disclosure about governance and about risk management. But the most publicized provisions of the entire bill are the ones that incentivize whistle-blowers. They can receive 10 percent to 30 percent of penalties that are over \$1 million.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

Much of Dodd-Frank's implied mandate is the oversight of financial derivatives and the monitoring of hedge funds and private equity pools. The impact of any of the supervision or enforcement evolving from those provisions of the act may or may not affect your business and its capital structure. Again, Dodd-Frank is extensive and its provisions could impact any activity in which your company engages.

### **CONCLUSION**

Governing in accordance with and complying with all the provisions of Reg FD, SOX, and Dodd-Frank can be onerous, frustrating, time-consuming, and soul-eroding. But inattention or noncompliance could be fatal. First and foremost: You, your counsel, your board, and your financial advisors must devise policies and procedures that will assure compliance with all these rules and regulations.

Then you can get on with running the business.

**CHAPTER 11**  
**GOVERNANCE:  
SHAREHOLDER  
ACTIVISTS AND  
“RIGHTFUL CONCERNS”**

**E**xperienced financial analysts will consider the value of a corporation's intangibles, such as trademarks, R&D practices, employee training programs, and governance policies. It has become standard practice to consider intangibles in valuation. Analysts acknowledge that such intangibles cannot be valued like fixed assets; however, analysts can defend including intangibles in a research report.

## INVESTOR RELATIONS FOR THE EMERGING COMPANY

Analysts cite instances of cause and effect with respect to intangibles. Some of the effects could be caused by the regard in which consumers, regulators, and the general public hold these intangibles. “Good citizen” practices with respect to environmental concerns, hiring practices, and transparency are becoming highly valued by investors other than social activists. Nevertheless, fiduciary concerns are still the overriding factor.

The issue of corporate responsibility is that of “rightful concerns” by those who characterize themselves as social activists. The rightful concerns of your shareholders are governance and procedural prudence. Your rightful concern is increasing your company’s net worth. Oversight accountability or, more accurately, procedural prudence, overrides any social activist’s agenda or rightful concerns. Procedural prudence is not merely a concept. It is a fiduciary duty grounded in statutes.

Persons assigned responsibility (and accountability) whose imprudent actions diminish the value of assets entrusted to them are liable to severe penalties—and lawsuits. Owners and directors should keep this in mind. There will be reminders about this throughout this book.

There are informed people who might characterize activists as persons who want to exercise power without taking responsibility for the consequences. Some of these same people think that activism has no effect other than to cause massive portfolio distortions—and that more harm than good results from activists. In this book, we have tried not to express any opinions about particular agendas or views. We

## GOVERNANCE: SHAREHOLDER ACTIVISTS AND “RIGHTFUL CONCERNS”

address social activists’ concerns in a manner that prompts you to think about your thinking with respect to activist investors.

### LABELS

Aside from the advocacy issues of employment practices, environmental impacts, and offshore operations, intramural oversight of corporate activities is always on a list of rightful concerns. Hence the concept of socially responsible investing (SRI) has been expanded to include governance. Rather than rally around the old SRI label, activists and advocates for the redress of perceived wrongs now employ the acronym of ESGI (environmental, social, and governance investing).

But those acronyms and the concepts for which they stand are not precise enough to use in discussing agency issues; therefore, we will employ more commonly used terms. We will distinguish between two primary groups of activists. We will refer to those who are champions of transparency and fiscal accountability as *shareholder activists*. Shareholder activists’ concerns will be addressed in the context of corporate governance. Those who weigh shareholder value as less of a concern compared to how a company adheres to values held by a particular group of advocates will be referred to as *social activists*.

The concerns of shareholder activists are the least complex. Governance issues have more specificity. We will discuss corporate governance first.

## **SHAREHOLDER ACTIVISTS AND CORPORATE GOVERNANCE**

The consensus of experienced investors is that there are four areas of activity on the basis of which shareholders can assess governance:

1. qualifications of the board members,
2. executive compensation practices,
3. merger and acquisition issues, and
4. capital structure.

### ***Qualifications of Board Members***

Governance should be conducted within the context of the corporation's best practices. It follows then that board members should know what those best practices are. Even board members with the least experience in the given industry should have a basic understanding of the comparative measures by which companies in that industry are valued. One comparative measure is how well companies comply with the regulations relevant to their business activities. For example, EPA dictates will impact the manner in which a manufacturing company or an extractive company goes about its business. At least one director on the board of such a company should be knowledgeable about environmental regulations and strictures.

Experienced investors agree that the most important attribute of an independent director is leadership experience. The most effective directors are those who have successfully managed organizations that consistently reach performance benchmarks

## **GOVERNANCE: SHAREHOLDER ACTIVISTS AND “RIGHTFUL CONCERNS”**

in their respective industries. They know how to ask tough and probing questions and have developed a feel for the dynamics that have the most impact on an organization. They can direct their fellow board members' focus to those critical activities that enhance the company's value for shareholders.

### ***Executive Compensation Practices***

The responsible view is that compensation plans should be structured to hire and retain the kind of people who grow the company's market capitalization at a rate appropriate to the risks and costs that the investor is incurring. Experienced investors want evidence that a lot of thought has been given to establishing a compensation plan that links short-term performance with sustained increases in shareholder value. Excluding benefits, executive compensation generally consists of base salary, short-term incentives such as bonuses, and purchase options on listed stock.

### ***Merger and Acquisition Issues***

M&A challenges and decisions are the most demanding and perilous of all corporate activities. Microcap investors and shareholders should scrutinize every aspect of the activities associated with M&A. They should think about the fees a company will pay out to investment bankers, accountants, tax experts, and attorneys. There is also the matter of additional compliance and disclosure issues, and there can be antitrust issues.

More important than all other concerns, investors must not overlook the subjective issues: what do the current

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

market values of the stock of the two companies really represent? Over what time period should incremental cash flows be projected? Is one party's discount rate more appropriate than the other party's? What criteria will be used to discharge or retain members of the combined work force? What about that argument of enhancing your competitive position? Will that position prevail tomorrow in the face of unforeseen changes?

### ***Capital Structure***

Experienced investors and business consultants point out that the way management deploys its cash is a reliable major indicator of its judgment and potential for increasing shareholder value. Depending on the industry, a company's mix of cash, equity, and debt should be governed by how and where assets need to be directed. If your company is a technology company, particularly a biomedical or a pharmaceutical company, R&D expenses make up the greatest part of your operating budgets. Equity funding is not likely to provide for these heavy outlays. A successful product can generate a lot of cash, much of which could fund the research and development of a product with the potential for the same degree of success. Directing the greater part of large cash positions to raise dividends, repurchase stock, or achieve that great strategic fit rather than fund further R&D programs might be a big reason for a greater degree of oversight by the board of directors.

Regarding equity and debt capitalization, benchmarks vary by industry groups. Rather than focus on the balance between a company's stock value and the sum of its long-term

## **GOVERNANCE: SHAREHOLDER ACTIVISTS AND “RIGHTFUL CONCERNS”**

debt, experienced investors and shareholder activists look at how a company’s debt is rated. They reason that present and future debt service costs are more relevant to sustained growth than some arbitrary ratio of debt to equity.

There can be instances when a well-managed company may need to raise cash through some special issuance, such as preferred stock, convertible securities, or warrants. Informed shareholders might agree that such funding is prudent—and moreover, likely to enhance shareholder value. There is, however, one chief concern of conscientious investors and activists when appraising a special issue: The company should not undergo the aggravation and cost of special issues unless the money to be raised is sufficient to fund the designated activity/mission for a considerable length of time. Going back to the market for more special-issue capital could indicate that the company is not as deliberate in its capital budgeting as it should be.

Reviewing how capital budgeting decisions are approved and how capital is acquired is a legitimate governance concern.

### ***Conclusions Regarding Shareholder Activists***

Experienced, responsible, and sincere shareholder activists understand that governance is not just about compliance. Rather, governance includes overseeing practices that assure a systematic increase in shareholder equity and support shareholder rights.

