

A Current Guide to Direct Listings

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Over the course of December 2019, Gibson Dunn published its “Current Guide to Direct Listings” and “[An Interim Update on Direct Listing Rules](#)” discussing, among other things, the direct listing as an evolving pathway to the public capital markets and the U.S. Securities and Exchange Commission’s (SEC) rejection of a proposal by the New York Stock Exchange (NYSE) to permit a privately held company to conduct a direct listing in connection with a primary offering, respectively.

The NYSE continued to revise its proposal in consultation with the SEC and, on August 26, 2020, the SEC approved an amendment to the NYSE’s proposal that will permit primary offerings in connection with direct listings. The August 26 order, which would have become effective 30 days after being published in the Federal Register, was stayed by the SEC on September 1, 2020 in response to a notice from the Council of Institutional Investors (CII) that it intended to file a petition for the SEC to review the SEC’s approval. On December 22, 2020, the SEC issued its final approval of the NYSE’s proposed rules. Consequently, Gibson Dunn has updated and republished its Current Guide to Direct Listings to reflect today’s landscape, including an overview of certain issues to monitor as direct listing practice evolves included as Appendix I hereto.

Direct Listings: An evolving pathway to the public capital markets.

Direct listings have increasingly been gaining attention as a means for a private company to go public. A direct listing refers to the listing of a privately held company’s stock for trading on a national stock exchange (either the NYSE or Nasdaq) without conducting an underwritten offering, spin-off or transfer quotation from another regulated stock exchange. Under historical stock exchange rules, direct listings involve the registration of a secondary offering of a company’s shares on a registration statement on Form S-1 or other applicable registration form publicly filed with, and declared effective by, the Securities and Exchange Commission, or the SEC, at least 15 days in advance of launch—referred to as a Selling Shareholder Direct Listing.^[1] Existing shareholders, such as employees and early stage investors, whose shares are registered for resale or that may be resold under Rule 144 under the Securities Act, are able to sell their shares on the applicable exchange, but are not obligated to do so, providing flexibility and value to such shareholders by creating a public market and liquidity for the company’s stock. Historically, companies were not permitted to raise fresh capital as part of the direct listing process. On December 22, 2020, however, the SEC issued its final approval of rules proposed by the NYSE that permit a primary offering along with, or in lieu of, a direct secondary listing—referred to as a Primary Direct Floor Listing.^[2] Upon listing of the company’s stock, the company becomes subject to the reporting and governance requirements applicable to publicly traded companies, including periodic reporting requirements under the Securities Exchange Act of 1934, as amended (the Exchange Act), and governance requirements of the applicable exchange.

Companies may pursue a direct listing to provide liquidity and a broader trading market for their shareholders; however, the listing company can also benefit even if not raising capital in a Primary Direct Floor Listing. A direct listing, whether a Primary Direct Floor Listing or a Selling Shareholder Direct Listing, will provide a company with many of the benefits of a traditional IPO, including access to the public markets for capital raising and the ability to use publicly traded equity as an acquisition currency.

Advantages of a direct listing as compared to an IPO.

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Immediate Benefits to Existing Shareholders.

In both a Selling Shareholder Direct Listing and Primary Direct Floor Listing, all selling shareholders whose shares are registered on the applicable registration statement or whose shares are eligible for resale under Rule 144 will have the opportunity to participate in the first day of trading of the company's stock. Shareholders who choose to sell are able to do so at market trading prices, rather than only at the initial price to the public set in an IPO. The ability to sell at market prices on the first day of a listing can be a significant benefit to existing shareholders who elect to sell. However, this benefit assumes there is sufficient market demand for the shares offered for resale.

Potentially Wider Initial Market Participation.

The traditional IPO process includes a focused set of participants, and institutional buyers tend to feature prominently in the initial allocation of shares to be sold by the underwriting syndicate. Direct listings offer access to a wider group of investors, as any investor may place orders through its broker. In a Selling Shareholder Direct Listing, any prospective purchasers of shares are able to place orders with their broker-dealer of choice, at whatever price they believe is appropriate, and such orders become part of the initial-reference, price-setting process. The price-setting mechanisms applicable to Primary Direct Floor Listings differ in material respects from the practice that has developed with respect to Selling Shareholder Direct Listings. In a Primary Direct Floor Listing, prospective purchasers of shares are able to place orders with their broker-dealer of choice at whatever price they believe is appropriate, but will have priority for purchases at the minimum offering price specified in the related prospectus.

Flexibility in Marketing.

IPO marketing has become more flexible since the introduction of rules providing for "testing-the-waters" communications by Emerging Growth Companies and, starting December 3, 2019, all companies.^[3] However, a direct listing allows a company to avoid the rigidity of the traditional roadshow conducted for a specified period of time following the publicly announced launch of an IPO and allows it to tailor marketing activities to the specific considerations underlying the direct listing. For instance, the traditional roadshow has been replaced in some direct listings by an investor day whereby the company invites investors to learn about the company one-to-many, such as via a webcast, which can be considered more democratic as all investors have access to the same educational materials at once. Marketing efforts may include one or more of these investor days and a roadshow-like presentation, conducted at times deemed most advantageous (although the applicable registration statement must still be publicly filed for at least 15 days in advance of any such marketing efforts). Although the approximate timing of the direct listing can be inferred from the status of the publicly filed registration statement, the company may have more flexibility as to the day its shares commence trading on the applicable stock exchange.

