Direct Listing: How Spotify Is Streaming on the NYSE and Why the SEC Should Press Play

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INTRODUCTION

Uber. WeWork. Airbnb. SpaceX. Spotify. The list could go on—but each of these companies started as a small start-up and grew into aa massively well-funded corporation fueled by various venture capital (VC) and private equity (PE) firms.[1] Take Spotify: the music streaming service that was once just an idea in Sweden has now raised approximately

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[1] Avery Hartmans, *The $10 Billion Club: Meet the 8 Most Valuable Startups in the US*, BUS. INSIDER (Jan. 2, 2017, 10:00 AM), http://www.businessinsider.com/most-valuable-us-startups-2016-12/#8-dropbox-1.

$2.7 billion since its founding in 2008.[2] Spotify, however, remained private for ten years while relying solely on VC and PE funds.[3]

If a company previously wanted to raise $2.7 billion in funding, going public would likely be the only option.[4] This is no longer the case. VC firms invested $84.2 billion in 8,076 companies during 2017.[5] Angel investors, PE firms, hedge funds, investment companies (e.g., mutual funds) and other investment sources likewise provide further funding to growing companies. Thus, if a thriving company needs capital, it can obtain said capital from the boardroom of a Silicon Valley VC firm or the New York offices of a PE firm—not solely on the trading floor of the New York Stock Exchange (NYSE).

But what happens when these companies decide to go public? Or, what happens when the various VC and PE firms induce the company to go public in order to exit their investment on the public market? The obvious answer in the past was the oh-so-coveted initial public offering (IPO). During an IPO, a company can raise a new round of capital while the VC/PE firms gain the ability to sell their shares on the public market.[6] However, IPOs have been plagued by underpricing,[7] high underwriting fees,[8] and corporate-insider favoritism.[9] IPOs have been spectacular for the bottom lines of underwriters, but they do not always benefit issuers, public investors, and investment funds.

Instead of engaging underwriters to conduct an IPO, Spotify decided to pursue a novel new idea: direct listing of its shares on the

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[2] *Spotify Funding Rounds*, CRUNCHBASE, https://www.crunchbase.com/organization/spotify/funding_rounds/funding_rounds_list (last visited Feb. 21, 2018) [hereinafter "Spotify Funding Rounds"].

[3] *Id.* (Spotify has obtained funding from several venture capital firms including Kleiner Perkins Caufield & Byers and Horizons Ventures, as well as private equity firms Technology Crossover Ventures and Tiger Global Management).

[4] ANDREW J. SHERMAN, RAISING CAPITAL: GET THE MONEY YOU NEED TO GROW YOUR BUSINESS 197 (2d ed. 2005).

[5] PITCHBOOK-NATIONAL VENTURE CAPITAL ASSOCIATION, *Venture Monitor Q4 2017* (Jan. 2018), https://nvca.org/research/venture-monitor/ [hereinafter "Pitchbook"].

[6] *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 105–06 (8th ed. 2017); *see also* Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., Nov. 1998, at 131, 134, https://hbr.org/1998/11/how-venture-capital-works (outlining the business model of venture capital firms with the IPO as an exit strategy).

[7] Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1795 (2002).

[8] Mark Abrahamson et al., *Why Don't U.S. Issuers Demand European Fees for IPOs*, 66 J. FIN. 2055, 2056–57 (2011).

[9] *See In re* eBay, Inc. S'holders Litig., No. C.A. 19988-NC, 2004 WL 253521, at *1 (Del. Ch. Jan. 23, 2004) (allocation of shares in eBay IPO to "insiders," including members of eBay's board of directors, could constitute a breach of fiduciary duty of loyalty); *see also* Michael Dambra et al., *The Consequences to Analyst Involvement in the IPO Process: Evidence Surrounding the JOBS Act*, J. ACC. ECON. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2530109 (finding investors purchasing IPO shares with analyst involvement lose over 3 percent of their investment by the time of the firm's subsequent earnings release).

NYSE.[10] Spotify has already proved that it can raise abundant capital without the IPO process; therefore, the underwriting and issuing of new shares is unnecessary for the company. Only existing shares—mostly belonging to VC/PE firms and insiders—started trading on the NYSE. A direct listing is not without its shortcomings, but Spotify was able to avoid underwriting fees, dilution to existing shareholders, lockup periods, and other costs associated with a traditional IPO.[11] Spotify's shares started trading on April 3, 2018, with a first-day closing price of $149.01—13 percent above the reference price of $132.00.[12] This successful direct listing has the potential to affect the future of "going public" for many other well-known, growing companies.[13]

This Note proposes that given Spotify's successful launch on the NYSE, direct listings will become increasingly popular—primarily for start-ups but also as an exit strategy for VC and PE firms in their nonpublic investments. Part II of this Note will discuss the process of "going public" via an IPO or a direct listing. Part III will use Spotify as an illustrative example of the direct listing process. Part IV will consider the advantages and disadvantages of direct listing. Part V will conclude that the Securities and Exchange Commission (SEC or the Commission) should embrace the direct listing process and will propose concrete actions the SEC can take to facilitate and streamline the direct listing process.

I. BECOMING A PUBLIC COMPANY: THE OLD AND THE NEW PROCESS

"[I]f it were up to Mr. Zuckerberg, Facebook would remain private."[14] Facebook did, however, famously go public.[15] Most companies traditionally go public for business or funding reasons. More recently, though, fewer companies have been going public—waiting until legally required. Under federal law, a company must register when it either (i) reaches total assets greater than $10 million and a class of equity securities held by 2,000 or more persons (or 500 or more persons who are

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[10] Ben Sisario & Michael J. de la Merced, *Spotify Is Said to Be Going Public in Early 2018*, N.Y. TIMES (Jan. 3, 2018), https://www.nytimes.com/2018/01/03/business/media/spotify-ipo-streaming-music.html.

[11] Alan Jones, *Demystifying direct listings*, PWC DEALS BLOG (June 9, 2017), http://usblogs.pwc.com/deals/demystifying- direct listings/.

[12] Maureen Farrell et al., *Spotify's Splashy Debut Pressures Banks*, WALL ST. J. (Apr. 3, 2018, 7:31 PM), https://www.wsj.com/articles/spotify-shares-jump-in-market-debut-1522773951 (A "reference price" is the price set by financial analysts based on previous trades in private placement markets).

[13] *See*, *e.g.*, Dan Primack, *Spotify could affect Uber's IPO plans*, AXIOS (May 30, 2017), https://www.axios.com/spotify-could-affect-ubers-ipo-plans-1513302638-82c54054-52f3-4b51-adea-ddd08bacdbe9.html.

[14] Shayndi Raice, *Facebook's Goal: to Be a Blue Chip*, WALL ST. J. (Dec. 22, 2011), https://www.wsj.com/articles/SB10001424052970203893404577100433735615126.

[15] *Id.*

not accredited investors),[16] (ii) trades shares on a national securities exchange,[17] or (iii) offers securities to the public.[18]

Modern companies such as Facebook avoid going public for a number of reasons, most notably the costs associated with the registration process and the periodic reporting requirements.[19] Mr. Zuckerberg publicly stated that he resisted going public because he believed it would affect the "culture" of Facebook: "[E]mployees [should be] focused on making great products, not the stock price."[20] What was left unspoken, though, was that if Facebook can raise massive amounts of capital from VC firms, PE funds, or investment banks, why would it subject itself to the onerous requirements of being a public company?[21] If reports are correct, Mr. Zuckerberg was ultimately persuaded to go public because of the 2,000-shareholder (then 500-shareholder) threshold.[22] Other companies may decide to go public for numerous reasons specific to each business. Thus, how does a company go public—legally speaking? The traditional method was via an IPO, but the direct listing process has recently emerged as a novel method for going public.

A. The IPO: Wall Street's Favored Method

The most common way to go public is through the IPO.[23] For the last century, this has been the aspiration of most small companies with their eyes on growth. Large investment banks and law firms are able to easily guide an issuer through the process. However, the process has been subject to several abuses.

1. The Long And Winding IPO Process

After the company has restructured and organized itself internally (a major undertaking in itself), the first external step in the IPO process is

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[16] 15 U.S.C. § 78l(g).

[17] *Id.* at § 78l(a).

[18] *Id.*

[19] PwC, *Considering an IPO to fuel your company's future? Insight into the costs of going public and being public*, PWC DEALS 13 (Nov. 2017), https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf (noting gross underwriting fees of 5.6 percent, plus an additional $3.2–6.9 million of offering costs directly attributable to the IPO).

[20] Raice, *supra* note 14.

[21] Susanne Craig & Andrew Ross Sorkin, *Goldman Offering Clients a Chance to Invest in Facebook*, N.Y. TIMES DEALBOOK (Jan. 2, 2011, 11:31 PM), https://dealbook.nytimes.com/2011/01/02/goldman-invests-in-facebook-at-50-billion-valuation/; *see also* PwC, *supra* note 19, at 20 ("Based on our survey results, on average companies incur more than $1 million of annually recurring costs as a result of being public[.]").