Assuring that the above-discussed four issues are managed judiciously and transparently is the best way of evaluating your company’s governance. However, there is another

issue that impacts governance practices and may require even more judicious management and oversight. It is the matter of engagement with social activists.

### **SOCIAL ACTIVISTS AND CORPORATE GOVERNANCE**

There is a long history of social activism, whether directed at government institutions or at businesses. Social activists are most likely to have made clear moral judgments. They think that it is easy to make those judgments and to align their investment decisions with their core values. These core values evolve from concerns about environment, human rights, justice, labor practices, product quality/safety, workforce diversity, abortion, and community involvement.

Regardless of the ease with which activists make moral judgments, a portfolio manager's fiduciary standards of procedural prudence must not be ignored. The implied and/or explicit provisions of a pension plan's or endowment's investment policy may not permit moral judgments to be weighed equally with other factors in deciding how funds are invested. Trustees will proceed with care when crafting an investment policy that permits social activist criteria to be part of investment decisions and the oversight process.

#### ***Sustainable Investing***

The term *sustainable investing* is frequently used by activists. This term was first used by environmental activists, but it is now used as the concise designation for balancing a growth

## **GOVERNANCE: SHAREHOLDER ACTIVISTS AND “RIGHTFUL CONCERNS”**

economy, protecting the environment, and acting in a socially responsible way.

Sustainable investing is considered a most noble challenge by some; others consider it an ignoble abrogation of fiduciary duty. Like holistic medicine, the term sustainable investing is now used to denote a type of activity that transcends the scope of traditional practice. Some of the more established activist-investors now market themselves as sustainable investment advisors.

Can such a style lend itself to sophisticated attribution analysis? Stay tuned.

### ***Conclusions Regarding Social Activists***

If your company is in compliance with all local, state, and federal laws governing those issues around which social activists rally, then don't worry. Get on with running the business. Where a portfolio manager stands with respect to activists' concerns versus his interests in your company is his problem. What can you do about it?

## **PROXY ACCESS**

Any discussion of governance and shareholder activism will soon turn to the issue of proxy access. We briefly mentioned proxies in [chapter 9](#). At the core of the proxy issue is the obvious question of where stockholders' power begins and the board's power ends. The conventional answer is that the board's power ends when more shares of stock vote against a board proposal than the number of shares of stock voted

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

with the board. This is a simple statement about a complex challenge.

Larger-cap companies than yours have a large shareholder base. Other than wanting sustained increases on their investment, these shareholders often do not have any other common interests. Any attempt to organize shareholders to challenge a board's policies or its slate of directors is expensive in time and money. Only dissident groups with very deep pockets can support sustained proxy fights. But well-funded dissidents continue to gain some representation on the board. There have been several recent instances of companies conceding seats on the board rather than engaging in a proxy fight. As your company grows and your stock float increases, it is increasingly likely that your company's board could be subject to this type of action. Thus, keep this possible threat in mind as you and your advisors plan for growth.

### **CONCLUSION**

Activist can be classified into two groups: social activists and shareholder activists. Shareholder activists are concerned with a sustained increase in the value of a company's capital shares and with protecting shareholders' rights. Those concerns are addressed by corporate governance policies that dictate transparency, foresight, and judgment. These policies can easily be implemented by monitoring four functions of your business: the appointment of directors, the compensation of executives, prudent valuations of merger and acquisition opportunities, and the allocation of capital.

## **GOVERNANCE: SHAREHOLDER ACTIVISTS AND “RIGHTFUL CONCERNS”**

Social activists are concerned with aligning their investment decisions with their values. When their values conflict with the accepted legal and ethical activities of your path to increased equity value, ignore their concerns and get on with running your business.

**CHAPTER 12**  
**THE SEC AND FINANCIAL**  
**REPORTING**

**T**he Securities and Exchange Commission (SEC) is a federal agency established by the Securities Exchange Act of 1934. That act is a keystone in the regulation of securities markets and outlines the powers of the SEC to interpret, supervise, and enforce federal securities laws, principally those prohibiting fraud. The SEC has the authority to bring administrative proceedings against firms and persons the agency believes are violating securities laws; however,

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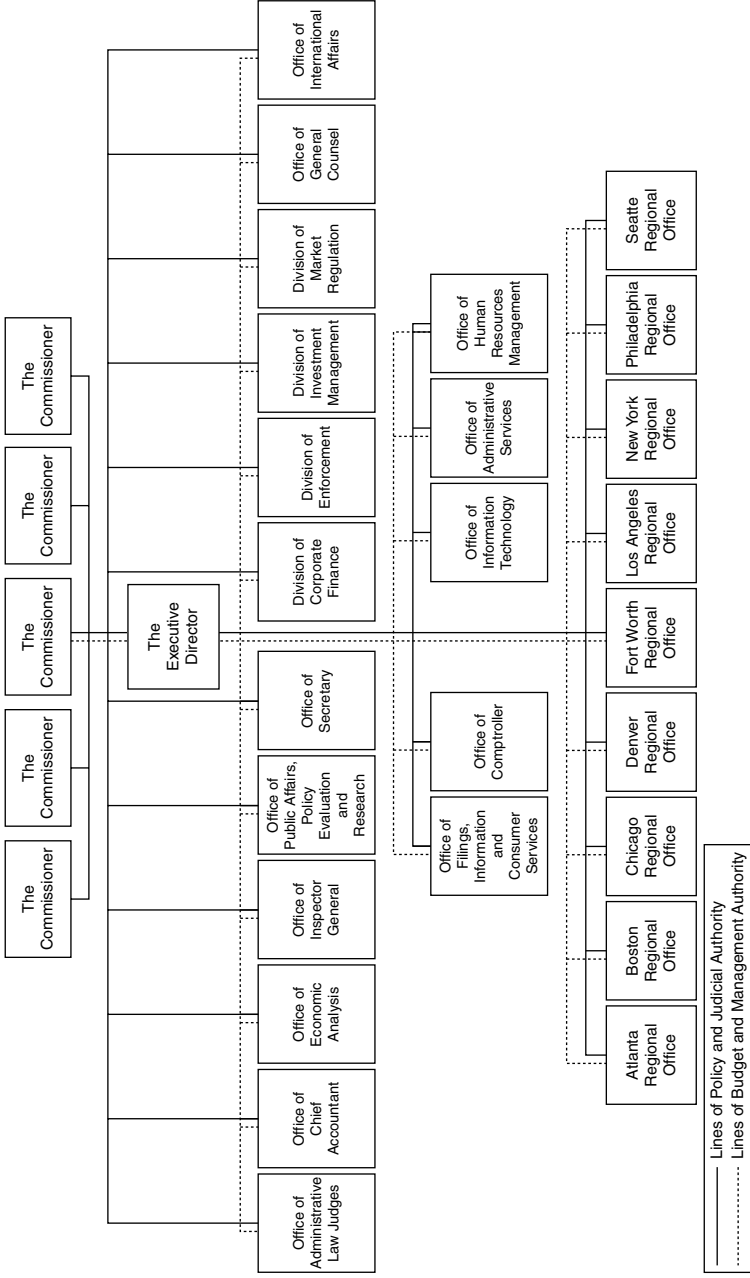
allegations of criminal violations of these laws are prosecuted by the Justice Department. The functions of the SEC should be considered quasi-judicial in nature because appeals from its decisions can be taken to federal courts. [Figure 12.1](#) is an organizational chart of the SEC.

### FINANCIAL REPORTING

Ensuring full and fair disclosure of all material facts about companies whose securities are publicly traded is one of the SEC's major responsibilities. The Division of Corporate Finance ensures that information contained in new issue prospectuses and IPO offerings is complete and not misleading. The Office of the Chief Accountant deals with matters relating to financial reporting. Regulation S-X governs the form and content of financial statements and also governs the means by which financial information is reported. From time to time, the agency issues documents that detail and update financial reporting prescriptions and recommendations.

