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DIRECT LISTINGS: GOING PUBLIC WITHOUT AN IPO

In this article, the authors discuss the considerations and motivations for a company going public by way of a direct listing. They then turn to the stock exchange rules and SEC regulations that govern the direct listing process, as well as the procedures and role-players, highlighting the ways the process both mimics and differs from a traditional IPO.

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With companies like Spotify and Slack recently going public through a direct listing, companies, investors, and shareholders have been increasingly focused on the direct listing process. In a direct listing, a company is able to publicly list its stock without a traditional underwritten “initial public offering,” or IPO. While direct listings are not new, recent changes to stock exchange rules opened the door for Spotify and Slack to go public without an IPO, with others to potentially follow. This article focuses on the considerations that go into a direct listing and the various ways the process and format compare to a traditional IPO. First, we provide an overview of the process of going public and the considerations when pursuing a direct listing. Second, we discuss the rules and requirements of direct listings under current regulations and stock exchange rules. Third, we detail the role-players and procedures involved in filing, listing, and opening trading in a direct listing. Finally, we discuss recent developments in direct listings, including potential rule changes.

I. BACKGROUND

A private company looking to go public has various motivations and considerations. In a traditional IPO, going public presents an opportunity to raise equity capital through the sale of stock to the public. Under the current regulatory framework, companies pursuing a direct listing are not permitted to raise capital as part of the direct listing. Instead, going public provides liquidity to existing shareholders by allowing existing investors to sell their shares into the public market. In a traditional IPO, however, existing shareholders are often limited in their ability to sell their shares for a certain period of time (often 180 days) by lock-up agreements with the underwriters. In a direct listing, existing shareholders are not constrained by lock-up agreements. Additionally, public stock may be used as currency for acquisitions and employment consideration. Going public also provides a company with public awareness, giving a company market exposure, branding, and credibility in a way that may attract institutional

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investors, aid in raising debt financing, and support other business objectives.

A. Direct Listing

A direct listing takes place when a company's outstanding shares are listed on a stock exchange without an underwritten offering. A direct listing is structured as a resale of securities held by existing shareholders rather than a primary offering of new shares. In a direct listing, prospective purchasers are able to buy shares directly from any willing existing shareholder looking to sell after listing. In this way, there is no fixed, predetermined number of shares available for sale, and there is no initial public offering price.

Prior to February 2018 when the amended stock exchange rules took effect, companies that qualified under then-existing stock exchange rules for direct listings could become a reporting company by filing a registration statement on Form 10 under the Securities Exchange Act of 1934 or on Form S-1 (or Form F-1 for foreign private issuers) under the Securities Act of 1933 and simultaneously list its shares on a stock exchange. This approach has been used by a handful of companies over the past 15 years.¹ However, stock exchange rules limited the ability of companies to utilize this method to go public, particularly if they did not already have an established trading market in their stock. Under the amended stock exchange rules utilized by Spotify and Slack, a company without an established trading market can pursue a direct listing if it meets certain conditions. Under these rules, a company must file a registration statement on Form S-1 (or Form F-1 for foreign private issuers), which is the same form used by companies pursuing a traditional IPO. The amended stock exchange rules, described in more detail below, may

open the door for other companies looking to go public without an IPO.

B. Considerations

While a direct listing offers an alternative to the traditional IPO, there are various similarities and differences to an IPO that must be weighed. Some of these considerations include: (1) whether a company needs to raise capital; (2) the diversity of the existing shareholder base and its willingness to sell; (3) the benefits of a traditional and targeted marketing campaign to typical IPO investors; (4) whether the company will benefit from traditional book-building and stock allocation in a traditional IPO in contrast to dispersed buyers and sellers of existing company stock; (5) the existing public profile of the company and the benefits of, or need for, an extensive equity research analyst education process, as utilized in a traditional IPO; and (6) fees and transactions costs. Generally, companies that are mature and well-capitalized appear to be better candidates for a direct listing, as they do not need to rely on the capital-raising feature of an IPO and have a known business model and existing investor base to support trading upon listing. While there are other factors and facets to consider, this inquiry will depend on the company, its goals, and its ability to navigate either process.

II. RULES AND REQUIREMENTS

This section outlines the qualifications under the listing rules, the necessary filings with the Securities and Exchange Commission, or SEC, and the disclosure required under the applicable rules and regulations.