[22] 15 U.S.C. § 78l(g).

[23] SHERMAN, *supra* note 4, at 200.

choosing an underwriter. Underwriters work under one of two contracts: (i) the firm commitment contract or (ii) the best-efforts contract.[24] In the firm commitment contract, the underwriter takes on the risk by purchasing the security at a fixed price and then sells the security to the public at a higher offering price.[25] On the other hand, in the best-efforts contract, the underwriter agrees to use its best efforts to place the shares with the public at the agreed offer price.[26] The underwriter pays the issuer the proceeds from the shares sold, minus the commission.[27] Although one underwriter historically managed large issuances, it is now common practice for an underwriting "syndicate" to manage the issuance, led by a "lead underwriter."[28]

Regardless of the agreement reached with the underwriter, the underwriter receives its "gross spread," i.e., the difference between the amount paid to the issuer of securities and the public offering price.[29] From 2015 to 2017, the weighted average of gross underwriting fees was 5.6 percent of gross proceeds.[30] Snap Inc., commonly referred to as Snapchat, managed to negotiate the underwriting fee down to 2.5 percent.[31] Even this considerably low fee amounted to $85 million in underwriting fees raked in by the syndicate.[32]

After the issuer has chosen an underwriter, the next step is to file a registration statement with the SEC under the Securities Act of 1933 (Securities Act),[33] usually a Form S-1[34] (or a Form F-1 for foreign issuers).[35] Form S-1 includes two parts. Part I is the prospectus, a legal document that must be distributed to the initial investors containing a host of information including business operations, risk factors, use of proceeds, determination of the offering price, legal attributes of the shares, and information on the underwriters.[36] Part II includes information not

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24 *See generally* COX, *supra* note 6, at 107.

25 *Id.*

26 *Id.* at 108.

27 *Id.*

28 *Id.*

29 GRETCHEN MORGENSON AND CAMPBELL R. HARVEY, THE NEW YORK TIMES DICTIONARY OF MONEY AND INVESTING: THE ESSENTIAL A-TO-Z GUIDE TO THE LANGUAGE OF THE NEW MARKET, 356–57 (2002).

30 PwC, *supra* note 19, at 13.

31 Maureen Farrell, *Snapchat Parent Plans to Pay Banks 2.5% of IPO Proceeds*, WALL ST. J. (Jan. 20, 2017), https://www.wsj.com/articles/snapchat-parent-plans-to-pay-banks-2-5-of-ipo-proceeds-1484950998 (noting the 2.5 percent fee is the third-lowest percentage ever paid by a U.S. technology company valued over $1 billion).

32 Snap Inc., Prospectus Filed Pursuant to Rule 424(b)(4), Registration No. 333-215866 (Mar. 1, 2017), https://www.sec.gov/Archives/edgar/data/1564408/000119312517068848/d270216d424b4.htm [hereinafter "Snap Inc. Prospectus"].

33 15 U.S.C. § 77f; *see also* SEC, Registration under the Securities Act of 1933 (Sept. 2, 2011), https://www.sec.gov/fast-answers/answersregis33htm.html.

34 17 C.F.R. § 239.11.

35 17 C.F.R. § 239.31.

36 SEC, Form S-1 Registration Statement under the Securities Act of 1933 at 4 (Apr. 2017), https://www.sec.gov/files/forms-1.pdf.

required in the prospectus, such as recent sales of unregistered securities, exhibits, financial statement schedules, and other related information.[37] Preparing and filing a registration statement under the Securities Act is time-consuming and expensive process.[38] The White House Office of Management and Budget (OMB) estimates 667 "average burden hours per response" for Form S-1.[39] By way of example, Tesla Motors, Inc.'s prospectus is 173 pages long, with an additional 38 pages of produced exhibits and 11 pages for Part II.[40] Congress and the SEC have taken steps to reduce the burden of filing the registration statement. The OMB's "average burden hours per response" is down over 300 hours from the previous estimate of 972.32 hours.[41] Additionally, the Commission now allows companies to file documents early in the IPO process on a confidential basis,[42] which has resulted in an 80 percent reduction in the number of days from announcement of the IPO until the first day of trading.[43]

After the registration statement is filed with the SEC, the company must wait 30 days for comments from the SEC and then respond to those comments.[44] During this "quiet period," companies are largely required to remain silent about the issuance so as not to inflate the value of the stock artificially.[45] Fifteen days after the SEC publicly files the registration statement, the issuer may begin its "road show."[46] During this process, the

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[37] *Id.* at 6.

[38] *Id.*

[39] *Id.* at 1.

[40] Tesla Motors, Inc., Form S-1 Registration Statement under the Securities Act of 1933 (Jan. 29, 2010), https://www.sec.gov/Archives/edgar/data/1318605/000119312510017054/ds1.htm.

[41] 79 Fed. Reg. 150, 45510 (Aug. 5, 2014).

[42] SEC, Draft Registration Statement Processing Procedures Expanded (June 29, 2017), https://www.sec.gov/corpfin/announcement/draft-registration-statement-processing-procedures-expanded.

[43] Brandon Kochkodin and Alex Barinka, *IPO Timelines Are Cut by 80% After SEC's Private Filing Decision*, BLOOMBERG (Dec. 22, 2017), https://www.bloomberg.com/news/articles/2017-12-22/ipo-timelines-are-cut-by-80-after-sec-s-private-filing-decision.

[44] 17 C.F.R. § 230.461.

[45] SEC, *Fast Answers: Quiet Period* (May 18, 2017), https://www.sec.gov/fast-answers/answersquiethtm.html. Note that the actual rules on communications to prospective investors and "gun jumping" are much more complicated than indicated in this article. *See* Seth Rasmussen, *Let's Not Jump the Gun: An Analysis of the Current State of Section 5 and Recent SEC Actions Involving Section 5 Violations*, 44 SEC. REG. L.J. 159 (2016); *see also* Skadden, Arps, Slate, Meagher & Flom LLP, *Securities Offerings and Gun Jumping: What You Can and Cannot Do*, Corp. Fin. Alert (Nov. 2012), http://www.skadden.com/sites/default/files/publications/Corporate_Finance_Alert_ Securities_Offerings_and_Gun_Jumping_What_You_Can_and_ Cannot_Do.pdf.

[46] SEC, *Jumpstart Our Business Startups Act Frequently Asked Questions: Confidential Submission Process for Emerging Growth Companies* (Apr. 10, 2012), http://www.sec.gov/divisions/corpfin/guidance/ cfjumpstartfaq.htm. This rule was later expanded to all companies. *See Draft Registration Statement Processing Procedures Expanded*, *supra* note 42.

investment bankers, as well as members of management of the issuer, travel to meet with prospective investors.[47] The road show is particularly important because orders are generally taken at this time, with investors indicating how many shares they would like to purchase and what price they are willing to pay (although the investment bank has already set a target price range).[48]

When the road show is complete—with hopefully a fully subscribed (or oversubscribed) offering—the underwriter will price the shares the day before trading based on the orders received.[49] Once the underwriter has priced the shares, the underwriting syndicate will allocate the shares to the investors.[50] Underwriters attempt to allocate shares to investors who plan to be long-term holders of the stock, using lock-up periods to achieve this goal;[51] however, banks may be biased in favor of rewarding their investors that generate the highest brokerage commissions (e.g., hedge funds with active trading).[52] Once the underwriter has allocated and distributed all the shares, the stock starts trading on a national exchange, such as the NYSE, with public investors buying and selling shares of the issuer in the secondary market.[53]

After the shares begin trading, the lock-up period begins for some purchasers. The purpose of the lock-up period is to prevent the market from becoming flooded with a large number of shares—an event that would likely lower the stock's price.[54] This lock-up period, though, is not mandated by the SEC; it is a contractual agreement among the lead underwriter, other syndicate members, broker-dealers purchasing the shares, and insiders.[55] Although the law does not mandate the lock-up period, without it, many of the insiders and underwriters will still likely be unable to trade at this time because they were necessarily granted access to nonpublic information.[56]

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[47] Nicole Lee, *The Initial Public Offering (IPO) Process: Got Facebook Shares?*, MERGERS & INQUISITIONS (May 18, 2012), https://www.mergersandinquisitions.com/initial-public-offering-process-ipo/.

[48] *Id.*

[49] *Id.*; *see also* Bob Pisani, *How an IPO gets done, step by step*, CNBC (Sept. 17, 2014), https://www.cnbc.com/2014/09/17/alibaba-how-an-ipo-gets-done-step-by-step.html.

[50] *See generally* Shane A. Corwin & Paul Schultz, *The Role of IPO Underwriting Syndicates: Pricing, Information Production, and Underwriter Competition*, 60 J. FIN. 443, 446 (2005) (detailing typical allocation methods used by underwriting syndicates).

[51] *See generally* Lowinger v. Morgan Stanley & Co., 841 F.3d 122, 131 (2d Cir. 2016) (describing typical lock-up agreements).