#### *Financial Filing Requirements*

The SEC requires public companies to file a number of specific reports. [Table 12.1](#) is a listing of the reports most frequently filed and the information that must be included in each. The most common reports are Forms 10-K and 10-Q. The financial statements and the notes in these forms must be reviewed and accepted by an outside independent auditor. Form 10-K must be filed with the SEC within 90 days after the end of your company's fiscal year, while 10-Q statements



**Figure 12.1** US Securities and Exchange Commission.

## INVESTOR RELATIONS FOR THE EMERGING COMPANY

**Table 12.1** What should be included in SEC filings 10-K, 10-Q, and 8-K

Report Contents	10-K	10-Q	8-K
Auditor's name	A		
Auditor's opinion	A		
Auditor's changes	A		
Nature of business	A		
History of business	F		
Changes in organization	A	A	
Changes in shareholders (major changes)	A	A	A
Debt structure		A	
Depreciation schedules	A		
Dilution factors	A	A	
Directors, officers, insiders		A	
Earnings per share		A	A
Annual audited financial information	A		
Interim unaudited financial information	A		
Foreign operations	A		
Loan agreements	F	F	
Plants and properties	A		
Products and services	A		
Securities financial structure	A	F	
Subsidiaries	A		

A = always included, F = frequently included

are filed quarterly within 45 days from the end of each fiscal quarter.

Moreover another form, Form 8-K, must be filed when your company undergoes some important event that your stockholders should know about. Investors can retrieve these forms at [www.sec.gov](http://www.sec.gov).

The CFO is the person in your company responsible for establishing and monitoring the internal controls necessary to provide reasonable assurance that the financial statements have been prepared in accordance with the Generally Accepted Accounting Principles.

Again, the SEC carries a “big stick” and neither walks nor talks softly.

### ***The Audit Committee of the Board of Directors***

Your audit committee must be composed of outside, independent directors. Your audits committee must ensure that shareholders in your company receive a balanced, complete, and transparent picture of your company’s financial condition. Appendix 12-A is a sample audit committee charter.

### ***The Independent Auditor***

Form 10-K must be prepared under the scrutiny of an outside accounting firm. The SEC is vigilant about your company’s efforts to ensure the auditor’s independence from any influence exerted by someone from your company, or by someone within the auditor’s firm.

This concern about influence exerted from within the auditor’s firm has evolved from the way large multinational accounting firms have transformed themselves. The very large firms have established consulting practices in information management, benefits administration, and strategic planning. The revenues from those activities match or exceed revenues from auditing and tax form preparation.

The SEC’s appropriate concern is about a conflict of interest: How impartial is the audit certification from a firm you are also retaining for consulting services? Smaller CPA firms seeking to do business with your company may offer services, such as managing your benefit programs or

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

advising you about complying with employment laws. We recommend that you do not engage your auditing for any other service.

The SEC is watching how your public company is keeping its books. If anyone in your company suggests some chicanery in your financial reporting process, suggest to that person that they consult a qualified mental health professional. Do this while you are helping that person clean out their desk.

### **ELEMENTS OF EFFECTIVE FINANCIAL REPORTING**

Earlier in this book, we briefly discussed how microcap investment managers analyze your financial reports. These professionals assign greater weight to different measures and ratios depending on their respective approaches to analyzing financial statements. What is presented in your balance sheet, your P&L, and your statement of cash flow is pertinent and relevant to everyone in your shareholder constituency you are working to build.

Here is what one portfolio manager managing over \$5 billion told attendees of a local National Investor Relations Institute (NIRI) luncheon: “I slice and dice very possible number...the onus is on IR professionals to address every question of interest to investors.”

#### ***The Income Statement***

The income statement reports earnings, about which there are two concerns: Can an increase in earnings be sustained? How were the earnings computed? We addressed the implications

of the first question in our discussion of consensus risk. The second question is the focus of what follows

## **Revenues**

FASB mandates distinguish between gross revenue and net revenue. Gross revenue is the amount invoiced, and net revenue is how much a company retains after paying a wholesaler or a manufacturer for the product(s) invoiced or services rendered. The amounts of revenues received in different fiscal quarters may differ substantially. Resist the temptation to smooth out “lumpy” revenues. The SEC and experienced investors consider that practice misrepresentation. Delays in posting revenues do occur and experienced investors understand this. What they don’t like is revenues from a larger than usual sale apportioned over several fiscal quarters. They are also suspicious of the flip side, namely reporting all revenue stipulated in a long-term contract as revenue received in one quarter.

The SEC’s position is that revenue is to be recognized when it is earned and realized or realizable. The SEC describes the following four underlying conditions that must exist:

1. There must be persuasive evidence that an arrangement exists.
2. Delivery of goods must have occurred or services must have been rendered.
3. The price is fixed or determinable.
4. Collectability is reasonably assured.

The key questions remain. Did money come in as a result of the sale? Is any money owed to the actual selling principal in

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

the transaction? Did the money go into the operating account at a bank? Should some of the money have gone into a reserve account?

### **Expenses**

The accrual issue about what should be charged as direct expenses and what should be capitalized is common to any public company. These concerns have been around ever since there have been federal agencies. Consider how the IRS views expenses compared to how the SEC views them. As an experienced investment manager put it: “The accounting practices of the stocks I buy must portray economic reality, because economic reality is going to catch up with a company one way or another. One measure of economic reality is having expenses match up with the revenues the expenses generated whether those outlays are expensed or capitalized.” The SEC and FASB recognize that there is some incongruity with respect to accruals. That incongruity is the focus of much dialogue among some of the leading finance and accounting scholars.

### ***The Balance Sheet***

The balance sheet should reflect your path to enhancing shareholder value. If you have been operating as a public company for at least five years, you should have an overall ratio of at least one and a quarter the amount of assets to liabilities. Experienced investors want an increase in equity and an increase in your company’s cash (or cash equivalents). They will pay attention to your accounts receivable. How are

you disclosing the provisions of your debt? Are you disclosing call provisions, conversion terms, and balloon schedules?

### ***The Statement of Cash Flows***

The statement of cash flows is the third report to be filed. This is the “you can run, but you can’t hide” report. There are no accruals here. The three main sections of this report are as follows:

1. cash flows from operations,
2. cash flows from investments, and
3. cash flow from financing activities.

This is the report experienced investors use to compute the net increase or decrease in your cash flow within the reporting period as well as your company’s free cash flow. Free cash flow is the money generated beyond your company’s operating, financing, and investing needs. This is the common measure of liquidity. Adequate free cash flow is a condition to which your shareholders want you to aspire.

Free cash flow is not computed from any cash flow resulting from tax deductions allowed from employees exercising stock options. This practice of stock options continues to create financial reporting dilemmas.

### ***Management’s Discussion and Analysis***

There is increasing pressure from professional investors and regulators for public companies to expand the section of

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

financial reporting commonly referred to as Management's Discussion and Analysis (MD&A). There are three related objectives for this MD&A focus:

1. to provide a narrative explanation of a company's financial statements to enable investors to see the company through the eyes of management;
2. to improve overall financial disclosure and provide the context within which financial statements should be analyzed; and
3. to provide information about the quality of, and risks to, a company's earnings and cash flow.

### ***Accounting for Stock Options***

The SEC, FASB, and shareholder advocacy groups continue issuing pronouncements, directives, and opinions about accounting for stock options. We suggest ignoring all comments about options diluting stock values. These comments may not be relevant to the valuation of your company. What is relevant are matters about what you report in your accounting statements. What is pertinent is how options are valued and any facts regarding the repricing of options.

### ***Audit Fees***

You are required to report how much you paid annually to any outside auditing firm, including how much you paid for nonaudit services.

***Additional Information***

We believe there are some active investors who outperform the market indices. We believe that their sustained success is due to how they analyze companies. Winning investors have always looked beyond the numbers in mandated reports. You and your management team should think about what you could add to your reports that would provide valuable information for savvy microcap portfolio managers.

