ALERT MEMORANDUM

Direct Listings 2.0 – Primary Direct Listings

September 10, 2020

In 2018, Spotify's direct listing of its shares for trading on the New York Stock Exchange without a traditional IPO turned decades-old market practice on its head. To take full advantage of this development, financial advisors and interested companies immediately began looking for further enhancements and flexibility. Efforts focused particularly on creating a process that would allow a so-called "primary direct listing," where a company could skip the traditional underwritten IPO and list not only shares for sale by existing stockholders, as Spotify did, but also new shares to be issued and sold directly to investors without the intermediation of an underwriter.

Recent developments at NYSE, Nasdaq and the SEC suggest that a primary direct listing may be closer to happening, although not without a fight over investor protection and liability concerns. This note revisits the process and regulatory changes implemented in the Spotify direct listing, considers Securities Act liability related to direct listings, including a decision of first impression from the Northern District of California, and discusses recent rule amendment proposals at NYSE and Nasdaq to change listing requirements and create opening trade pricing mechanisms to facilitate primary direct listings. Last we consider the SEC process and concerns around direct listings and recent investor efforts to force the SEC to reconsider the implementation of exchange rules changes related to primary direct listings.

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Recap – Secondary Direct Listings – What Spotify Did and Why

The Spotify direct listing facilitated sales by affiliate and non-affiliate shareholders directly on the NYSE with no traditional underwriting. Unlike the typical IPO, there was no offering of a specified amount of stock at a specified public offering price, but instead an opening price was established on the exchange reflecting the balance of buy and sell orders, and then trading commenced.

As further explained below, the SEC required Spotify to file a resale registration statement under the Securities Act of 1933 to permit specifically identified shareholders to sell at any time while the registration statement was effective. This registration included about 31% of the outstanding shares that were held by affiliates or by non-affiliates for whom the Rule 144 holding period had not yet ended. This left about 60% of the outstanding shares held by non-affiliates that were free to sell at any time under Rule 144. Once Spotify's shares were listed, shareholders in this latter group were free to sell on the exchange and the registration statement made no difference to their resale options.[1]

Spotify agreed that it would keep the Securities Act registration effective for at least 90 days so that affiliated shareholders could sell. Thereafter, the registration statement was withdrawn and all shareholders were able to continue to sell under Rule 144, subject to the usual limitations on volume and manner of sale for affiliates.

As noted, no underwriters were needed for execution of the 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 an "Investor Day" presentation, and thinking through the market issues presented by the direct listing approach. The prospectus explicitly stated that, except for consultation on the opening price, 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."

To facilitate trading and present the issuer to the investor community, Spotify conducted an Investor Day in advance of the listing. Much like a traditional road show, the two-hour-long presentation was live-streamed and made available on the company's website, in conjunction with other investor meetings. The company's financial advisors were engaged to help prepare the presentations, but they did not participate in them.

To allow the Spotify listing, important changes had to be made to the applicable listing rules. In February 2018, after rounds of consultation, the SEC approved NYSE-proposed rule changes clearing the path for the direct listing. First, the NYSE's rule 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. As described in the prospectus, the opening price would not be based on a book-building process leading to an initial public offering price, but rather on pre-opening buy and sell orders and the financial advisor's "understanding of the ownership of [the issuer's] outstanding ordinary shares and prelisting buying and selling interest in [the issuer's] ordinary shares that it becomes aware of from potential investors and holders." The issuer would not be involved in this discussion of the opening price: the DMM and the financial advisor would consult "without coordination with [the issuer], consistent with

[1] The remaining 9% of shares were held by a large investor, who agreed to hold on to the shares for two years and were not included in the registration. For further discussion of the mechanics of the Spotify listing, see our Alert "Spotify's Direct Listing – A Look Under the Hood" (April 17, 2018) here.

the federal securities laws in connection with our direct listing."

