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Direct Listing on the New York Stock Exchange: “Undertaking” the Underwriter REDUX

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On Tuesday, December 22, 2020, the U.S. Securities and Exchange Commission (“SEC”) issued Release No. 34 -90768 (the “Release”), approving the proposal by the New York Stock Exchange (“NYSE”) to allow primary direct listings of securities on the NYSE without going through the Initial Public Offering process. This step means that companies able to meet the listing requirements spelled out in Chapter One of the NYSE’s Listed Company Manual can become listed on the NYSE without the involvement of an underwriter or the “firm commitment” of that underwriter to purchase the securities from the company and then resell them to the public. Direct listing, thus, saves the costs of the underwriting (typically between 1% – 7% of the price offered to the public, depending on the relative strength of the company and the perceived demand of the public for the shares being offered). Direct listing also “saves” the scrutiny that the underwriter is legally required to accord to the offering as it conducts “due diligence.” In February 2018, the SEC approved direct listings by selling shareholders, i.e., where the company whose shares are listed does not raise any capital in the transaction. To date, that option has been used successfully by Spotify AB, Slack Technology, Inc., and Palantir Technologies, Inc., although the Slack listing did result in litigation concerned with the quality of disclosure about the prospects of Slack.

Direct Listing on the New York Stock Exchange

On Wednesday, August 26, 2020, the SEC approved an additional modification to the NYSE Listed Company Manual to allow PRIMARY direct listings, where the company, as a company, either alone or with selling shareholders, can become a company with publicly traded shares listed on the NYSE. The SEC approval came after some ten months of the NYSE submitting proposals, receiving rejections or objections, and revising and resubmitting proposals. See my prior blog post of September 2, 2020, as amended on September 4, 2020, “Direct Listing on the New York Stock Exchange: ‘Undertaking’ Underwriting,” which lays out something of the development of stock exchange listings and the details of the NYSE’s primary direct listing proposal. But then on September 8, 2020, (after giving prior notice to the SEC and to the NYSE) the Council of Institutional Investors (“CII”) petitioned the SEC to review its August 26 Approval Order. As a result, the SEC stayed the effectiveness of its approval and scheduled deadlines for submission of supporting papers: in the case of CII to disallow the approval; and in the case of the NYSE to confirm the approval. Under Section 19b(2)(C) of the Securities Exchange Act of 1934, as amended (the ’34 Act), the SEC must approve a proposed rule change proposed by a Self-Regulatory Organization,

such as the NYSE, if “the Commission finds that the proposed rule change is consistent with the …['34 Act] and the applicable rules and regulations thereunder.”

In the 40-page Release, the SEC revisited all of the technical details of the NYSE primary direct listing proposal approved on August 26, 2020. It also considered two major points raised by CII: one, that primary direct listings are unlikely to involve lockup agreements; and two, that due to the “traceability” doctrine developed by the courts, investors are more at risk when purchasing stock of a company which has engaged in a primary direct listing. Underwriters typically (but are not legally obligated to) require company ”insiders” – directors, officers, and holders of a substantial number of shares – to enter into so-called “lockup agreements” as a condition to agreeing to underwrite the offering. The lockup period (from three months to sometimes a year)prevents those insiders from selling in the immediate aftermath of going public. The lockup limits the number of shares being sold and also prevents an appearance of “taking the money and running” by the insiders. Both aspects tend to help maintain the share price above the offering price to the public. The 'traceability” issue is more complex. Under Section 11 of the Securities Act of 1933, as amended, a purchaser in a public offering can establish liability of the company if the purchaser can show a misstatement of a material fact in the offering documents, or the omission of a fact which makes the statements in the offering document materially misleading. The purchaser need not prove intent on the part of the company to misstate or mislead; it is essentially a negligence standard. However, if the purchaser cannot show that he/she purchased the shares in the offering in which a deficient offering document was used, a purchaser can only recover for investment if the purchaser can show scienter (essentially fraudulent intent or gross negligence). The difficulty with a primary direct listing is that there is limited capacity to trace the actual origin of shares purchased or show that there was a suspect offering document involved.