**Appendix 12-A: An Audit  
Committee Charter**

Here is a suggested wording for a directors' document chartering an audit committee.

**ORGANIZATION**

***Members***

The audit committee will consist of three or more directors who are not full-time employees of the company's management team, and who meet the requirements defined by the New York Stock Exchange (NYSE) Listed Company Manual. The members of the audit committee and its chairman will be appointed by the Board of Directors.

***Meetings***

Audit committee meetings will be held on the same day as regularly scheduled Board of Directors meetings, as well as other times as called by the Audit Committee Chairperson.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

A majority of the members of the Audit committed shall constitute a quorum.

### **ROLES**

The function of the Audit Committee is oversight. In fulfilling their responsibilities (described below), it is recognized and understood that the members of the Audit Committee are not full-time employees of the company and are not accountants or auditors by profession.

### **RESPONSIBILITIES**

The responsibilities of the Audit Committee are as follows:

1. Evaluate and select the outside auditor.
2. Advise on the selection and/or removal of the General Auditor.
3. Review and recommend changes to the Internal Audit Charter.
4. Review, on an annual basis, a written statement prepared by the outside auditor delineating all relationships relevant to audit independence between the auditor and the Company.
5. Discuss with management and the independent auditor all matters relating to all quarterly and fiscal year-end financial reports including, but not limited to:  
independent auditor's responsibility under generally accepted audited standards;  
significant auditing standards;

## THE SEC AND FINANCIAL REPORTING

management judgments and accounting estimates;  
audit adjustments;  
difficulties encountered in performing the audit;  
disagreements with management;  
consultation with other accounting/audit professionals;  
major issues discussed with management, prior to retention;  
auditor's judgment about the quality of the entity's accounting procedures.

6. Review with the independent auditor and members of senior management the adequacy and effectiveness of the Company's financial controls and financial reporting processes.
7. Meet at least annually with the senior internal auditing executive and the independent auditors in separate executive sessions.
8. Prior to filing, review SEC Forms 10-Q and 10-K, including the section under Managements Discussion and Analysis.
9. Prior to publication, review all of the Company's reports to shareholders.
10. Prepare for inclusion in the annual proxy statement a report that includes at least the following:  
A statement that the Committee has reviewed and discussed the audited financial statements with management. A statement that the committee has discussed with the independent auditors all matters required for Statement on Auditing Standard No. 61 (Required Communications wih Audit Committees).

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

A statement that the Committee has reviewed written disclosures from, and held discussions with, the independent auditors.

11. Review the charter annually.
12. Review management's retained counsel's assessments of the corporation's compliance with laws, regulations, and company policies with respect to payment to entities retained as foreign sales consultants.
13. Meet with the board-appointed Ethics and Business Conduct Committee to review compliance with generally agreed-upon ethical business practices, as well as any stipulated standards such as The Defense Industry Initiative on Business Ethics and Conduct.
14. Review any pending or threatened litigation, including any assumption of expenses incurred by management or employees involved in company-related legal proceedings.

**PART III**  
**CORPORATE PRACTICES  
FOR EFFECTIVE INVESTOR  
RELATIONS**

**CHAPTER 13**  
**ESTABLISHING AN**  
**INVESTOR RELATIONS**  
**PROGRAM**

**C**onducting IR activities within emerging corporations does not require establishing and staffing a distinct investor relations department. IR functions can be handled by the CFO, the retained legal counsel, and a contracted IR advisor. You do need a program to inform investors and shareholders about how you are increasing value for shareholders. And your finance department may need some advice about distribution of 10-Q and 10-K reports as well as appropriate means by which to disclose material developments. Those

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

information and disclosure activities can be coordinated with your finance department by an experienced IR advisor.

At some point in your growth, circumstances will make an in-house IR department imperative. The major advantage of having an in-house IR department is assuring and controlling confidentiality. For this reason, we recommend that the IR function report directly to the CFO.

### **THE IR DEPARTMENT'S ACTIVITIES**

Your IR department should be assigned the following tasks:

1. Assist the finance department in overseeing filings with the SEC.
2. Assist the outside auditing firm in formatting reports and serving as liaison between your company's departments and the outside auditors.
3. Prepare and distribute the annual report and Management Discussion and Analysis (MD&A).
4. Create and disseminate all news releases about material developments.
5. Schedule and organize the annual meeting.
6. Schedule and organize all teleconferences, road shows, and investor presentations.
7. Prepare and distribute due diligence reports and media kits.
8. Work with the CFO and counsel to ensure an effective system for monitoring financial reporting and disclosure.
9. Work with other departments within the company to ensure that they are complying with all reporting and disclosure requirements.

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### ***Everyone on the Same Page, All the Time***

Please reread activity number nine. We argue that *all* other aspects of corporate communications are subelements of investor relations: advertising, general announcements, new product introductions, and crisis management. We do not argue that these functions should report to an IR department. We do argue, however, that the directors institute a policy requiring the IR function to be given advance notice of any forthcoming announcements from *any* department. This policy is not intended to get IR's approval or sign off, but it is simply a best practice policy to ensure that IR gets an appropriate notification. This is another reason why we recommend that IR report directly to the CEO or CFO.

### ***Developing an "Investment Thesis"***

Don Markley of Lippert/Heishorn & Associates (Los Angeles) recommends that every company develop its own investment thesis to convey to prospective investors. This focused activity should comprise the following four sections that translate into market share and enhanced value for shareholders:

1. the market opportunity and the number of individual and institutional investors;
2. the market dynamics in your favor: your company's competitive advantage, its product or service superiority, better distribution networks, intellectual property;
3. your strategy that will leverage your competitive advantage into market activity; and

4. a summary of how the above three factors will enhance earnings and cash flow.

## **QUALIFICATIONS FOR THE HEAD OF AN IR DEPARTMENT**

The overriding question in choosing a candidate to direct your IR activities is whether this person truly understands your business. That is, would you hire that candidate for a sales, marketing, or product development position? If your answer is no, reconsider why you were considering that person for the IR job. Keep in mind that an effective IR operation requires an IR head that “walks the walk” and “talks the talk.”

Another critical question is whether this person will be a team player. One of the IR head’s functions will be blending the messages of disparate departments into a common, unified voice. That requires enlisting the assistance of other key players in your company. Leadership aptitude is not to be ignored. Can this candidate command respect and motivate a wide range of different personalities to act in the best interest of your company?

### ***Education and Background***

The person you hire to run your IR activities should have at least three years of experience in investor relations. The experience should include dealing with high-net-worth individuals and with institutional investors. Choose a candidate with writing skills and experience with disclosure, compliance, conference planning, and teleconference oversight.

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A candidate with extensive experience in one large corporation may have acquired expertise in only one activity. The person selected to manage the IR activities for your emerging program should have the temperament to tolerate the mundane tasks of administration and preparing reports.

### ***Understanding the Investment Industry***

Your candidate needs to know capital markets and corporate finance. That knowledge is best acquired by working for a broker/dealer, an investment management company, or an accounting firm. We recommend not hiring a corporate communications professional whose understanding of finance is likely limited. We often hear CEOs say, “I can teach them what they need to know”; what they likely mean is: “They just need to punctuate the written stuff. I will tell them what to say.” We don’t agree with this ventriloquist approach to IR.

IR’s critical function requires more than a working knowledge of securities law. You can bring somebody up to speed on what to do and say where compliance is concerned. The real challenge is finding a candidate who can grasp the subtleties and dynamics of investors and markets.

## **MEASURING THE EFFECTIVENESS OF YOUR IR PROGRAM**

Like advertising and other promotional expenses, the return on investment in IR activities is not easily measured. Seldom

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will you see your IR activities immediately impact the market price of your stock. The market is a forward-looking discounting system composed of much information and many opinions. The way in which the market assigns value to different stocks is complicated.

