

# Direct Listings: A challenge to traditional IPOs?

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# Agenda

*Direct listings are an alternative to the traditional IPO process and, lately, they have generated much attention.*

- An overview of direct listings
- Documentation requirements for a direct listing
- Current exchange requirements
- The role of the financial adviser and the DMM
- Amendments to the NYSE rules and the direct listing with primary offering
- Concerns raised by commenters in connection with the amendments
- Tracing requirements and securities liability considerations
- Comparison to a traditional IPO
- Comparison to a merger with a SPAC



# Documentation Requirements

# Documentation Requirements

- The issuer must have declared effective a registration statement covering the resale of shares held by the Company's existing shareholders.
- This registration statement will be on a Form S-1 for domestic issuers or on a Form F-1 for foreign private issuers.
- The issuer must also file a Form 8-A for Exchange Act purposes.
- Existing shareholders must deposit their shares through DTC after the effectiveness of the resale registration statement in order to resell their shares on the stock exchange.
- A resale registration on Form S-1/F-1 will contain substantially similar information to that contained in a primary S-1/F-1 (or IPO S-1).
  - A few items will differ such as the price range, the plan of distribution and related selling stockholder disclosures.

# Documentation Requirements *(cont'd)*

- As a result, the drafting process, the diligence process and the process with the auditors in connection with financial statement preparation will be similar.
- The SEC review process also can be expected to be similar to the process undertaken in connection with an IPO registration statement.
- The new SEC confidential review process applies to registration statements filed to register securities under the Exchange Act.
- An issuer that confidentially submits an initial registration statement under Exchange Act Section 12(b) must file it publicly at least 15 days prior to the anticipated effective date of the registration statement.
- Once the registration statement is declared effective, the issuer becomes subject to the Exchange Act reporting requirements as well as corporate governance requirements.

# Documentation Requirements *(cont'd)*

- Generally, there will be no lock-up restriction on existing stockholders although contractual agreements can be reached with holders that would cause them to lock up their shares.
- There will be no traditional post-IPO quiet period.
- An issuer who completes a direct listing may not necessarily benefit from research coverage and will not have the same engagement with research analysts that it would have had in the context of an IPO.



# Documentation Requirements *(cont'd)*

- Companies that are emerging growth companies (EGCs) and smaller reporting companies (SRCs) have scaled-back disclosure requirements under the federal securities laws compared to other filers.
- The disclosure accommodations provided to EGCs and SRCs relate to:
  - Disclosure of executive compensation
  - Compliance with new or revised accounting standards
  - The number of years of financial statements

# Documentation Requirements *(cont'd)*

- Both the NYSE and Nasdaq use independent third party valuations to determine whether a company meets the exchange's quantitative initial listing requirements.
- The valuation must be completed by an independent third party with significant experience in providing such valuations, and must consider, among other factors, the audited annual financial statements and interim quarterly financial statements that will be included in the registration statement.






# The Role of Financial Advisor and the DMM

# The Role of Financial Advisor and DMM


- Financial Advisors in a Direct Listing = Investment Banks
  - Not a syndicate because it's not an underwritten offering
  - But, it's still a group of investment banks because there are multiple financial advisors
- Designated Market Maker (DMM)\*
  - DMMs have obligations to maintain fair and orderly markets for their assigned securities
  - DMMs operate both manually and electronically to facilitate price discovery during market opens, closes, and during periods of trading imbalances or instability
  - Crucial for offering the best prices, dampening volatility, adding liquidity, and enhancing value
  - DMMs apply their market experience and judgment of dynamic trading conditions, macroeconomic news and industry-specific intelligence, to inform their decisions

Source: \*NYSE

# The Role of Financial Advisor and DMM *(cont'd)*

- What is the Financial Advisor **allowed** to do in a direct listing?
  - Help prepare and draft the registration statement
  - Help prepare and draft investor presentations
  - Consult with the DMM with respect to the opening price
  - Provide research (25 days post the direct listing)