[52] Lee, *supra* note 47.

[53] *Id.*

[54] Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 748 (2005).

[55] *Id.*

[56] *See* 17 C.F.R. § 240.10b5-1; *Lowinger*, 841 F.3d at 127.

2. The Underwriters Always Have the Issuers' Best Interests in Mind—Right?

The IPO process is now familiar among issuers, underwriters, law firms, and regulators; but so are some less-than-favorable IPO practices engaged in by underwriters.

One well-documented phenomenon in the IPO market is underpricing.[57] Underpricing is when a firm issues securities at a price less than their market value.[58] The "market value" is typically measured by the first-day closing price.[59] Thus, an IPO is underpriced if the first-day closing price is higher than the offer price.[60] This is commonly referred to as "money left on the table"[61] because, had the IPO not been underpriced, that issuer would have received said money.[62] From 1960 to 2015, IPOs in the United States have been underpriced by 16.8 percent on average.[63]

The reason for IPO underpricing is less certain, but several prominent theories have emerged. A well-accepted theory comes from Professor Kevin Rock, who proposes that asymmetric information causes underpricing.[64] Rock theorized that uninformed investors bid without regard to the quality of the IPO, whereas sophisticated investors use their superior knowledge to bid only on quality IPOs.[65] Eventually, the inferior IPOs (i.e., the lemons) will result in extreme losses, and the uninformed investors will leave the market.[66] However, since there are not enough sophisticated investors to keep the market functioning, underwriters need uninformed investors in the IPO market.[67] To solve this problem, the underwriters engage in underpricing to keep the uninformed investors bidding on all IPOs regardless of their quality.[68]

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57 Ritter & Welch, *supra* note 7, at 1795 ("At the end of the first day of trading, . . . shares traded on average at 18.8 percent above the price at which the company sold them.").

58 MORGENSON & HARVEY, *supra* note 29, at 356.

59 Ritter & Welch, *supra* note 7, at 1797.

60 *Id.*

61 *Id.*

62 *Id.*; *see also* Jay R. Ritter, *Money Left on the Table in IPOs by Firm* (Jan. 30, 2015) (unpublished manuscript), https://site.warrington.ufl.edu/ritter/files/2015/08/Money-Left-on-the-Table-in-IPOs-by-Firm-2015-08-04.pdf (detailing recent underpricing in the U.S. IPO market).

63 Jay R. Ritter, *Initial Public Offerings: Updated Statistics* (Mar. 8, 2016) (unpublished manuscript), at 24 tbl.8, https://site.warrington.ufl.edu/ritter/files/2016/03/Initial-Public-Offerings-Updated-Statistics-2016-03-08.pdf.

64 Kevin Rock, *Why New Issues Are Underpriced*, 15 J. FIN. ECON. 187, 187 (1985).

65 *Id.*

66 *Id.*

67 *Id.*

68 *Id.*; *see also* Steven Davidoff Solomon, *Why I.P.O.'s Get Underpriced*, N.Y. TIMES DEALBOOK (May 27, 2011), https://dealbook.nytimes.com/2011/05/27/why-i-p-o-s-get-underpriced/.

This theory—strikingly similar to "the lemon problem"[69]—can explain why underwriters frequently underprice IPOs. Another theory posits that IPO underpricing is caused by conflicts of interest among investment bank underwriters and their clients.[70] Underwriting banks are incentivized to underprice IPOs because doing so enables them to reward their regular customers with high first-day returns, thus ensuring that the clients will return to the investment bank.[71] As evidence of this theory, higher underwriting fees have been found to reduce underpricing (and vice versa).[72]

Regardless of the many theories[73] attempting to explain why underwriters underprice IPOs, the fact of the matter is that issuers frequently "leave money on the table" during the offering. This can have lasting, if not devastating, effects on the issuer. For example, during the eToys, Inc. IPO, Goldman Sachs suggested an offer price of $20 per share (discounted to Goldman Sachs at $18.65 per share).[74] Yet, the first-day closing price was an astonishing $77 per share, and the price stabilized at $48.13 per share after three days.[75] eToys alleged in a lawsuit against Goldman Sachs that had the shares not been underpriced, the company would have had additional funds to keep up with demands and potentially avoid its ultimate bankruptcy.[76] Leaving money on the table is now common course in the IPO process—but issuers will always have a "what if" mentality about the capital that could have gone into their coffers but instead went to investment bank clients.

It is important to note that it is not just the issuer who leaves money on the table: the VC and PE firms who invested in the issuer also lose out when IPOs are underpriced. Recent empirical studies have shown that IPOs of VC-backed firms were more underpriced than those of non-VC-backed firms.[77] It is true that VC and PE firms are not obliged to follow the underwriters recommended price, but they customarily do

[69] George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 74 Q. J. ECON. 488 (1970).

[70] Michael Goldstein, *Analysis of IPOs: Financial Markets and Instruments* (Dec. 3, 2012) (unpublished manuscript), http://faculty.babson.edu/goldstein/Teaching/FIN3560Fall2012/2012%20group%20projects/Analysis%20of%20IPOs.pdf.

[71] *Id.*

[72] Tim Loughran & Jay Ritter, *Why Has IPO Underpricing Changed Over Time?*, FIN. MGMT., 5, 8, 31 (2004).

[73] *See* Solomon, *supra* note 68.

[74] EBC I, Inc. v. Goldman Sachs & Co., 936 N.Y.S.2d 92 (N.Y. App. Div. 2011).

[75] *Id.*; Michael J. De La Merced, *Goldman Settles Lawsuit Over eToys I.P.O.*, N.Y. TIMES DEALBOOK (Sept. 19, 2013, 5:50 PM), https://dealbook.nytimes.com/2013/09/19/goldman-settles-lawsuit-over-etoys-i-p-o/.

[76] De La Merced, *supra* note 75; COX, *supra* note 6, at 131.

[77] Bill B. Francis & Iftekhar Hasan, *The Underpricing of Venture and Nonventure Capital IPOs: An Empirical Investigation*, 19 J. FIN. SERVS. RES. 99, 100 (2001); Peggy M. Lee & Sunil Wahal, *Grandstanding, Certification and the Underpricing of Venture Capital Backed IPOs*, 73 J. FIN. ECON. 375, 377 (2004); Loughran & Ritter, *supra* note 72, at 13; *contra* Yacine Belghitar & Rob Dixon, *Do venture capitalists reduce underpricing and underperformance of IPOs?*, 22 APPLIED FIN. ECON. 33, 33–24 (2011).

follow it.[78] For example, during the Snapchat IPO, VC firm Benchmark Capital Partners sold 10,695,868 shares at $17 each—the price recommended by the underwriting conglomerate.[79] However, Snapchat had a first-day closing price of $24.48, a 44 percent increase.[80] Although it should be noted that Snapchat stock is, as of August 2018, trading at approximately $12 for a multitude of reasons—market forces, business decisions, celebrity statements[81]—Benchmark Capital Partners ultimately sold its shares at $17 for stock some thought was worth $24.48 at the time. With over ten million shares, Benchmark left a considerable amount of money on the table.

In addition to VC and PE firms, IPOs are typically not the best investment for Main Street investors in the long run.[82] IPOs typically underperform when compared to other companies in an index and compared to other companies with the same market capitalization.[83] Warren Buffett once said, "An IPO is like a negotiated transaction—the seller chooses when to come public— and it's unlikely to be a time that's favorable to you. So, by scanning 100 IPOs, you're way less likely to find anything interesting than scanning an average group of 100 stocks."[84]

The IPO is Wall Street's preferred method, but issuers have begun to challenge this orthodox practice and utilize new, innovative methods for going public.

B. The Direct Listing: The New Kid on the Block

A direct listing allows an issuer to be listed on an exchange without raising new capital.[85] Only existing shares of the issuer begin

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[78] *See*, *e.g.*, Michelle Castillo, *Here's how much Snap's founders made from its IPO*, CNBC (Mar. 2, 2017, 10:04 AM), https://www.cnbc.com/2017/03/02/snap-ipo-what-evan-spiegel-bobby-murphy-will-make.html.

[79] *Id.*

[80] Anita Balakrishnan, *Snap closes up 44% after rollicking IPO*, CNBC (Mar. 2, 2017, 11:19 AM), https://www.cnbc.com/2017/03/02/snapchat-snap-open-trading-price-stock-ipo-first-day.html.

[81] *See*, *e.g.*, Robert Leonard, *Snap Forgot About Their Users*, SEEKING ALPHA (Feb. 26, 2018), https://seekingalpha.com/article/4150621-snap-forgot-users; Kaya Yurieff, *Snapchat stock loses $1.3 billion after Kylie Jenner tweet*, CNN TECH (Feb. 23, 2018, 12:11 PM), http://money.cnn.com/2018/02/22/technology/snapchat-update-kylie-jenner/index.html.

[82] Ritter & Welch, *supra* note 7, at 1795.