A. Stock Exchange Rules

Prior to February 2018, the ability to list private companies not previously registered with the SEC was limited. Prior to amendment of the New York Stock Exchange ("NYSE") and Nasdaq listing rules at that time, the only way a prospective company could directly list was by demonstrating \$100 million aggregate market value of publicly held shares based on both an independent third-party valuation and the most recent trading price for the company's shares in a private

¹ See, e.g., Coleman Cable, Inc., Prospectus, Reg. No. 333-138750 (filed Mar. 2, 2007); Maiden Holdings, Ltd., Prospectus, Reg. No. 333-146137 (filed May 6, 2008); Mustang Bio, Inc., Form 10-12G Registration Statement (effective Oct. 24, 2016); Orion Marine Group, Inc., Prospectus, Reg. No. 333-145588 (filed Dec. 20, 2007); Rosetta Resources Inc., Prospectus, Reg. No. 333-128888 (filed Feb. 13, 2006).

placement market.² Under the then-existing stock exchange rules for a direct listing, the trading price of the company required a sustained trading history in a private placement market over a multiple-month period, which foreclosed the direct listing option for many companies that did not have an established private placement market, including Spotify. In 2017, the NYSE began the formal rule filing process with the SEC to permit direct listings for companies like Spotify, which lacked the sustained trading activity in a private placement market.³ The Nasdaq followed with a similar proposal.⁴

The amended NYSE rules were approved by the SEC in February 2018,⁵ and amended Nasdaq rules implementing a similar change followed in concert.⁶ The new rules provide an exception to the private placement market trading requirement for companies looking to list on the NYSE⁷ or Nasdaq⁸ that have an independent third-party valuation of at least \$250 million aggregate market value of publicly held shares. The Nasdaq rule amendments outline the role of the financial advisor in a direct listing with respect to liaising with the stock exchange and determining the opening trading price.⁹ The NYSE changes also require that the company use a financial advisor in consultation with the NYSE's designated market maker in determining the opening trading price.¹⁰ Companies are still required to qualify under distribution

requirements,¹¹ price requirements,¹² one of the financial standard tests set forth in the listing rules,¹³ and other corporate governance requirements. Subsequently, the SEC approved Nasdaq rule changes to allow direct listings on the Nasdaq Global Market and Nasdaq Capital Market exchanges, where previously direct listings were only permitted on the Nasdaq Global Select Market.¹⁴

B. SEC Requirements

To publicly list its shares for the first time, a company can register under the Exchange Act or the Securities Act. Generally, a company must register under the Securities Act if the transaction being registered involves an offering and sale of securities, and can register under the Exchange Act if the relevant transaction does not involve an offering and sale of securities. The liability regime under the U.S. federal securities laws is stricter for Securities Act registrations as compared with Exchange Act registrations.

Under the Securities Act, a company will use Form S-1 (or Form F-1 for foreign private issuers) to register a certain number of a class of securities, typically for a public sale and distribution. Section 11 liability applies to any untrue statement of material fact or material omission in a Securities Act registration statement,¹⁵ and Section 12(a)(2) liability applies to any untrue statement of material fact or material omission in a prospectus or

² *NYSE Listed Company Manual*, at § 102.01B (amended Oct. 18, 2012); *Nasdaq Listing Rules*, Rule 5315 (amended Apr. 1, 2011).

³ New York Stock Exchange LLC, File No. SR-2017-30, June 13, 2017, <https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-filings/filings/2017/NYSE-2017-30.pdf> (proposing to amend footnote E to § 102.01B of the NYSE Listed Company Manual and Rules 15, 104 and 123D).

⁴ The Nasdaq Stock Market LLC, File No. SR-2019-001, Jan. 25, 2019, <http://nasdaq.cchwallstreet.com/Nasdaq/pdf/nasdaq-filings/2019/SR-Nasdaq-2019-001.pdf> (proposing modifications to certain provisions of the listing process for direct listings).

⁵ Rel. No. 34-82627 (2018).

⁶ Rel. No. 34-85156 (2018).

⁷ *NYSE Listed Company Manual*, at § 102.01B(E) (amended Feb. 2, 2018) [hereinafter *NYSE LCM*]; *NYSE Rules*, Rule 15(c), Rule 104(a)(2), Rule 123D(d) (amended Feb. 2, 2018).

⁸ *Nasdaq Listing Rules*, Rule IM-5315-1 (adopted Feb. 13, 2019).

⁹ *Nasdaq Listing Rules*, Rule 4753 (amended Feb. 13, 2019).

¹⁰ *NYSE Rules*, Rule 104(a)(2) (amended Feb. 2, 2018).

¹¹ *NYSE LCM*, at § 102.01A (retaining the requirement of 400 beneficial holders of round lots of 100 shares under the new direct listing rule); *Nasdaq Listing Rules*, Rule 5505(a)(3) (amended July 5, 2019); Rel. No. 34-86314 (2019) (amending the requirement on the Nasdaq Capital Market exchange as of August 2019 to 300 round lot holders for listing, with at least half of the minimum required number of round lot holders, each holding unrestricted securities of at least \$2,500).

¹² *NYSE LCM*, at § 102.01B (requiring an offering price of at least \$4 at the time of initial listing); *Nasdaq Listing Rules*, Rule 5505(a)(1) (requiring a minimum bid price per share upon initial listing).

¹³ *NYSE LCM*, at § 102.01C (outlining the financial standard tests a company must meet to list on the NYSE, such as the "Earnings Test" or "Global Market Capitalization Test"); *Nasdaq Listing Rules*, Rule 5315(f) (outlining the financial standard tests a company must meet to list on the Nasdaq, such as the test for earnings, capitalization with cash flow, capitalization with revenue or assets with equity).

