**Podcast Transcript**

# Capital Markets: The Nuts and Bolts of a Direct Listing

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Lee: Are direct listings a viable alternative to the traditional IPO for private companies wishing to access the capital markets? Are the Securities and Exchange Commission, the New York Stock Exchange and NASDAQ receptive to direct listings?

I'm Leeann Lee and you're listening to BakerHosts. On today's episode we'll explain the nuts and bolts of a direct listing and dive into this trend. We'll explore why companies may consider the direct listing as an alternative to the traditional IPO, and we'll discuss how the SEC, NASDAQ and New York Stock Exchange currently view direct listings.

Our guest today is Mike Lawhead, a partner in BakerHostetler's Securities and Corporate Governance practice team. Who is resident is our Los Angeles and Costa Mesa offices. Welcome to the show Mike.

Lawhead: Thank you Leeann, glad to be here.

Lee: So, to start our conversation can you explain the concept of a direct listing to our listeners?

Lawhead: Sure, as its name suggests. A direct listing is the registered sale of a private company stock directly into the public markets. And the listing of that stock on a national exchange, such as the New York Stock Exchange or the NASDAQ without an underwritten offer. In a direct listing the company still files a registration statement with the SEC, company must still comply with the listing rules of the applicable exchange and the company will directly engage in whatever marketing efforts and investor outreach there are for the offering.

However, the company will typically not pay any underwriting discounts or commissions, doesn't conduct any formal road show. Additionally, as of now, in a direct listing the selling shareholders in the offering, not the company itself, will receive any proceeds. And finally the price of the share sold in a direct listing is typically set by an auction rather than an agreement and it reflects the market price of the stock at the time of the auction.

Lee: Okay, so how does that differ from a traditional IPO?

Lawhead: Well there's several differences but let's focus upon a few of the key differences. In a traditional IPO the company generally engages one or more investment banks to underwrite the sale of the company stock in the public markets. What this means, by underwriting is the company will sell a block of its shares to the underwriters who will then be responsible for going on and selling them to the public. To that end, those underwriters will conduct road shows with the company to market the offering. The underwriters will build the book of institutional investors who participate in the offering and the underwriters will work with the company eventually to price the offering to the public.

The compensation the underwriters receive for these efforts, which are known as underwriter discounts and commissions, is the difference between the public offering price, meaning the price that the underwriters actually sell the shares to the public on the first day of the IPO and the price the underwriters pay to the company for those shares. That difference, and those underwriting discounts and commissions can be substantial depending on how large the IPO is.

In a direct listing, however, you don't have any underwriters and thus the company doesn't have to pay any underwriter discounts and commissions. In a traditional IPO the company also receives the proceeds from the offering because it is selling the shares directly to the underwriters who then turn around and sell them to the initial IPO investor. Plus, any money that comes in from that offering goes directly to the company for working capital. As of today however, in a direct listing context, a company may only conduct what is called a secondary direct listing meaning they can only sell the shares of its selling shareholders not its own block and this means that whatever proceeds come in, as I mentioned earlier, go to those selling shareholders, not the company itself. So the company typically takes no money in a directly listing as of now.

Finally, in a traditional IPO certain shareholders of the company such as its officers, directors and what we call principal shareholders, those who own greater than 10%, will be bound by lockup agreements. Those lockup agreements prevent those shareholders from selling their shares in the public markets for a specified period of time after the offering which is typically six months. This means that insiders cannot participate in an IPO and don't really get any kind of benefit, any kind of bump in the stock or anything like that so they're tied up for several months. In a direct listing you don't have lockups, the selling shareholders and the participants and thus they can participate in and benefit from that direct listing.

Lee: Well given those differences can you tell me a bit more about why a company would want to use a direct listing?

Lawhead: Well it's interesting. As I mentioned, at this time the company itself doesn't sell any shares in the listing, in a direct listing, and thus does not receive any proceeds. So what is the benefit? Well first, in a direct listing the company may have happy shareholders. As I mentioned just a moment ago, in a direct listing the shareholders aren't locked up so those selling shareholders who are named in the registration statement filed for the direct listing have the opportunity to sell their shares directly into the public markets on the first day of trading and take whatever the market is willing to give them. But they're allowed to participate immediately whereas in the IPO context those shareholders would have to wait until the lockup period expires.

