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GOING PUBLIC WITHOUT AN IPO

Earlier this year, the music streaming service Spotify went public without conducting an underwritten IPO, making it the largest company to do so through a direct listing. The author discusses Spotify's direct listing, the advantages and disadvantages of going public without an IPO, companies that make good candidates for direct listing, and the future of this approach to going public.

By John C. Partigan *

On April 3, 2018, shares of music streaming service Spotify began trading on the New York Stock Exchange. At the end of its opening day of trading, 30,526,500 shares were traded on the NYSE (ticker: SPOT), representing a value of approximately $4.55 billion based on the closing price on that day, making it the largest company to go public through a direct listing.[1]

Spotify's decision to go public without a traditional initial public offering was made possible by recent changes to the NYSE's listing requirements — which some commentators have dubbed the "Spotify rule," that went into effect on February 2, 2018.

In this article we'll discuss Spotify's direct listing, the advantages and disadvantages of going public without an IPO, companies that make good candidates for direct listing, and what this all means for the future of direct listing.

WHAT IS A DIRECT LISTING UNDER THE SPOTIFY RULE?

A "Direct Listing" simply means listing the shares of a company for trading on a stock exchange (in this case, the NYSE) without conducting an underwritten IPO, spin-off, or transfer of the listing from another stock exchange. The shares of a privately held company are publicly traded as a result of this process and the company becomes subject to the periodic reporting requirements under the Securities Exchange Act of 1934, but no new shares are issued to the public. Unlike a traditional IPO, no new capital is raised by the company. The primary purpose of a Direct Listing is to provide a liquidity event for the company's existing shareholders who purchased their shares in the private capital markets.

In a Direct Listing, the company is required to file with the U.S. Securities and Exchange Commission a resale shelf registration statement solely for the purpose

[1] The Spotify direct listing ranked as the 8th largest technology company IPO after its first day of trading, just behind Google in 2004, according to Dealogic. The shares traded on April 3, 2018 represented 17% of Spotify's ordinary shares outstanding as of March 21, 2018.

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of allowing existing shareholders to sell their shares. The registration statement will be on Form S-1 for domestic issuers and Form F-1 for foreign private issuers, which are the same forms, and the same level of disclosure that would be required, for a traditional underwritten IPO. As a result, the regulatory process and timelines for a Direct Listing and a traditional underwritten IPO are similar.[2]

As a technical matter, in a Direct Listing, the company is not registering the offer and sale of securities by the company (primary offering) or its selling shareholders (secondary offering) because the transaction involves an application to cause the outstanding shares to be made eligible for trading on an exchange, and not a proposed distribution or sale of securities that would need to be registered. In its initial rule-making proposals, the NYSE took the position that it could list a company upon the effectiveness of an Exchange Act registration statement (Form 10).[3] However, the NYSE ultimately revised its proposal,[4] presumably due to pressure from the SEC, to require that a Direct Listing be accompanied by a Securities Act registration statement — in effect, leveling the playing field between a Direct Listing and a traditional IPO, even when the analytical basis for this requirement is not entirely clear.

A company considering a Direct Listing will need to be able to demonstrate compliance with all of the listing criteria of the applicable stock exchange.[5] Until Footnote (E) of Section 102.01 (B) of the NYSE Listed Company Manual was recently amended, Spotify would not have been eligible to list on the NYSE because it could not demonstrate that its shares held by non-affiliates would have a market value of at least $100 million based on the trading of the shares in a trading system for unregistered securities operated by a national securities exchange or a registered broker-dealer (Private Placement Market).[6] Prior to the Direct Listing, Spotify's shares traded in private transactions, as noted in its prospectus, but not on a Private Placement Market. Under the Spotify Rule, the NYSE, in its discretion, may approve a company for listing that does not have any history of trading in a Private Placement Market if the company provides an independent third-party valuation evidencing a market value of its shares held by non-affiliates of at least $250 million.[7] The NYSE explained that the amendment "allows the Exchange to list a company's securities in the absence of trading on a Private Placement Market, provided the company is clearly large enough to be suitable for listing on the Exchange."[8]

At the time it provides such valuation, the valuation agent may not own or have the right to acquire within 60 days more than 5% of the class of securities to be listed. In addition, the valuation agent or any affiliates may not have been engaged to provide investment banking services in connection with the listing and may not have provided any investment banking services to the company applying for the listing within the preceding 12 months.