[83] *Id.* ("[T]he average IPO under-performed the CRSP value-weighted market index by 23.4 percent and underperformed seasoned companies with the same market capitalization and book-to-market ratio by 5.1 percent.").

[84] Whitney Tilson, *Notes from the 2004 Berkshire Hathaway Annual Meeting* 29 (May 1, 2004), http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Warren%20Buffett/Berkshire%20Hathaway%20Annual%20Meeting%20Notes%202004.pdf.

[85] Jones, *supra* note 11.

trading publicly on the secondary market.[86] In the words of Erin Griffith at *Fortune* magazine: "If an IPO is like a wedding, a direct listing is running off to elope. A faster, easier, cheaper route to the same result."[87] Before Spotify's direct listing, only 11 companies had completed a direct listing on a national stock exchange.[88] All these companies were relatively unknown, with a median market capitalization of $530 million.[89] This is largely because prior to February 2018, only NASDAQ allowed direct listings,[90] and the NASDAQ rules did not precisely address such listings.[91] In the summer of 2017, the NYSE proposed a rule change to the SEC that would allow for direct listings of companies.[92] The SEC subsequently approved the rule change on February 2, 2018.[93] Spotify is the only major corporation to have conducted a direct listing as of April 2019.[94]

The first step in the direct listing process comes far before the actual listing: issuing shares via private placement. This is important because, although many pre-IPO companies are incorporated as corporations and issue shares, many are not (i.e., they are LLCs).[95] Most VC- or PE-backed companies will be corporations with shares issued to the VC or PE firm, other investors, and insiders; thus, investors have already achieved this step. Typically, the shares will be issued as private

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[86] *Id.*

[87] Erin Griffith, *The Risky Side of Spotify's Unusual IPO Plans*, FORTUNE (Apr. 7, 2017), http://fortune.com/2017/04/07/spotify-ipo- direct listing/.

[88] Robert Pozen et al., *Opinion: Here's how a hot company can go public without an IPO*, MARKETWATCH (Dec. 7, 2017, 3:27 PM), https://www.marketwatch.com/story/heres-how-a-hot-company-can-go-public-without-an-ipo-2017-12-07.

[89] *Id.*

[90] Tom Zanki, *NYSE Rule Change Would Make It Easier To List Without IPO*, LAW360 (June 12, 2017, 4:05 PM), https://www.law360.com/articles/933065/nyse-rule-change-would-make-it-easier-to-list-without-ipo.

[91] NASDAQ STOCK MKT., INC., MARKETPLACE RULES R. 5505 (2018).

[92] NYSE LLC, Form 19b-4, Proposal to amend footnote E to Section 102.01B of the NYSE Listed Company Manual and Rules 15, 104, and 123D (June 13, 2017), https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-filings/filings/2017/NYSE-2017-30.pdf [hereinafter "NYSE Form 19b-4"].

[93] SEC, Release No. 34-82627, Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 3, to Amend Section 102.01B of the NYSE Listed Company Manual to Provide for the Listing of Companies that List Without a Prior Exchange Act Registration and that Are Not Listing in Connection with an Underwritten Initial Public Offering and Related Changes to Rules 15, 104, and 123D (Feb. 2, 2018), https://www.sec.gov/rules/sro/nyse/2018/34-82627.pdf [hereinafter "Release No. 34-82627"].

[94] In February 2019, Slack Technologies Inc. stated that it had confidentially filed a registration statement with the SEC in anticipation of a direct listing. Maureen Farrell, *Slack Files to Go Public With Direct Listing*, WALL ST. J. (Feb. 4, 2019, 3:46 PM), https://www.wsj.com/articles/slack-files-confidentially-to-go-public-with- direct listing-11549301336. Additionally, Bermuda-based Watford Holdings Ltd. conducted a direct listing of approximately $140 million in common shares. *See* Watford Holdings Ltd., Prospectus Filed Pursuant to Rule 424(b)(3) (Mar. 26, 2019), https://www.sec.gov/Archives/edgar/data/1601669/000162828019003516/watford424b3.htm.

[95] *See*, *e.g.*, Ryan Feit, *Don't Let Venture Capitalists Force You To Convert To A C-Corporation*, INC. (Jan. 14, 2015), https://www.inc.com/ryan-feit/don-t-let-venture-capitalists-force-you-to-convert-to-a-c-corporation.html (op-ed by CEO and founder of SeedInvest explaining how the company remained an LLC during a Series A funding round despite "considerable pressure [from VC firms] to convert into a C-corporation").

placements pursuant to Regulation D.[96] As VC and PE firms are "accredited investors,"[97] companies run into few regulatory hurdles issuing these shares pursuant to either Rule 504 or Rule 506 of Regulation D because the 35-shareholder limitation does not apply to accredited investors.[98]

In theory, the shares could be issued under Regulation A (nicknamed "Regulation A+" after the JOBS Act reforms).[99] This would allow the issuer to raise up to $50 million and solicit from the general public.[100] However, Regulation A triggers several reporting requirements, such as an offering statement and semiannual reports.[101] These reporting and registration requirements are what the issuer is likely trying to avoid in the first place, and thus Regulation A will seldom be used in a direct listing.

After shares are issued, the company will need to file a registration statement with the SEC.[102] Arguably, once a registration statement pursuant to the Securities Exchange Act of 1934 (Exchange Act) is effective, the shares may begin trading. This registration statement would be filed on Form 10[103] or Form 8-A[104] for U.S.-based issuers (Form 20-F[105] for foreign private issuers). However, as with most things in life, the process is not that simple.

When the NYSE first announced that it would change its rules to allow for direct listings, the proposed rule allowed for listing "without a concurrent public offering or Securities Act registration."[106] Almost all commentators assumed that the issuer would file a registration statement under the Exchange Act (i.e., the "'34 Act")—not the Securities Act (i.e., the "'33 Act").[107] However, the SEC sought comments from the public specifically on whether companies should be allowed to conduct direct

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[96] 17 C.F.R. § 230.500–08.
[97] *Id.* at § 230.501(a).
[98] *Id.* at § 230.506(b).
[99] *See id.* at § 230.251–63.
[100] *See id.* at § 230.251(a)(2); *see also id.* at § 230.255.
[101] *See id.* at § 230.252; *see also id.* at § 230.257.
[102] 15 U.S.C. § 78l (2012).
[103] 17 C.F.R. § 249.210.
[104] *Id.* at § 249.208a.
[105] *Id.* at § 249.220f.
[106] NYSE Form 19b-4, *supra* note 92, at 13.
[107] *See*, *e.g.*, John C. Coffee, Jr., *The Spotify Listing: Can an "Underwriter-less" IPO Attract Other Unicorns?*, THE CLS BLUE SKY BLOG (Jan. 16, 2018), http://clsbluesky.law.columbia.edu/2018/01/16/the-spotify-listing-can-an-underwriter-less-ipo-attract-other-unicorns/; Deborah J. McLean and John C. Partigan, *NYSE direct listing — proposal for NYSE listing as an alternative to a traditional IPO*, NIXON PEABODY LLP SECURITIES LAW ALERT (May 30, 2017), https://www.nixonpeabody.com/-/media/Files/Alerts/2017-May/NYSE_direct_listing_30MAY2017.ashx.

listings without filing a concurrent Securities Act registration statement.[108] Only one comment, which was written by Cleary Gottlieb Steen & Hamilton LLP, was received directly on this topic. In Cleary's opinion, "the information required to be included in an Exchange Act registration statement on Form 10 or Form 20-F, which is substantially the same as an IPO registration statement under the Securities Act, is sufficient to inform prospective investors about the issuer and its common stock . . . ."[109]

Nonetheless, after the comment period closed, the NYSE amended its proposed rule change to require companies to file a Securities Act registration statement before public trading could commence.[110] Although no correspondence from the SEC is publicly available on this issue, it appears likely that the SEC forced this change to the initial proposal.[111] A year following the NYSE's move, NASDAQ amended its rules to "clarify" its direct listing process and also to require a Securities Act registration statement.[112]

Therefore, issuers must file a Securities Act registration statement, namely, Form S-1 or Form S-3. This is the same onerous registration statement required for an IPO.[113] The practical effects of this distinction are high. An Exchange Act registration statement automatically becomes effective 60 days after filing unless selected for review by the SEC staff,[114] whereby a Securities Act registration statement is reviewed by the SEC staff within 30 days and then must be cured of all defects before it becomes effective.[115] Securities Act registration also requires a "quiet period" in which the company must refrain from "gun jumping" by limiting information related to the issuance that is released to the public.[116] Issuers filing under the Securities Act are also subject to its liability provisions.[117]

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[108] SEC, *Self-Regulatory Organizations; New York Stock Exch. LLC; Order Instituting Proceedings to Determine Whether to Approve or Disapprove A Proposed Rule Change, As Modified by Amendment No. 2, to Amend Section 102.01b of the NYSE Listed Co. Manual to Provide for the Listing of Companies That List Without A Prior Exch. Act Registration & That Are Not Listing in Connection with an Underwritten Initial Pub. Offering & Related Changes to Rules 15, 104, and 123D* (Sept. 15, 2017), https://www.sec.gov/rules/sro/nyse/2017/34-81640.pdf ["Release No. 34-81640"].