¹⁴ Rel. No. 34-87648 (2019).

¹⁵ 15 U.S.C. § 77k.

oral communication in connection with the offer or sale of securities.¹⁶ Subsequently, the company can register common stock under the Exchange Act by filing a short-form registration statement on Form 8-A.¹⁷

Under the Exchange Act, a company will use Form 10 to register a class of securities pursuant to Section 12(b) or Section 12(g) of the Exchange Act.¹⁸ While Form 10 does not carry Securities Act liability and there are no “gun-jumping” issues,¹⁹ there is still liability for material false or misleading statements or omissions in connection with the purchase or sale of securities under Section 10(b) of the Exchange Act (and SEC Rule 10b-5).²⁰

Prior to the amended listing rules, companies going public through a direct listing could file a registration on Form 10 to become a reporting company under the Exchange Act. Under this approach, no specific resale offering transaction is registered. A company utilizing the stock exchanges’ revised direct listing rules must file on Form S-1 (or Form F-1 for foreign private issuers), taking the form of a resale registration statement.²¹ As noted in public comments to the NYSE’s proposal, the decision to remove the provision allowing a company to list upon effectiveness of an Exchange Act registration statement ensured that a company would need to adhere to the traditional review and comment process, as well as gun-jumping and Securities Act liability considerations.²²

Additionally, a Securities Act resale registration statement ensures that all existing shareholders — to the

extent all shares and selling shareholders are listed in the registration statement — can sell their shares on the first day of trading, as Form S-1 registers the resale of all shares that are not otherwise already freely tradeable under Rule 144 of the Securities Act.²³ Rule 144 provides an exemption from registration under the Securities Act, where the public resale of restricted securities is permitted by holders that meet a number of conditions.²⁴ Without registration under the Securities Act, under the Rule 144 safe harbor, affiliates and other holders of restricted stock could otherwise be subject to a delay before they can sell. Subsequently, a company conducting a direct listing will generally deregister the Form S-1 (or Form F-1) after 90 days.²⁵ This window represents the relevant length of time for a company to be deemed a reporting company under Rule 144.²⁶ When no longer reselling under the resale registration statement, selling stockholders are no longer subject to its attendant Securities Act liabilities.

C. Disclosure Differences

While there have only been a few direct listings in the manner of Spotify and the rules and practice of disclosure are not definitively settled, registration statements in a direct listing are in most respects substantially similar to that of an underwritten IPO. Additionally, the confidential filing and SEC staff review rules that apply to traditional IPOs also apply to direct listings on Form S-1. In a Securities Act direct listing resale registration statement, the sections and topics largely align with that of a traditional IPO, with differences in disclosure intrinsic to the direct listing format. To begin, there is no pre-determined number of shares to be sold and specified to be registered in a direct listing. The company will generally look to register shares that are not otherwise freely tradeable under Rule 144. Accordingly, Spotify and Slack had sections of their respective prospectuses listing the registered holders (or categories of registered holders) of existing stock, with qualifications that such holders may or may not elect to sell their stock.²⁷

¹⁶ 15 U.S.C. § 77l.

¹⁷ 17 CFR § 249.208a.

¹⁸ 15 U.S.C. § 78l(b), (g).

¹⁹ U.S. Securities and Exchange Commission, *Quiet Period*, Fast Answers, <https://www.sec.gov/fast-answers/answersquiet.htm.html> (last modified May 18, 2017) (outlining that federal securities laws limit what information a company can release to the public before the registration of an initial public offering has been approved by the SEC).

²⁰ 15 U.S.C. § 78j(b); 17 CFR § 240.10b-5.

²¹ *Supra*, note 5, at 3 n.11 (amending the proposal to eliminate proposed changes to Footnote (E) of Rule 102.01B that would have allowed a company to list immediately upon effectiveness of an Exchange Act registration statement only).

²² Jeffrey P. Mahoney, Council of Institutional Investors, Comment to File No. SR-NYSE-2017-30, February 22, 2018, <https://www.sec.gov/comments/sr-nyse-2017-30/nyse201730-3128154-161930.pdf>.

²³ 17 CFR § 230.144.

²⁴ *Id.*

²⁵ Spotify Technology S.A., Post-Effective Amendment No. 1 to Form F-1 (filed June 20, 2018); Slack Technologies, Inc., Post-Effective Amendment No. 1 to Form S-1 (filed Sept. 5, 2019).

²⁶ *Supra*, note 23.

²⁷ 17 CFR § 229.507; Spotify Technology S.A., Prospectus, Reg. No. 333-223300 (filed Apr. 3, 2018), at 147-149 [hereinafter *Spotify Prospectus*]; Slack Technologies, Inc., Prospectus, Reg.