News about your company may move within the market in seconds and may have an impact on your stock's price. However, the best measure of the effectiveness of your IR efforts could be what the share price was six months ago or how your share price moves when compared to a similar company's stock price.

Therefore, from time to time you should compare the value of your company's share price to that of other companies in your industry sector. If your stock's price-to-earnings ratio is higher than that of a company that has a pattern of financial performance similar to yours, then you have attained a return on your investment in IR activities. If your P/E ratio is less than that of a peer company with similar performance to yours, you should review your IR strategies.

You should implement a system and process for comparative measures of stock price and performance. To gauge your performance compared to peer or same-sector companies, compile for each company the six-month figures in the following categories:

1. growth rate of revenue,
2. revenue per share,
3. P/E ratio,

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4. growth rate of earnings,
5. earnings as a percentage of revenues,
6. current ratio,
7. debt-to-equity ratio,
8. ratio of current assets to current liabilities, and
9. cash flow per share.

Compare your company's measures with those of the sample group. Then look at the relationship between each company's numbers and its listed share price. How do these numbers and ratios compare to those of your company? Are there any apparent anomalies?

## **MONITORING THE EFFECTIVENESS OF YOUR IR ACTIVITIES**

Another tracking system we recommend is easier to administer and provides ongoing evidence of investors' interest. Maintain a system for tallying the things that logically correlate with interest in your company, such as the following:

1. number of investor queries,
2. number of investor information packages requested,
3. number of appointments with the sell side,
4. number of appointments with the buy side,
5. number of conference calls set up,
6. number of conference call participants,
7. number of presentations made, and
8. number of attendees at presentations.

## **TRACKING YOUR STOCK**

The present market value of your stock may not be an accurate appraisal of the market's regard for your company's prospects, so the following measures, other than share price, need to be monitored at least weekly:

1. Changes in daily volume
2. Changes in the number of shareholders
3. Changes in shares held among institutions
4. Changes in short positions
5. Changes in the amount of odd-lot transactions
6. Marked changes in volatility
7. Marked changes in price relative to the market
8. Changes in the number of institutional owners

The next two chapters describe the critical activities of an effective IR program.

**CHAPTER 14**  
**BEST PRACTICES FOR**  
**NEWS RELEASES**

The rate at which communications technology changes precludes discussion of the most efficient or effective channels or media through which a company distributes its news. This chapter's focus is on the preparation, content, and formatting of news releases.

Other than the SEC forms, news releases are the most important form for disclosing material information. Indeed, at times a news release has greater importance than an SEC

form. Many material event news releases are issued between SEC filing dates.

### **MATERIALITY**

Information is defined as material when there is substantial likelihood that a reasonable shareholder would consider it important and that the information would have been viewed by the reasonable shareholder as having significantly altered the total mix of information made available.

Circumstances and situations associated with what is required in the Management Discussion and Analysis (MD&A) are obviously material as are events likely to come to fruition. The introduction of a new product, a new management structure, a merger, or a turn of fortune are some examples of information that is material.

Preparing a news release about material events requires focused writing. That is, the writing must mainly be concerned with the materiality of the content. Only report or describe a situation or circumstance within the confines of the material facts being released. Avoid disclosing information about another separate material event in the same press release.

### ***Always Appear Savvy***

Avoid subjective appraisals or vague comments, such as: “The company expects next quarter’s earnings to be more in line with management’s expectations.” This may seem an egregious example, but we have seen statements such as this too

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many times. This is not an example of what the SEC encourages as “forward-looking information.” Thus, be factual or be quiet.

### ***Known, Likely, and Uncertain***

The very best practice with respect to material news is not limiting news releases to known events or situations. Disclosure in the context of an MD&A requires addressing likely and uncertain developments as well. This no surprises approach to disclosure enhances your appeal to experienced investors. Always report on a situation or circumstance that is presently known and is reasonably likely to have a material effect on your business. Again, just focus on that specific situation or circumstance, remembering that it is the subject of the news release and determines the content and focus of the release.

Deliberate planning overrides IR just as it does in other business activities. Contingency planning is required. Reflect on the impact of likely events and those that seem unlikely. Always keep the IR department in the planning loop, making sure that it is prepared to disclose quickly the effects of events.

## **PREPARATION OF THE NEWS RELEASE**

[Figure 14.1](#) is an example of a news release. The key elements of a professionally prepared news release can be summarized as follows:

1. The headline should be in all caps and centered. It should also be as brief as possible and lead the readers into the

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body of the release. Don't write "ABC announces a letter of intent to go public," but say, "ABC intends to go public." The headline should incorporate the shortest possible name for the company; that is, usually you can leave out "Inc."

2. The dateline should include the city and state where the release is issued. This is usually where the company is headquartered. Alternatively, this might be places where the company is doing business or is expecting to do business. Business editors always give preference to companies they consider local. The dateline should also give the full and official name of the company, specify the exchange on which it trades, and identify any particular index in which it is included.
3. The body of the release is the information the company aims to disclose. The body should be written to make a point quickly and not dilute the release with irrelevant or superfluous information. It should be no more than 400 words. That is the length editors prefer in a news story. Those 400 words should include a safe harbor statement.
4. The tag line and contact information includes information about the company, its web URL, and a name and number for an editor to call for further information and follow-up.
5. The safe harbor statement must be included if the release contains forward-looking statements. If the release mentions what the company expects in the future, then that should be construed as forward-looking and must be identified as such in a safe harbor statement.

## BEST PRACTICES FOR NEWS RELEASES

<p><b><u>FOR IMMEDIATE RELEASE</u></b></p> <p><b>COMPANY HEADLINE</b></p> <p><b>CITY, STATE, DATE</b> – Company Name, Exchange Listing, and Trading Symbol</p> <p>XYZ Company announced..... ..... .....</p> <p>For further information, contact: Name, phone, fax, e-mail</p> <p>The company notes that statements in this press release, and elsewhere, that look forward in time, which include everything other than historical information, involve risks and uncertainties that may affect the company’s actual results of operations. The following important factors (among others that are discussed in the company’s filings with the Securities and Exchange Commission) could cause actual results to differ materially from those set forth in the forward-looking statements: [List the relevant factors here.]</p>
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**Figure 14.1** Suggested news release format.

The common practice is to end the news article/press release with three number symbols ### centered at the bottom of the page. In any case, you should have your counsel check out the release before you make it public.

### **DISTRIBUTION OF THE NEWS RELEASE**

The distribution of press releases should be as planned and focused as your company’s advertising and promotional activities. A blanket or shotgun approach to distributing press releases is not effective, efficient, or economical. Moreover,

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there are some regulatory restraints on when you can release announcements of material news.

### ***The National Association of Securities Dealers***

Within the National Association of Securities Dealers (NASD) is a group referred to as MarketWatch. This group's task is to monitor the movement of stocks for sudden and large changes in price and/or volume; it is especially vigilant about when and how material events are discussed. MarketWatch has a procedure for previewing the release of news or information that could affect a stock's price and trading: news such as the death or resignation of a key executive, a disaster, a product recall, or a hostile tender offer. During market trading hours, corporations are required to submit news releases to MarketWatch 10 minutes before making them public.

Companies do not need to adhere to the rule regarding lead time when the market is closed, but they must submit press releases 20 minutes prior to the opening of the next trading session. The best practice is to distribute all releases no later than 7:30 am eastern time.

### ***Your Main Constituents***

You must inform your market makers or auction market specialist *directly* about the news at the same time that you release news impacting the share price to the public. But do not provide advance notification. You should also transmit the release to your shareholders at the same time as you release the news to the public, which includes the investment community, your

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industrial peers, and the business press. Don't forget periodicals and newsletters that specialize in or provide extensive coverage of your industry, your customers, and suppliers.