[109] Letter from Cleary Gottlieb Steen & Hamilton LLP to Brent J. Fields, Secretary, SEC (Oct. 12, 2017), https://www.sec.gov/comments/sr-nyse-2017-30/nyse201730-2638121-161267.pdf.

[110] New York Stock Exchange LLC, Form 19b-4, Amendment No. 3, *Proposal to amend footnote E to Section 102.01B of the NYSE Listed Company Manual and Rules 15, 104, and 123D* (Dec. 8, 2017), https://www.sec.gov/comments/sr-nyse-2017-30/nyse201730-2782322-161654.pdf.

[111] *See, e.g.*, Cleary Gottlieb Steen & Hamilton LLP, *Spotify's Direct Listing – A Look Under the Hood*, Alert Memorandum (Apr. 17, 2018), https://www.clearygottlieb.com/-/media/files/alert-memos-2018/spotifys- direct listing--a-look-under-the-hood.pdf ("In view of the SEC's apparent insistence on Securities Act registration in an NYSE direct listing . . . .") [hereinafter "Cleary Gottlieb Alert Memorandum"].

[112] SEC, *Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Adopt Listing Standards for Direct Listings and Clarify Related Rules* (Feb. 15, 2019), https://www.sec.gov/rules/sro/nasdaq/2019/34-85156.pdf.

[113] *See* discussion *supra* pp. 5–6.

[114] 15 U.S.C. § 78l(g)(1) (2012).

[115] 17 C.F.R. § 230.461.

[116] *See generally* Skadden, *supra* note 45; *see also* discussion *infra* pp. 29–30.

[117] *E.g.*, 15 U.S.C. § 77l.

Consequently, the automatic effective date and lack of quiet period are highly advantageous for companies when navigating the registration process, but the SEC has disallowed this practice, and issuers seeking to be listed on an exchange must file a Securities Act registration statement.

The company will not need to file with any individual states under "Blue Sky" requirements.[118] Although the SEC has never commented on this topic, the shares are "covered securities" because they are listed on a national securities exchange.[119]

After the issuer has filed a Securities Act registration statement, it will register with the exchange. In order to do so, the issuer will need to engage a transfer agent[120] if it has not already done so. For a direct listing on the NYSE, an issuer must show a $100 million market value of publicly held shares, which is demonstrated by (i) an independent third-party valuation and (ii) the "most recent trading price of the issuer's common stock in a trading system for unregistered securities operated by a national securities exchange or a registered broker-dealer (a "Private Placement Market")."[121] If the issuer's common stock is not traded in a Private Placement Market, or if the trading is not adequate to support a price based on sustained history of trading over several months, an issuer must show a $250 million market value of publicly held shares as determined by an independent third party.[122] It remains to be seen whether the NYSE will change its rules on its other exchanges (e.g., NYSE American, NYSE Arca Equities, etc.) to allow for direct listings for smaller companies. NASDAQ allows for direct listings on its Global Select Market (i.e., the large-cap market) and, as of April 2019, plans to file a proposed rule change to adopt requirements for its Capital Market (i.e., the small-cap market) and Global Market (i.e., the mid-cap market).[123]

After the independent third-party financial analyst completes the company's valuation and the Securities Act registration statement is effective, the shares may begin trading on a date chosen by the company and the exchange. On the date before trading begins, the financial analyst will provide a "reference price" for the shares to the Designated Market

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[118] *See* 15 U.S.C. § 77r (2012).

[119] *Id.* at § 77r(b)(1); *see also* Coffee, *supra* note 107 ("Direct listings will presumably qualify under Section 18 of the Securities Act for an exemption from state 'blue sky' registration requirements as 'covered securities.'").

[120] A transfer agent is an "organization (such as a bank or trust company) that handles transfers of shares for a publicly held corporation by issuing new certificates and overseeing the cancellation of old ones and that usu. also maintains the record of shareholders for the corporation and mails dividend checks." Agent, BLACK'S LAW DICTIONARY (10th ed. 2014).

[121] 2 N.Y.S.E. Guide (CCH), Rule 102.01B n.E, ¶ 102.01B.

[122] *Id.*

[123] *See The Nasdaq Stock Market LLC*, *supra* note 112, at 3.

Maker (DMM).[124] On the morning when trading will commence, the DMM will publish the reference price and then will announce the opening price based on buy/sell orders as trading begins.[125]

The VC/PE firms, insiders, and all other shareholders will be able to sell their shares on the exchange once trading begins on the open market, or they can sell their shares to the market makers at the reference price. These shareholders, though, must have held the shares for one year in order to sell pursuant to Rule 144;[126] however, this obstacle can be overcome if the issuer registers those previously restricted shares in its resale shelf registration statement (under the Securities Act).[127] Shareholders who have held their shares for less than one year will need to strictly follow the "Plan of Distribution" as described in the issuer's shelf registration statement.[128]

II. SPOTIFY: SOON TO BE STREAMING ON THE NYSE

Spotify is the first technology "decacorn" (i.e., a company valued at more than $10 billion) and the first company in general to pursue a direct listing on the NYSE. Given Spotify's successful direct listing, the company will serve as a model for other VC- or PE-funded companies. A look at the history of Spotify and its direct listing undertaking is illustrative of the direct listing process in general.

A. From a Small Apartment in Stockholm to Every Board Room in Silicon Valley

Spotify AB was founded in 2006 in Stockholm, Sweden, by Daniel Ek and Martin Lorentzon.[129] Both Ek and Lorentzon founded start-ups before Spotify—namely, Ek founded Advertigo, an online advertising

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[124] Memorandum from NYSE Regulation to New York Stock Exchange LLC ("NYSE") Members and Member Organizations regarding NYSE Rule 15, 104, and 123D Rule Changes Relating to NYSE Direct Listings (Mar. 28, 2018), https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-interpretations/2018/NYSE%20Info%20Memo%2018-02.pdf. [hereinafter "Memorandum from NYSE"].

[125] *Id.*

[126] 17 C.F.R. § 230.144(d)(1)(ii) (2018).

[127] *See* Spotify Tech. S.A., SEC No-Action Letter (unpublished) (Mar. 23, 2018), https://www.sec.gov/divisions/marketreg/mr-noaction/2018/spotify-technology-032318-regm.pdf (recommending no action for Spotify's "plan of distribution" which allowed shareholders who have not held shares for one year to nonetheless begin trading on the opening day in accordance with the plan detailed in the prospectus).

[128] *Id.* at 10. For example, Spotify shareholders restricted by Rule 144 could sell their shares only "in brokerage transactions on the NYSE or other public exchanges" or at registered alternative trading venues. *Id.* at n.13.

[129] Paul Sawers, *Spotify: The story so far*, TNW (Jul. 14, 2011), https://thenextweb.com/eu/2011/07/14/spotify-the-story-so-far/.

company acquired by TradeDoubler, of which Lorentzon was a founder.[130] Both the founders left TradeDoubler to start Spotify.[131]

In 2006, illegal music file sharing was rampant via platforms such as LimeWire and BitTorrent indices such as The Pirate Bay.[132] Global revenue for the recording industry peaked in 1999 at $27 billion; by 2008, though, revenues were almost half that at $14 billion.[133] Thus, in 2008, Spotify was able to strike deals with the four major record labels—Universal Music Group, Sony Music Entertainment, Warner Music Group, and EMI Group—allowing for on-demand "streaming" of music.[134] Streaming allows users to listen to music digitally without actually purchasing the music via iTunes or other retailers.[135] Although other streaming services such as Pandora existed in 2008, Spotify was unique in that users could pick and choose songs "on demand" from Spotify's library of music.[136]

Unlike the quintessential garage in Silicon Valley, Spotify was started in Ek's small apartment in Stockholm.[137] As rumor has it, the founders "worked together for a few months inside Ek's small apartment, where the servers were heating up to the point where even in winter they had to walk around half naked."[138] Spotify officially launched in October 2008, primarily as an invite-only service.[139] One year after the app's launch, Mark Zuckerberg changed his Facebook status to "Spotify is so good"—unquestionably a major boost for the company.[140]

Soon after the company was founded, its headquarters were moved to London and the business expanded operations throughout Europe.[141] In July 2011, Spotify expanded its operations into its largest

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[130] Spotify Tech. S.A., Amendment No. 3 to Form F-1 Registration Statement under the Securities Act of 1933 (Form F-1) at 129 (Mar. 23, 2018) [hereinafter "Spotify Form F-1"].

