Weil Alert

Weil

June 2023

Revisiting Direct Listings

Is Your PE Portfolio Company or Newly Restructured Company a Good Candidate for a Direct Listing?

By Corey Chivers and Mercedez Taitt-Harmon

Direct listings continue to show promise as a potential avenue for investors to monetize their investment in private companies. Direct listings, sometimes referred to as direct public offerings, involve an initial stock exchange listing by a company of its common stock without an underwritten public offering. While in practice direct listings have not been as popular as traditional initial public offerings (IPOs) or SPAC business combinations, for the right candidate, a direct listing may prove to be a cost-effective exit opportunity. In particular, private companies – such as newly restructured companies with positive cash flow and a strong balance sheet but lacking the growth profile required for an IPO, or companies that have undergone private funding rounds and are not immediately in need of new capital for liquidity – are potentially strong candidates for a direct listing. Furthermore, since the lead times and preparations required for IPOs, SPAC business combinations and direct listings are similar, a company can take steps to prepare for any of these alternatives, while taking time to decide upon the ultimate preferred approach.

The Promise of Direct Listings

Following the adoption of enabling rules by both the New York Stock Exchange (NYSE) and Nasdaq, and some high profile transactions in recent years, direct listings have emerged as a potential new path for investors and other stakeholders to monetize their shareholdings.

The potential benefits of direct listings include:

- *Market supply and demand.* The "democratization" of the IPO process whereby all pre-existing investors and all interested potential new investors alike are able, at their discretion, to participate in the initial offering at trading prices and volumes dictated by actual supply and demand for the stock. In a traditional IPO, the sellers may only sell through the underwriters, often at a significant discount to the anticipated trading price, and typically only institutional investors are given an allocation by the underwriters to participate at the initial public offering price;
- *Retaining the value of the first-day "bounce."* The company's pre-existing investors are able to benefit from gains in the stock price, rather than seeing the benefit of the traditional first-day "bounce" (i.e. the uptick in trading prices during the first day of trading above the public offering price paid by IPO investors to the underwriters) inure to the benefit of the IPO investors who receive an allocation from the underwriters;

- *No Lock-up.* The potential for immediate and ongoing liquidity for officers, directors and pre-existing investors by avoiding, or at least retaining the ability and discretion to customize, the traditional 180-day lock-up;
- *Establishing a public secondary market with no commitment to a specific primary or secondary offering.* The ability to establish an active market for a company's common stock, which allows a pre-existing investor the ability to mark-to-market its investment, without committing to a significant upfront primary or secondary offering; and
- *No dilution.* Pre-existing investors avoid the potential dilution associated with raising new capital, potentially at a discount.[1]

The Reality

In spite of the initial fanfare, there have been relatively few direct listings. And, apart from notable examples such as Spotify, Slack, Palantir and Coinbase, direct listings largely appear to have emerged without significant publicity.

In part, the current lack of direct listings is a reflection of low activity generally in the market for new equity issuances, including the cool down in the IPO market and the challenges faced by SPACs in completing acquisitions. The relatively low number of direct listings also likely reflects in part the fact that, unlike in the case of underwritten IPOs or SPAC business combinations, there are few incentivized market participants (such as underwriters or SPAC sponsors) actively promoting the direct listing alternative.

However, there are other impediments to a more robust direct listing market, as compared to IPOs or SPAC business combinations, including the following:

- *Absence of Underwriter Marketing Activities.* Regulatory limitations on financial advisors regarding pre-listing marketing activity, which preclude companies from engaging financial advisors to arrange purchases in the offering, create a vacuum of potential new investors that underwriters have traditionally procured and which companies themselves must generate through their own investor outreach efforts;
- *Limited Ability to Allocate Significant Shares to Desired Accounts.* Unlike the IPO allocation process in which the issuer and underwriters can make allocation decisions that take into account whether an investor may be viewed as a more desirable long-term holder of the issuer's stock, such as a "long-only fund," there is less of an ability to ensure that such investors can buy a substantial position in the issuer's stock in a single transaction and as a result, trading after the initial listing may be more volatile;
- *No Stabilization in Direct Listings.* One benefit to investors in a traditional IPO is the ability for underwriters to provide after-market support for the trading price of the stock by engaging in permitted stabilization activities. This downside protection is not permitted in direct listings, which may discourage institutions from taking a larger initial position in a direct listing;
- *Less Initial Analyst Coverage.* In most IPOs, there are more underwriters than there are financial advisors in direct listings, which typically results in greater analyst coverage and more investor engagement post-transaction. This dynamic can lead to more market visibility and higher trading volume for companies that choose the traditional IPO route;

[1] In addition, there have been suggestions in the past that issuers may find direct listings more attractive because, as recently reaffirmed by a unanimous Supreme Court decision in *Slack Technologies, LLC, et al., v. Pirani*, they benefit from a statutory liability framework that reduces the exposure to certain types of securities litigation. While similar suggestions have been made in the past regarding SPAC business combinations, particularly prior to heightened regulatory scrutiny, our experience is that issuers in practice do not seriously consider this factor in weighing potential alternatives.