### ***Wire Services***

Two wire services provide distribution of news releases to the global securities markets: P.R. Newswire and Business Newswire. Establish and maintain a close relationship with an account representative at each of those companies. Make sure that your IR staff has a system for transmitting news releases to analyst and investment managers who have expressed an interest in your company. Analysts and portfolio managers might receive as many as 2,000 e-mails or press releases in a week. Ask your target institutional managers how they prefer to receive information about your company.

### ***About Wire Services***

There are several advantages to using a wire service:

- *Simultaneous delivery*, which avoids selective disclosure problems. Using wire services is thus an important element in complying with Reg FD dissemination rules.
- *Credibility* is enhanced when you use major wire services.
- *Distribution to all media* is assured because wire services generally distribute to all local print and broadcast media, to all disclosure agencies, trade associations, internet sites, and the wire's own website.
- *Efficiency and cost-effectiveness* are key advantages because you need only make your distribution selections, determine

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the time of release, and e-mail the documents to the wire service. The wire services distribute the information instantaneously and simultaneously to thousands of outlets.

- *Targeting* the news release to its intended audience is easy; for example, you may want your news to be limited to certain industries or constituencies, and the wire services will then reliably distribute the news release based on your specific criteria.
- *Distribution to the major purveyors* such as Yahoo! is a major benefit of news service distribution.
- *Proofreading* is done as a matter of general practice. It is important to have one more pair of eyes review your text before releasing it. Most wire services have two people review copy before it is finally released.
- *Formatting* is done so as to conform to the wire services' standards.

## WORKING WITH A WIRE SERVICE

Wire services offer a broad range of services, and working with them can make your IR activities less onerous and ensure that mandated disclosure requirements are met. To get the most from these services, you need to know how best to work with them.

### *Distribution Arrangements*

Client companies can upload, store, and utilize e-mail and fax distribution lists; this allows you to specify when and to whom to send a news release. Clients are assured that the same text

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is going to everyone on the target list. The wire service will monitor the distribution to assure compliance with existing rules and regulations.

### ***Be Available***

Make sure that the wire service can reach someone in authority at your business between the time you sent the release and the time specified for distribution. Provide 24-hour contact information.

### ***Crossing the Wire***

Wire services will call and confirm the time that your news was released to the public (known in the news profession as “crossing the wire”).

### ***Getting Distribution Beyond the Wire***

The press is always looking for experts to quote. Reporters want at least three sources of confirmation for each news event. Being accepted as an expert source is another opportunity for you to obtain greater visibility for your company.

## **TRACKING THE NEWS**

In addition to assuring that your news gets disseminated, you also need to track the news, primarily for two reasons:

1. Tracking allows company executives to know what is being said about the company by investors, customers, and the general public. If the company or its representatives are

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quoted inaccurately or identified incorrectly, corrective measures can be taken quickly.

2. Tracking gives company decision makers a more comprehensive view of business trends and the activities of their competition.

The internet news explosion has spawned internet capturing (clipping) services, which offer three types of monitoring: news, newsgroups, and public arenas. These services can track thousands of newsgroup, corporate, government, and education sites on the internet. Subscribers receive notifications with abstracts of the articles and hyperlinks to the sites where the coverage appears. Many of these services offer web delivery, clipping, and archiving services.

### ***Broadcast Monitoring***

Mentions from news broadcast are available within an hour of the actual broadcast. Broadcast services provide all stories that mention the search criteria specified by the client. Stories are sorted by network, date, geographical location, and station. Some services include the number of viewers.

### ***Local and Regional Media***

Don't underestimate the level of interest in your business of business editors at your local and regional news media. Your business is a local employer and a purchaser of local goods and services. The growth of your company enhances the local economy (which impacts advertising revenues).

## **BEST PRACTICES FOR NEWS RELEASES**

These editors and news directors can be strong allies in your total corporate communications campaign. It is not only best practice but indeed the only sensible practice to make sure that they get news about your company as soon as any other outlet does. Consider providing scoops when you have some new information that is interesting but not deemed material.

### ***Public Relations Agencies***

Media coverage about your company greatly reinforces your stock's investment appeal. A public relations agency can be a most effective ally in raising interest in your company among investors. But do not hire any PR agency until you have completed a due diligence study that includes the following check points:

1. How long has the agency been in business?
2. How many clients does it have who have been clients for three years or more?
3. Is the agency willing to refer you to all its clients?
4. Has the agency ever been accused of misrepresentation or any other kind of malfeasance? Are agency staff members conscientious about regulations, most notably Reg FD?
5. What is the average length of employment of its account executives?
6. What is its reputation among the media?
7. What services will it provide?
8. What are the terms under which you will be working with the agency?

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One of the key issues in choosing an agency is the manner in which its executives have advised/assisted clients on handling material news that was bad news.

### ***Following Up***

Establish a procedure for determining what resulted from your news release. Monitor not only changes in your stock's price but also changes in volume. The response of the market to the news may not be immediate. Remain alert to any changes in price or volume.

Record all calls triggered by the release. If a caller's question indicates that you did not provide all the relevant information about a particular material event, then issue a follow-up release addressing the specific question.

The real value of retaining a clipping/monitoring service will be realized soon after the release of material news. You can ascertain the scope and degree of interest in your company by the number of mentions that these services garner for you.

### **THE PRESS KIT**

Besides news releases, an effective IR program should have a fact sheet and an executive summary. These two items are usually combined with the most recent news releases and the latest 10-K or 10-Q report to make up what is called a press kit. A press kit is assembled for distribution to anyone requesting information about the company. Brochures about your company's products and/or services may also be

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included. These assembled documents provide the basis for due diligence study of your company.

### ***The Fact Sheet***

A fact sheet is a list of talking points and is generally formatted in bullet points. It should contain only information that has previously been disclosed. Don't use the fact sheet to disclose new information. The bullet formatting is employed to better enhance the fact sheet's use as a talking point outline for phone calls to investors, brokers, and the media. The order of talking points is as follows:

1. Name of the company
2. A single sentence about what the company does
3. The company's competitive advantage
4. Where the company is listed and the trading symbol
5. Key material information about what makes the stock attractive
6. The float and shares outstanding
7. The market cap
8. The names of brokers who are following the stock

### ***Executive Summary***

The executive summary is similar in scope and format to a report prepared by broker analysts. It differs in that it does not contain any of the following:

1. buy or sell recommendations,
2. no performance targets, and
3. it has no risk disclosure section.

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The executive summary should be no longer than four pages. The format we recommend is presented in appendix 14-A.

Again, do not disclose any new information in an executive summary. However, if you enclose a safe harbor statement within the executive summary, you can make forward-looking statements. Prudent practice, however, dictates not including any forward-looking statements. As a matter of fact, compliance officials at many firms prohibit their brokers from sending out any literature that includes forward-looking statements.

### **THE NEXT CHAPTER**

The next chapter presents a review of the best practices of the other two significant activities that characterize a professional IR program: group presentations and conference calls, which some professional investors consider to be of even greater importance than news releases.

## **Appendix 14-A: Suggested Format for an Executive Summary**

### **COMPANY SUMMARY**

- Description of the company's business in less than 30 words
- The exchange on which the stock is traded
- The trading symbol(s)
- Shares outstanding
- Float: All shares that are available *for public trading*
- Transfer agent: Include contact information

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- The name of the accounting firm
- The corporate address
- The stock's recent price: The \$ bid as of the date of the report (show the date)
- Trading range: Show the price range over the past 12 months
- Revenue year-end
- Assets: Use the same amount as in latest 10-Q report and show date
- Liabilities: Use the same amount as in the latest 10-Q report and show date
- Equity: Use the same amount as in the latest 10-Q report and show date
- Book value per share: Use the latest number from the 10-Q report and show date
- Number of employees
- The date of the fiscal year-end

### ***Business Summary***

State concisely the basic business plan of the company. Describe the company's competitive advantages.

### ***Industry***

Give a brief description of the industry in which the company competes. The total size of the industry should be stated as well as the industry's growth rate over the past five years. State the number of competitors and the company's present market share.

