

Open Questions Remain after SEC Approves Primary Direct Listings on the NYSE

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Direct listings have emerged as one of the new innovative pathways to the U.S. public capital markets, thought to be ideal for entrepreneurial companies with a well-recognized brand name or easily understood business model. We have also found them attractive to companies that are already listed on a foreign exchange and are seeking a dual listing in the United States. Because direct listings have been limited to secondary offerings by existing shareholders, they have not been an attractive option for companies seeking to raise new capital in connection with going public. That has changed now that the NYSE will permit primary offerings in connection with direct listings – or “Primary Direct Floor Listings” (see “*Gibson Dunn Guide to Direct Listings*” below).

Primary offerings through direct listings pose new challenges and questions, but nonetheless have the potential to expand access to the U.S. public markets. This new option to raise capital in connection with a listing is expected to increase the number of companies that find direct listings attractive, although we do not expect direct listings to serve as a replacement for underwritten IPOs generally. [\[1\]](#) Many of the open questions we discussed when the NYSE’s Selling Shareholder Direct Floor Listing rules were amended in 2018 ([link here](#)) are raised again with the new rules on Primary Direct Floor Listings (see “*Open Questions*” below).

History

It has taken more than a year for the NYSE’s rule changes to become effective. As we previously discussed ([link here](#)), in December 2019, the NYSE submitted its first rule proposal to the SEC that would permit a privately held company to conduct a direct listing in connection with a primary offering, but this proposal was quickly rejected by the SEC. As we further detailed ([link here](#)), the NYSE subsequently revised and resubmitted the proposal, which was approved by the SEC on August 26, 2020 following a public comment period. However, only five days later, the SEC stayed its approval order after 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. CII objected to the proposals to allow Primary Direct Floor Listings arguing that such an offering would harm investors by limiting investors’ legal recourse for material misstatements in offering documents. In particular, CII raised concerns regarding the ability of investors to “trace” the purchase of their shares to the applicable offering document. Another criticism of the NYSE’s proposal is that the rule changes could not guarantee sufficient liquidity for a trading market in the applicable securities to develop following the direct listing.

Final Approval

On December 22, 2020, the SEC issued its [final approval](#) of the NYSE’s proposed rules. The SEC states that, following a de novo review and further public comment period, it has found that the NYSE’s proposal was consistent with the Exchange Act and the rules and regulations issued thereunder and, furthermore, that the proposed rules would “foster[]

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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 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 “Issuer Direct Offering 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 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 discussed 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.

“This is a game changer for our capital markets, leveling the playing field for everyday investors and providing companies with another path to go public at a moment when they are seeking just this type of innovation,” NYSE President Stacey Cunningham said in a statement. In a separate statement, Commissioner Elad L. Roisman stated, “Primary direct listings represent an alternative way for companies to fairly and efficiently offer shares to the public in a manner that preserves important investor protections” and have “the additional benefit of increasing opportunities for investors to purchase shares at the initial offering price, rather than having to wait to buy in the aftermarket.”

The two Commissioners who dissented (Allison Herren Lee and Caroline A. Crenshaw) and certain investor protection groups have issued statements expressing concern that the absence of a traditional underwriter removes a key gatekeeper present in traditional IPOs that helps prevent inaccurate or misleading disclosures.

New Requirements for Primary Direct Floor Listings

Under the NYSE’s rules, a privately held company seeking to conduct a primary offering in connection with a direct listing will qualify for such a primary offering if (a) it meets the already existing requirements for a direct listing (e.g., 400 round lot holders, 1.1 million publicly held shares outstanding and minimum price per share of at least \$4.00 at the time of initial listing); and (b) (i) the company issues and sells common equity with at least \$100 million in market value in the opening auction on the first day of listing, or (ii) the market value of common equity sold in the opening auction by such company and the market value of publicly held shares (i.e., excluding shares held by officers, directors and 10% owners) immediately prior to listing, together, exceed \$250 million. In each case, such market value will be calculated using a price per share equal to the lowest price of the price range established by the issuer in its registration statement for the primary offering (the price range is defined as the “Primary Direct Floor Listing Auction Price Range”).

