ALERT MEMORANDUM

Spotify's Direct Listing – A Look Under the Hood

April 17, 2018

Spotify finally went public on April 3, following an unusual path known as "direct listing" – the shares started trading on the New York Stock Exchange, without any of the contractual or marketing arrangements that attend a typical IPO. No traditional road show or bookbuilding, no allocations. No one promising to sell, no underwriters promising to buy. The company even declined to ring the opening bell.

It sounds simple, but like streaming music, it turns out to be tricky to implement. Will other issuers and their shareholders consider this model for developing a public trading market? That will depend on how well it serves the interests of the company and its investors, by providing a liquid market, satisfactory price discovery, and potentially acquisition currency. For those that do consider it, this note takes a closer look at the details from a securities lawyer's point of view.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or any of our partners and counsel listed under Capital Markets in the "Our Practice" section of our website.

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1. What Spotify Did

Spotify listed its shares on the NYSE, and they began trading on April 3. But Spotify did not sell any shares, and none of its shareholders committed to do so either. So unlike the usual IPO, there was no underwriting, and no offering of a specified amount of stock at a specified public offering price.

Because there was no underwriting syndicate, there was no overallotment option, no syndicate short position, and no stabilization – mechanisms that tend to support the trading price after an IPO. Nor were there any lockup agreements, which in the usual IPO reduce the potential impact of excess supply or "overhang" on the market price.

2. The Sellers

All that happened on April 3 was that Spotify's shares had a ready market on the NYSE, where anyone could buy them. But who could sell, and how many shares?

- Spotify has one shareholder that has agreed with Spotify to hold onto its shares until 2020 – the Chinese internet giant Tencent, which owns about 9%. The other shareholders have no similar limitations and no lock-ups.

- About 60% of the outstanding shares are held by non-affiliates that have held for at least one year and are free to sell at any time under Rule 144. Those holders were free to sell anyway, and the registration statement made no difference to their legal options, though obviously the listing improved their practical options.

- The remaining shares, about 31% (including about 21% owned by the two founders), are held by affiliates, or by non-affiliates that have not held long enough to sell under Rule 144. All of these shares were registered on Spotify's F-1 resale shelf registration statement, so they could be sold freely into the market as of April 3.

For the shares in this last bucket, any sales would have to conform to the description in the "plan of distribution" disclosure in the prospectus. It says shares can be sold "in brokerage transactions on the NYSE or other public exchanges or registered alternative trading venues" – the language on alternative trading venues was added in the final prospectus, presumably to accommodate dark pools and similar venues. Spotify says it will use reasonable efforts to keep the registration statement effective for 90 days, but after 90 days it plans to withdraw the registration statement (according to a no-action submission to the SEC). So the window for sales under the registration statement is brief, although after 90 days these holders will be able to sell under Rule 144, subject to the usual limitations on volume and manner of sale, and the non-affiliates among them will be able to sell freely if their holding period has run in the meantime. None of these holders has a registration rights agreement.

So when Spotify began trading, about 91% of the shares were available to be sold, but the prospectus was silent on whether any holder actually intended to sell. Some shareholders obviously have sold and no doubt that will continue, but it's unlikely we will know who sold, or whether they did so under the registration statement, at least until the next annual report on Form 20-F. Because Spotify is a foreign private issuer, Section 16 reporting of insider trades does not apply, so there is no requirement of prompt disclosure for insider sales as there would be for a domestic issuer. The buyers of those shares may not know they purchased under the registration statement, because the sales permitted by the plan of distribution will be generally covered by Rule 153, meaning that broker-dealers will not have to deliver a prospectus or a Rule 173 registered sale notice.

3. SEC Registration Process

In order to get its shares listed, Spotify had to register with the SEC. It filed a resale shelf registration statement under the Securities Act of 1933, to permit specifically identified shareholders to sell at any time while the registration statement is effective. As discussed in more detail in point 11 below, the NYSE proposed to amend its rules to SEC to permit a direct listing without Securities Act registration, but it withdrew its proposal apparently at the SEC's request.