Another key difference are the sections and provisions relating to pricing. In a direct listing, pricing is not pre-determined and there is no price range on the cover of the “red herring” preliminary prospectus. The cover page of the preliminary prospectus will instead outline how the opening public price will be determined, with disclosure in the prospectus discussing how the opening price is determined by buy-and-sell orders collected by the stock exchange from broker-dealers and how the market for the sales will open.²⁸ Some relevant details may include the recent high and low private transaction sales prices for the company’s stock.²⁹ In the direct listings for Spotify and Slack, the stock exchange reference price and opening price were not determined until after the registration statement was declared effective. In this instance, reference prices are tied to recent private secondary trades and serve only as a guidepost for the public.

Relatedly, the risk factors may also need to disclose that the opening price may have little correlation with historical sales prices of the company’s stock.³⁰ Other risk factors may also need to cover the various unique features of a direct listing, including the interaction of financial advisors with the stock exchange or its designated market maker, uncertainties relating to the listing process, and the potential volatility of trading volume and price of shares.³¹ During the Spotify comment process, the SEC also noted that differences between a traditional IPO and a direct listing should be adequately disclosed, including the lack of lock-up agreements, lack of “book-building,” risk of fluctuations in trading prices following initial listing, and lack of safeguards of a traditional underwritten IPO process.³² While direct listings of this nature are few, the related

SEC comment letters serve as a yardstick for the types of items specific to a direct listing that may be necessary to disclose.

The plan of distribution is also relevant to a resale registration statement, though it will differ from a traditional IPO. It will outline that shareholders may sell their shares, rather than list the underwriter syndicate and the number of shares to be sold.³³ The SEC has also commented that this section should detail the procedures that apply to determining the opening trading price on the stock exchange and how buy-and-sell orders are assessed without a traditional pricing range.³⁴ In a direct listing, the plan of distribution section will further contrast the role of financial advisors with the role of investment banks in an underwritten IPO.³⁵ Because there is no underwriting, the limited role of financial advisors is carefully depicted in this way.³⁶

Financial advisors also play an important role in the preparation of filings and the process of listing. The names of financial advisors, their arrangements with the company, and any compensation afforded to such advisors are generally required to be disclosed in the prospectus.³⁷ Furthermore, if financial advisors are involved in advising existing shareholders, such role should also be disclosed.³⁸ However, there is no offering to underwrite and the role of financial advisors is therefore more limited than in a traditional IPO. In a traditional IPO, underwriting compensation is required to be disclosed.³⁹ Generally in a prospectus, underwriting discounts and commissions are listed on the cover and additional underwriting compensation is listed in the “Underwriting” section. In a resale registration statement in a direct listing, any financial

footnote continued from previous page...

No. 333-231041 (filed June 20, 2019), at 151-155 [hereinafter *Slack Prospectus*].

²⁸ Spotify Technology S.A., SEC Comment Letter on Draft Registration Statement on Form F-1 (Jan. 17, 2018), at 2 [hereinafter *Spotify January Comment Letter*]; Slack Technologies, Inc., SEC Comment Letter on Draft Registration Statement on Form S-1 (Mar. 1, 2019), at 2 [hereinafter *Slack March Comment Letter*].

²⁹ Slack March Comment Letter, at 5.

³⁰ Spotify January Comment Letter, at 2.

³¹ See generally Spotify January Comment Letter; Slack March Comment Letter.

³² Spotify January Comment Letter, at 2, 3.

³³ Spotify Prospectus, at 185-186; Slack Prospectus, at 169-170.

³⁴ Spotify January Comment Letter, at 6.

³⁵ *Supra*, note 33.

³⁶ *Id.*

³⁷ Spotify January Comment Letter, at 6, 7; Spotify Technology S.A., SEC Comment Letter on Draft Registration Statement on Form F-1 (Feb. 15, 2018), at 4.

³⁸ Spotify January Comment Letter, at 7.

³⁹ 17 CFR § 229.508(e); Financial Industry Regulatory Authority, Corporate Financing Rule — Underwriting Terms and Arrangements, Rule 5110(b).

advisory fee may instead be listed in a separate section covering other expenses of the listing.⁴⁰

III. PROCEDURES AND PLAYERS

Similar to a traditional IPO, various stakeholders and role-players are involved in preparation of filings, interfacing with the stock exchange, discovery of the stock price, and handling of the process generally. In a direct listing, the company, investment banks, early investors, and prospective stockholders shape the process in a way that is unique to the format, despite many similarities with that of a traditional IPO. Though the components — such as registration, investor education, opening, and trading — are familiar, the when and how of each step may differ.

A. Preparation of Materials

In an IPO or direct listing, the company is tasked with preparing the prospectus. Many actors assist or guide the company in this task, including investment banks, lawyers, auditors, and other advisors, as well as the SEC through its comment process. Additionally, the content and timing of the registration statement is dictated by the structure and objectives of a direct listing.