Since, as I said, there's no lockup period in a direct listing this means that the selling shareholders will have immediate liquidity assuming there's a market for the shares and could benefit in that way. This would probably make them happy. The selling shareholders would also be able to sell their shares in an auction context at the then current market price rather than whatever the pre-set IPO price was. The selling shareholders also in a direct listing can share their shares to a wider audience of purchasers. And as I mentioned in a traditional IPO the underwriters compile a book of institutional investors to participate and that's effectively it. So the shareholders also have a wider base of folks they can go out to.

And in a direct listing those selling shareholders can sell to any willing purchaser so they're not tied up by any limitations of who's going to be buying in the traditional IPO context or anything like that. Finally, in the absence of underwriters, the company doesn't have to pay any underwriting discounts or commissions or participate in any kind of formal road show. So the company is free to conduct the offering as it chooses at whatever cost it chooses and have that opportunity for shareholders available. So really the benefit is happy shareholders.

Lee: That sounds like a good benefit. So what companies have opted to use direct listings so far?

Lawhead: As of now very few companies have opted to go public using this route. This is primarily due to the fact that, at this time, as I mentioned several times, the exchange rules, the rules of the SEC, I'm sorry, the rules of NASDAQ and the New York Stock Exchange only permit secondary listings by selling shareholders. This means that a company cannot conduct what is called a primary offering which is an offering of its own shares by itself and raise money through that process. So that means that those companies that have opted to use a direct listing to go public typically have been well capitalized private companies that did not need to avail themselves of the public markets to raise money for themselves. A simple benefit is getting their stock shareholders liquidity and going public.

I'd say two prominent examples of companies that have used the direct listing process recently are Slack and Palantir which as we know are both well capitalized companies and they've used it as an opportunity to get their shareholders liquidity. Slack went through the process in 2019 and Palantir recently filed its resale registration statement for a direct listing.

Lee: Okay. Well how do the SEC, the New York Stock Exchange and NASDAQ view direct listings right now?

Lawhead: At this time the listing rules of the New York Stock Exchange and NASDAQ only permit secondary direct listings. Meaning, as I've mentioned, that the company can only conduct a direct listing for secondary offerings of its shares by its selling shareholders. A company may not offer its shares in a primary offering via a direct listing at this time.

Now in late 2019 the New York Stock Exchange proposed a listing rule amendment that would permit companies to raise capital via a primary direct listing if they satisfied certain public float and other requirements set by the New York Stock Exchange. In August 2020 the SEC approved the New York Stock Exchange's proposed amendment and NASDAQ followed the New York Stock Exchange's lead shortly thereafter with its own proposed rule amendment.

With SEC approval of that rule amendment it appeared that companies would finally have the opportunity to raise money with a direct listing. However, shortly after the SEC issued its order an institutional investor advocacy group called the Council of Institutional Investors that had filed comment letters opposing the New York Stock Exchange's rule amendments filed a petition with the SEC for a review of its order approving the rule amendments. As a result, under applicable procedural rules the SEC's order approving the rule amendment was automatically stayed. This means that it's frozen and essentially the New York Stock Exchange's proposed rule amendment has not been approved.

During this stay the SEC will look into the issues raised by the Council of Institutional Investors and the order that it gave will remain frozen until the SEC orders otherwise. So for now direct listings remain available only for secondary offerings by selling shareholders.

Lee: So with all of that in mind what does the future hold with respect to direct listings?

Lawhead: Well I think this depends on where the SEC ends up with the proposed rule amendments that were put forth by the New York Stock Exchange and NASDAQ and on how the direct listing process evolves following any such approval. For the reasons we discussed earlier the direct listing process has become increasingly popular with certain groups, particularly venture capitalists that have invested in startups and are looking for liquidity. However, until companies can avail themselves of direct listings or themselves for primary offerings and for their own fundraising efforts the direct listing will probably remain the domain of a limited group of well capitalized companies that can use the process to benefit their shareholders. And what this means to me is that the traditional IPO is not in any imminent harm of going away.

Lee: Great. Well thank you for your insight Mike we really enjoy having you here today.

Lawhead: Thank you, happy to be here.

Lee: If you have any questions for Mike his contact information is in the show notes. You can also visit our Securities Offerings and Compliance publication webpage on bakerlaw.com where Mike has authored several alerts and articles. As always, thanks for listening to BakerHosts.