A second NYSE rule change addressed technical matters of how to establish that a company will have sufficient public float for listing purposes. 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. For purposes of a direct listing, NYSE changed this requirement 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. The rule also clarified that a company would continue to be subject to other listing requirements, including as to number of round lot holders, number of shares outstanding and the minimum price per share.[2]

A third proposed change, which would have allowed a direct listing without a Securities Act registration, was met by the SEC with questions and was not ultimately adopted.[3] The filing of a Securities Act registration statement results in potential Securities Act liability, which is seen by the SEC as an important source of discipline in the IPO process. Liability risk is greater under Section 11 of the Securities Act (which applies because of the Securities Act registration) than under the comparable Exchange Act provisions (which apply even absent a Securities Act registration). This risk may, however, be somewhat offset by practical considerations related to the direct listing process. In the Spotify direct listing, trading was done on the exchange in the same manner as ordinary secondary market trading and the registration statement noted that all sales were limited to ordinary brokerage transactions. The buyers of those shares would not know they purchased under the registration statement, because the sales permitted by the plan of distribution were generally covered by Rule 153 under the Securities Act, meaning that broker-dealers would not have to deliver a prospectus under Rule 174 or a Rule 173 registered sale notice. As a result, there was no practical way to determine for any particular trade whether sales were made by affiliates under the registration statement or by non-affiliates (where in a traditional IPO at least some portion of trading is "traceable" to the registration statement). The lack of underwriters and the lack of traceability of shares to the registration statement gave rise to concern over practical limitations on the ability to effectively assert liability for material misstatements and omissions and the lack of a party with a persuasive statutory motive to perform due diligence. A recent court decision potentially reducing the requirements for asserting Section 11 liability in the context of a direct listing is discussed below under "What Spotify Didn't Do."

Another complication of Securities Act registration in connection with a direct listing was 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 a Regulation M distribution were found to be present, the mechanics of Regulation M's limitations might be unclear in this new context. To address this concern, 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 for Regulation M purposes of five days prior to the commencement of trading, and

[2] Following the Spotify listing, The Nasdaq Stock Market LLC (Nasdaq) submitted, and the SEC approved, a rule change regarding price-based requirements for direct listings to facilitate secondary direct listing. Nasdaq Listing Rule IM-5315-1 "Determination of Price-Based Requirements for Direct Listings on the Nasdaq Global Select Market."

[3] In a release seeking comment on the NYSE proposals, the SEC 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."

the Division replied that it would not seek enforcement action.

What Spotify Didn't Do

The Spotify direct listing led the way for other direct listings, notably the direct listing of Slack in 2019 and the pending Palantir and Asana direct listings. Overall, the IPO market has continued to be dominated by traditional underwritten, book-built transactions, though. One reason that direct listings may not have proved as popular as the initial interest in Spotify and Slack implied is the inability of the issuer to raise funds by issuing stock for its own account.

As discussed above, Spotify's direct listing raised and left unanswered questions as to the Securities Act liability risk associated with direct listings. In April of this year, however, in a decision of first impression arising from the Slack direct listing, a judge in the Northern District of California declined to impose a tracing requirement for Section 11 claims relating to a direct listing, holding that there was a "good reason" for dispensing with the tracing requirement in that context in order to avoid "completely obviat[ing] the remedial penalties" of the Securities Act. *Dennee v. Slack Technologies Inc.*, No. 19-cv-05857-SI (N.D. Cal. Apr. 21, 2020). The *Slack* decision also rejected arguments that, as a matter of law, the plaintiff could not prove damages under Section 11, or satisfy the statutory seller requirement of Section 12(a)(2), in the context of a direct listing. The *Slack* decision is currently in the early stages of an appeal, but if it stands and other courts follow, it will open the door to Securities Act liability for direct listings, which is a risk companies may consider in deciding whether to go public, particularly where they have no need for new equity capital.[4]

Primary Direct Listings – NYSE and Nasdaq Rules Changes

On December 11, 2019, the NYSE filed with the SEC a proposed rule change to provide for primary direct listings. In a technical process, that rule change was subsequently withdrawn and amended while the SEC and the NYSE discussed the proposed changes. On June 22, 2020 the NYSE filed an amendment to the proposed rule change and the SEC approved the rule change as amended (the "2020 NYSE Rule Change") on August 26, 2020.