The role of lawyers in a direct listing is largely consistent with that of an IPO, where lawyers help manage the process, draft the prospectus, and guide the registration and listing process. The auditors also play the same role, where their audit of financial statements and review of interim financial statements track that of an IPO. Because there is no underwritten offering in a direct listing, there are no underwriters, but investment banks serve as financial advisors. Like an IPO, investment banks typically help draft and review the prospectus, assist in drafting materials to be presented to potential investors, and generally conduct a due diligence process similar to an IPO. However, because of the direct listing format and the lack of offering, their role is somewhat limited or reshaped.

One point of note in the role of financial advisors is the lack of a “roadshow” in a direct listing. In a traditional IPO, the company will go “on the road” with the underwriters to meet with potential institutional investors and market the company’s story. The underwriters will also facilitate orders to purchase shares and “build the book” for the offering, which describes

the underwriters’ process for assessing and recording investor demand. In a direct listing, there is no underwritten offering, and shares to be sold and purchased are determined by individual holders. With no underwritten offering and no book to build, investment banks do not play a direct role in soliciting interest or assessing aggregate demand. Unlike an underwritten IPO where equity investor outreach is conducted through the investment banks, investor outreach is conducted internally through the company, with investor relations and senior management at the company taking a primary role. Spotify and Slack both conducted an online and public “investor day,” which served a similar function to a roadshow in educating existing and prospective investors.⁴¹ Investment banks may provide assistance in preparing the content, but the banks cannot and do not run the outreach and investor education process.⁴²

While the registration statement is prepared with the help of financial advisors, the role of financial advisors is clearly delineated in such filing so as not to construe the investment banks as underwriters. As discussed in the previous section, the role of arrangement with and any fees awarded to financial advisors will likely be disclosed in the resale registration statement.

The timing of the registration statement is unique. In the case of Spotify and Slack, the resale registration statement went effective over a week prior to opening for trading.⁴³ During this pre-listing period between effectiveness and trading, each company issued public financial guidance and financial outlook information to potential investors.⁴⁴ Historically, public guidance is

⁴⁰ Spotify Prospectus, at 187; Slack Prospectus, at 75; Slack Technologies, Inc., Form S-1 Registration Statement (effective June 7, 2019), at II-1.

⁴¹ Spotify Technology S.A., *Investor Day — March 2018*, Mar. 15, 2018, <https://investors.spotify.com/events/investor-day-march-2018/default.aspx>; Slack Technologies, Inc., *Investor Day*, May 13, 2019, https://www.youtube.com/watch?v=KHNQeFpsYdY&feature=emb_logo.

⁴² Spotify Technology S.A., SEC No-Action Letter (Mar. 23, 2018), <https://www.sec.gov/divisions/marketreg/mr-noaction/2018/spotify-technology-032318-regm.pdf>, at 3-4.

⁴³ Spotify Technology S.A., Notice of Effectiveness, File No. 333-223300 (Mar. 23, 2018); Spotify Prospectus; Slack Technologies, Inc., Notice of Effectiveness, File No. 333-231041 (June 7, 2019); Slack Prospectus.

⁴⁴ Spotify Technology S.A., *Spotify Technology S.A. Releases Financial Outlook for First Quarter and Fiscal Year 2018* (Form 6-K) (Mar. 26, 2018); Slack Technologies, Inc., *Slack Announces First Quarter Fiscal Year 2020 Results, Second Quarter Fiscal Year 2020 Guidance and Fiscal Year 2020 Full Year Guidance* (Form 8-K) (June 10, 2019).

unusual in an IPO due to liability concerns.⁴⁵ Public companies are not required to provide investors with projections of future operating results, but the decision to provide guidance to the market and the extent of such guidance is an individual one. In a direct listing, where outreach is conducted by the company to existing and prospective holders looking to sell or buy, the companies aim to inform investors in the lead-up to listing so they can assess whether and how much to sell or purchase. In the case of Spotify and Slack, the outlook information was not filed on a free writing prospectus and was not incorporated into the prospectus.⁴⁶

B. Pricing

The direct listing process and stock exchange rules also contain unique features and role-players. Companies qualifying under the revised stock exchange direct listing rules must get a third-party valuation of aggregate market value of shares, which valuation is typically provided by an investment bank that qualifies under the stock exchange parameters.⁴⁷ Furthermore, in a traditional IPO, the stabilization agent has control over opening the stock for trading.⁴⁸ In a direct listing, there is no underwritten offering and no stabilization agent. Under Nasdaq rules, a lead financial advisor is appointed by the company to liaise with the exchange and open the stock for trading.⁴⁹ Under the NYSE rules, this role is carried out by a lead financial advisor indirectly through the NYSE's designated market maker.⁵⁰

As previously discussed, there is no roadshow run by investment banks in connection with a direct listing. In an IPO, underwriters solicit indications of interest from investors and “build a book” during the roadshow. This allows the underwriters and the company to evaluate the aggregate demand for the offering from the submitted bids in order to set the IPO price. The price range, found on the cover of the red herring prospectus, aims to cover where the IPO price based on the “book-building”

process will land.⁵¹ In contrast, a direct listing's price is set by buy-and-sell orders from individual investors. Because the investment banks do not participate in book-building, pricing a direct listing is characterized by its greater uncertainty and very different process.