# The Role of Financial Advisor and DMM *(cont'd)*

- What can't the Financial Advisor do in a direct listing? 
  - May not plan investor meetings
  - May not participate in investor meetings
  - May not underwrite the offering (no book building process)
  - May not stabilize stock or provide price support
  - After determination of opening price by DMM, limited involvement
  - The Financial Advisors are not “force multipliers” in a direct listing; **THE ONUS FALLS ON COMPANY!**

# The Role of Financial Advisor and DMM *(cont'd)*

- What does the DMM do?
  - DMM is responsible for price discovery
  - DMM publishes “reference price” after close of market on the day before stock starts to trade
  - The “reference price” can be based in part on historical secondary market activity and input from financial advisors
  - DMM establishes the opening price
  - DMM maintains an orderly market for the shares; supply and demand of shares
  - **Key terms:** Reference Price, Opening Price, Day One Closing Price



# Concerns Raised by Amendments



# Concerns Raised by Amendments

- The two SEC Commissioners who dissented (Allison Herren Lee and Caroline A. Crenshaw) and certain investor protection groups have issued statements expressing concern that, because of the absence of traditional underwriters, the primary direct listing process will lack a key gatekeeper present in traditional IPOs that helps prevent poorly run or fraudulent companies from going public.
- These two dissenting Commissioners suggest that guidance as to what may trigger status as a statutory underwriter should have been considered and concurrently provided.



# Tracing Requirements and Securities Liability

# Tracing Requirements and Securities Liability

- Primary direct listings could exacerbate existing challenges investors face in recovering losses for false or inaccurate statements made in public offerings.
- Generally, in order to assert claims under Section 11 of the Securities Act, plaintiffs are required to “trace” their purchases to a registration statement.
- In April 2020, in a case of first impression, this presumption regarding the tracing requirement for Section 11 claims in a case involving a direct listing was dispensed with as it would lead to a result that was at variance with the policy objective of the legislation.

# Tracing Requirements and Securities Liability *(cont'd)*

- The SEC noted that:
  - *"...concerns regarding shareholders' ability to pursue claims pursuant to Section 11 of the Securities Act due to traceability issues are not exclusive to nor necessarily inherent in Primary Direct Floor Listings. Rather, this issue is potentially implicated anytime securities that are not the subject of a recently effective registration statement trade in the same market as those that are so subject."*



# Comparison to a Traditional IPO

# Comparison to a Traditional IPO

- What is similar?
  - A registration statement
  - SEC review process
  - Quiet period restrictions when “in registration”
  - The Financial Advisors still earning fees



# Comparison to a Traditional IPO *(cont'd)*

- What is different?
  - Usually well-known, brand name companies (but that is changing)
  - No roadshow! Need to educate investors in different ways, such as an investor day that is webcast.
  - Investment banks not setting up meetings; meetings still taking place, just set up directly by company
  - A DL is not underwritten; until trading begins, can't see sellers and buyers
  - No lock-ups (although Palantir did indeed do a lock up)
  - Fees for investment banks could be lower

# Comparison to a Traditional IPO *(cont'd)*

- What is different? Educating the street!
  - No “street model” guidance like in a “regular-way” IPO; all forward looking guidance provided in public domain and in a much more limited fashion. For example, only 1 quarter and 1 year out and only selected financial metrics
  - Investor Education via an investor day; publicly webcast, potentially Q&A from investors
  - Investor Education via an earnings call as a private company; no Q&A or company-generated Q&A
  - 1x1 meetings with sellside research analysts and buy-side analysts and portfolio managers, set up by company. No traditional roadshow
  - Need a more robust IR function before listing given the “direct education” component of Direct Listing
  - Need to be mindful that research will get published

# Comparison to a Traditional IPO *(cont'd)*

- What is different? Price Discovery and the book-building process
  - No pre-listing visibility into buyers and sellers (although a pre-listing capital raise with cross-over investors help with price discovery)
  - There is no book-building; there is effectively zero curation of initial investors. Meaning, there is no “pot-list” of 500+ investors that bought at IPO price
  - Since there is no allocation process, the “mix” of investors may be different; More “long-only” mutual funds and fewer “fast money” hedge funds
  - Since there may not be a “pop” in stock price on day one, may have much more serious investors as page one shareholders; not as many flippers of the stock