Spotify relied on the SEC's confidential review policy, submitting a draft registration statement on December 18, 2017 and an amended draft on January 31, 2018. On February 28, Spotify made the first public filing of its registration statement. (The draft submissions are now publicly available on EDGAR, but the SEC's comment letters won't be available until sometime in May.) Presumably the public filing date was chosen with an eye on Spotify's March 15 Investor Day, based on the SEC's confidential submission policy, which requires a public filing at least 15 days before beginning a road show.

The SEC declared Spotify's registration statement effective on March 23. As in any IPO, Spotify also filed a second, brief registration statement on Form 8-A to register under the Securities Exchange Act of 1934 to permit trading on the NYSE, and that also became effective on March 23.

4. Presenting the Company to Investors

Spotify did not conduct the road show marketing effort customarily associated with an IPO. It did, however, conduct an "Investor Day" on March 15 – a single, two-hour-long live presentation that was live-streamed and then made available on the company's website. This was much like a road show presentation, except for the absence of underwriters, travel, repeat performances and any particular shares for sale. There were other investor education meetings, according to the prospectus, and Spotify also said (in a no-action submission to the SEC, discussed in point 11 below) that it "may engage in potential additional investor education activities … including possible follow-up Investor Days and individual meetings with investors." The company's financial advisors were engaged to help prepare these presentations, but as described below they did not participate in the actual presentations.

The core Investor Day presentation was treated as a free writing prospectus (FWP) that, because it was a road show and was made generally available, was not required to be filed, which is consistent with the usual practice in IPOs. In addition to the core Investor Day presentation, Spotify also posted four additional decks with oral commentary on specific topics. These too were FWPs, but Spotify filed the materials and scripts with the SEC, presumably because they were not presentations by management and accordingly did not meet the SEC's definition of a road show.

5. Role of Investment Banks

No underwriters are needed for a direct listing, but Spotify did engage three investment banks to serve as its financial advisors. Much about the process presumably required extensive advice – in particular, positioning the equity story for the prospectus and the Investor Day, and thinking through the market issues presented by the direct listing approach.

In an IPO, underwriters also participate in marketing the shares to investors, and they conduct bookbuilding – gathering indications of interest at particular price levels in order to arrive at a size and price for the IPO. Here there was no bookbuilding, and the financial advisors apparently investigated demand separately from the issuer's own marketing initiatives described above. The prospectus explicitly stated that, except for consultation on the opening price (discussed in point 9 below), the financial advisors were not "engaged to participate in investor meetings or to otherwise facilitate or coordinate price discover [*sic*] activities or sales of our ordinary shares in consultation with us". And the no-action submission says the engagements "expressly provide that the Financial Advisors will not further assist the Company in the planning of, or actively participate in, investor meetings." This limitation may have been intended in part to support the view that the financial advisors are not underwriters under the Securities Act, and do not have potential liability under Section 11, with respect to all sales under the registration statement.

There was substantial media attention to whether the direct listing threatens the traditional IPO business model, with the associated fees for investment banks. The IPO of a company Spotify's size would have entailed a substantial amount of gross underwriting spread, depending (obviously) on what proportion of the shares was underwritten; of course the underwriters would also have had costs that do not arise in a direct listing, and more important they would have taken risks that do not arise in a direct listing. Spotify's prospectus reported only $35 million in fees for "other advisers," presumably including the financial advisors.

6. Guidance

In one respect, Spotify went beyond what IPO companies usually do. On March 26, Spotify issued a press release providing its financial outlook for the first quarter and full year 2018. By that time, Spotify's registration statement was already effective and it was a reporting company under the Exchange Act, and it furnished the press release to the SEC on Form 6-K. Indeed, the decision to seek effectiveness on March 23 (late on a Friday, 10 days before trading began) may have been related to the desire to issue the outlook on March 26 (early on a Monday).

Spotify did not file the outlook press release as a free writing prospectus or include the outlook disclosure in the prospectus. That approach resembles what seasoned public companies often do – put out guidance in a release that is not incorporated in effective registration statements, and furnish that to the SEC (on an Item 7.01 Form 8-K for a domestic issuer, or a Form 6-K for a foreign issuer). This approach involves determining that the guidance is not a material omission from the prospectus or the registration statement – a reasonably familiar exercise.