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### ***Customers***

Include the total number of customers and list the most prominent ones in bulleted form. A list of customers is an opportunity for your company to gain credibility. The fact that your company has many large customers is a tacit endorsement of its products and services.

### ***History***

Present the company's history as a series of milestone events: year founded, year incorporated, first patent, etc.

### ***Background***

Provide a short narrative describing the background.

### ***Management***

List the top half dozen executives and their duties, responsibilities, and major accomplishments.

### ***Current Development***

Describe recent contracts received or some recent milestone event.

### ***Future Expectations***

If there is a contract pending or a new product about to be launched, discuss these events in a paragraph. Do so in a nonspecific manner without any guidance with respect to projected outcomes or performance impacts.

## **BEST PRACTICES FOR NEWS RELEASES**

### ***Conclusion Section***

We suggest a summary in a bulleted list of 10-15 reasons why an investor should consider buying shares in your company. Include the following disclaimer if the report is prepared by an outside agency:

The author of this report is not a registered investment advisor or a broker/dealer. The content of this report is provided as an information service only, and past performance of previously featured companies does not guarantee the future success of any company. Information contained herein is based upon data obtained from the company as well as other recognized statistical services, issuer reports, communications, or other sources believed to be reliable. Sources include interviews with management, news releases, and SEC forms. However, such information has not been verified, and we make no representation to its accuracy and completeness. Any statements nonfactual in nature constitute only current opinions that are subject to change. Our company, its officers, directors, and employees may have positions in securities referred to in this report and may from time to time buy or sell these said securities. Neither the information nor any opinion expressed shall be construed to be or constitute an offer to buy securities mentioned herein. This report was prepared for compensation, [state the amount of compensation], which may have been any combination of cash or securities. This report does not purport to be a complete statement of all data relevant to the securities mentioned. Use of the information provided herein is at the sole risk of the investor. The author, associated shareholders, or employees/consultants do not accept any liability whatsoever for any direct or consequential loss that may arise from any use of this report or its contents.

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These securities may involve a high degree of risk. These securities may be considered speculative and therefore not suitable for the strictly conservative investor. Forward-looking statements involving any representations other than historical facts involve risks and uncertainties that could cause outcomes to differ from projections. Receipt of this report shall not create, under any circumstances, any implications that there has been no change in the affairs of the company profiled. Any readers of this report who are considering purchasing securities mentioned herein should consult their own financial advisors prior to making any investment decision. The author further urges readers of this report who are considering investing in the company to check its filings with the Securities and Exchange Commission (SEC).

If you use any forward-looking statements, a safe harbor statement similar to the samples provided in [chapter 9](#) should also be included.

**CHAPTER 15**  
**BEST PRACTICES FOR**  
**CONFERENCE CALLS AND**  
**PRESENTATIONS**

Not surprisingly, printed information does not have as immediate an impact on the price of your stock as oral communication has. Even less surprising is that conversations or personal presentations to limited audiences are the most likely opportunities for getting into disclosure trouble. Do not disclose material information for the first time to limited audiences! You cannot be too vigilant about this. Analysts, experienced investors, and reporters are masters at

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prompting you to divulge everything that is material or could soon be material. They are not violating any regulations by asking questions. The aggravation they may exhibit when you cite Reg FD pales in comparison to the response you will get from the SEC for improper disclosure. Be ever mindful. When in doubt, KYMS.

If you inadvertently disclose new information that could be deemed material, inform the SEC within 10 minutes and distribute a general news release within 20 minutes. And file an 8-K report with the SEC within 3 hours. You have likely ruined your teleconference or presentation, but that is just another unfortunate consequence of a slip of the tongue.

If you plan to disclose new material information in a teleconference or a presentation, release it to the press shortly before the call or presentation. *We recommend never scheduling presentations or teleconferences during market trading hours.*

### THE TELECONFERENCE (AKA THE CONFERENCE CALL)

A microcap portfolio manager who is not easily exasperated recently remarked to us: “I have never participated in a conference call that I thought was conducted in an appropriate and efficient way!” She was talking about the scores of teleconferences conducted by companies just like yours. Reg FD has greatly complicated the process of conducting effective conference calls. In theory, a company cannot limit participation. In practice, the logistical challenges imposed by Reg FD on arranging conference calls have moved many executives and IR professionals to tears or to venting their anger

## **BEST PRACTICES FOR CONFERENCE CALLS AND PRESENTATIONS**

with inappropriate language. The best practices of complying with the onerous burdens of Reg FD are still evolving.

You must outline a structure to follow throughout the conference call. Stick to that outline up to the time when you open the conference to questions from the participants. Sticking to the outline ensures that you will stay focused and that you will not disclose new material information. A conference call is an appropriate channel through which to make forward-looking statements; therefore, always begin a conference call by reading a safe harbor statement.

If the call is fully available through a webcast, then the call itself is considered a full-disclosure venue.

### ***Scheduling a Conference Call***

The best practice with respect to scheduling conference calls is to schedule them four times a year, shortly after you have released your quarterly report. The date of the call should be on the same day these reports are sent to the SEC and the news release summarizing the information is distributed.

Send the reports to the SEC and distribute the news releases five minutes after the close of trading. Schedule the conference call for ten minutes later. Announce the date and time of the scheduled conference call seven to ten days before you will be hosting that conference call. The best days for conference calls are midweek.

### ***Conducting the Conference Call***

The CEO should be the featured speaker. The meeting should open with someone reading directly from the safe

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

harbor statement. Then the CEO introduces the other company executives who will be participating in the call. Limit the number of participants to three.

Focus the call on the recently disclosed material information. The CEO should make only those forward-looking statements that have been scripted. Other senior members should then have no more than five minutes to comment or elaborate on the previous statements. Then open the teleconference for questions. Repeat each question before addressing it. Make sure that the person asking the question is identified. Answer each question succinctly. Defer the answer to the company executive who is best informed on the matter in question. If you or someone can't answer a question, say so immediately and be precise about why you cannot answer the question. Keep the call going until there are no more questions. Close the call by thanking the callers for their time and interest.

### ***Conference Call Follow-Up***

Within two days of a conference call, participants should be contacted for their comments about and evaluations of the call. You should have established sufficient rapport to get honest and candid responses. You need constructive criticism so as to learn how to make subsequent conference calls better.

## **PRESENTATIONS AND ROAD SHOWS**

Live presentations to shareholders and prospective investors (via sponsored conferences or shareholder meetings) have the most immediate impact on share price. What are

## **BEST PRACTICES FOR CONFERENCE CALLS AND PRESENTATIONS**

the features of an effective presentation that makes a good impression?

1. The presentation (excluding Q&A) should last no longer than 20 minutes.
2. It should provide a clear statement about what the company does.
3. The presentation should use effective visual aids.
4. It should have a logical format.
5. It should have clear transitions from one element to the next.
6. The presentation should provide information that is relevant to the audience.
7. It should present information clearly and without jargon.
8. The presentation should be well rehearsed.

### ***A Clear Statement of What the Company Does***

Begin every presentation with a clear and concise explanation of what your company does. We have been to several presentations at which the spokesperson assumed that the investor audience knew what the company did. The spokesperson never explained their business and how they distinguished themselves from their competition.

### ***Effective Slides***

Fewer words supported by well-conceived visuals create more impact. Each slide should display the presenter's talking points for about one minute. Think of a slide as you would of the headline in a news release: it should arouse interest.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

Don't think of slides as the main features of the presentation. The speaker's presentation is always the focus. Slides merely reinforce visually the messages being conveyed.

### ***Avoid Jargon***

The heavy use of jargon in a presentation could make a spokesperson appear arrogant. Avoid jargon when making a presentation to any group comprising people outside of your industry.

## **MEETINGS WITH INVESTMENT PROFESSIONALS**

Live presentations and meetings restricted to investment professionals need to be conducted differently depending to which side you are speaking.