[2] Spotify submitted its draft Registration Statement on Form F-1 for confidential review on December 18, 2017. The process from the initial filing to effectiveness of the registration statement took approximately 95 days. Spotify received 70 SEC staff comments overall with respect to the registration statement, including a number related to the specific terms of the Direct Listing, and others related to the company's business description and other general disclosures. Overall, this timeline is not significantly shorter than what one would expect for an underwritten IPO filed by a company of this size and with similar operations.

[3] NYSE proposal (SR-NYSE-2017-12) filed with the SEC on March 27, 2017.

[4] SEC Release 34-82627 (published February 2, 2018).

[5] For example, see Section 102.00 (for equity securities of domestic companies) and Section 103.00 (for equity securities of foreign private issues) of the NYSE Listed Company Manual.

[6] The most prominent Private Placement Market is the NASDAQ Private Market. Other private placement secondary markets include Second Market, Shares Post, and Scenic Advertisement, each registered with FINRA as brokerages.

[7] Footnote (E) to Section 102.01 (B) of the NYSE Listed Company Manual.

[8] NYSE Information Memo (IM-18-02) (March 28, 2018).

The valuation agent must also have significant experience and demonstrable competence in the provision of such valuations. The valuation agent must consider the registration statement's required annual financial statements and financial statements for any completed fiscal quarters subsequent to the end of the last year of audited financials, among other factors.

After receiving the valuation, the NYSE will continue monitoring the company up to the time of listing, taking consideration of any market factors that could diminish the company's value. If the valuation no longer reflects the company's market value, the NYSE may withdraw its approval at any time prior to the listing date.

SPOTIFY GOES PUBLIC

On April 3, 2018, the opening day of trading on the NYSE, 30,526,500 shares of Spotify were traded. The opening public price was $165.90 and the closing public price was $149.01. At the end of its opening day of trading on the NYSE, Spotify had a market cap of $26.54 billion.

In trading as a private company, prior to listing, the sale prices for Spotify's ordinary shares ranged from $37.50 to $125 per share during 2017, and from $90 to $132.50 per share from January 1, 2018 through February 28, 2018. The Designated Market Maker ("DMM") assigned to the security by the NYSE set a "Reference Price" for Spotify at $132 per share in consultation with a financial advisor to the company pursuant to NYSE Rule 15. The DMM ultimately established the opening public price much higher at $165.90 per share based on buy and sell orders collected by the NYSE from various broker dealers during the morning of April 3 and its determination of where buy orders could be matched with sell orders at a single price. On July 30, 2018, Spotify's ordinary shares closed on the NYSE at $182.83, 38% above its reference price of $132, and representing a market cap of $32.3 billion. The Spotify shareholders likely regard the Direct Listing as a resounding success.

Spotify's resale registration statement permitted the resale of 55,731,480 ordinary shares (about 31% of the outstanding shares), constituting "restricted securities" under SEC Rule 144. The registered shares were held by two groups of existing shareholders: (i) officers, directors, 10% shareholders, and other affiliates of the issuer (including 21% of the outstanding shares held by the two founders of Spotify) and (ii) non-affiliates who had not held their shares long enough to satisfy the one-year holding period requirement for a resale under Rule 144. Spotify kept its registration statement effective for 90 days to permit resales on the NYSE by these registered shareholders and then filed a post-effective amendment to terminate the effectiveness of the registration statement.

Prior to the Direct Listing, Chinese internet giant Tencent (a 9% shareholder of Spotify) had entered into a three-year lock-up expiring in 2020, unrelated to the listing. No other Spotify shareholders were subject to any lock-up or similar restriction on selling shares. As a result, approximately 91% of the outstanding shares were eligible to be sold on the opening day of trading. By contrast, in a typical underwritten IPO, officers, directors, and large shareholders would be required to agree not to sell their shares in the market (subject to certain exceptions) for a lock-up period of 180 days.