- *Significant Financial Advisor Fees.* In practice, many direct listing issuers in lieu of paying the IPO underwriting discount have still paid significant advisory fees to investment banks to provide marketing and other financial guidance – a reality that belies the promise of significantly reduced fees;
- *No New Equity Capital.* Traditionally, the direct listing does not provide a source of additional liquidity to the company itself through an equity raise, which makes this alternative less attractive to companies in need of new capital; and
- *Significant Impediments under Stock Exchange Rules.* Stock exchange rules requiring at the time of listing 300 to 450 round-lot holders and at least a $30 to $40 million aggregate market valuation of publicly-held shares (i.e., shares not held by a 10% holder) often pose a challenge to an issuer with concentrated holdings in its investor base.

In part, to address the challenges posed by stock exchange rules referred to above and, in part, to provide direct listing companies with the ability to raise new capital like in an IPO, new NYSE and Nasdaq rules provide companies with the ability to conduct a primary capital raise through the stock exchange auction, alongside the listing of common stock held by pre-existing investors. However, to date, no issuer has taken advantage of these new rules on either stock exchange and it remains to be seen how these new rules will work in practice.

Optimal Candidates for a Direct Listing

Given some of these impediments, not all companies are strong candidates for a direct listing. Nevertheless, certain private companies may be good direct listing prospects, including newly restructured companies with positive cash flow and a strong balance sheet or companies that have undergone private funding rounds and are not immediately in need of new capital for liquidity.

Direct listings executed to date include some combination of the following:

- *Strong Brand and Retail Interest.* Issuers that have a strong brand identity or dedicated retail following (e.g., Spotify, Slack, Roblox, Coinbase, SquareSpace, ZipRecruiter), which will attract investor interest, and issuers, who through established sponsor contacts within the investor community, are otherwise able to engage in investor marketing, even in the absence of a retail following;
- *Ability to Meet Stock Exchange Public Float and Holder Requirement.* Issuers that have sufficient equity held by less-than-10% shareholders to meet stock exchange "public float" requirements, including the 300-450 round lot holder requirement. Companies have typically been able to meet these requirements as a result of equity distributed in prior private rounds of financing, equity offered to employees, service providers and business associates, or equity distributed to non-controlling creditors in a bankruptcy distribution. In some cases, issuers have engaged in pre-listing transactions specifically to satisfy exchange requirements;
- *No Need for Immediate New Equity Capital.* Issuers that have a robust balance sheet and no immediate need for liquidity or deleveraging; and
- *Other Attractive Financial Characteristics.* Direct listing issuers to date have also typically enjoyed other attractive financial characteristics, such as positive revenue performance and a favorable growth history.

The "Silent" Direct Listing

In a direct listing, financial advisors are not engaged to arrange for investors to purchase common stock in the offering, as would be the case for underwriters in an IPO, but most companies arranging for a direct listing have nevertheless incurred substantial fees for the assistance of financial advisors. For instance, eight of the 13 direct listings that have occurred as of the time of this Alert reported incurring financial advisor fees ranging from $19.5 million to $48.0 million. Analysts at investment banks that served as financial advisors have typically initiated research coverage, which supports the development of a robust secondary market.

However, we have also seen a few companies that are willing to establish a listing and allow the market, including potential research coverage, to develop over time, without engaging a full syndicate of financial advisors. Perhaps reasoning that a stock exchange listing and public secondary market will provide superior liquidity than the informal over-the-counter market trading that may already exist, these issuers have devoted substantially less financial resources to seeking the same level of financial advisor assistance up front for the initial listing.

Comparison of Potential Exit Alternatives

As a reflection of overall current market conditions, the direct listing market currently appears to be relatively quiet. However, this is not to say that companies are not currently preparing for potential future direct listings. In fact, this may be an opportune time for well-situated issuers to begin preparing for a potential exit in anticipation of the return of investor appetite for equity issuances. Given the substantial amount of preparation required in common for any of an IPO, SPAC business combination or direct listing, companies can begin to prepare now for each of these alternatives, while remaining agnostic as to the ultimate path to follow.