In an IPO, the price and number of shares to be sold are determined the day prior to the first day of trading on the stock exchange.⁵² The IPO price serves as a reference price, but the opening price on the stock exchange is set via an opening auction that is similar to a direct listing opening. In an IPO, this price is often set at a level that is expected to result in a moderate “pop” — an increase in stock price on the first day of trading. In a direct listing, the financial advisors assist in setting a reference price, but this price is generally tied to recent private secondary trades in the company's stock and, as noted, serves only as a guidepost for the public.⁵³ The stock exchange reference price is determined on the day prior to the first day of trading on the exchange.⁵⁴ This occurs after the registration statement is declared effective in the direct listing process, so such price is not disclosed in the registration statement. Disclosure in the preliminary prospectus cautions that the trading price may have no correlation to any price range indications or the reference price.⁵⁵ The opening price is determined by buy-and-sell orders collected by the stock exchange from broker-dealers, which correlates with the opening auction in an IPO, but the number of shares to be sold is not fixed. Because selling shareholders are selling directly into the market, there is no risk of losing out on a potential “pop” in price, as with an IPO. Financial advisors may also work with existing holders preparing

⁴⁵ 15 U.S. Code § 78u-4 (detailing that the Private Securities Litigation Reform Act of 1995 “safe harbor” for certain types of forward-looking statements does not protect forward-looking statements made in connection with an IPO).

⁴⁶ See generally Spotify Prospectus; Slack Prospectus.

⁴⁷ *Supra*, note 7; *supra*, note 8.

⁴⁸ NYSE, *NYSE IPO Guide*, Second Edition (2013), https://www.nyse.com/publicdocs/nyse/listing/nyse_ipo_guide.pdf, at 42.

⁴⁹ *Supra*, note 9.

⁵⁰ *Supra*, note 10.

⁵¹ 17 CFR § 229.501(b)(3).

⁵² *Supra*, note 48.

⁵³ *Supra*, note 9; *supra*, note 10.

⁵⁴ Ankit Ajmera, *Slack reference price for direct listing set at \$26/share*, REUTERS (June 19, 2019), <https://www.reuters.com/article/us-slack-listing-reference-price/slack-reference-price-for-direct-listing-set-at-26-share-idUSKCN1TK31V> (announcing the reference price for Slack shares on June 19, 2019, with listing to occur on June 20, 2019); Stephen Nellis, *NYSE sets Spotify reference price at \$132*, REUTERS (Apr. 2, 2018), <https://www.reuters.com/article/us-spotify-ipo-price/nyse-sets-spotify-reference-price-at-132-idUSKCN1HA06A> (accounting the reference price for Spotify shares on Apr. 2, 2018, with the expected start of trading to occur on Apr. 3, 2018).

⁵⁵ *Supra*, note 30.

for sale, and such any such role should be disclosed in the prospectus.⁵⁶

Once the auction has commenced on the morning of trading and the demand size and price start to emerge, buyers and sellers adjust orders throughout the morning. Once an equilibrium is reached, the designated market maker (either the company's lead financial advisor or the NYSE designated market maker in consultation with the company's financial advisor) will open the stock for trading. In an IPO, the underwriters are given the capability to stabilize the price through a "greenshoe" or over-allotment option, which allows them to sell up to 15% more shares than initially offered.⁵⁷ If the stock rises, the underwriters can cover the 15% short position by exercising the greenshoe, and if the stock falls, the underwriters will buy back the 15% in the market, adding demand to the post-IPO trading.⁵⁸ In a direct listing, there is no underwritten offering, so there is no mechanism by which the investment banks can stabilize the price once the stock is opened for trading. The potential for resulting volatility is one of many features that distinguishes direct listings from the traditional IPO.

IV. RECENT DEVELOPMENTS AND OUTLOOK

A. Additional NYSE Proposed Rules

One of the main drawbacks of a direct listing is the inability to raise capital when going public. Currently, the direct listing process only permits the resale of existing shares by shareholders, not the offering of new shares by the company. On November 26, 2019, the NYSE proposed changes to the rules that would allow companies conducting a direct listing to concurrently raise capital through the public markets upon listing.⁵⁹ The proposal would have allowed a company to sell shares on its own behalf in an opening auction upon direct listing, without an underwritten public offering.⁶⁰ It also addressed the \$250 million market valuation requirement and proposed that companies that don't

meet this requirement before listing could instead qualify if they sell at least \$250 million in market value of shares in the opening auction on the first day of trading.⁶¹ Further, it proposed to delay the 400 round lot shareholder requirement until 90 days after the listing date.⁶²

On December 6, 2019, the SEC rejected this request to amend the direct listing rules to permit a capital raise at listing.⁶³ While the SEC did not provide details on this rejection, there are likely a few reasons for hesitation. Under the NYSE proposal, investors in a direct listing would be unaware of the price and dilutive effect of the offering. In a traditional IPO, the price and number of shares for sale are fixed, and there is limited ability to price above or below the range or to upsize or downsize the offering. In an open auction as described in the NYSE proposal, the company would be able to opportunistically increase or decrease shares at the opening price with limited disclosure or advance warning to investors. Additionally, the SEC may want to limit availability of direct listings to mature larger companies looking to provide liquidity to existing shareholders, in contrast to companies that need to raise capital, who can still pursue a traditional public offering to accomplish such goals.