Prior to the commencement of secondary trading of its shares on the NYSE, Spotify obtained a no-action letter from the staff of the SEC's Division of Trading and Markets to provide assurances that the proposed Direct Listing, resale registration, and certain planned investor-related activities would not be deemed a "distribution" for purposes of SEC Regulation M under the Exchange Act.[9] In the no-action letter request, Spotify represented that the company, its financial advisors, the registered shareholders, and their affiliated purchasers would not bid for, purchase, or attempt to induce any person to bid for or purchase any shares of Spotify during a "restricted period" that commenced on the fifth business day prior to the determination by the DMM of the opening trading price of the shares on the NYSE, and ended with the commencement of secondary market trading in the shares on the NYSE.

In addition, pursuant to its no-action letter request, Spotify represented that for a period of at least 90 days after the Registration Statement on Form F-1 had been declared effective by the SEC: (i) Spotify would not offer or issue any new shares for sale under the Form F-1 or receive any proceeds from the sale of shares by any of the registered shareholders; (ii) resales of the shares would be effected solely through ordinary brokerage transactions into an independent market not controlled by the company or its financial advisors and without any special selling efforts, and Spotify would have no input as to if or when any registered shareholder may, or may not, elect to sell their shares, or the prices at which such sales may occur; (iii) the company's financial advisors would be engaged solely to provide advice and assistance to the company with respect to the filing of

[9] SEC No-Action Letter, Spotify Technology S.A. (T.P. File No. 18-10) (March 23, 2018).

the Form F-1 and the listing, but not to provide underwriting services or stabilize or support the price of the shares, and would not assist the company in the planning of, or actively participate in, investor meetings; (iv) the company's financial advisors would receive a flat fee for their advisory services (which fee was not dependent on the amount or price of the shares registered or ultimately sold pursuant to the Form F-1) and would not have discretionary authority with respect to any potential brokerage accounts they may establish for any registered shareholders, and the company would not pay for any fees or expenses relating to any such brokerage accounts; and (v) the DMM would be unaffiliated with Spotify and the financial advisors, would operate independently of such persons, and would be solely responsible for establishing the opening trading price of the shares on the NYSE and maintaining an orderly market for the shares.

Although now seemingly successful, Spotify's novel approach to going public did not come without risk.

Following review of Spotify's Form F-1, the SEC noted several potential key risk factors. First, the direct listing wouldn't have the typical IPO safeguards, which could result in volatile trading volume and price uncertainty. Without an underwriter's greenshoe to permit the purchase of additional issuer shares at the IPO price, trading prices could also fluctuate after the initial listing. And, there was no book-building process to determine indications of interest and there would also be an unpredictable supply of shares available for sale. Lastly, there was a risk that an active, liquid, and orderly market might never develop or be sustained.

The SEC staff also required that the following risk factors be separately discussed in the prospectus: (i) the opening price may have little or no relationship to the company's historic trading prices; (ii) the lack of contractual lock-up agreements and the related impact; (iii) without customary underwriter stabilizing activities, trading prices may fluctuate after the initial listing; and (iv) the uncertainty of the NYSE process.[10]

ADVANTAGES OF DIRECT LISTING

With no lock-up agreements restricting resales by directors, officers, or principal shareholders, Direct Listing provides many potential advantages for existing shareholders, including enhanced liquidity. Because the company does not issue any new shares, there's no dilution for existing shareholders.

Direct Listing also permits registered resales of shares by affiliates without complying with the volume limitations and holding period conditions that would typically apply under Rule 144 following an underwritten IPO.

By going public without an IPO, private investors and employee shareholders can sell their shares through an orderly process on the NYSE, instead of the private placement market. And, as a result, they may obtain better and more efficient market-based pricing.

A Direct Listing also saves money by allowing companies to forgo a traditional IPO and avoid hefty underwriting fees.

