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Professional Perspective

Evolving Perspectives on Direct Listings after Spotify and Slack

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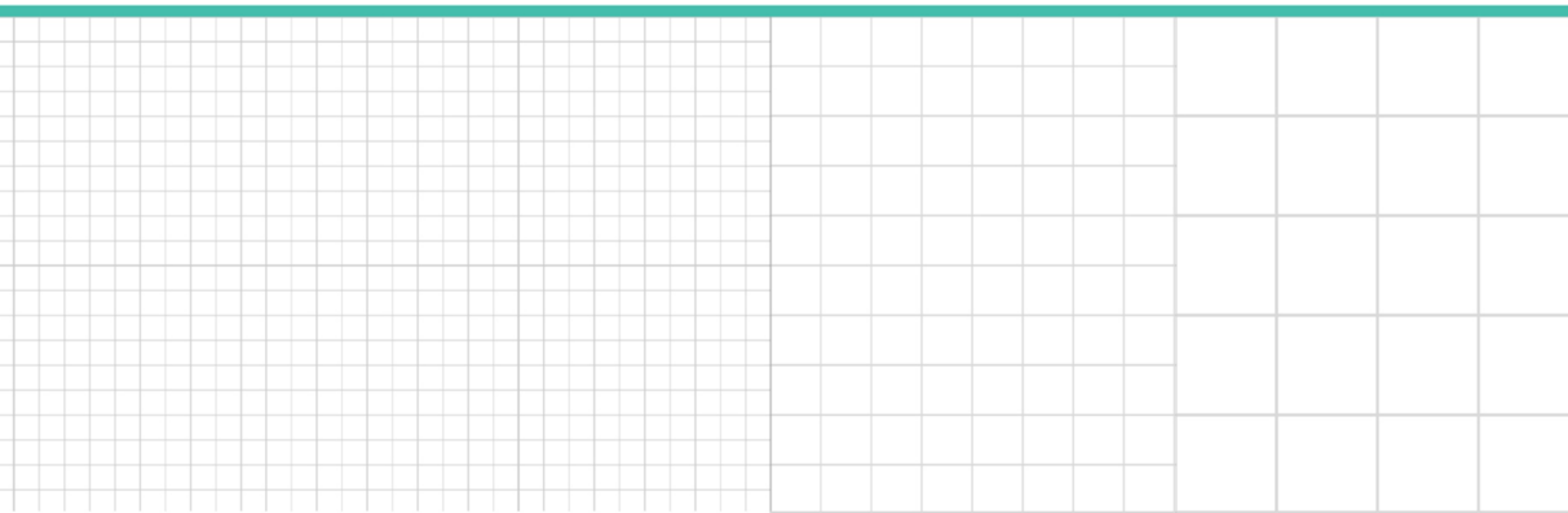

Evolving Perspectives on Direct Listings after Spotify and Slack

Contributed by Benjamin Cohen, Marc Jaffe, Michelle Lu, Greg Rodgers, and John Williams, Latham & Watkins LLP

In a direct listing, a company's outstanding shares are listed on a stock exchange without a primary or secondary underwritten offering. Existing security holders become free to sell shares on the stock exchange at market-based prices. Since there is no underwritten offering, a direct listing does not require the participation of investment banks acting as underwriters. This means that certain features that are typical of a traditional initial public offering—such as lockup agreements and price stabilization activities—are not present in a direct listing. This article explores certain characteristics and roles involved in this approach to becoming a public company, and incorporates insights from the Spotify and Slack direct listings, which Latham & Watkins worked on and were completed in April of 2018 and June of 2019, respectively.

Why a Direct Listing?

A direct listing can allow companies to achieve several important objectives as part of becoming a public company. Importantly, unlike a traditional IPO, due to regulatory limitations, the direct listing process has not been used by companies to concurrently raise capital; however, as discussed below, companies in need of capital have alternative means of receiving debt or equity investments before or after listing, subject to certain limitations.

Enables market-driven price discovery. In a traditional IPO process, during the "road show," the underwriters build an order book by collecting indications of interest from potential investors. Based on this order book, discussions with investors, and the company, a price is set for sale to investors in the IPO. By contrast, in a direct listing, the price per share in the opening trade on the first day of trading is determined based on buy and sell orders submitted from a much broader pool of potential investors and sellers through the facilities of a stock exchange. In theory, due to the increased size of the market and the fact that bids can be more exactly calibrated for size and price, the resulting stock price set by this public market should be a truer market-driven price than one set through the book-build process.

Offers greater liquidity for its existing stockholders. As part of a traditional IPO process, lockup agreements typically restrict additional sales of shares outside of the IPO by certain existing stockholders and the issuer for 180 days post-listing. These agreements are meant to help manage post-offering supply and reduce volatility, but come with the downside of preventing sales by the pre-IPO stockholders, the group that has born the risks of ownership the longest. In a direct listing, a company is able to provide liquidity to existing stockholders without lockup agreements, and, as a result, the stockholders are free to sell their shares immediately.