On December 11, 2019, the NYSE resubmitted its proposal, with amendments to enable a company to meet the requirements for listing if (1) the company sells at least \$100 million (instead of \$250 million) in market value of shares in the opening auction on the first day of trading or (2) the company attains a minimum aggregate value of \$100 million based upon the market value of the shares sold in such opening auction.⁶⁴ The proposal otherwise reiterated the initial proposal, including the request for capital-raising abilities and the grace period for the round lot holder requirement.⁶⁵ This proposal is still under consideration.

⁵⁶ *Supra*, note 38.

⁵⁷ U.S. Securities and Exchange Commission, *Excerpt from Current Issues and Rulemaking Projects Outline*, Nov. 14, 2000 (last visited Apr. 13, 2020), https://www.sec.gov/divisions/corpfin/guidance/ci111400ex_regs-k_sss.htm.

⁵⁸ 17 CFR § 242.104.

⁵⁹ New York Stock Exchange LLC, File No. SR-2019-67, Nov. 26, 2019, <https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-filings/filings/2019/SR-NYSE-2019-67.pdf>.

⁶⁰ *Id.*, at 4.

⁶¹ *Id.*, at 4-5.

⁶² *Id.*, at 5.

⁶³ Joshua Franklin, *SEC rejects NYSE's proposal on U.S. direct listings*, REUTERS (Dec. 6, 2019), <https://www.reuters.com/article/us-sec-directlistings-nyse/sec-rejects-nyse-proposal-on-u-s-direct-listings-idUSKBN1YA2BM>.

⁶⁴ New York Stock Exchange LLC, File No. SR-2019-67, Dec. 11, 2019, <https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-filings/filings/2019/SR-NYSE-2019-67,%20Re-file.pdf>.

⁶⁵ *Id.*

The field of direct listings is still evolving, and potential participants must weigh the advantages and disadvantages of the current process, as well as amendment activity from the stock exchanges. Presently, companies that are more mature and well-capitalized are best equipped for a direct listing. Though recent proposals from the NYSE aim to expand the pool of candidates to companies that want to raise capital or have fewer shareholders, such requests are currently unresolved after the SEC's initial rejection. The direct listing option has been infrequently used, but is gaining traction for companies looking to curb the cost and burden of going public. It is yet to be seen whether direct listings will be a viable competitor to the traditional IPO, but reducing transaction costs and process hurdles will assuredly remain a focus going forward.

B. Slack Direct Listing Litigation

The Securities Act liability regime and its application to direct listings is also the subject of recent notable litigation resulting from the Slack direct listing. Following Slack's direct listing, a securities class action was brought against Slack, its directors and officers, and certain large shareholders for alleged material misstatements and omissions in Slack's registration statement and prospectus.⁶⁶ The financial advisors in the Slack direct listing were not named as defendants, so the court did not rule on the question of whether the advisors might have underwriter liability. The defendants moved to dismiss on multiple grounds, including that the plaintiffs did not have standing under Section 11 or Section 12(a)(2) of the Securities Act for their claims and that the plaintiffs would not be able to obtain damages.⁶⁷ The defendants argued, among other things, that (1) to make a claim under Section 11, a plaintiff must be able to prove the purchased shares were bought pursuant to or "traceable" to the registration statement, yet the plaintiffs were unable to do so because the shares sold under Rule 144 were indistinguishable from the shares sold under the resale Form S-1, (2) a plaintiff could not quantify damages under Section 11 because there is no fixed offering price in a direct listing, and (3) the individual defendants (i.e., Slack's directors and officers) were not statutory sellers under Section

12(a)(2).⁶⁸ The Northern District of California denied the defendants' motions to dismiss on such counts.⁶⁹

Historical case law interpreting Section 11 generally requires a plaintiff to "trace" his or her acquired shares to the registration statement in order to make a claim for Section 11 liability.⁷⁰ Section 11 provides that a claim for material misstatements and omissions in a registration statement can only be brought by "any person acquiring such security,"⁷¹ and courts have traditionally held that the "such security" language means that anyone bringing a Section 11 claim must be able to trace their shares back to the registration statement. The structure and mechanics of a traditional IPO make it easier to trace the purchased shares because the newly listed shares following the IPO are generally only those that were offered pursuant to the IPO registration statement. In a traditional IPO, holders of any other existing shares that may be exempt from registration under Rule 144 are typically subject to a 180-day lock-up agreement with the underwriters. In this way, most shares sold in the first 180 days after an IPO are "traceable" to the registration statement. In a direct listing, however, registered shares and unregistered shares that are freely sellable under Rule 144 are both sold immediately into the market and comingled, making it very difficult — if not impossible — to trace whether shares were purchased pursuant to or traceable to the registration statement. While this mixed market could also be present in a traditional IPO, the effect of unregistered shares is limited by the aforementioned lock ups.