[131] *Id.*

[132] Sawers, *supra* note 129; *see also* Stephen Witt, *Goodbye to Piracy: How the Internet—and I—grew out of illegal music sharing*, SLATE (June 24, 2015), http://www.slate.com/articles/arts/music_box/2015/06/illegal_music_sharing_is_ending_how_the_internet_finally_grew_up_and_learned.html (describing the history of illegal music sharing and how Spotify helped to solve this problem).

[133] Sawers, *supra* note 129 (citing Brendan Greeley, *Daniel Ek's Spotify: Music's Last Best Hope*, BLOOMBERG BUSINESSWEEK (July 13, 2011), https://www.bloomberg.com/news/articles/2011-07-13/daniel-ek-s-spotify-music-s-last-best-hope).

[134] Sawers, *supra* note 129.

[135] *See* Molly Hogan, Note, *The Upstream Effects of the Streaming Revolution: A Look into the Law and Economics of A Spotify-Dominated Music Industry*, 14 COLO. TECH. L.J. 131, 136 (2015).

[136] *Id.* at 139–40.

[137] ITEO, *The legend of Swedish unicorns: The reality of billion dollar startups from Sweden*, MEDIUM (Nov. 30, 2017), https://medium.com/@Iteo/the-legend-of-swedish-unicorns-6e42d9c2894b.

[138] *Id.*

[139] Sawers, *supra* note 129.

[140] ITEO, *supra* note 137.

[141] *Id.*

market yet: the United States.[142] As of March 2018, Spotify is available in 61 countries throughout the world, including most of Europe, North America, South America, and the Asia Pacific region.[143] Although Spotify started as a small invite-only service, this is no longer the case. As of December 31, 2017, Spotify had 157 million monthly active users and 71 million paid users.[144] Spotify believes this is "nearly double the scale of our closest competitor, Apple Music."[145]

Spotify operates under a "freemium" business model by offering certain features free of charge while charging for more advanced features.[146] For example, only paid users can listen to music offline and can listen to "on demand" tracks on a mobile device.[147] Nonpaying users must listen to ads between songs.[148] Under its agreements with the record labels, Spotify pays artists "per stream"—$0.00014123 for the free service and $0.00066481 for the paid service as of February 2017.[149] The company has paid more than €8 billion (approximately $9.8 billion US) in royalties to artists, music labels, and publishers since its launch.[150]

Spotify had zero difficulties raising capital in the past. The company previously raised roughly $2.7 billion in both debt and equity.[151] VC firms in Silicon Valley such as Kleiner Perkins, GV (formerly named Google Ventures), Accel Partners, and Andreessen Horowitz invested in the company during its various rounds of equity financing.[152] Technology Crossover Ventures (TCV) and Tiger Global Management—both PE firms—invested in the company and remain major shareholders.[153] Likewise, Sony Music, Goldman Sachs, and Fidelity have all reportedly invested in the business.[154] Additionally, Spotify raised $1 billion in convertible debt from PE firm TPG, hedge fund Dragoneer Investment

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[142] *Id.*

[143] Spotify, *Where is Spotify available?*, https://support.spotify.com/is/using_spotify/the_basics/full-list-of-territories-where-spotify-is-available/ (last visited Mar. 1, 2018).

[144] Spotify Form F-1, *supra* note 130, at 1.

[145] *Id.*

[146] *See generally* John M. Newman, *Copyright Freeconomics*, 66 VAND. L. REV. 1409, 1439 (2013).

[147] Spotify, *What subscriptions do you offer?*, https://support.spotify.com/us/account_payment_help/subscription_information/subscription-levels/ (last visited Mar. 1, 2018).

[148] *Id.*

[149] Daniel Sanchez, *Exclusive Report: Spotify Artist Payments Are Declining In 2017, Data Shows*, DIGITAL MUSIC NEWS (May 16, 2017), https://www.digitalmusicnews.com/2017/05/16/spotify-audiam-low-rates/ (detailing Spotify's per-stream rates as of February 2017).

[150] Spotify Form F-1, *supra* note 130, at 3.

[151] Spotify Funding Rounds, *supra* note 2.

[152] *Id.*

[153] Spotify Form F-1, *supra* note 130, at 148–49.

[154] Katie Roof & Josh Constine, *Spotify has filed to go public*, TECHCRUNCH, Feb. 28, 2017, https://techcrunch.com/2018/02/28/spotify-has-filed-to-go-public/.

Group, and clients of Goldman Sachs.[155] In all, the private capital market has been willing to give Spotify as much cash as it desires.

B. *"Our listing differs significantly from an underwritten initial public offering"*[156]

Rumors of Spotify going public have existed for years, but finally in May 2017 the company started taking steps in that direction by persuading the NYSE to change its rules to allow for a direct listing.[157] The SEC officially approved this change on February 2, 2018,[158] at which point Spotify had already filed its Securities Act registration statement (Form F-1) confidentially with the SEC staff.[159] On February 28, 2018, Spotify Technology S.A. made its Form F-1 public on the EDGAR database.[160]

The company revealed that it has 178,112,840 ordinary shares outstanding.[161] On the private placement markets, the low and high sales prices per ordinary share were $37.50 and $125.00, respectively, and during the period from January 1, 2018 through February 22, 2018 those prices were $90.00 and $132.50, respectively.[162] Prior to trading, the company completed a 40-to-one share split to "reduce the per share price of our ordinary shares to a more customary level for a newly listed company on the NYSE."[163]

Spotify describes its pricing method as follows:

> As this listing is taking place via a novel process that is not an underwritten initial public offering, there will be no book building process and no price at which underwriters initially sold shares to the public to help inform efficient price discovery with respect to the opening trades on the NYSE. Pursuant to NYSE Rules, we have engaged Morgan Stanley & Co. LLC ("Morgan Stanley") as a financial advisor to be available to consult with the designated market maker (the "DMM") in setting the opening public price of our ordinary shares on the NYSE. Based on information provided by the NYSE, the

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155 Douglas MacMillan et al., *Spotify Raises $1 Billion in Debt Financing*, WALL ST. J., Mar. 29, 2016, https://www.wsj.com/articles/spotify-raises-1-billion-in-debt-financing-1459284467.

156 Spotify Form F-1, *supra* note 130, at 45.

157 NYSE Form 19b-4, *supra* note 92, at 3.

158 Release No. 34-82627, *supra* note 93, at 1.

159 Lucas Shaw & Alex Barinka, *Spotify Files to Go Public on New York Stock Exchange*, BLOOMBERG (Jan. 3, 2018), https://www.bloomberg.com/news/articles/2018-01-03/spotify-is-said-to-file-to-go-public-on-new-york-stock-exchange.

160 Spotify Form F-1, *supra* note 130, at 1.

161 *Id.* at iv.

162 *Id.* at 175.

163 *Id.* at 186.

> opening public price of our ordinary shares on the NYSE will be determined by buy and sell orders collected by the NYSE from broker-dealers and the NYSE is where buy orders can be matched with sell orders at a single price. Based on such orders, the DMM will determine an opening price for our ordinary shares in consultation with Morgan Stanley pursuant to NYSE rules.[164]

This method comes directly from the NYSE's new rules on direct listings.[165] Spotify engaged Morgan Stanley, Goldman Sachs, and Allen & Co.[166] to serve as financial advisors—not underwriters—in the listing.[167] In the words of Spotify, "the financial advisors have not been engaged to participate in investor meetings or to otherwise facilitate or coordinate price discovery activities or sales of our ordinary shares in consultation with us, except . . . with respect to consultation with the DMM on the opening public price in accordance with NYSE rules."[168]

The company lists several unique risks that a direct listing poses, including that: (i) there is no book building process and no price at which underwriters initially sold shares to the public to help inform efficient price discovery; (ii) there is not a fixed number of securities available for sale; (iii) very few shareholders have entered into contractual lock-up agreements; and (iv) there is no traditional road show with underwriters that could limit efficient price discovery.[169]

Spotify was able to convince two of its major shareholders, Tencent Music Entertainment Group and Tencent Holdings Limited, to enter into a lock-up period.[170] These two entities, which own 9.1 percent of Spotify, have agreed not to sell ordinary shares for a period of three years.[171] Yet, this left 90.9 percent of the shares free to trade on the first day of trading.

The company decided not to conduct a traditional road show, instead hosting an "investor day":[172] a two-hour-long presentation that contained much of the same information as a road show.[173] The investor day presentation was treated as a free-writing prospectus; however, no filing was made because the presentation was publicly available on

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164 *Id.* at 46.
165 *See* 2 N.Y.S.E. Guide (CCH), Rule 102.01B n.E, ¶ 102.01B; Memorandum from NYSE, *supra* note 124, at 1–2.
166 Spotify Form F-1, *supra* note 130, at 181.
167 *Id.*
168 *Id.*
169 *Id.* at 46–49.
170 *Id.* at 45.
171 *Id.* at 49.
172 *Id.* at 45–46.
173 Spotify AB, Investor Day - March 2018, https://investors.spotify.com/events/investor-day-march-2018/default.aspx (last visited Apr. 24, 2018) [hereinafter "Investor Day"].