Provides unfettered access to buyers and sellers of shares, allowing existing stockholders the ability to sell their shares immediately after listing at market prices. The traditional IPO process includes a limited set of participants: a company and possibly certain existing stockholders who are offering to sell their shares in the IPO, an underwriting syndicate of investment banks that builds an order book of indications of interest from potential investors, and the investors who receive the initial allocation of shares being offered in the IPO at the price to the public appearing on the front page of the prospectus. Institutional buyers tend to feature prominently in the initial allocation.

In the Spotify and Slack direct listings, no fixed number of shares were sold to the public and no allocations were available at a set public offering price; rather, prospective purchasers of shares could place orders with their broker of choice, at whatever price and size they believed was appropriate and that order would be part of the opening trade price-setting process on the stock exchange. This open access feature and the ability of virtually all existing holders to sell their shares, and of a much broader group of investors to buy their shares, creates a powerful market-driven dynamic for the efficient pricing of the shares upon opening of trading.

Evolving Perspectives on Direct Listings

In April 2018, Spotify completed a direct listing by listing its shares for trading on the New York Stock Exchange. In June 2019, Slack completed a direct listing when its shares began trading on the New York Stock Exchange. Following these

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listings, there has been increased interest in the direct listing structure as an alternative to traditional IPOs, particularly among venture capitalists, founders and their respective companies.

Volatility and Volume

In a direct listing, unlike a typical IPO, there is not a book-building process and no price at which underwriters initially sell shares to the public to help inform price discovery with respect to the opening trades on the exchange. Instead, buy and sell orders are collected from broker-dealers, and this information is used by the designated market maker and the stock exchange to inform the opening price for the shares. This process for determining the price per share is novel, and there is concern it could result in greater volatility and lower volume in connection with listing. However, both Spotify and Slack had relatively low volatility on the first day of trading on a high volume of shares.

Spotify opened at $165.90 per share and closed the first day of trading at $149.01 per share. Slack opened at $38.50 per share and closed the first day of trading at $38.62 per share. With Spotify's intraday volatility of 12.3% and Slack's intraday volatility of 8.9%, Spotify's and Slack's shares experienced low volatility compared to other large technology IPOs in the past decade. Further, Spotify's trading volume on the first day of trading was 17% of outstanding shares, and Slack's trading volume on the first day of trading was 27% of outstanding shares.

The relatively low volatility and high volume of Spotify's and Slack's shares in the opening days of trading has reduced the concerns regarding the novel pricing structure and the potential for high volatility and low volume in the opening of trading. However, given the very small sample size of direct listings to date, volume and volatility considerations should remain something for working groups to consider in light of the particular pre-listing ownership of the company.

Investor Education

In a typical IPO, the underwriters take representatives from the company (usually the chief executive officer and chief financial officer) on a one or two-week “road show,” a series of group meetings with buy-side institutional investors, and one-on-one meetings with large institutional investors. By contrast, in a direct listing, a traditional “road show” with underwriters is not conducted prior to the opening of trading. Instead, in Spotify and Slack, an investor day presentation was publicly streamed live with attendance and questions from the investor community. In addition, a company pursuing a direct listing may elect to meet individually with potential investors (effectively conducting a version of its own “roadshow”), subject to certain limitations.

Because these alternative investor education activities are organized and undertaken by the company, rather than underwriters, and because they are unconventional forms of investor education activities, there has been a concern that there may not be efficient or sufficient price discovery or sufficient demand among potential investors at the opening of trading. In particular, there has been a concern that traditional buy and hold investors might not participate in the non-traditional listing, as they do in an IPO.

Following the results from the direct listings by Spotify and Slack, companies may now have greater confidence in their ability to complete a direct listing without a traditional underwriter-organized “road show” and using alternative forms of investor education activities permitted by the direct listing process. However, each company will need to calibrate the amount and type of investor education activities they undertake based on various factors, including the profile of the company, the business model, and any existing interest from institutional or retail investors, as it is critical for the market-based pricing of a direct listing that the buy-side understand the company's business.

Interest in Market-Based Pricing

In a traditional IPO process, the price per share to the public is determined based on indications of interest collected from various potential investors and discussions among the company, the underwriters, and the company's pricing committee. In a direct listing, the price per share at the open is determined based on buy and sell orders submitted from potential investors and sellers and this process is facilitated by a designated market maker. Among companies and their existing stockholders, there is a growing interest in market-based pricing from buy and sell orders submitted by brokers to the exchange.

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In particular, there has been a growing interest by some companies and their pre-listing stockholders in avoiding an IPO that trades up materially from the price sold in the IPO, as this is evidence of "money left on the table" by the seller, be it the company or pre-listing stockholders. Many in the venture capital community have expressed support for the direct listing approach to setting the initial price based on buy and sell orders, rather than using indications of interest submitted to underwriters.