Brand Visibility.

As direct listings are still a relatively novel concept in U.S. capital markets, any direct listing with moderate success, in particular a direct listing involving a primary capital raise, will likely draw broad interest from market participants and relevant media. This effect is multiplied when the listing company has a well-recognized brand name.

No Underwriting Fees.

A direct listing can save money by allowing companies to avoid underwriting discounts and commissions on the shares sold in the IPO. In direct listings to date, the companies have engaged financial advisers to assist with the positioning of the company and the preparation of the registration statement. Such financial advisors have been paid significant fees, though substantially less than traditional IPO underwriting discounts and

commissions. This may marginally decrease a company's cost of capital, although the company will still incur significant fees to market makers or specialists, independent valuation agents, auditors and legal counsel.

More Flexible Lockup Agreements.

In most direct listings to date, existing management and significant shareholders are not typically subject to the restrictions imposed by 180-day lockup agreements standard in IPOs. Notwithstanding, as practice evolves, practice may vary from transaction to transaction. For example, Spotify's largest non-management shareholder was subject to a lockup and Palantir's directors and executive officers were subject to a lockup period. We expect that lockup arrangements in direct listings will continue to be more tailored to the particular company's circumstances than in traditional IPOs.

Certain issues to consider before choosing a direct listing.

Establishing a Price Range or Initial Reference Price.

No marketing efforts are permissible without a compliant preliminary prospectus on file with the SEC, and such prospectus must include an estimated price range. In a traditional IPO and Primary Direct Floor Listing, the cover page of the preliminary prospectus contains a price range of the anticipated initial sale price of the shares. In a Selling Shareholder Direct Listing, the current market practice is to describe how the initial reference price is derived (e.g., by buy-and-sell orders collected by the applicable exchange from various broker-dealers). These buy-and-sell orders have in the past been largely determined with reference to high and low sales prices per share in recent private transactions of the subject company. In cases where a company does not have such transactions to reference, additional information will be necessary to educate and assist investors and help establish an initial bid price. In addition, the listing company in a direct listing may elect to increase the period between the effectiveness of its registration statement and its first day of trading, thereby allowing time for additional buy-and-sell orders to be placed. In either case, the financial advisor to the company will play an important role in establishing a price range or initial reference price, as applicable.

Financial Advisors and Their Independence.

In a Selling Shareholder Direct Listing, the rules of both the NYSE and Nasdaq require that the listing company appoint a financial advisor to provide an independent valuation of the listing company's "publicly held" shares and, in practice, assist the applicable exchange's market maker or specialists, as applicable, in setting a price range or initial reference price, as applicable. In past direct listings, in particular those involving the NYSE, the financial advisor that served this role was not the financial advisor the listing company engaged to advise generally, including to assist the company define objectives for the listing, position the equity story of the company, advise on the registration statement, assist in preparing presentations and other public communications and help establish a firm price range in a Primary Direct Floor Listing. As reviewed in detail below, the financial advisor that values the "publicly held" shares and assists the applicable exchange's market maker or specialists, as applicable, must be independent, which under the relevant rules disqualifies any broker-dealer that has provided investment banking services to the listing company within the 12 months preceding the date of the valuation.

Shares to be Registered.

In a direct listing, in addition to new shares being issued in connection with a Primary Direct Floor Listing, a company generally registers for resale all of its outstanding common equity which cannot then be sold pursuant to an applicable exemption from registration (such as Rule 144), including those subject to registration rights obligations. The company may also register shares held by affiliates and non-affiliates who have held the shares for less than one year or otherwise did not meet the requirements for transactions without

restriction under Rule 144.^[4] Companies may also register shares held by employees to address any regulatory concerns that resales of shares by employees occurring around the time of the direct listing may not have been entitled to an exemption from registration under the Securities Act. All shares subject to registration may be freely resold pursuant to the registration statement only as long as the registration statement remains effective and current. The company will typically bear the related costs.

Direct Listing-Specific Risks.

Traditional IPOs offer certain advantages that are not currently present in direct listings. Going public without the structure of an IPO process is not without risk, such as the need to obtain research coverage in the absence of an underwriting syndicate that has research analysts or the need to educate investors on the company's business model. Any company considering a direct listing should contemplate whether its investor relations apparatus is capable of playing an outsized role in coordinating marketing efforts and outreach to potential investors, both in connection with the listing and after the transaction. Notably, in a Selling Shareholder Direct Listing, the listing company's management plays no role in setting the initial reference price, and certain market-making activities conducted by the underwriting syndicate may be unavailable. In a Primary Direct Floor Listing, the listing company's management may play an outsized role in determining an initial price range. Either scenario may present unacceptable risk for companies that may otherwise be poised to undertake a direct listing.