“Undertaking” the Underwriter

The SEC, accepting arguments made by the NYSE as well as its own analysis, rejected both of the CII points. The SEC noted that lockup agreements are NOT legally required and that there is no bar to having lockup agreements in place in connection with a primary direct listing. The SEC also noted that both a State and a Federal Court in the Slack Technology, Inc., litigation had refused to dismiss plaintiffs' claims under Section 11, despite the difficulty in tracing the purchase transactions. The SEC noted that a financial adviser (required by the primary direct listing process), depending on all the facts and circumstances, might be held to be an underwriter and subject to underwriter liabilities. Moreover, the SEC observed CII's concerns about the ability to pursue a Section 11 claim “due to traceability issues are not exclusive to nor necessarily inherent in Primary Direct Floor Listings; [r]ather, this issue is potentially implicated anytime that securities that are not the subject of a recently effective registration statement trade in the same market as those that are so subject.” The SEC goes on to note that courts have interpreted Section 11 to “permit aftermarket purchasers …to recover damages under Section 11.” The SEC conceded that such recoveries have to date required an ability to trace the shares back to the offering with the deficient disclosures, but the SEC also said that this “judicially-developed doctrine” is subject to judicial modification to meet the contextual circumstances, citing as authority *Pirani v. Slack Techs., Inc.*, 2020 U.S. Dist LEXIS 70177 (N.D. Cal., April 21, 2020). Or in other words, the SEC effectively invites the judiciary to review the doctrine. Implicitly saying 'You, Courts created this issue; use your inventive powers to fix it', or as more diplomatically stated by the SEC “[w]e expect judicial precedent on traceability in the direct listing context to continue to evolve.”

But the Release was not the last word about primary direct listing on the NYSE. On the day following the issuance of the Release two of the five SEC Commissioners (Allison Herren Lee and Carline A.

Crenshaw) issued a three-page single-spaced Statement on Primary Direct Listings. The two Commissioners wrote, "Unfortunately, the [NYSE] rule fails to address very real concerns regarding protections for investors. As a result, we are unable to support this specific approach." They do concede, "the current IPO process is far from perfect;" noting that the current process "imposes relatively high fees on issuers." But then they engage in criticizing SEC actions more generally stating, "the underlying problem that we confront today is that the SEC has chipped away at the public securities market year after year; [e]xemption after exemption from foundational Securities Act requirements has allowed, if not incented" companies to remain private, raising capital through any number of private offering mechanisms. This is a topic noted in several of my previous blog posts, ""'Accredited Investor': Regulatory Design, the Revised Definition, and the Unfinished Result" (September 15, 2020) and "Keeping Securities Disclosures in the Pink: Amendments to SEC Rule 15c2-11" (October 29, 2020). Commissioners Herren Lee and Crenshaw assert that "[t]his private market proliferation results in far fewer investment opportunities for retail investors in the public markets, where there is a more level playing field and where information asymmetries and other power imbalances are alleviated." The two Commissioners claim that the absence of a firm commitment underwriter risks far less due diligence and more deficient disclosure AND that the lack of traceability raises "the potential inability of shareholders to recover losses for inaccurate disclosures." They offer suggested improvements such as requiring ON-GOING auditor attestations and management assessments of the company's internal controls during the primary direct listing process. They also caution about the risk of increased price volatility with the absence of an underwriter performing stabilization functions in the aftermarket. One senses that these comments may be replayed after primary direct listings occur, especially with the upcoming change of administration in Washington.

The "Wolf" of Wall Street

One other ancillary note: on September 15, 2020, the SEC published listing rule changes proposed by NASDAQ on September 4, 2020, which paralleled (but had some variations from) the NYSE primary direct listing proposal, now approved by the SEC. On December 23, 3020, the Director of the SEC Division of Trading and Markets issued a Staff Statement Regarding NASDAQ Rule Proposal promising "to work to expeditiously complete, as promptly as possible accommodating public comment, a review of" the NASDAQ proposals to allow primary direct listings on NASDAQ. In a footnote, the Director notes that the Staff Statement sets forth the views of the Division and is not binding on the SEC.

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