### ***Brokers***

In our experience, brokers prefer group meetings. A group dynamic can emerge from a well-run presentation. Brokers tend to follow one another. If one successful broker expresses interest in your company, others will be interested. Brokers do not prefer group meetings. Brokers feel one-on-one meetings make them feel more accountable to the issuer. They also like the option of attending or not attending any particular meeting.

### ***Investment Managers and Analysts***

Institutional investors, however, want only one-on-one meetings. They expect any presentation to be tailored to them.

## **BEST PRACTICES FOR CONFERENCE CALLS AND PRESENTATIONS**

They want the opportunity to interrupt with questions and to control the exchange.

### **CONCLUSION**

The previous two chapters reviewed the best means for taking advantage of the communications resources available. The next chapter talks about the best means to counter a growing threat to the effectiveness of your IR program.

**CHAPTER 16**  
**BEST PRACTICES FOR**  
**USING THE NET:**  
**CONFRONTING THE**  
**CHAT ROOM POX**

In [chapter 5](#), we advised you to be vigilant about “pump and dump” schemes. With the internet these schemes can be implemented easily by unscrupulous brokers and criminals using chat rooms and message boards. Just as insidious are the dialogues in chat rooms and on message boards where the goal may not be chicanery but just passing on unattributed gossip. Some of this “stuff” (our editor’s more delicate ‘s’ word) may not be part of a “pump and

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

dump” operation. Nevertheless, inaccurate information gets out there and can be critically wounding to your company’s reputation.

Some miscreants have made a very good living playing to people’s propensity to “invest and then investigate.” The internet has enhanced the capability of criminals to take advantage of that propensity.

Whether or not chat room and other posting of inaccurate information are illegal should not be your primary concern. Your primary concern is that misinformation’s impact on how your company’s stock is valued and traded. Your concern may be expressed with this perplexed query: Why would anyone want to buy or sell a stock solely on what they saw posted or discussed on the internet? Because they are human, that’s why.

### **FANNING FLAMES OF GRIEVANCE**

Internet insurgents may not always have the objective to affect the value of your company’s stock. There have been numerous cases of so-called news spread with malicious intent by former employees and disgruntled current employees. Moreover, dissatisfied customers who have slipped through your customer-relations activities or your product warranty programs could also resort to such tactics. You may even be the target of an activist group.

Dealing with these hostile situations probably won’t involve the SEC. If the SEC does get involved, its role in such a situation may not be what you expected.

## **BEST PRACTICES FOR USING THE NET**

### ***Whom Does the SEC Protect?***

Microcap stocks are more likely to be subject to cyberspace scams, schemes, and rumors than are larger-cap stocks. The SEC is adept at early identification of and intervention in internet financial fraud. The SEC's role is to protect investors from fraudulent activity, not your company. There are instances when investors who were victims of fraud had some of their losses returned. There have been no instances when courts or agencies have mandated the restoration of the market value of a stock diminished by fraudulent activity—or the madness of crowds.

## **WHAT TO DO AND WHAT NOT TO DO**

There have been so many attempts on the internet to manipulate stock prices that an accepted set of practices has evolved to counter the scammers and those who just like to blow smoke. These practices are grounded in practicality and in law. No one has the time to track down the identity of every purveyor of misinformation, and no company can afford the legal costs of challenging every rumor or opinion as slander or libel. Meet this problem with the same reasoned judgment you would use when you confront other challenges to your company.

### ***Wrong News Can Never Be Good***

*Misinformation on the web will never benefit your company.* There is no such thing as a false rumor that would bring an

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

enduring increase in the price of your company's stock. Once a price-enhancing rumor is dispelled about a stock, the price of that stock almost always will retreat to a level below what it was before the rumor was circulated.

### ***The Appropriate Response***

Don't go on a message board or into a chat room to refute what was said on those particular sites about your company. You cannot win against guerilla insurgents. They have little to lose in their jungle. Your every word on their sites will sink you further into a morass from which there may be no escape.

Instead, respond through appropriate channels and with reasoned counters. The appropriate channels are press releases, press conferences, e-mails, teleconferences, and your own website. Take advantage of your website, and use the financial reporting section to refute the garbage.

Address this "stuff" at length with supporting documents in the very next SEC form you file. If this misinformation is having or could have a severe impact on your business or share price, file a Form 8-K immediately. (You may be in violation of an SEC filing requirement if you don't get that 8-K out right away.)

Judgment rules here. Don't waste time or money preparing responses to generalities or to petty, snide remarks. Vigorously address the items that impinge on your company's reputation or that impact the price of your company's stock.

## **BEST PRACTICES FOR USING THE NET**

### ***Appropriate Action***

In addition to quickly filing a Form 8-K, notify the following:

1. your local district attorney,
2. your attorney,
3. the nearest SEC office,
4. the exchange where your stock trades,
5. your market makers,
6. your state office of securities regulation, and
7. the accounting firm that does your audits.

Be prepared to immediately provide these parties with all relevant documentation about the content, the site(s), and the date and time when you became aware of the misinformation. Tell these parties what you have done and are doing.

Keep in mind that even if the perpetrators of internet deception are caught and convicted, there is likely to be residual harm. You and your management team must establish contingency practices and procedures that will quickly identify or even prevent such incidents.

### ***Web Surveillance***

We recommend retaining a web surveillance firm. There are a number of firms that will monitor the internet for any mention of your company. Their operations are an extension of clipping services. Choose a firm that will provide you with the full text of any mention of your company and the name and location of the websites that mention your

company. The scope of a firm's surveillance is one factor in selection, but just as important is how quickly a firm can provide you with the sites and sources where your company was mentioned.

### ***Restrictions on Your Employees***

Controlling what is communicated from your company will help keep pump-and-dumpers and smoke-blowers from getting material for playing the misinterpretation game. Your company should have an e-mail policy that is unambiguous and easy to enforce. Strictly control what is permitted for transmission. Designate those who are permitted to prepare and transmit internet traffic from your company.

An e-mail policy is based on the common presumption that the company's computer system is company property and should be used only for company purposes. Make sure that all employees know that all e-mail will be monitored by designated company executives.

Stipulate that no employee has the right to privacy in any communication over the company's e-mail system. Detail what kind of language should not be contained in any e-mail message. Make sure everyone in the company knows who in the company is entitled to access all e-mail messages.

Your e-mail policy must be made known to all of your employees. Put a waiver statement on your system. Require that all employees stipulate with signature that they have read the policy and agree to comply with all its provisions.

## **ONE MORE TIME**

Emerging companies like yours are highly susceptible to cyberspace scams, schemes, and rumors that can do lasting harm. Constant vigilance is the most effective counterstrategy. Sound internal policies are always the most effective preventive and countering tactics.

# **CHAPTER 17**

## **CONCLUSION**

**T**his book is intended to guide you in your efforts to increase value of your company's common stock. The focus has been on how the securities markets really work and how the markets appraise the value of your company's equity. What follows is a summary of the key concepts presented in this book:

1. The common stocks of emerging public companies are appealing investments because there is a greater likelihood of a faster rate of earnings growth.

## **INVESTOR RELATIONS FOR THE EMERGING COMPANY**

2. Microcap stocks have higher return premiums because microcap stocks are perceived as riskier investments than stocks with greater capitalization.
3. Shareholders of microcap stocks are much quicker to divest themselves of those shares at the first hint of “bad news.”
4. The market price of a microcap stock will never have any critical mass without substantial ownership by institutional investors, most notably microcap mutual funds.
5. The three most important features of microcap stock are liquidity, liquidity, and liquidity.

Investors in microcap stocks expect the unexpected. They expect executives of the companies they own to confront and deal with all the challenges emerging companies face. They expect an emerging company to communicate its actions and responses to any challenges it encounters. When that company’s actions and responses are communicated in a way that demonstrates responsibility, prudence, and courage, experienced investors will stay the course. More likely, they will be buying when others are selling. Keep strong, stay brave, and have fun!

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