The NYSE and Nasdaq rules applicable to a direct listing.

Background.

The direct listing rules of both the NYSE^[5] and Nasdaq Global Select Market^[6] are substantially similar and are structured as an exception to each exchange's requirement concerning the aggregate market value of the company to be listed. Prior to the direct listing rules, companies that did not previously have their common equity registered under the Exchange Act were required to show an aggregate market value of "publicly held" shares in excess of \$100 million (\$110 million for Nasdaq Global Select Market, under certain circumstances), such market value being established by both an independent third-party valuation and recent trading prices in a trading market for unregistered securities (commonly referred to as the Private Placement Market).

"Publicly held" shares include those held by persons other than directors, officers and presumed affiliates (shareholders holding in excess of 10%). The Private Placement Market includes trading platforms operated by any national securities exchange or registered broker-dealers. Generally, in a direct listing, the relevant company either (i) does not have its shares traded on a Private Placement Market prior its listing or (ii) underlying trading in the Private Placement Market is not sufficient to provide a reasonable basis for reaching conclusions about a company's trading price.

Direct Listings on Secondary Markets.

Nasdaq rules permit direct listings onto the Nasdaq Global Market and Nasdaq Capital Market, the second- and third-tier Nasdaq markets, respectively.^[7] If the company to be listed on a secondary market does not have recent sustained trading activity in a Private Placement Market, and thereby must rely on an independent third-party valuation consistent with the rules described above, such calculation must reflect a (i) tentative initial bid price, (ii) market value of listed securities and (iii) market value of publicly held shares that each exceed 200 percent of the otherwise applicable requirements.

Requirements for a Direct Listing.

The direct listing rules discussed above were intended to provide relief for privately held "unicorns," or companies that are otherwise sufficiently capitalized and which do not need

to raise money. Each exchange’s listing standards applicable to direct listings by U.S. companies are summarized, by relevant exchange, in the table that follows:

Overview of Listing Standards Applicable to Direct Listings

	NYSE (Selling Shareholder Direct Listing)	NYSE (Primary Direct Floor Listing)	Nasdaq Global Select Market	Nasdaq Global Market	Nasdaq Capital Market
Market Value of Publicly Held Shares (i.e., held by persons other than directors, officers and presumed affiliates)	The listing company must have a recent valuation from an independent third party indicating at least \$250 million in aggregate market value of publicly held shares. (<i>Rule 102.01A(E)</i>) ^[8]	The listing company (i) must sell at least \$100 million of shares in the opening auction or (ii) show that the aggregate market value of shares sold in the opening auction, together with publicly held shares, exceeds \$250 million, in each case with market value calculated using the lowest price per share set forth in the related prospectus.	The listing company must have a recent valuation from an independent third party indicating at least \$250 million in aggregate market value of publicly held shares. (<i>Rule IM-5315-1(b)</i>) ⁹	The listing company must have a recent valuation ^[9] from an independent third party indicating in excess of \$16 million to \$40 million in aggregate market value of publicly held shares, depending on the financial standard met below. (<i>Rule 5405</i>)	The listing company must have a recent valuation ¹⁰ from an independent third party indicating in excess of \$10 million to \$30 million in aggregate market value of publicly held shares, depending on the financial standard met below. (<i>Rule 5505</i>)
Financial Standards	The listing company is required to meet one of the following applicable financial standards: (i) Each of (a) aggregate adjusted pre-tax income for the last three fiscal years in excess of \$10 million, (b) with at least \$2 million in each of the two most recent fiscal years	<i>Same as the NYSE (Selling Shareholder)</i>	The listing company is required to meet one of the following applicable financial standards: (i) Each of (a) aggregate adjusted pre-tax income for the last three fiscal years in excess of \$11 million, (b) with at least \$2.2 million in each of the two most recent fiscal years	The listing company is required to meet one of the following applicable financial standards: (i) Each of (a) aggregate adjusted pre-tax income in excess of \$1 million in the latest fiscal year or in two of the last three fiscal years and (b) Stockholders’ equity in	The listing company is required to meet one of the following applicable financial standards: (i) Each of (a) Stockholders’ equity in excess of \$15 million and (b) two years of operating history. (ii) Each of (a) Stockholders’

and (c) positive income in each of the last three fiscal years (the “ <u>NYSE Earnings Test</u> ”).	and (c) positive income in each of the last three fiscal years (the “ <u>Nasdaq Earnings Standard</u> ”).	excess of \$15 million.	equity in excess of \$4 million and (b) market value of listed securities in excess of \$100 million.
(ii) Global market capitalization of \$200 million (the “ <u>Global Market Capitalization Test</u> ”).	(ii) Each of (a) average market capitalization in excess of \$550 million over the prior 12 months, (b) \$110 million in revenue for the previous fiscal year and (c) aggregate cash flows for the last three fiscal years in excess of \$27.5 million and positive cash flows for each of the last three fiscal years (the “ <u>Capitalization with Cash Flow Standard</u> ”).	(ii) Each of operating history.	(iii) Total assets and total revenue in excess of \$75 million in the latest fiscal year or in two of the last three fiscal years.
	(iii) Each of (a) average market capitalization in excess of \$850 million over the prior 12 months and (b) \$90 million in revenue for the previous fiscal year (the “ <u>Capitalization with Revenue Standard</u> ”).	(iii) Market value of listed securities in excess of \$150 million.	(iv) Total assets and total revenue in excess of \$75 million in the latest fiscal year or in two of the last three fiscal years.
	(iv) Each of (a) market capitalization in excess of \$160 million,		