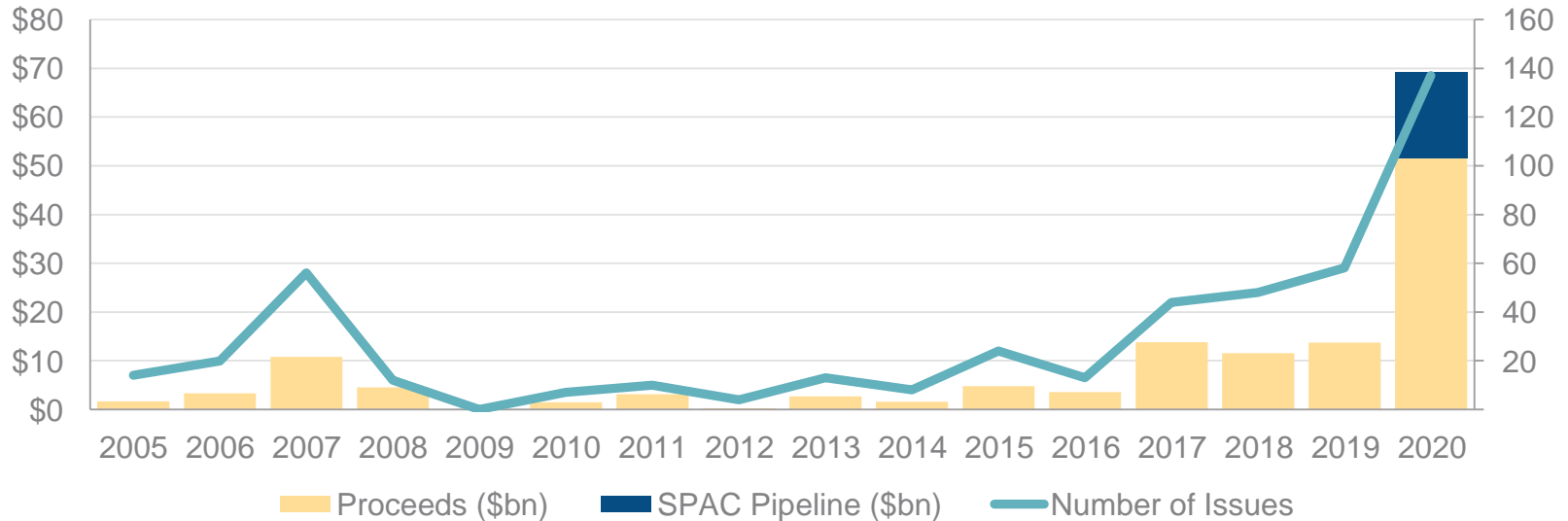
# Comparison to a SPAC Merger

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- What is a Special Purpose Acquisition Company (“SPAC”)?
  - Newly formed company with no assets or operations
  - Registers with the SEC the offer and sale of stock and warrants
  - Business plan: Find an operating company to buy using IPO proceeds
  - May or may not specify industry or geographic focus
  - Must identify a target company to acquire within a specified time frame
- For an operating company, merging with and into a SPAC is an alternative to a traditional IPO
- SPACs have existed for many years, but there has been a recent surge in popularity—this may be explained by several changes:
  - Higher quality sponsors
  - More blue-chip investors
  - Bulge bracket underwriters
  - Better sponsor-investors alignment structures

# Comparison to a SPAC Merger *(cont'd)*

US-listed SPAC volumes rise 275% YOY to all-time high of \$51.5 billion





# Comparison to a SPAC Merger *(cont'd)*

- If SPACs do not complete initial business combination before deadline:
  - Must liquidate their trusts
  - Redeem their investors (plus interest)
  - Founder's shares not redeemed for cash upon liquidation
- Therefore, sponsors incentivized to find suitable target
- Process of acquiring private company target called "de-SPACing"
- Investors may redeem regardless of vote for or against transaction
- Investors may hold warrants even if they redeem common stock
- Unlike traditional mergers, reverse break-up fees are rare
- After merger, target operating company is surviving public company