In *Slack*, the district court declined to impose a tracing requirement and remarked that applying a tracing requirement in the context of a direct listing would "completely obviate the remedial penalties of Sections 11, 12 and 15."⁷² This approach marks a significant shift from the traditional application in Section 11 securities litigation. The district court noted that direct listings presented a "unique circumstance" where registered shares are "available on the first day simultaneously with shares exempted from registration" and that the "such security" language in Section 11 should be read more

⁶⁶ *Dennee v. Slack Technologies Inc.*, No. 19-cv-05857-SI (N.D. Cal. Apr. 21, 2020) [hereinafter *Slack*].

⁶⁷ Defendants' Notice of Mot. and Mot. to Dismiss, No. 19-cv-05857-SI (filed Nov. 8, 2019).

⁶⁸ *Slack*, at 8, 14, 16.

⁶⁹ *Slack*, at 14, 16, 19.

⁷⁰ 15 U.S.C. § 77k.

⁷¹ *Id.*

⁷² *Slack*, at 13.

broadly.⁷³ Under the court’s ruling, anyone “acquiring a security of the same nature as that issued pursuant to the registration statement” may pursue a Section 11 claim.⁷⁴

Additionally, the district court reasoned that the defendants did not demonstrate that the plaintiff could not recover damages under Section 11 as a matter of law.⁷⁵ The defendants argued that the existence of a price at which a “security was offered to the public” is necessary to make a Section 11 claim.⁷⁶ The district court denied the defendants’ narrow view of the public offering price requirement for calculation of damages and noted that damages are not an element of a Section 11 claim but instead are an affirmative defense.⁷⁷ The court further concluded that the plaintiff may pursue a “value-based theory of damages which is a fact-intensive inquiry and that is not appropriate for resolution at the pleadings stage.”⁷⁸

Further, the district court held that the plaintiffs alleged enough facts sufficient to plead an active

solicitation theory under Section 12(a)(2) against Slack’s directors and officers.⁷⁹ The district court noted that those defendants signed the offering materials, that several of the defendants solicited sales during Slack’s “Investor Day” outreach, and that all defendants were “financially motivated” to solicit such sales.⁸⁰ Due to the factual nature of the solicitation question, the district court agreed that such issue should be left to a jury and denied the defendants’ motion for lack of standing.⁸¹

Because of the complexities related to “tracing,” determining damages, and determining who are “statutory sellers” in a direct listing, many practitioners viewed direct listings as a tougher path for plaintiffs bringing Securities Act liability claims. However, the *Slack* ruling indicates that courts might be more flexible in these areas in order to maintain the potential for liability. The recent orders by the Northern District of California in *Slack* have been appealed to the Ninth Circuit Court of Appeals, so the law is not fully settled in this area.⁸² ■

⁷³ *Slack*, at 13-14.

⁷⁴ *Slack*, at 14.

⁷⁵ *Slack*, at 16.

⁷⁶ *Id.*

⁷⁷ *Slack*, at 15-16.

⁷⁸ *Slack*, at 16.

⁷⁹ *Slack*, at 18-19.

⁸⁰ *Slack*, at 19.

⁸¹ *Id.*

⁸² Defs.’ Notice of Mot. and Mot. to Certify Order for Interlocutory Appeal, No. 19-cv-05857-SI (filed May 5, 2020).

CLE QUESTIONS on Pitts et al., *Direct Listings: Going Public Without an IPO*. Circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one credit for New York lawyers (nontransitional) for this article. Complete the affirmation, evaluation, and type of credit, and return it by e-mail attachment to rscrpubs@yahoo.com. The cost is \$40, which will be billed to your firm. To request financial aid, contact us by e-mail or fax, as provided above.

1. A direct listing is structured as a resale of securities held by existing shareholders rather than a primary offering of new shares. **True** **False**
2. The new NYSE rules approved by the SEC in February 2018 provided an exception to the private placement market trading requirement for companies looking to list on the NYSE that have an independent third-party valuation of at least \$250 million aggregate market value of publicly held shares. **True** **False**
3. A company utilizing the stock exchanges' revised direct listing rules must file on Form S-1, taking the form of a resale registration statement. **True** **False**
4. Because there is no underwritten offering in a direct listing, investment banks play no role in drafting and reviewing the prospectus and other materials to be presented to potential investors. **True** **False**
5. In 2019 the NYSE proposed changes to the rules that would allow companies conducting a direct listing to concurrently raise capital through the public markets upon listing. **True** **False**

A F F I R M A T I O N

_____, Esq., an attorney at law, affirms pursuant to CPLR

[Please Print]

2106 and under penalty of perjury that I have read the above article and have answered the above questions without the assistance of any person.

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