			(b) total assets in excess of \$80 million, and (c) stockholders' equity in excess of \$55 million (the "Assets with Equity Standard").			
Distribution Standards	The listing company must meet all of the following distribution standards:	Same as the NYSE (Selling Shareholder)	The listing company must meet all of the following liquidity requirements:	The listing company must meet all of the following distribution standards:	The listing company must meet all of the following liquidity requirements:	
	(i) 400 round lot shareholders;		(i) 450 round lot shareholders or 2,200 total shareholders;	(i) 400 round lot shareholders;	(i) 300 round lot shareholders;	
	(ii) 1.1 million publicly held shares; and		(ii) 1.25 million publicly held shares; and	(ii) 1.1 million publicly held shares;	(ii) 1 million publicly held shares; and	
	(iii) Minimum initial reference price of \$4.00.		(iii) Minimum initial reference price of \$4.00.	(iii) Minimum initial reference price of \$8.00.	(iii) Minimum initial reference price of \$8.00 OR closing price of \$6.00. [10]	
Engagement of Financial Advisor	Any valuation used in connection with a direct listing must be provided by an entity that has significant experience and demonstrable competence in the provision of such valuations. (Rule 102.01A(E))	Not required in connection with a Primary Direct Floor Listings as the prospectus is required to include a price range within which the company anticipates selling the shares it is offering.	Any valuation used in connection with a direct listing must be provided by an entity that has significant experience and demonstrable competence in the provision of such valuations. (Rule IM-5315-1(e))	Same as the Nasdaq Global Select Market	Same as the Nasdaq Global Select Market	
	A valuation agent will not be deemed to be independent if (Rule 102.01A(E)):		A valuation agent shall not be considered independent if (Rule IM-5315-1(f)):			
			(i) At the			

(i) At the time it provides such valuation, the valuation agent or any affiliated person or persons beneficially own in the aggregate, as of the date of the valuation, more than 5% of the class of securities to be listed, including any right to receive any such securities exercisable within 60 days.

(ii) The valuation agent or any affiliated entity has provided any investment banking services to the listing applicant within the 12 months preceding the date of the valuation. For purposes of this provision, "investment banking services" include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing

time it provides such valuation, the valuation agent or any affiliated person or persons beneficially own in the aggregate, as of the date of the valuation, more than 5% of the class of securities to be listed, including any right to receive any such securities exercisable within 60 days.

(ii) The valuation agent or any affiliated entity has provided any investment banking services to the listing applicant within the 12 months preceding the date of the valuation. For purposes of this provision, "investment banking services" include, without limitation, acting as an underwriter in an offering for the issuer; acting as a financial adviser in a merger or acquisition; providing venture

venture capital, equity lines of credit, PIPEs (private investment, public equity transactions), or similar investments; serving as placement agent for the issuer; or acting as a member of a selling group in a securities underwriting.

(iii) The valuation agent or any affiliated entity has been engaged to provide investment banking services to the listing applicant in connection with the proposed listing or any related financings or other related transactions.

capital, equity lines of credit, PIPEs (private investment, public equity transactions), or similar investments; serving as placement agent for the issuer; or acting as a member of a selling group in a securities underwriting.

(iii) The valuation agent or any affiliated entity has been engaged to provide investment banking services to the listing applicant in connection with the proposed listing or any related financings or other related transactions.

Upon satisfaction of the above requirements of the applicable exchange, the exchange will generally file a certification with the SEC, confirming that its requirements have been met by the listing company. After such filing, the company's registration statement may be declared effective by the SEC (assuming the SEC review has run its course). In practice, the SEC has reviewed registration statements that contemplate a direct listing in substantially the same manner it reviews traditional IPO registration statements, with some additional focus on process as direct listing practice and the related rules evolve. After the registration statement is declared effective by the SEC, the company becomes subject to the governance requirements of the applicable exchange (subject to compliance periods) and the reporting requirements under the Exchange Act. The company may then establish the day its equity will commence trading in consultation with the applicable exchange, which could be the same day as the SEC declares the registration statement effective, assuming, in the case of a Selling Shareholder Direct Listing, the exchange's market maker or specialists, as applicable, and the financial advisor appointed by the company are able to determine an initial reference price.