The approach also involves determining that publishing the guidance is not an offer, because if it were an offer it would need to be filed as a free writing prospectus. For a seasoned public company that regularly publishes guidance, that conclusion can be easy, among other reasons because of the exemption under Rule 168, which provides that it is not an offer when an issuer that meets specified conditions releases forward-looking information. But it is not clear whether Spotify could meet the condition under Rule 168 that the issuer has previously released or disseminated information of the same type in the ordinary course of its business. Absent the exemption, the conclusion that there is no offer might be more difficult for a first-time publication of guidance just days before an typical IPO.

7. Founder Control

Like many other major tech companies, Spotify's capital structure has a feature to ensure that its founders can continue to control it. The two founders hold 10 voting "beneficiary certificates" for each ordinary share they hold of record, so between them they have about 80% of the total voting power despite having record ownership of only about 21% of the shares. The beneficiary certificates expire upon transfer of the related shares, although the board has discretion to make exceptions and to issue additional beneficiary certificates.

There has been recent criticism of differential voting rights at public companies, coming from some institutional investors, index providers and proxy advisors. At Spotify, all shareholders have voting rights, so it is not as problematic from this perspective as voting/nonvoting structures like Snap. And unlike some dual-class capital structures, the additional voting rights are in effect personal to the founders and would not be exercisable by their transferees or presumably their heirs, and they expire if the founders' record ownership falls below a specified number of shares (representing about 4% of the currently outstanding shares). However, there is no sunset provision, which the Council of Institutional Investors and others have advocated.

8. Foreign Private Issuer Status

Spotify is a Luxembourg company, and it qualifies as a foreign private issuer (FPI) under the SEC's rules, so it filed using the SEC's forms for FPIs, and its financial statements are presented under IFRS and in Euros. Interestingly, it did not take advantage of a major accommodation for FPIs under the SEC's rules: it provided disclosures on executive compensation as if it were a domestic issuer, and the prospectus said it will continue doing so – presumably in the annual report on Form 20-F, since it will not be subject to the proxy rules.

As an FPI, Spotify will be exempt from the requirement to file quarterly reports on Form 10-Q, and the prospectus did not indicate how Spotify plans to handle interim reporting, except for a reference in a risk factor to its intention to "[provide] quarterly financial information to the SEC." It will be interesting to see how fast it publishes quarterly results, and what they include – whether it is just along the lines of an earnings release, or also includes more complete financial statements, notes and MD&A as a 10-Q would require.

Spotify will also be exempt from the event-driven reporting requirements of Form 8-K. It will be required to file current reports on Form 6-K, but Form 6-K filings are generally triggered by required filings in another jurisdiction – based on the paradigm, prevalent when Form 6-K was first adopted, in which an FPI that lists in the United States is typically also listed in some other, home market. Today, for many FPIs with a U.S. listing there is no other listing. Since Spotify is not a reporting company elsewhere, it will have latitude to decide for itself what and how often to file.

Similarly, Spotify will be exempt from the requirements of Regulation 14A relating to proxy solicitations. The prospectus did not suggest that it will solicit proxies for its annual meeting, beyond the publications required by Luxembourg law. Also as mentioned above, because Spotify is an FPI, its insiders will not be subject to Section 16 reporting of their purchases and sales.

9. <u>NYSE Rule Changes (1) – The Opening Price</u>

In June 2017, the NYSE proposed to amend its rules to better accommodate a direct listing. The NYSE amendment process did not explicitly refer to Spotify in particular, but it was widely understood to be prompted by consideration of Spotify's plans. The changes became effective in February 2018, just in time for Spotify to rely on them.

Three elements of the NYSE's rule changes are of particular interest.

First, several changes addressed how to determine the opening trading price, in the absence of underwriters and an IPO price. The key element was the requirement that, unless there is sufficient recent trading in a private placement market, the issuer must engage a financial advisor to work with the NYSE's designated market maker (DMM) to determine the opening price. In the Spotify offering, the financial advisor for this purpose was Morgan Stanley, which also otherwise acted as one of the issuer's financial advisors. The prospectus carefully pointed out that the opening price would not be based on a bookbuilding process or an initial public offering price, but rather on pre-opening buy and sell orders and Morgan Stanley's "understanding of the ownership of our outstanding ordinary shares and pre-listing buying and selling interest in our ordinary shares that it becomes aware of from potential investors and holders."