The 2020 NYSE Rule Change allows for primary direct listings, referred to as "Primary Direct Floor Listings," in which a company lists and sells shares directly to investors for its own account in the opening auction on the first day of trading (the "Opening Trade"), subject to the effectiveness of a Securities Act registration statement. The rule allows for a primary direct listing by itself or side-by-side with a secondary direct listing (a "Selling Shareholder Direct Floor Listing").

The rule changes provide for further changes to the minimum listing value, allowing a company to meet the applicable aggregate market value requirement if either (1) the company will sell at least $100 million in market value of its shares in the Opening Trade or (2) the aggregate of the Primary Direct Floor Listing amount and the shares that are publicly held immediately prior to the listing is at least $250 million, with the market value calculated using a price per share equal to the lowest price of the price range established by the issuer in its registration statement.

The 2020 NYSE Rule Change sets forth the process for establishing pricing and completing the Opening Trade. A Primary Direct Floor Listing would be processed on the NYSE by a single member organization entering a single Issuer Direct Offering Order (an IDO Order), which would be a sell order by the issuer with a limit price equal to the lowest price of

[4] For further discussion of the Slack decision, see our Alert, "Slack's Direct Listing – Court Allows Securities Act Claims Without Requiring Tracing" (April 30, 2020) here.

the price range in the issuer's registration statement. The IDO Order would be required to be for the number of shares offered by the issuer in the prospectus and it could not be modified or cancelled. A DMM would then effectuate a direct listing auction manually and the DMM would be responsible for determining the auction price. If the price established is below the lowest price in the range or above the highest price in the range, or there is not sufficient buy interest to satisfy both the IDO Order and all better-priced sell orders (from selling stockholders) in full, the auction will be deemed to have failed. Failure of the auction for reasons of price or buyer interest would result in the shares not trading and any orders being cancelled.[5]

To include all the issuer primary shares and increase the potential for the listing to be successful, the IDO Order would have priority over other sell orders at the same price if the auction price were at the limit price.

The SEC approval release made clear the SEC's focus on pricing disclosure and discovery mechanisms and concern over manipulative acts. In the approving release, the SEC noted: "The Commission believes that the IDO Order requirements described above help to mitigate concerns about the price discovery process in the opening auction and would provide some reasonable assurance that the opening auction and subsequent trading promote fair and orderly markets and that the proposed rules are designed to prevent manipulative acts and practices, and protect investors and the public interest in accordance with Section 6(b)(5) of the Exchange Act." Additionally, the 2020 NYSE Rule Change notes that services of any financial advisor and the DMM must comply with securities laws, including Regulation M and other anti-manipulation requirements. The SEC noted favorably the inclusion of the reminder on Regulation M in the amended rule.

The SEC also addressed the concerns over Securities Act liability, noting that the Securities Act does not require the involvement of an underwriter in a registered offering. The Commission noted, however, that "given the broad definition of 'underwriter' in the Securities Act, a financial advisor to an issuer engaged in a Primary Direct Floor Listing may, depending on the nature and extent of the financial advisors' activities and on the facts and circumstances, be deemed a statutory 'underwriter' with respect to the securities offering, with attendant underwriter liabilities." The SEC also pointed to the reputational interests and potential liability of financial advisors as incentives for financial advisors to engage in robust due diligence, as was purportedly done in the Spotify and Slack direct listings, notwithstanding the lack of a firm commitment underwriting.

With respect to issues of tracing and Section 11 liability, the SEC noted that this is a broader issue in the context of aftermarket securities purchases and the difficulty in tracing exchange trades. Without further discussing the issue, the SEC noted the California *Slack* case and the possibility of developing jurisprudence in the area. The SEC noted in a final comment that it did not believe the proposed rule change (and, therefore, primary direct listings) posed a heightened risk to investors.