NYSE's recent rule changes: Primary capital raise via direct listing

Allowing companies to conduct their initial public offering outside of the traditional IPO format (i.e., an underwritten firm commitment) could potentially revolutionize the way in

which companies go public. Historically, companies were not permitted to raise fresh capital as part of the direct listing process. On June 22, 2020, the NYSE filed a revised proposal with the SEC that would allow companies to publicly raise capital through a direct listing, which was approved by the SEC staff on August 26, 2020. The NYSE's proposal, which would have become effective 30 days after being published in the Federal Register, was stayed by the SEC on September 1, 2020, after the Council of Institutional Investors (CII) made public its intention to file a petition for the SEC's Commissioners to review the August 26 order approving the NYSE's proposal. The grounds for CII's Petition for Review of an Order are discussed below. On December 22, 2020, the SEC issued its final approval of the NYSE's proposed rules. The NYSE's rules, which we expect will become effective 30 days after being published in the Federal Register, will allow a company to sell shares on its own behalf, without underwriters, in addition to or in place of a secondary offering by shareholders.

Under the NYSE's rules, companies hoping to conduct a primary offering while listing pursuant to the NYSE's proposed rules will be required to either:

- sell at least \$100 million in the opening auction on the first day of listing, thereby ensuring that there will be at least \$100 million in public float after the first trade; or
- the aggregate market value of publicly held shares immediately prior to listing together with the market value of shares sold by the company in the opening auction totals at least \$250 million, with such market value calculated using a price per share equal to the lowest price of the price range established in the related prospectus.

The NYSE previously proposed a "Distribution Standard Compliance Period" whereby, in a Primary Direct Floor Listing, the requirements to have 400 round lot shareholders and 1.1 million publicly held shares would be operative after a 90-day grace period. Under the proposal approved by the SEC, companies conducting a Primary Direct Floor Listing must meet these and all other initial listing requirements at the time of initial listing.

To facilitate Primary Direct Floor Listings, the NYSE's proposal includes a new order type that would permit a Primary Direct Floor Listing to settle only if (i) the auction price would be within the price range specified by the company in its effective registration statement and (ii) all shares to be offered by the company can be sold within the specified price range, together with other technical revisions to the order process to enable and ensure compliance with the foregoing. Notably, the NYSE will create a new order type to be used by the issuer in a Primary Direct Floor Listing, referred to as an Issuer Direct Offering Order ("IDO Order"), which would be a limit order to sell that is to be traded only in a Primary Direct Floor Listing. The IDO Order would have the following requirements: (1) only one IDO Order may be entered on behalf of the issuer and only by one member organization; (2) the limit price of the IDO Order must be equal to the lowest price set forth in the applicable prospectus; (3) the IDO Order must be for the quantity of shares offered by the issuer, as disclosed in the prospectus in the effective registration statement; (4) the IDO Order may not be cancelled or modified; and (5) the IDO Order must be executed in full in the direct listing auction. The NYSE's proposal also includes additional revisions to related definitions that are "intended to clarify the application of the existing rule and . . . not substantively change it."

Nasdaq.

The Nasdaq Stock Market also has pending before the SEC a proposed rule change to allow primary-offering, direct listings in the context of Nasdaq's own distinct market model, some of which require fewer record holders than the NYSE for direct listings. Additionally, on December 22, Nasdaq submitted a separate proposed rule change on this issue for which Nasdaq seeks immediate effectiveness without a prior public comment period. On December 23, the Staff of the Division of Trading and Markets of the SEC issued a public statement that "the Staff intends to work to expeditiously complete, as promptly as

possible accommodating public comment, a review of these proposals, and as with all self-regulatory organizations' proposed rule changes, will evaluate, among other things, whether they are consistent with the requirements of the Exchange Act and Commission rules."

CII's Objection & SEC Response

On August 31, 2020, the Council of Institutional Investors (CII) notified the SEC of its intention to file a petition for the SEC's Commissioners to review the August 26 order approving the NYSE's proposed rule change.^[11] On September 8, 2020, CII filed its petition for review with the SEC, setting forth its principal criticism that liberalization of direct listing regulations in the face of current limitations on investors' legal recourse for material misstatements and omissions is not consistent with Section 6(b)(5) of the Exchange Act,^[12] which requires exchange rules be "designed . . . to protect investors and the public interest." CII previously raised concerns that the NYSE proposal would not guarantee sufficient liquidity for a trading market in the securities to develop after the listing, but did not raise this concern in its petition for review.

Section 11 & Traceability Concerns.

Section 11 of the Securities Act of 1933 (Section 11) provides legal action against a wide range of corporate actors in connection with material misstatements or omissions contained in a registration statement, where a person acquires securities traceable to that registration statement in reliance on such misstatements or omissions. Under the precedent established in *Barnes v. Osofsky*,^[13] a person bringing such a claim for material misstatements or omissions contained in a registration statement under Section 11 must generally show that either the securities they held were purchased at the time of their initial offering or that they were issued under the deficient registration statement and purchased at a later time in the secondary market, which is referred to in concept as traceability. As discussed above, in a direct listing, a company generally registers for resale all of its outstanding common equity that cannot then be sold pursuant to an applicable exemption from registration. Generally, holders of shares that are eligible for resale pursuant to an applicable exemption from registration may, simultaneous with shares sold under an effective registration statement, sell unregistered shares in transactions under Rule 144 or otherwise not subject to, or exempt from, registration under the Securities Act. As a result, shares available in the market upon a direct listing include both shares sold under the registration statement and shares sold pursuant to an exemption from registration (and therefore not under the registration statement). At a high level, shares sold pursuant to a registration statement may be subject to claims under Section 11 as well as under Rule 10b-5 under the Exchange Act (the general anti-fraud provisions of the Exchange Act), while shares sold otherwise than under a registration statement may be subject to claims only under Rule 10b-5. Due to differences in the standards of the two rules, and defenses available to the company or other defendants, it may generally be more difficult for a holder to make successful claims with respect to shares not sold pursuant to a registration statement.