# Comparison to a SPAC Merger *(cont'd)*

- SPAC must file proxy statement on Schedule 14A
  - If SPAC intends to register new securities as part of transaction, SPAC must also file a proxy/prospectus on Form S-4 (or F-4)
  - The continuing company may be able to qualify as a foreign private issuer (FPI)
- Proxy statement or proxy/prospectus statement must contain:
  - Financial statements of SPAC, target, and any businesses, if any, acquired by target
  - Description of post-transaction company and its management, directors, governance structure, and material contracts
  - Pro forma financial information reflecting proposed business combination
  - Management's discussion and analysis for the SPAC and for target
  - Selected historical data of SPAC and target, including pro forma financial data
  - Comparative per share information, including pro forma per share data

# Comparison to a SPAC Merger *(cont'd)*

- Merging with and into a SPAC may be faster
  - However, that will depend on:
    - Nature of negotiations between SPAC and operating company target
    - Shareholder approval process
  - Will also require significant management time and resources
  - Entails negotiation of merger agreement and related ancillary documents
  - Operating company will also be required to prepare required proxy or proxy/prospectus disclosures (similar to what is required for a traditional IPO)
- Going public via SPAC may provide greater certainty
  - Merger consideration and valuation set when merger agreement executed
  - Repricing may be possible due to market volatility or other reasons
  - A SPAC may be willing to undertake a transaction with a company that is earlier stage
- May provide flexibility regarding content and timing of communication
  - Fewer restrictions on business combination discussions

# Comparison to a SPAC Merger *(cont'd)*

- Historically, concern with SPAC sponsor-stockholder interest alignment
- Sponsors typically receive founder's shares for nominal consideration
  - Sponsors may profit even if future acquisition proves unsuccessful
  - Recently, some changes in SPAC structure; for example, Bill Ackman foregoing all founder's shares
- SPACs create short-term arbitrage opportunities
  - SPACs allow investors to keep warrants even if they redeem shares
  - May impede long-term investing
  - SPACs traditionally attract hedge fund investors
- Redemption rights create inherent uncertainty about available funds
  - May mitigate this via issuing additional equity or equity-linked securities
  - Capital-raising transaction may also provide additional capital to grow



# Comparison to a SPAC Merger *(cont'd)*

- The market may not like the proposed initial business combination
  - Post-merger, over 50% of SPACs experienced poor aftermarket performance
  - Over time, this trend may reverse itself, especially with better sponsors
- SPACs may lack investment bank and institutional investor relationships
  - This may hinder equity research coverage and market making of securities
  - Investor outreach may not translate into institutional investor familiarity
- SPACs incur significant costs and the process for the operating company is not cheaper in comparison

# Comparison to a SPAC Merger *(cont'd)*

- A SPAC and a former SPAC will be a shell company for three years post merger
  - Not entitled to use a free writing prospectus
  - Not able to rely on SEC communications safe harbors
  - Not entitled to rely on research safe harbors
  - Not eligible to qualify as a WKSJ
  - Stockholders cannot rely on Rule 144 for one year following merger





## Choose Your Path to Public:

**Direct Listing, now with a capital raise**

In today's world, businesses need even more flexibility and transparency to meet evolving customer, talent and market demands. Going public is a powerfully effective solution to meet those needs but companies no longer need to view an IPO as their only path to public.

That's why the NYSE worked closely with issuers, regulators and the global market community to create the NYSE Direct Listing. In a Direct Listing, the full liquidity of the market values a company on day one without temporary constraints — no reduced allocations or required lockup periods. This uninhibited price discovery reduces the cost of capital and democratizes access and opportunity for all investors.

*Source: NYSE*

# Additional Resources



The Free Writings & Perspectives (FW&Ps) blog provides up to the minute information regarding securities law developments, particularly those related to capital formation.

FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or “late state” private placements, PIPE transactions, IPOs and the IPO market, new financial products, and any other securities related topics that pique our and our readers’ interest.

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## [Primary Direct Listings: A Hybrid Approach to a Traditional IPO Alternative](#)



This legal alert describes primary issuances in connection with a direct listing of a class of the issuer’s equity securities on the exchange.

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