O'Melveny | omm.com

Going Public?

HOW TO DETERMINE IF A DIRECT LISTING IS RIGHT FOR YOU

What is a direct listing?

In a direct listing, a company's stock is listed on a stock exchange for public trading *without* an underwritten offering.

- This listing enables a company to become a publicly traded company without participating in an underwritten offering, or what is referred to as a traditional or typical IPO.
- The primary activities involved and fees incurred in a typical IPO are still conducted in a direct listing - i.e., registration and review process with the SEC, involvement of investment banks, investor outreach, and trading. But there are some key differences, which are outlined below.
- As with any transaction involving securities, a direct listing must still comply with the Securities Act, the Exchange Act and the listing exchanges rules and regulations.
- A direct listing is still not a commonly used structure for a public listing. The first direct listing was conducted in 2018 by Spotify. Through 2021, only about a dozen companies have gone public by direct listing.

What are the key characteristics of a direct listing?

CAPITAL CAN BE RAISED.

- A company is permitted to sell securities for its own account as part of its initial listing, allowing it to raise new capital.
  - New shares would be sold in the opening auction on the first day of trading on the relevant exchange.
- This means that capital raised by the sale of new shares may cause dilution to existing stockholders.

NO UNDERWRITTEN COMPONENT.

There is no organized selling effort at the time of a direct listing. At the time of listing, there is no contractual commitment by the company or existing stockholders to sell their shares. As a result, there is no underwritten component of the transaction, which means there is:

- *No underwriting fee*. In a typical IPO, an underwriting fee of 7% of the offering size is paid to the investment banks that serve as underwriters. This fee is not paid in a direct listing.
  - Investment banks play a role in a direct listing as "financial advisors" rather than as underwriters. The fee paid to financial advisors is typically less than 7%. See below discussion under, "Financial advisors still play a critical role."

- *No lock-up*. In a typical IPO, existing stockholders are asked to agree to a lock-up of 180 days from the date of IPO pricing, which prohibits them from selling, hedging or distributing shares. In a direct listing, existing stockholders are not asked to sign lock-ups—they are able to sell their equity on the first day of trading if they choose to do so.
  - Note that lock-ups are executed in the typical IPO in order to make a specific number of shares available for trading (i.e., only the shares registered in the IPO) with the goal of allowing the stock to stabilize before a significant volume comes onto the market.
  - A direct listing typically will not trigger the lock-up provisions agreed to in private rounds.
  - See also "A direct listing can be structured to enable all existing stockholders to freely sell their equity upon listing" below.s
  - Spotify and Slack both had successful first days of public trading: (a) Spotify's shares closed at $149.01 per share, above its $132 reference price, and 30 million shares were traded, and (b) Slack's shares closed at $38.70 per share, above its $26 reference price, and 136 million shares were traded.
- *No need for FINRA filings and fees*. A direct listing should not trigger the filing and approval requirements that apply to a traditional IPO under the corporate financing rules of the Financial Industry Regulatory Authority (FINRA). This is because FINRA is the primary organization that monitors and regulates U.S. stockbrokers and brokerage firms, including in connection with the selling and distribution of securities by these firms.

KEY (AND MOST "CUMBERSOME") DISCLOSURE REQUIREMENTS ARE THE SAME AS FOR A TRADITIONAL IPO.

A direct listing still requires that shares are registered with the SEC under the Securities Act.

- As a result, a direct listing requires the use of an S-1 registration statement to register the subject shares.
- This registration statement will be reviewed and commented on by the SEC.
- This process and timing, and the related disclosure requirements, are the same as a traditional IPO.
- But given the different components of a direct listing, there is some deviation in the actual disclosure. For example, the cover page disclosure around price and the plan of distribution / underwriting section are different.
  - In a traditional IPO, a price range for the anticipated share price in the IPO is included on the front cover page of the prospectus. The determination of this range, and ultimately the sale price, involves the input of the company, any selling stockholders and the underwriters, as well as the investors that were approached during book building as discussed below.
  - In a direct listing, the cover page will note that the opening trading price will be determined by buy and sell orders provided to the stock exchange's designated market maker and will further note that the designated market maker, in consultation with the company's designated financial advisor, will determine the opening price. The cover page will also typically include the recent high and low sales prices per share in recent private transactions.
- The same public company obligations (i.e., Exchange Act annual, quarterly, key event and beneficial

ownership reporting, Sarbanes Oxley internal and disclosure controls and procedures requirements, stock exchange corporate governance standards, etc.) will apply to a company that becomes public whether through a traditional IPO or a direct listing.

FINANCIAL ADVISORS STILL PLAY A CRITICAL ROLE.

Direct listings also involve financial advisors - which are typically investment banks.

- Similar to an underwriter, a financial advisor helps define the objectives for the listing and provides advice regarding positioning the company's equity story for the prospectus and the Investor Day, as well as regarding general market investor expectations.
- However, financial advisors do not participate in book building or pricing support or stabilization, as they typically would in an IPO.
- One of the financial advisors will, however, work with the stock exchange's designated market maker to help determine an opening price for the shares.
  - This involves the financial advisor providing the designated market maker information about the ownership of the company's equity and the pre-listing selling and buying interest that it is aware of. For example, the financial advisor will have discussions with the company's investors to assess whether those investors intend to sell in the public markets upon listing.