As highlighted by CII in its petition, investor concerns about the traceability of shares sold in a direct listing were highlighted in a recent case of first impression concerning direct listings.^[14] In that case, the listing company argued that a Section 11 claim could not be brought as the complaining investors could not distinguish between the shares sold under the registration statement and unregistered shares sold by an insider and were consequently unable to establish traceability. Although the district court in that case denied the motion to dismiss, appeal of the issue before the U.S. Court of Appeals for the Ninth Circuit is pending. The ultimate decision in the Ninth Circuit, which includes Silicon Valley, could play an outsized role in future cases.

In earlier commentary, the SEC noted that although the NYSE's proposal did present a "recurring" Section 11 concern, as the issue was not "exclusive" to Primary Direct Floor Listings, approval of the NYSE's proposal did not pose a "*heighted* risk to investors"

(emphasis added). CII's petition also raises certain proposals that it argues would alleviate investors' burden in proving traceability, such as the introduction of blockchain-traceable shares, and should be addressed in advance of liberalizing direct listing rules to accommodate Primary Direct Floor Listings.

Final Approval.

On December 22, 2020, the SEC issued its final approval of the NYSE's proposed rules, finding the NYSE's proposal is consistent with the Exchange Act and the rules and regulations issued thereunder and, furthermore, that the proposed rules would "foster[] competition by providing an alternate method for companies of sufficient size [to] decide they would rather not conduct a firm commitment underwritten offering." The SEC's December 22 order discussed several procedural safeguards included by the NYSE in its proposed rules that were intended to "clarify the role of the issuer and financial advisor in a direct listing" and "explain how compliance with various rules and regulations" would be addressed. These changes include the introduction of an "IDO Order type," the clarification of how market value would be determined in connection with primary direct listings and the agreement to retain FINRA to monitor compliance with Regulation M and other anti-manipulation provisions of federal securities laws.

Notably, the SEC's December 22 order rejects the notion that offerings not involving a traditional underwriter would "'rip off' investors, reduce transparency, or involve reduced offering requirements or accounting methods," finding that the relevant "traceability issues are not exclusive to nor necessarily inherent in" Primary Direct Floor Listings. In approving the NYSE's proposal and reaching its conclusion that the NYSE's proposal provided a "reasonable level of assurance" that the applicable market value threshold supports a public listing and the maintenance of fair and orderly markets, the SEC specifically noted that the applicable thresholds for the equity market value under the revised rules were at least two and a half times greater than the market value standard that exists for a traditional IPO (\$40 million). The SEC order also positively discusses steps taken by the NYSE to ensure compliance by participants in the direct listing process with Regulation M and other provisions of the federal securities laws.

The two 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. In its order approving the NYSE's revised rules on Primary Direct Floor Listings, the SEC suggests that, depending on the facts and circumstances, a company's independent financial adviser could be subject to Securities Act liability, or at least lawsuits alleging underwriter liability, in connection with direct listings. The two dissenting Commissioners, however, suggest that guidance as to what may trigger status as a statutory underwriter should have been considered and concurrently provided.

Conclusion

In any event, direct listings are a sign of the times. As U.S. companies raise increasingly large amounts of capital in the private markets, the public capital markets are responding to the need to provide a wider variety of means for a private company to enter the public capital markets and provide liquidity to existing shareholders. Although direct listings will undoubtedly provide new opportunities for entrepreneurial companies with a well-recognized brand name or easily understood business model, we do not expect direct listings to replace IPOs any time soon. Direct listing practice is evolving and involves new risks and speedbumps. There are a number of novel issues and open questions raised by the evolving direct listing landscape, some of which are highlighted in Appendix I hereto (*Open Questions for Direct Listings*). Regulatory divergence between the price-setting mechanisms applicable to Primary Direct Floor Listings and Selling Shareholder Direct Listings may spur further rulemaking to conform to applicable standards. Gibson Dunn will

also continue to update this *Current Guide to Direct Listings* from time to time to further describe the applicable rules and provide commentary as practices evolve. Any company considering an entry to the public capital markets through a direct listing is encouraged to carefully consider the risks and benefits in consultation with counsel and financial advisors. Members of the Gibson Dunn Capital Markets team are available to discuss strategy, options and considerations as the rules and practice concerning direct listings evolve.