Spotify's website.[174] The company also posted several investor relations videos and a blog post by CEO Daniel Ek on its website, which it reported to the SEC as a free-writing prospectus.[175]

C. April 3, 2018

The SEC declared Spotify's Form F-1 effective on March 23, 2018[176] and, just ten days later, on April 3, 2018, shares of SPOT began trading on the NYSE.[177] Although the company chose not to ring the bell, that did not stop the NYSE from giving Spotify a grand welcome. A large Spotify banner adorned the exchange's iconic Wall Street entrance, the Swedish flag flew from the exchange, the company's logo was displayed throughout the trading floor, and the exchange's social-media posts prominently featured the new listing.[178]

The financial analysts, namely, Morgan Stanley, determined a reference price of $132.00 based on the price at which the shares traded in the private placement market.[179] At 12:43 p.m.—a new record for the latest opening time on the NYSE—the SPOT shares began trading at $165.90.[180] This was the price set by the designated market marker, Citadel Securities, based on buy and sell orders.[181] The price rose to a day high of $170.00, but it ultimately closed the day at $149.01—a price 13 percent above the reference price.[182]

Just 5.6 million shares were traded at the opening price, or 5 percent of the total number available to trade, according to data compiled by Bloomberg.[183] Ultimately, 30.5 million shares were traded before the stock closed.[184] This is much lower than for a typical IPO. For example,

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174 *Id.*; 17 C.F.R. § 230.433(d)(8) (a road show presentation made publicly available need not be filed with the SEC).

175 *See*, *e.g.*, Spotify Technology S.A., Filing under Securities Act Rules 163/433 of free writing prospectuses (Mar. 23, 2018), https://www.sec.gov/Archives/edgar/data/1639920/000119312518092823/d563658dfwp.htm (Form FWP for investor relations videos).

176 Spotify Technology S.A., File No. 333-223300, Notice of Effectiveness (Mar. 23, 2018, 3:00 PM), https://www.sec.gov/Archives/edgar/data/1639920/999999999518000666/xslEFFECTX01/primary_doc.xml.

177 Farrell et al., *supra* note 12.

178 *See*, *e.g.*, New York Stock Exchange (@NYSE), TWITTER (Apr. 3, 2018, 3:26 PM), https://twitter.com/NYSE/status/981281807684526080 (video posted by NYSE to social media celebrating the new listing).

179 Farrell et al., *supra* note 12.

180 *Id.*

181 *Id.*

182 *Id.*

183 Alex Barinka, *Fewer Spotify Shares Sold Than Expected in Unusual Listing*, BLOOMBERG (Apr. 5, 2018, 4:00 AM), https://www.bloomberg.com/news/articles/2018-04-05/fewer-spotify-shares-sold-than-expected-in-unusual-listing.

184 *Id.*

158.03 percent of equity float traded on Dropbox's first day, compared to 29.08 percent for Spotify.[185]

The launch was widely regarded as a success.[186] Spotify continued its Wall Street success after the launch as well. As of August 2018, SPOT is trading at around $180, with an all-time high of $198.99.[187] Other pre-IPO companies will look to Spotify's example to determine if a direct listing is right for them.

III. SHOULD COMPANIES GO DIRECTLY TO THE EXCHANGE?

A direct listing has many advantages over the traditional IPO. On the other hand, direct listing will not be the preferred method for every company going public.

The lack of underwriting fees is the foremost advantage of a direct listing. These fees, which average 5.6 percent of gross proceeds,[188] add up to millions of dollars for an issuer. As noted, Snapchat paid $85 million in underwriting fees even though the company was able to negotiate a lower 2.5 percent fee.[189]

Not having an underwriter, though, comes with some risks. The underwriters engage in a "road show" in which they market upcoming securities offerings to prospective investors, especially large institutional investors.[190] However, the road show has been called a "dog-and-pony" show[191]—as evidenced by the fact that Mark Zuckerberg avoided Facebook's road show meetings.[192] But the road show can be crucial for companies that are not followed closely in the financial press. Some practitioners suggest that companies conducting a direct listing should still engage in an optional road show to educate potential buyers and create higher demand.[193] Spotify conducted an "investor day" to educate the public, which consisted of a live presentation that was posted on the company's website.[194]

Although incurring no underwriting fees is a major advantage of direct listing, the process is still quite expensive. Spotify reported on SEC

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[185] *Id.*

[186] *Id.*; *see also* Ben Sisario and Matt Phillips, *Spotify's First Day on Wall Street Is a $26.5 Billion Success*, N.Y. TIMES, Apr. 3, 2018, at B3, https://nyti.ms/2H6XbZh.

[187] NASDAQ, Spotify Technology S.A. Ordinary Shares Historical Stock Prices, https://www.nasdaq.com/symbol/spot/historical (last visited Aug. 2, 2018).

[188] PwC, *supra* note 19, at 13.

[189] Snap Inc. Prospectus, *supra* note 32, at 1.

[190] Lee, *supra* note 47.

[191] Owen Davis, *Spotify's Direct Listing Is A Beautifully Pure Sell Signal*, DEALBREAKER (Jan. 3, 2018, 3:01 PM), https://dealbreaker.com/2018/01/spotify- direct listing-sell-signal/.

[192] Raice, *supra* note 14; *see also* Jon Kamp et al., *Facebook IPO Show Visits Boston: CEO Zuckerberg Skips Main Pitch but Holds Private Meetings With Some Firms*, WALL ST. J. (May 9, 2012, 4:55 AM), https://www.wsj.com/articles/SB10001424052702304363104577392123342009202.

[193] Jones, *supra* note 11.

[194] Investor Day, *supra* note 173.

filings that the total cost of its direct listing was €35–€40 million (approximately $42.6–$48.7 million US).[195] It is possible that Spotify incurred numerous expenses simply by being the first company to conduct a major direct listing (e.g., increased legal costs). Nonetheless, this is quite a price tag for a process hailed as being "cheaper" than an IPO.[196] The average cost (excluding the underwriting fee) of an IPO for a company with revenues above $1 billion is $6.9 million.[197] By way of example, another tech decacorn—Dropbox, Inc.—conducted an IPO just ten days before Spotify.[198] The following chart demonstrates the differences in prices and results between the two companies' offerings:

	SPOTIFY TECHNOLOGY S.A.[(1)(2)]	**DROPBOX, INC.**[(1)(2)]
Valuation (first-day closing price)	$26.5 billion	$11.2 billion
Revenue (2017)	$4.9 billion	$1.1 billion
Proceeds, before expenses, to issuer	--	$538 million
Underwriting fees	--	$33 million
Other expenses directly attributable to IPO/direct listing	$45.7 million[(3)]	$7 million
Total costs attributable to IPO/direct listing	$45.7 million	$40 million
Expenses in proportion to revenue[(4)]	**0.93%**	**3.64%**
Expenses in proportion to valuation[(5)]	**0.02%**	**0.36%**
"Money left on the table" for issuer[(6)]	--	$269.3 million

(1) All prices are in reported U.S. dollars and therefore converted from Euros for Spotify.

[195] Spotify Technology S.A., Form 6-K, Exhibit 99.1, Spotify Technology S.A. Releases Financial Outlook For First Quarter And Fiscal Year 2018 (Mar. 26, 2018), https://www.sec.gov/Archives/edgar/data/1639920/000119312518095067/d560151dex991.htm.

[196] *See*, *e.g.*, Griffith, *supra* note 87.

[197] PwC, *supra* note 19, at 7.

[198] *See* Sara Salinas, *Dropbox closes more than 35 percent higher at $28.48 a share on first day of trading*, CNBC (Mar. 23, 2018, 4:30 PM), https://www.cnbc.com/2018/03/23/dropbox-dbx-ipo-stock-starts-trading-on-the-nasdaq.html.

(2) All figures (other than valuation and "money left on the table") have been taken from the company's public filings available on the SEC's EDGAR database.
(3) Measured by the median of the company's estimated costs (€35–€40 million), converted to U.S. dollars.
(4) Measured by total costs attributable to IPO/direct listing divided by revenue (2017).
(5) Measured by total costs attributable to IPO/direct listing divided by Valuation (first-day closing price).
(6) Measured by the first-day closing market price less IPO offer price multiplied by number of shares offered. Number does not take into account potential direct listing underpricing effects for *shareholders* discussed *infra*.

This chart shows that while Spotify's direct listing expenses were high, they were lower in proportion to revenue and valuation than Dropbox's IPO expenses.

An obvious disadvantage of a direct listing is that no new capital is raised. The IPO gives the issuer an influx of capital, whereas the direct listing only offers shareholders an existing way to sell previously issued shares. This is, however, not a problem for most VC- and PE-funded companies. And, in reality, this is not a problem for most viable companies worthy of investment. Venture capital firms invested $84.2 billion in funding to 8,076 companies during 2017.[199] Everyone from Amazon[200] to Jay-Z[201] wants into the VC space. Private equity firms raised a record $453 billion from investors in 2017, leaving the industry with more than $1 trillion to invest in companies.[202] In fact, Bain & Company expounded that during 2017, "[General Partners] grew even more frustrated with not finding and closing enough good deals."[203] Thus, it appears that raising capital for most companies in the private market is not a genuine problem.