THE ROAD SHOW IS CONDUCTED SOLELY FOR INVESTOR EDUCATION AND RELATIONSHIP BUILDING, AND DOES NOT INCLUDE BOOK BUILDING.

A road show is an opportunity for a company to (a) tell its story to the investor community and (b) build relationships with key investors.

- In a traditional IPO road show, book building by the underwriters also occurs.
  - The underwriters collect indications of interest at particular price levels to determine the size and price for the IPO. They also work to develop the right mix of types of investors for the company.
  - The underwriters will also participate in the actual presentations.
  - The investors that receive shares in a traditional IPO are typically institutional investors.
  - In a direct listing, all prospective purchasers of shares participate in the price-setting process by placing their orders with their broker at the price they believe is appropriate.
- In a direct listing road show, no book building occurs and only management presents to investors.
  - The financial advisors will investigate market demand separately from the company's own marketing activities.
- The logistics around a direct listing road show are also different than for an IPO road show
  - In a direct listing, the road show typically will take place in the form of (a) a live webcast that is widely available (this is referred to as "Investor Day"), and (b) several one-on-one meetings with investors.
    - A direct listing "Investor Day" can be conducted once, for a few hours. The live webcast is typically made available to any interested party.
    - However, the length and number of total presentations for a direct listing road show will largely depend on how familiar the investor community is with the company's product and

business model.

- A typical IPO road show is conducted over two weeks when management and the underwriters, together, make presentations to groups of institutional investors. One-on-one meetings are also conducted during a typical IPO road show.

A DIRECT LISTING CAN BE STRUCTURED TO ENABLE ALL EXISTING STOCKHOLDERS TO BE ABLE TO FREELY SELL THEIR EQUITY UPON LISTING.

A direct listing can achieve this by registering all shares held by existing stockholders that are not already freely tradeable pursuant to a registration exemption.

- There are various exemptions to registration that permit secondary sales of a company's securities. The most commonly used exemption is Rule 144. But even under Rule 144, certain stockholders would not be able to freely trade their shares at the time of listing without registration. Through the direct listing process, those shares can be registered.
- Note that in Slack's direct listing, the registration statement registered the Class A common stock underlying certain of the restricted stock units that vested and settled as a result of the direct listing.
- A typical IPO registration statement could also register those shares, but that would be highly unusual, given that the typical IPO only registers the securities that are actually being sold in the underwritten offering.

A DIRECT LISTING ENABLES A COMPANY TO PROVIDE THE PUBLIC MARKET GUIDANCE BEFORE PUBLIC TRADING COMMENCES.

The shares sold in a typical IPO will be listed, and public trading of the company's shares will commence, prior to the company's first release of guidance. However, in the two direct listings that have occurred thus far, both companies issued guidance before the listing occurred.

- This is a practical option for direct listings because, in a direct listing, meaningful time (*i.e.*, five to seven days) can lapse between a registration statement going effective and the shares commencing trading.
  - In a typical IPO, the registration statement goes effective the day before public trading commences, which does not provide sufficient time for the guidance to be issued.
- Once the registration statement goes effective, the guidance can be "furnished" on a Form 8-K rather than as part of the registration.
  - This assumes that the guidance is not a material omission from the registration statement and that the guidance is not an offer to buy or sell the company's securities.
  - This also assumes that the SEC would not consider the issuance of the guidance as a violation of its restrictions around publicity in advance of an offering.
- Presumably this additional disclosure, not seen in a typical IPO, is meant to provide additional transparency to facilitate pricing discovery in advance of initial public trading.

BOTH THE NYSE AND NASDAQ HAVE SPECIFIC RULES REGARDING PUBLIC FLOAT AND THE DETERMINATION OF THE OPENING PRICE THAT WOULD TYPICALLY APPLY TO DIRECT LISTINGS.

- In order to support healthy trading, the stock exchanges want to ensure that issuers will have sufficient public float and shares held by non-affiliates have a minimum aggregate value.
  - For an initial listing, the minimum aggregate value of shares held by non-affiliates must usually be $40 million (for the NYSE) and $45 million to $110 million (for Nasdaq).
  - In a typical IPO, the exchanges will rely on written representations from the lead underwriters to satisfy the above requirement.
  - For direct listings, the valuation can be based on the lesser of (a) an independent third-party valuation and (b) the most recent trading price for the company's common stock in a private placement market. If a company cannot provide a private placement market trading price for its stock, it can satisfy the requirement by obtaining an independent valuation of at least $250 million.
    - Both the NYSE and Nasdaq provide that a valuation agent is not independent if it or any affiliated person or entity:
      - beneficially owns, at the time of the valuation, in the aggregate more than 5% of the class of securities to be listed (including any right to receive any such securities exercisable within 60 days)
      - has provided any investment banking services to the company within the 12 months preceding the date of valuation; or
      - has been engaged to provide investment banking services to the company in connection with the proposed listing, any related financings, or other related transactions.

      "*investment banking services*" is broadly defined to include acting as an underwriter, financial advisor, placement agent or selling group member as well as providing venture capital, equity lines of credit, PIPEs, or similar investments.
- The exchanges also require that the company engage a financial advisor to work with the exchange's designated market maker to help determine the opening price of the shares, unless there is sufficient recent trading in the private placement market. *See also* "Financial advisors still play a critical role."

If you have any questions regarding direct listings, please contact Warren Lazarow, Jeeho Lee or another Momentum team member.