[1] Many foreign private issuers have listed their shares, in the form of American Depositary Shares (evidenced by American Depositary Receipts), on U.S. exchanges without a simultaneous U.S. capital raising, seeking such listing in connection with the company's filing of a registration statement on Form 20-F under the Securities Exchange Act of 1934, as amended, and the depositary bank's filing of a registration statement on Form F-6 under the Securities Act of 1933, as amended (a so-called "Level II ADR facility"). Such Level II ADR facilities are outside the scope of this article and should be separately considered with the advice of counsel.

[2] The NYSE's most recent proposal, submitted on June 22, 2020, is available at the following link: <https://www.sec.gov/comments/sr-nyse-2019-67/srnyse201967-7332320-218590.pdf>. The NYSE's prior proposal, submitted on December 12, 2019, is available at the following link: <https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-filings/filings/2019/SR-NYSE-2019-67%2c%20Re-file.pdf>. The NYSE's initial proposal, submitted on November 26, 2019, which was withdrawn, is available at the following link: <https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-filings/filings/2019/SR-NYSE-2019-67.pdf>.

[3] The SEC's revision to Rule 163B under the Securities Act of 1933, as amended, which permits "testing-the-waters" communications by all issuers, was adopted on September 25, 2019. The adopting release is available at the following link: <https://www.sec.gov/rules/final/2019/33-10699.pdf>.

[4] The SEC has published a helpful guide concerning Rule 144 transactions that is available at the following link: <https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html>. Such a transaction is outside the scope of this article and should be separately considered with the advice of counsel.

[5] Certain NYSE rules are reviewed herein. The NYSE Listed Company Manual, which contains all of the listing standards and other rules applicable to a company listed on the NYSE, is available at the following link: <https://nyse.wolterskluwer.cloud/listed-company-manual>.

[6] Certain Nasdaq rules are reviewed herein. The Nasdaq Equity Rules, which contain all of the listing standards and other rules applicable to a company listed on Nasdaq, are available at the following link: <http://nasdaq.cchwallstreet.com/>.

[7] On August 15, 2019, Nasdaq submitted to the SEC proposed rule changes related to direct listings on the Nasdaq Global Market and Nasdaq Capital Market, the second- and third-tier Nasdaq markets, respectively. The Nasdaq proposal, submitted on August 15, 2019, is available at the following link: <https://www.sec.gov/rules/sro/nasdaq/2019/34-86792.pdf>. Nasdaq's amendment to its proposal, submitted on November 26, 2019, is available at the following link: <https://www.sec.gov/comments/sr-nasdaq-2019-059/srnasdaq2019059-6482012-199454.pdf>. The SEC's adopting release approving the Nasdaq proposal is available at the following link: <https://www.sec.gov/rules/sro/nasdaq/2019/34-87648.pdf>.

[8] There must be an independent valuation where a company goes public without an underwriting syndicate that would otherwise represent to the applicable exchange that

such exchange's distribution requirements will be met by the contemplated offering. If consistent and reliable private-market trading quotes are available, both the independent valuation and valuation based on private-market trading quotes must show a market value of "publicly held" shares in excess of \$100 million (\$110 million for Nasdaq Global Select Market, under certain circumstances).

[9] In lieu of a valuation for listings on the Nasdaq Global Market and Nasdaq Capital Market, the exchange may accept "other compelling evidence" that the (i) tentative initial bid price, (ii) market value of listed securities and (iii) market value of publicly held shares each exceed 250 percent of the otherwise applicable requirements. Under the rules, as amended, such compelling evidence is currently limited to cash tender offers by the company or an unaffiliated third party that meet certain other requirements.

[10] To qualify under the closing price alternative, the listing company must have: (i) average annual revenues of \$6 million for three years, or (ii) net tangible assets of \$5 million, or (iii) net tangible assets of \$2 million and a three-year operating history, in addition to satisfying the other financial and liquidity requirements listed above. If listing on the Nasdaq Capital Markets under the NCM Listed Securities Standard in reliance on the closing price alternative, such closing price must be in excess of \$4.00.

[11] The Council of Institutional Investors' August 31 notice to the SEC is available at the following link: https://www.cii.org/files/issues_and_advocacy/correspondence/2020/August%2031%202020%20%20letter%20to%20SEC-AB.pdf. The SEC's letter to the NYSE notifying the exchange of the stay of the SEC staff's August 26 order is available at the following link: <https://www.sec.gov/rules/sro/nyse/2020/34-89684-carey-letter.pdf>.

[12] The Council of Institutional Investors' Petition for Review of an Order is available at the following link: <https://www.sec.gov/rules/sro/nyse/2020/34-89684-petition.pdf>.

[13] 373 F.2d 269 (2d Cir. 1967).

[14] See generally *Pirani v. Slack Technologies, Inc.*, 445 F.3d 367 (N.D. Cal. 2020).