The NYSE will also create a new order type to be used by the issuer in a Primary Direct Floor Listing and rules regarding how that new order type would participate in a Direct Listing Auction. Specifically, the NYSE will introduce an Issuer Direct Offering Order (“IDO Order”), which would be a Limit Order to sell that is to be traded only in a Direct Listing Auction for 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 of the Primary Direct Floor Listing Auction Price Range; (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. Consistent with current rules, a Designated Market Maker (“DMM”) would effectuate a Direct Listing Auction manually, and the DMM would be responsible for determining the Auction Price. Under the new rules, the DMM would not conduct a Direct Listing Auction for a Primary Direct Floor Listing if (1) the Auction Price would be below the lowest price or above the highest price of the Primary Direct Floor Listing Auction Price Range; or (2) there is insufficient buy interest to satisfy both the IDO Order and all better-priced sell orders in full. If there is insufficient buy interest and the DMM cannot price the Auction and satisfy the IDO Order as required, the Direct Auction would not proceed and such security would not begin trading.

While not a change, the NYSE emphasized in its proposal that any services provided by a financial advisor to the issuer of a security listing in connection with a Selling Shareholder Direct Floor Listing or a Primary Direct Floor Listing (the “financial advisor”) and the DMM assigned to that security must provide such services in a manner that is consistent with all federal securities laws, including Regulation M and other anti-manipulation requirements.

Nasdaq Is Next

The Nasdaq Stock Market also has pending before the SEC a proposed rule change to allow primary offering in connection with 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.”

Gibson Dunn Guide to Direct Listings

Any company considering 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 and considerations as the rules and practice concerning direct listings evolve. Gibson Dunn will also continue to update its *Current Guide To Direct Listings* ([available here](#)) from time to time to further describe the applicable rules and provide commentary as practices evolve.

Open Questions

It remains to be seen how the NYSE’s revised rules and forthcoming rules from NYSE and Nasdaq will play out in practice. 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.

- **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?

[Read More](#)

Thank you to associate Evan Shepherd for his valuable assistance with this article and the Current Guide to Direct Listings.*

[1] The SEC Final Release states in footnote 114: “While the Commission acknowledges the possibility that some companies may pursue a Primary Direct Floor Listing instead of a traditional IPO, these two listing methods may not be substitutable in a wide variety of instances. For example, some issuers may require the assistance of underwriters to develop a broad investor base sufficient to support a liquid trading market; others may believe a traditional firm commitment IPO is preferable given the benefits to brand recognition that can result from roadshows and other marketing efforts that often accompany such offerings. Thus, we do not anticipate that all companies that are eligible to go public through a Primary Direct Floor Listing will choose to do so; the method chosen will depend on each issuer’s unique characteristics.”

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:

J. Alan Bannister – New York (+1 212-351-2310, abannister@gibsondunn.com)
Hillary H. Holmes – Houston (+1 346-718-6602, hholmes@gibsondunn.com)
Boris Dolgonos – New York (+1 212-351-4046, bdolgonos@gibsondunn.com)
Stewart L. McDowell – San Francisco (+1 415-393-8322, smcdowell@gibsondunn.com)
James J. Moloney – Orange County, CA (+1 949-451-4343, jmoloney@gibsondunn.com)
Evan Shepherd* – Houston (+1 346-718-6603, eshepherd@gibsondunn.com)

Please also feel free to contact any of the following practice leaders:

Capital Markets Group:

Andrew L. Fabens – New York (+1 212-351-4034, afabens@gibsondunn.com)
Hillary H. Holmes – Houston (+1 346-718-6602, hholmes@gibsondunn.com)

GIBSON DUNN

Stewart L. McDowell – San Francisco (+1 415-393-8322, smcdowell@gibsondunn.com)

Peter W. Wardle – Los Angeles (+1 213-229-7242, pwardle@gibsondunn.com)

Securities Regulation and Corporate Governance Group:

Elizabeth Ising – Washington, D.C. (+1 202-955-8287, eising@gibsondunn.com)

James J. Moloney – Orange County, CA (+1 949-451-4343, jmoloney@gibsondunn.com)

Lori Zyskowski – New York (+1 212-351-2309, lzyskowski@gibsondunn.com)

**Mr. Shepherd is admitted only in New York and is practicing under the supervision of Principals of the Firm.*

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