The prospectus was also careful to specify that the issuer would not be involved in this discussion of the opening price. In language added in its February 2018 filing, and not required by the NYSE rule itself, the prospectus said that the DMM and Morgan Stanley would consult "without coordination with us, consistent with the federal securities laws in connection with our direct listing." It will be interesting to see, when the SEC comment letters become available, whether they prompted the inclusion of that statement.

10. <u>NYSE Rule Changes (2) – Minimum Public Float</u>

A second NYSE rule change addressed how to establish that a company will have a sufficient public float. For an initial listing, NYSE rules require a showing that the public float will exceed $40 million, for an IPO or a spin-off, or $100 million for other companies. But in the absence of underwriters and an IPO price, how should that showing be made?

The previous rule required the NYSE to look to both an independent valuation and recent trading prices in a "Private Placement Market" – defined as "a trading system for unregistered securities operated by a national securities exchange or a registered broker-dealer." The idea of relying on a Private Placement Market dates back to 2008, when Private Placement Markets seemed like they would be the Next Big Thing, because they would provide a venue for the resale of shares in companies that were not ready or not inclined to go public. But they have not flourished, and Spotify – a hot pre-IPO ticket if ever there was one – said in its prospectus that there has not been a recent sustained history of trading its shares in a private placement market.

NYSE's change was to allow a company to rely solely on an independent valuation, in the absence of recent trading in a Private Placement Market, if the independent valuation is at least $250 million.

Those changes relating to determination of the opening price and valuation of the public float were adopted essentially as the NYSE proposed them. But the third change the NYSE proposed was also interesting, and it met a different fate, described in the next section.

11. NYSE Rule Changes (3) – The Imaginary IPO

NYSE eligibility requirements say that generally, the exchange "expects to list companies in connection with a firm commitment underwritten IPO, upon transfer from another market, or pursuant to a spin-off." But they also contemplate the possibility of listing without a related underwritten offering if the company registers, on a Securities Act registration statement, only resales of shares sold in earlier private placements. Oddly, this is contained in a footnote to the NYSE's listing standard on the minimum size of the public float (Rule 102.01B, Note E).

The NYSE proposed in June 2017 to extend this so a company could list upon effectiveness of an Exchange Act registration statement, without any concurrent IPO or Securities Act registration.

On its face, that idea makes a lot of sense. The Exchange Act provides for registration to trade a security on a securities exchange, and obviously an initial listing requires Exchange Act registration. The Securities Act, on the other hand, provides for the registration of offers and sales, and it is entirely possible in an initial listing that no shareholder actually plans to sell, except shareholders who would be eligible to sell without Securities Act registration under Rule 144. Indeed, in the case of Spotify, the prospectus was silent on whether, with respect to the 31% of the shares covered by the registration statement, any of the holders intends to sell.

In September 2017, the SEC issued a release that sought comment specifically on whether the NYSE should allow direct listing without a concurrent Securities Act registration statement. The SEC release asked whether a direct listing, without prior trading and Securities Act registration, would "present unique considerations, including with respect to the role of various distribution participants, the extent and nature of pricing information available to market participants prior to the commencement of trading, and the availability of information indicative of the number of shares that are likely to be made available for sale at the commencement of trading." In December, the NYSE published a revised proposal without this feature.

It seems likely that the SEC required the change, but why would the SEC require that a direct listing be accompanied by Securities Act registration – in effect, that the regulatory process unfold as if there is an IPO even when there is not?

- Distribution. The first possible "unique consideration" the SEC mentioned was "the role of various distribution participants." It is hard to know for sure what the SEC had in mind on this point. As mentioned above, the roles of Spotify's financial advisors were disclosed in the prospectus, but it is not clear that any of them is a distribution participant whose role is required to be disclosed by SEC forms.

  However, the SEC's concern was apparently not disclosure but the role of the issuer. The issuer's role in promoting the development of a trading market for the benefit of its shareholders might suggest that any sales of the shares constitute a distribution, as that term is used under the Securities Act, requiring registration. If that is the concern, however, the result in Spotify's case is something of a half-measure, since only some shares were registered and most potential sellers (including the most probable sellers) were allowed to sell without relying on the registration statement. Several aspects of Spotify's conduct could be viewed as supporting this compromise: in particular, as discussed above, the company distanced itself from the pricing inquiry conducted by its financial advisors, the shareholders' consideration of whether to sell, and the establishment of the opening price.