APPENDIX I

Open Questions for Direct Listings (as of January 8, 2021)

Some of the relevant open questions include:

- **Will the loss of a traditional firm-commitment underwriter create additional risks for investors?** The NYSE's revised rules permit companies to raise new capital without using a firm-commitment underwriter. The two Commissioners who dissented (Allison Herren Lee and Caroline A. Crenshaw) and certain investor protection groups have expressed concern that the absence of a traditional underwriter removes a key gatekeeper present in traditional IPOs that helps prevent inaccurate or misleading disclosures. In its order approving the NYSE's revised rules on Primary Direct Floor Listings, the SEC suggests that, depending on the facts and circumstances, a company's financial advisers could be subject to Securities Act liability, or at least lawsuits alleging underwriter liability, in connection with direct listings. The two dissenting Commissioners, however, suggest that guidance as to what may trigger status as a statutory underwriter should have been considered and concurrently provided.
- **Will a Primary Direct Floor Listing create new risks for the listing company?** Under current rules and precedent, in a Primary Direct Floor Listing the listing company may have more rather than less liability in a direct listing than a traditional IPO. In a traditional IPO, because of customary lockup arrangements, investors can generally guarantee the traceability of their shares to the registration statement because only shares issued under the registration statement are trading

in the market until the lockup period expires. Under current case law, which is being appealed, the tracing requirement has been seemingly abandoned, meaning all the shares in the market can potentially make claims under Section 11.

- **How will legal, diligence and auditing practices develop around direct listings?** Because the listing must be accompanied by an effective registration statement under the Securities Act, the liability provisions of Section 11 and 12 of the Securities Act will be applicable to sales made under the registration statement. We note that in many of the direct listings to date, the companies have engaged financial advisors to assist with the positioning of the equity story of the company and advise on preparation of the registration statement, in a process very similar to the process of preparing a registration statement for a traditional IPO. Because a company will be subject to the same standard for liability under the federal securities laws with respect to material misstatements and omissions in a registration statement for a direct listing to the same extent as for a registration statement for an IPO, a company's incentives to conduct diligence to support the statements in its registration statement do not differ between the two types of transactions. Similarly, financial statement requirements, and the requirements as to independent auditor opinions and consents, do not differ between registration statements for direct listings and IPOs. Furthermore, follow-on offerings by the company that involve firm-commitment underwriting or at-the-market programs will require the traditional diligence practices. To date, there have been no lawsuits alleging that financial advisers in a direct listing could be subject to Securities Act liability in connection with direct listings.
- **What impact will the expanded availability of direct listings have on IPO activity?** One could argue that the greatest attraction of a direct listing is that it can nearly match private markets in being faster and less costly than an IPO. In some cases, it could provide similar liquidity as a traditional IPO, although trading price certainty and trading volume could be lower following a direct listing than following an IPO. Direct listings have been available on the NYSE and Nasdaq for a decade but have not been utilized regularly by large private companies in lieu of a traditional IPO. In any event, the requirement for 400 round lot holders will continue to be a hurdle for many private companies looking to list directly.
- **How will the initial reference price and/or price range in the prospectus be determined?** There is no reference price from another market for the DMM to apply and no negotiation between the issuer and the underwriter as in an IPO. The NYSE seems to bridge this gap with the requirement for the DMM to consult with an independent financial adviser to determine the initial reference price in a Selling Shareholder Direct Listing and, in a Primary Direct Floor Listing, to determine the price range to be set forth in the applicable prospectus. Eventually, a standardized set of practices around the financial adviser's work and presentation of the price to the issuer and the Exchange should develop.
- **Without the firm-commitment IPO process, in which the offering is oversold and heavily marketed, how will direct listed shares trade in the aftermarket?** Without an underwritten offering, the issuer will not engage in price finding and book building activities. In a direct listing, the issuer will also take on much of the role of investor outreach that is borne by underwriters in a traditional IPO. Although direct listing marketing efforts may include one or more investor days and a roadshow-like presentation, sell-side analysts will presumably not be involved, building models and educating investors. It may be more difficult for the issuer to tell its forward-looking story and build value into the trading price of the stock without research coverage prior to or after the listing. For this reason, the most successful direct listings to date have been well-known companies with widely recognized brands that have successfully engaged with a broad set of new investors. We expect that companies engaging in direct listings will continue to develop more robust internal investor/shareholder relations functions than may be needed for a company conducting a traditional IPO.

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- **Will large private placements (often called “private IPOs”) have a new advantage?** The expanded option to direct list, whether in a secondary or primary format, through an independent valuation alone may mean investors in a private company can have access to public markets faster than through an IPO process. When private companies market private equity capital raises, including private IPOs, they might use the direct listing option as a marketing tool to attract investors to the private placement.
- **Are there any companies that are well-positioned for a Primary Direct Floor Listing?** The NYSE's revised rules may prompt well-positioned companies to consider a capital raise where the private or IPO markets are otherwise unattractive. Furthermore, until Nasdaq's rules are approved, how will the NYSE's rules affect the decision of where to list?

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact any member of the Gibson Dunn team, the Gibson Dunn lawyer with whom you usually work in the firm's Capital Markets or Securities Regulation and Corporate Governance practice groups, or the authors:

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