Direct Listing Process

Throughout a direct listing process, it is critical to ensure that all parties understand their roles and responsibilities and any limitations on their roles. To this end and to ensure a smooth process overall, companies should ensure from the outset that all parties agree on rules of road since responsibilities and limitations differ in important ways from the traditional IPO process.

Financial Advisers

In both Spotify and Slack, the company engaged Goldman Sachs & Co. LLC, Morgan Stanley & Co. LLC and Allen & Company LLC as financial advisers in connection with their direct listings. The financial advisers assumed clearly defined roles, which included assistance with respect to the registration statement and in preparing presentations and other public communications. Outlined below are important roles and limitations applicable to financial advisers to a company pursuing a direct listing based largely on guidance gleaned from conversations with the staff of the Securities and Exchange Commission during the Spotify direct listing process.

Unlike a traditional IPO process, the financial advisers in a direct listing should not engage in any book-building activities, participate in investor meetings, or provide any price support or stabilization activities. The financial advisers in general also should not conduct price discovery activities; however, in the case of Spotify and Slack, which listed on the NYSE, certain financial advisors were selected by the company to consult with the designated market maker in accordance with NYSE rules.

In particular, when there is not a recent sustained history of trading prior to listing, NYSE listing rules require that a designated market maker consult with one or more financial advisers to effect a fair and orderly opening of trading without coordination with the company, consistent with the federal securities laws in connection with a direct listing.

In this process, the selected financial advisers are expected to provide input to the designated market maker regarding their understanding of the company's ownership and pre-listing selling and buying interest that they become aware of from potential investors and stockholders, including after consultation with certain institutional investors. Importantly, the financial advisers should not consult with the company regarding any of its activities related to advising the designated market maker.

Shares into The Depository Trust Company

The Depository Trust Company acts as depository for shares held at a brokerage firm, bank, dealer, or other similar organization for trading on an exchange. In a traditional IPO, the shares sold by the company would normally be held through Cede & Co., which acts as the nominee for DTC. In a direct listing, for the shares to be eligible for trading on the applicable exchange, a stockholder interested in selling shares must transfer such shares from being held directly as a stockholder of record to being held in "street name" through DTC. To complete this transition in time for the listing, each individual stockholder will need to work with their broker and the company's transfer agent to ensure that the shares are made available for trading on day one.

Future of Direct Listings

Following the direct listings by Spotify and Slack, there has been markedly more interest in this approach to becoming a public company as an alternative to a traditional IPO. Unlike IPOs, due to regulatory limitations, companies are not able to use the direct listing process to concurrently raise capital for the company whose shares are listed. However, companies with a need for capital may explore ways to raise capital prior to, or shortly after, the direct listing event.

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Companies considering a capital raise prior to a direct listing may complete a traditional private placement of convertible preferred stock shortly prior to the direct listing. In addition, such companies may also consider issuing convertible notes that convert into common stock of the company in connection with a direct listing or IPO. These can be structured to convert (or become convertible) into common stock based on the trading price of the common stock on the exchange. Similar to convertible notes issued by early stage companies in a seed financing or bridge financing, this alternative allows the company and the investors to defer a valuation until the applicable liquidity event.

Companies considering a capital raise after a direct listing, among other options, may consider registered equity offerings, issuing debt, and issuing unregistered convertible notes. For companies seeking to issue equity or other registered securities, during the first 12 months following the company's registration under Section 12 of the Securities Exchange Act of 1934, under certain conditions, the company can sell securities in a primary offering using a Registration Statement on Form S-1, or Form F-1.

Given the Resale Registration Statement for the direct listing would normally be effective for at least 90 days, we expect companies to wait until after this initial 90-day period to sell registered primary shares of the company in an underwritten offering. In addition, after 12 completed months from the date of registration under Section 12 of the Exchange Act, the company may be eligible to sell shares using a Shelf Registration Statement on Form S-3, or Form F-3, which offers greater flexibility and speed in selling shares to the public in a registered offering. Unlike at the time of the IPO, the pricing of these offerings would be able to take into account an existing trading market and trading history on an exchange to inform the pricing in such offering.

As always, companies can issue debt to raise capital to fund operations, or establish a revolving debt facility to allow immediate access to debt to fund operations. In addition, companies can issue convertible notes that are available for resale under Rule 144A of the Securities Act of 1933 to qualified institutional buyers.

Conclusion

The Spotify and Slack transactions proved that a direct listing is a viable alternative path to becoming a public company and can enable market-driven price discovery and offer existing stockholders immediate liquidity. However, this alternative is not right for every company and many will prefer a traditional IPO. Among other things, companies must consider factors relating to capital needs, stockholder composition, and investor education requirements. We believe that the additional option for companies is a positive development and that we will see more direct listings in the near future. We also believe that elements of the direct listing process, such as innovations around investor education and lock-up arrangements, may find their way into the traditional IPO process.

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