See ***Weil Alert: Keeping the IPO Door Open – What Every PE Portfolio Company Should be Doing Now to Maintain Optionality for an IPO in the Future***. Please click here.

Below is a comparison of certain features of IPOs, direct listings and SPAC business combinations:

	IPO	**Direct Listing**	**SPAC Business Combination**
Required SEC Registration Statement Disclosures	Registration Statement on Form S-1 or F-1 Includes: • 2-3 years of audited GAAP financial statements, with a PCAOB-compliant audit • Unaudited GAAP interim financial statements (with comparison to prior year interim period) • Business description • Management's discussion and analysis of financial condition and results of operations • Related party transaction disclosures • Beneficial ownership disclosures • Executive compensation disclosures	Resale Registration Statement on Form S-1 or F-1 Includes: • Disclosure comparable to an IPO Form S-1 or F-1	Registration Statement on Form S-4 or F-4 registration statement Includes: • Disclosure included in an IPO Form S-1 or F-1 for both SPAC and Target • Proxy information to SPAC stockholders • Post-closing resale registration statement on Form S-1 or F-1 typically required

Ability to Raise New Equity Capital	Yes	Not historically New rules allow for concurrent new capital raise in stock exchange auction, but these have not to date been tested Direct listing issuers frequently do not need additional equity capital immediately or have previously raised sufficient capital in private rounds	Potential for additional capital, including PIPE transactions. Post-transaction capital is uncertain given the redemption rights of the SPAC's public stockholders
Trading/Liquidity of Shares for Controlling Shareholders	An IPO may include a secondary sale or synthetic secondary sale Post-IPO controlling shareholders are typically subject to an 180-day lock-up Following expiration of the lock-up, affiliates may also be able to sell shares in registered follow-on offerings and block trades, under a resale shelf registration statement or pursuant to Rule 144	Controlling shareholders typically register their shares for resale in connection with the direct listing, providing immediate liquidity, subject to any voluntary constraints on resales Following expiration of the original resale registration statement filed in connection with the direct listing, controlling shareholders may also be able to sell shares in registered follow-on offerings and block trades, under a new resale shelf registration statement or pursuant to Rule 144	Subject to any sponsor lock-up, controlling shareholders typically register the resale of shares on a resale registration statement on Form S-1 or F-1 put in place following the business combination Rule 144 for is not available for deSPAC companies until one year following the filing of certain business combination information and is permanently subject to a current information requirement
Lock-ups	Typically 180 days for officers, directors and existing shareholders	Voluntary only for marketing reasons	Sponsors typically locked-up from six – 12 months post-business combination

Number of Shareholders Required	NYSE: 400 round lot holders must be available at commencement of listing, including investors purchasing in the IPO. Public float requirement of 500,000 shares to 1.1 million shares, depending upon tier of NYSE exchange [2] Nasdaq: 300 - 450 round lot holders must be available at commencement of listing, including investors purchasing in the IPO, depending upon tier of Nasdaq exchange. Public float requirement of 1 million shares to 1.25 million shares, depending upon tier of Nasdaq exchange [3]	NYSE: 400 round lot holders must be available at commencement of listing, depending upon tier of NYSE exchange. Public float requirement of 500,000 shares to 1.1 million shares, depending upon tier of NYSE exchange [4] Nasdaq: 300 - 450 round lot holders must be available at commencement of listing, depending upon tier of Nasdaq exchange. Public float requirement of 1 million shares to 1.25 million shares, depending upon tier of Nasdaq exchange [5] This requirement is one potential obstacle to a direct listing for many companies There are potential alternatives such as a private placement pre-filing to address this requirement	NYSE: 300 - 400 round lot holders at all times after the Business Combination to remain listed, depending upon tier of NYSE exchange.[6] Public float requirement of 500,000 shares to 1.1 million shares, depending upon tier of NYSE exchange [7] Nasdaq: 300 - 450 round lot holders (or at least 2200 total stockholders) at all times after the Business Combination to remain listed, depending upon tier of Nasdaq exchange. Public float requirement of 1 million shares to 1.25 million shares, depending upon tier of Nasdaq exchange [8] Anticipated high redemptions are an ongoing concern to maintaining listing Additionally, on both NYSE and Nasdaq, the SPAC continued listing standard of 300 round lot holders prior to the Business Combination, is lower than the 400 round-lot holders required at the point of post-Business Combination
Share Valuation Requirement	Public shares must have a valuation of $15M - $45M, depending on tier of stock exchange[9]	Public shares must have a valuation of $30M - $250M, depending on tier of stock exchange[10]	The SPAC will already have met the valuation requirement for initial listing; continued listing requirements will need to be met