Similar to the NYSE rule change, on August 24, 2020 Nasdaq filed a proposed rule change with the SEC to allow a company to raise capital as part of a primary direct listing. While there are some minor differences in the valuation determination in the respective rules, the notable difference from the NYSE rule is that Nasdaq would allow an issuer to proceed with a listing at a price up to 20% below the registration statement range, and with no limit above the registration statement range. This flexibility on pricing outside the range indicated in the prospectus would mean the likelihood of a failed auction would be lower than under the NYSE rule. One question that could be raised regarding the Nasdaq rule is how the mechanics

[5] The NYSE rule does not describe whether a secondary only listing could proceed after the failure of the primary, but at a minimum we think the issuer would need to consider the appropriate method of conveying updated disclosure to investors and what other conditions and timing constraints might be imposed by the SEC or the exchange.

of the listing process would work in any out-of-range scenarios and under what circumstances an amendment to the Securities Act registration statement might be necessary.

Although some details remain to be determined, the SEC's approval of the 2020 NYSE Rule Change was met by the securities industry and potential issuers as a welcome development and a sign that a primary direct listing could follow in the near term. Others, however, have challenged this new development. On September 8, 2020, a petition for review of the SEC approving order was filed by the Council of Institutional Investors (CII), an association of employee benefit plans and funds, state and local entities investing public assets and large foundations and endowments. The petition requests review of the proposals by the SEC commissioners, rather than just the SEC Division of Trading and Markets approval that was issued. CII raised issues of whether primary direct listings include adequate investor protections and noted concern over the traceability of shares and whether companies will use the primary direct listing to limit liability. The SEC had already stayed the implementation of the NYSE rule change until further notice, upon receiving advance notice of CII's petition, and on September 4, the NYSE filed a brief with the SEC in favor of a motion to lift the automatic stay. The NYSE contends that CII's concerns were already raised and considered in the comment process. Interestingly, the NYSE noted there would be "certain and imminent" harm to companies planning to take advantage of primary direct floor listings, perhaps indicating a deal in the wings. On September 8, CII filed a brief in opposition to the NYSE motion citing that the NYSE misstates the test for lifting an administrative stay and that public interest warrants maintaining the stay pending the SEC's considerations of CII's petition.

After the CII notice, the Nasdaq proposed rule change was removed from the SEC website. It may be that the SEC requested the withdrawal by Nasdaq as part of the usual back-and-forth on exchange rules proposals, as it did with the original NYSE rule proposal in December 2019, or the withdrawal could be a response to the CII notice and a decision by Nasdaq to wait for resolution on that front before proceeding.

Other Considerations for Primary Direct Listings

While the exchanges, financial advisors and companies wait for the CII petition to be filed and for the SEC to take further action with respect to the NYSE and Nasdaq rule changes, other open issues related to a primary direct listings remain.

A registration statement for a primary direct listing may be more complicated than for a pure secondary offering for several reasons. The NYSE and Nasdaq rule change proposals require a set number of shares in the opening trade, which will have to be included in the registration statement. However, both sets of rules allow a price range that may be difficult to establish if there is no underwritten offering. Further questions of whether there will be an opportunity to increase the size of an offering, or to increase the price outside the range, and whether the secondary direct listing can proceed if the primary direct listing fails, will likely be considered.

From its commentary in the adopting release, it is clear that the SEC continues to be concerned with Regulation M and market manipulation in the direct listing area. In Spotify, the issuer requested and received no-action relief from the SEC regarding Regulation M compliance. This no-action relief was granted in the context of selling stockholder direct listings, and the inclusion of primary shares in the offering could prompt rethinking of the Regulation M considerations given the direct involvement of the issuer. Similarly, the SEC noted its belief that financial advisors could be deemed underwriters, which could further complicate the Regulation M analysis or may force financial advisors to assume they have underwriter liability even without a firm commitment underwriting.

The concern expressed by CII and other commenters on the 2020 NYSE Rule Change over liability and investor protection, and the interpretation of the Slack decision by other courts, are clearly areas for further

discussion, litigation and jurisprudence. Furthermore, any change in SEC Commissioners could prompt new consideration of the liability and investor protection issues raised by CII and other investors. With these issues outstanding and the public battle over the NYSE rule changes, it may yet be some time before other key issues regarding the regulation and conduct of primary direct listings surface and can be resolved in the context of registration statement filed by an issuer in contemplation of a primary direct listing.

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