- Pricing Information. Another "unique consideration" the SEC suggested concerns pricing information available to the market. As Spotify's case illustrates, Securities Act registration only partially addresses this concern. The prospectus included disclosure of (a) pre-IPO trading prices in the private resale market, and (b) the process for establishing the opening price. That disclosure might not have been required under the SEC's forms for Exchange Act registration, although it could presumably have been elicited in the comment process on such a filing.

- Information on Available Shares. Another possible "unique consideration" was the availability of information about the number of shares to be made available for sale when trading starts. Disclosure on who owns the shares, and which are available for sale, is generally required in an Exchange Act registration statement as well as a Securities Act registration statement. But here again, Spotify's case shows that Securities Act registration does nothing to dispel the mystery about whether anyone will actually sell and how much.

- Liability. The prospect of liability risk under the Securities Act, especially for "gatekeepers" like the board of directors, the auditors and the underwriters, is an important source of discipline in the IPO process. Liability risk is greater under Section 11 of the Securities Act than under the Exchange Act, so perhaps this is an argument to require registration in a direct listing. But as Spotify illustrates, there is not necessarily any party that could be described as an underwriter, and in the absence of underwriters, there may not be any party with a persuasive statutory motive to perform due diligence. To complicate matters, the practical risk of a Section 11 claim seems relatively low, since it would be challenging to prove that any given market purchase can be traced to the registration statement, with (a) so many shares available to be sold without using the registration statement and (b) sales under the registration statement generally not requiring delivery of a prospectus or a Rule 173 notice of registered sale. So while participants in a direct listing have plenty of reasons to exercise care in respect of disclosure, it is hard to see a strong argument that additional liability risk from Securities Act registration adds to those reasons.

One consequence of the Securities Act registration is that securities dealers need to consider the restrictions on their activities that may arise from Section 4(a)(3) of the Securities Act and Rule 174, which provide (taking them together and simplifying slightly) that for shares of a newly reporting company, a dealer generally has no exemption for offers and sales of the shares subject to registration until 25 days have passed from the later of the effective date of the registration statement or the first date on which the shares were bona fide offered to the public. As a result, dealers might conclude – as they typically do in an IPO – that if they make a market or otherwise trade in the shares they cannot publish research during that 25-day period. They would also have to consider the scope of their prospectus delivery obligations in connection with sales of the shares, and whether those obligations differ depending on (a) whether the shares are traceable to the registration statement or to sales by non-affiliates under Rule 144 and (b) whether the sales are sold on an exchange (or otherwise directly to a broker or dealer) in a transaction eligible for Rule 153.

Another complication of Securities Act registration is the heightened possibility that a direct listing might be viewed as a distribution for purposes of Regulation M, the prophylactic anti-manipulation rule that limits the market activity of distribution participants. If so, the mechanics of Regulation M's limitations might be unclear. To address this, Spotify obtained a no-action letter from the SEC's Division of Trading and Markets. The submission represented that distribution participants would observe a restricted period of five days prior to the commencement of trading, and the Division replied that it would not seek enforcement action.

In view of the SEC's apparent insistence on Securities Act registration in an NYSE direct listing, it is worth considering whether a direct listing could be effected on Nasdaq without it. There is no requirement to that effect in Nasdaq's rules, and the NYSE's filings for its rule change assert that the NYSE believes Nasdaq would permit a direct listing without Securities Act registration. But after Spotify, it would be paradoxical for the SEC to permit an issuer in similar circumstances to list on Nasdaq without Securities Act registration.

There remain two situations that are essentially equivalent to a direct listing but in which Securities Act registration is not required under NYSE or Nasdaq rules: spin-offs and listing of FPI shares in the form of ADRs. With respect to spin-offs, of course, the SEC has a long-established analysis of the circumstances in which Securities Act registration is and is not required, under Staff Legal Bulletin No. 4 and numerous no-action letters. We have seen no indication that the SEC is inclined to reconsider either of those situations.

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