[2] NYSE Listed Company Manual 102.01A, NYSE American LLC Company Guide Section 102

[3] Nasdaq Listing Rules 5315(f)(1), 5405(a), 5505(a)

[4] NYSE Listed Company Manual 102.01A, NYSE American LLC Company Guide Section 102

[5] Nasdaq Listing Rules 5315(f)(1), 5405(a), 5405(b)(2), 5505(a)

[6] NYSE Listed Company Manual 102.01A, 102.06, NYSE American LLC Company Guide Section 102

[7] NYSE Listed Company Manual 102.01A, NYSE American LLC Company Guide Section 102

[8] Nasdaq Listing Rules 5315(f)(1), 5405(a), 5505(a)

[9] NYSE Listed Company Manual 102.01B; Nasdaq Rule 5315(f)(2)

[10] NYSE Listed Company Manual 102.01B; Nasdaq Rules 5505(a), 5505(b)(2), IM-5315-1

Other Liquidity/Initial Trading Considerations	Initial market demand may be greatly enhanced by the marketing and investor education activities of the underwriters (and their analysts) as part of the book-building process The company or selling stockholders give to underwriters the underwriting discount as compensation for their services As a result of the book-building process a public offering price is agreed with the underwriters. Typically, this price is designed to allow for a "bounce" in trading price during the first day of trading. Any benefit of this "bounce" inures to the benefit of investors who purchase in the IPO, not the company or selling stockholders Underwriters also are able to enter into transactions to stabilize the price in a declining aftermarket	The marketing activities by the company and financial advisors prior to the listing are significantly limited by regulatory constraints. Unlike in an IPO there is no ready after-market demand that has been created by the underwriters. Instead, market demand at the time of the initial trading on the exchange has been created largely by the direct efforts of the company, including through investor day marketing activities that must occur earlier than the five-business day window preceding the direct listing There is no book-building exercise, as in an IPO, to help establish an initial trading price. The trading price will be set based on actual demand at the time of listing, with any upside inuring to the benefit of the selling stockholders Neither the company nor the financial advisors engage in stabilization activities A liquid market may develop slowly, making this option potentially unattractive to selling stockholders who need an immediate and predictable monetization and companies who require immediate capital	There is already an existing trading market when the deSPAC occurs, although trading prices do not reflect true market value until redemptions have occurred and the business combination has closed
Underwriter/Financial Advisor	Underwriters are required to play an active role in marketing the offering, attracting investors and stabilizing trading	Financial advisor is required in connection with listing role Financial advisor is typically sought to assist issuer in designing investor education activities Independent valuation may also be required to meet listing criteria	Affiliated transaction requires SPAC to obtain fairness opinion

Financial Advisor Fees	Underwriting discount paid	No underwriter fees but potentially substantial financial advisor fees	Sponsor promote *plus* any financial advisor fees
Other Costs	Accounting costs for PCAOB audited financial statements Legal costs for Form S-1 or F-1 and resale registration statement	Comparable to IPO	Comparable to IPO

* * *

Corey Chivers (Corey.Chivers@weil.com) is a partner and Mercedez Taitt-Harmon (Mercedez.Taitt-Harmon@weil.com) is an associate in Weil's Capital Markets group. They were assisted by summer associate Micaela Grassi.

If you have questions regarding Direct Listings, IPOs or SPAC offerings, please feel free to reach out to your normal Weil contact or the following partners in Weil's Capital Markets group:

Frank Adams (NY)	View Bio	frank.adams@weil.com	+1 212 310 8905
Barbra Broudy (NY)	View Bio	barbra.broudy@weil.com	+1 212 310 8744
Ashley Butler (NY)	View Bio	ashley.butler@weil.com	+1 212 310 8855
Corey Chivers (NY)	View Bio	corey.chivers@weil.com	+1 212 310 8893
Heather Emmel (NY)	View Bio	heather.emmel@weil.com	+1 212 310 8849
Michael Hickey (NY)	View Bio	michael.hickey@weil.com	+1 212 310 8050
Merritt Johnson (NY)	View Bio	merritt.johnson@weil.com	+1 212 310 8280
Alexander Lynch (NY)	View Bio	alex.lynch@weil.com	+1 212 310 8971
Michael Stein (NY)	View Bio	michael.stein@weil.com	+1 212 310 8135

© 2023 Weil, Gotshal & Manges LLP. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations that depend on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP. If you would like to add a colleague to our mailing list, please click here. If you need to change or remove your name from our mailing list, send an email to weil.alerts@weil.com.