Spotify's Form 6-K reported approximately $29 million in "other advisors' fees" for its three financial advisors for the Direct Listing, Morgan Stanley, Goldman Sachs, and Allen & Company.[11] Although any comparison is problematic because no new shares were issued and no underwriter actually purchased any shares, these fees represented only about (i) one-half of one percent of the market price of the 30.5 million shares of Spotify that were traded on April 3, 2018 and (ii) three-tenths of one percent of the market price on April 3, 2018 of the 55.7 million shares registered on the Form F-1. By contrast, in a typical underwritten IPO, the underwriter's discount could be in the range of 4-7% of the value of the registered shares sold to the public.

Becoming a publicly traded company also has other potential general benefits, including access to the U.S. public capital markets for financing, use of company stock as acquisition currency, enhanced prestige, and name recognition.

DISADVANTAGES OF DIRECT LISTING

With the potential advantages of Direct Listing, come some potential disadvantages. For one, no new capital is raised with Direct Listing, which is often the primary motivation for going public. For a company like Spotify, the availability of substantial amounts of private equity capital made this potential disadvantage less of a concern. For smaller private companies, the lack of new

[10] SEC staff comment letter to Daniel Ek, Chief Executive Officer of Spotify Technology S.A., dated January 17, 2018.

[11] Spotify Technology S.A. Form 6-K for the month of May 2018 (filed May 3, 2018), at note 22 to the interim condensed financial statements.

money, coupled with the substantial increased costs of being a public company, could be a serious disadvantage of a Direct Listing.

There's also uncertainty regarding whether an active public market for the company's shares will develop or whether the trading price and resulting market capitalization for the company will exceed the history of trading in private transactions. A company pursuing a Direct Listing, as compared to a traditional IPO, would have a smaller public float because the transaction does not involve a public offering of new shares by the company.

With no lock-up period to keep shareholders from selling their shares and flooding the market, and with no market stabilization by underwriters, Direct Listing also brings an increased risk of immediate price volatility. An unsuccessful listing can also harm the company's reputation.

There are also the potential general disadvantages of being a publicly traded company, including additional legal, accounting, investor relations, and compliance costs, as well as ongoing disclosure obligations and the potential for competitive harm as a result. Once a company is publicly traded, it might lose control as a result of a hostile takeover.

SUITABLE CANDIDATES FOR DIRECT LISTING

There's a lot to consider when it comes to Direct Listing, so it's important to know what makes a suitable candidate. As a starting point, the company would need to confirm that it meets the general listing requirements of the NYSE (or other stock exchange). In addition, as discussed above, if the company does not have shares with a market value of at least $100 million trading in a Private Placement Market, it would need to have a valuation from an independent third-party valuation agent of at least $250 million under the NYSE rules. Other attributes of a suitable candidate for Direct Listing are noted below.

Direct Listing as an alternative path to liquidity may be better suited to a company with substantial name recognition surrounding its brand and products in order to increase the likelihood that its shares will gain market acceptance by institutional and retail investors without the extensive marketing and publicity typically associated with an underwritten IPO.

A profitable company that does not need to raise money and/or a company with access to plentiful capital in the private markets and a high valuation as a private company would also make a good candidate. Other candidates may include a company with a large group of existing private investors and employee shareholders seeking the ability to sell their shares. In all cases, the company needs to have the management sophistication and depth required for public company reporting and accounting.

FUTURE OF DIRECT LISTING

With success raising private capital, as well as strong brand recognition in the marketplace, Spotify proved to be a great candidate for Direct Listing. Most private companies need to raise new money through an IPO and there's a limited supply of privately held "Unicorns" that are able to assume the burdens associated with becoming a public company without the need to raise additional capital.

Both the NYSE and NASDAQ had rules permitting Direct Listings before the NYSE adopted the Spotify Rule. Only a handful of relatively obscure companies completed direct listings under these rules in the past. As a result, it seems likely that the Direct Listing will not supplant the traditional underwritten IPO, at least in the near term, until such time as one or more non-Unicorns are able to use it successfully. Although it's unclear whether Spotify's success will encourage other companies to take the Direct Listing route, the changes to the NYSE's listing requirements will certainly give more companies the opportunity. ■