Further, a major advantage of a direct listing is no shareholder dilution. In a typical IPO, new shares are issued to the new investors, diluting existing shareholder interests. Some companies have anti-dilution

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[199] Pitchbook, *supra* note 5, at 4–5.

[200] Stacey Higginbotham, *Amazon launches a $100 million fund to support the AI brain behind its Echo device*, FORTUNE (June 25, 2015), http://fortune.com/2015/06/25/amazon-alexa-fund/.

[201] Zameena Mejia, *Shawn Carter, professionally known as Jay-Z, is launching a venture capital fund*, QUARTZ (Feb. 22, 2017), https://qz.com/916883/jay-z-is-finally-launching-a-venture-capital-fund/.

[202] Joshua Franklin, *Global private equity funds raise record $453 billion in 2017: Preqin*, REUTERS (Jan. 4, 2018, 12:02 PM), https://www.reuters.com/article/us-privateequity-fundraising/global-private-equity-funds-raise-record-453-billion-in-2017-preqin-idUSKBN1ET23L.

[203] Bain & Co., *Global Private Equity Report 2017* (2017), at 14, http://go.bain.com/rs/545-OFW-044/images/BAIN_REPORT_Global_Private_Equity_Report_2017.pdf.

provisions[204] in effect, but others do not. In a direct listing, only existing shares are sold—eliminating the problem entirely.

The absence of underpricing is a topic that seems like an obvious advantage of the direct listing—but it might not be totally eliminated. There will be no underpricing for the issuer (i.e., no "money left on the table") because no new shares are issued; however, the existing shareholders may feel some of the same effects as typical underpricing. In an IPO, the underwriters recommend a price (which may be underpriced). In a direct listing, there are no underwriters, and therefore financial analysts set the price, typically based on the price in the private placement market. As Professor Coffee points out:

> Presumably, issuers that want to do a 'direct listing' will hire a financial firm specialized in valuation to provide the requisite valuation of the shares that are to be listed. Let's suppose that valuation comes to $1 billion, or $50 per share for some 20 million publicly held shares. The designated market maker on the NYSE would presumably start from this $50 per share valuation and possibly raise it before the opening trade if there was a high ratio of buy orders to sell orders. This is only marginally different from a 'firm commitment' IPO, where the negotiated price between the issuer and the underwriter might be $50, but the opening price on the NYSE could be $60.[205]

Professor Coffee was correct in this prediction with regard to Spotify. The reference price of the shares set by the third-party financial analysts was $132.00, but the market makers set the opening price at $165.90.[206] If the shareholders sold to the market makers before the opening at the reference price, there was essentially $33.90 in underpricing. In fact, 5.6 million shares traded at the opening price, or 5 percent of the total number available to trade.[207] The shareholders, though, could wait until trading commenced to sell their shares, which is the decision the majority of Spotify shareholders made. This decision carried risk because the price could fall, but the shareholders could sell at the market price. Therefore, although the issuer did not leave any money on the table, its shareholders might, nonetheless, feel as though their shares were underpriced.

Moreover, one area that could be an advantage but also a disadvantage is the lack of lock-up periods. Lock-up periods are not

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[204] Joseph L. Lemon, Jr., *Don't Let Me Down (Round): Avoiding Illusory Terms in Venture Capital Financing in the Post-Internet Bubble Era*, 39 TEX. J. BUS. L. 1, 13 (2003) (discussing common anti-dilution terms used by VC firms).

[205] Coffee, *supra* note 107.

[206] Farrell et al., *supra* note 12.

[207] Barinka, *supra* note 183. Bloomberg points out that this number is much lower than a typical IPO and that 5 percent of shares is relatively not that high. *Id.*

mandated by the SEC; they are contractual agreements among the underwriter and purchasers.[208] The lock-up period keeps the market from becoming flooded with a large number of shares and depressing the stock's price.[209] Several commentators have argued that companies conducting a direct listing need to negotiate with shareholders for lock-up periods to avoid volatility and flooding the market.[210] Spotify had few, if any, problems with flooding the market, despite the fact that only 9.1 percent of shareholders were subject to lock-up agreements.[211] Other companies, unlike Spotify, with investors eager to sell their shares, could be in a very different situation.

One potential advantage of direct listing is the lack of gun-jumping (or "quiet period") rules. However, the application of gun-jumping rules to companies conducting a direct listing remains exceedingly uncertain. The SEC provided no guidance in a public manner on this topic. After the comment period for the NYSE rule change ended, the Council of Institutional Investors submitted a comment stating that the group "strongly support[s]" the decision to require a Securities Act registration statement.[212] The reason cited by the Council for its approval was because the companies "will be subject to traditional review and comment process of the SEC staff . . . [and] issuers . . . will need to consider the application of the gun-jumping and liability provisions of the Securities Act."[213] The Council, however, cited a Skadden, Arps, Slate, Meagher & Flom LLP client publication—not an SEC publication or guidance.[214] However, it does not appear that Spotify followed all the gun-jumping rules during its direct listing. Typically, issuers must abide by a post-effective quiet period.[215] Yet, the morning Spotify's shares started trading on the NYSE, Spotify CEO Daniel Ek appeared on *CBS This Morning* to discuss the company and its direct listing.[216] Thus, it appears

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208 Hurt, *supra* note 54, at 748.

209 *Id.*

210 *See*, *e.g.*, Jacob Sonenshine, *Spotify is taking a big risk using a direct public offering*, BUSINESS INSIDER (Feb. 22, 2018, 7:48 AM), http://www.businessinsider.com/spotify-is-taking-a-big-risk-using-a-direct-public-offering-2018-2.

211 Spotify Form F-1, *supra* note 130, at 49.

212 Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Brent J. Fields, Secretary, Securities and Exchange Commission (Feb. 22, 2018), https://www.sec.gov/comments/sr-nyse-2017-30/nyse201730-3128154-161930.pdf.

213 *Id.* (citing Skadden, Arps, Slate, Meagher & Flom LLP, *Capital Markets Alert: SEC Approves NYSE Rules to Facilitate Direct Listings*, Client Memorandum (Feb. 8, 2018), https://www.skadden.com/insights/publications/2018/02/sec-approves-nyse-rules-to-facilitate-direct).

214 *Id.*

215 *See* 6B Securities Regulation Forms § 8B:74 (May 2018) (West). The typical post-effective quiet period begins when the registration statement is declared effective and ends when broker-dealers are no longer required to deliver a prospectus under the Securities Act (generally 25 days on a national stock exchange). *Id.*

216 *See* Lisa Marie Segarra, *'We're in the Early Days.' Spotify's CEO Is Talking About His Company's Unusual Non-IPO IPO*, FORTUNE (Apr. 3, 2018), http://fortune.com/2018/04/03/spotify-ceo-stock-nyse- direct listing-ipo/ (discussing the CBS interview and other comments made by CEO Daniel Ek).

that Spotify (or its lawyers) believed, at a minimum, that the post-effective quiet period did not apply to the direct listing. Conversely, Spotify remained quiet in the run-up to trading and submitted free-writing prospectus filings with the SEC about investor videos as well as a blog post.[217] The company's law firm, Latham & Watkins LLP, said in a client memo: "Due in part to the registration on Form F-1 (a Securities Act form), Spotify observed a traditional 'quiet period' while the registration statement was effective (much to the chagrin of the financial press)."[218]

Spotify's actions do not fully answer the question of gun jumping and the SEC providing no answer to the public. If companies that pursue a direct listing do not have to adhere to the gun-jumping rules, this would be a major advantage from both a regulatory and public-relations perspective. Many companies such as Google and Groupon ran into trouble with gun-jumping rules.[219] Avoiding this problem entirely, with the additional benefit of a CEO being allowed to appear on morning talk shows, would be incredibly attractive to a company about to go public.

Direct listing may not be for every company, but the process offers major advantages over the traditional IPO in several areas where the IPO falls flat.

IV. PRESS PLAY, COMMISSIONERS

Given Spotify's success, it is possible that direct listings will become increasingly popular. The SEC should promote this method of going public because it is better for public investors, issuers, and initial investors (e.g., VC firms). This Note will propose actions the SEC can take to facilitate and foster direct listings.

A. "Protect investors. Maintain fair, orderly, and efficient markets. Facilitate capital formation."[220]

The SEC should embrace and promote direct listings because this method promotes all three prongs of the SEC's stated mission: (i) protect

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[217] *See, e.g.*, Spotify Technology S.A., Filing under Securities Act Rules 163/433 of free writing prospectuses (Form FWP) (Mar. 23, 2018), https://www.sec.gov/Archives/edgar/data/1639920/000119312518092823/d563658dfwp.htm (EDGAR free-writing prospectus filing for investor relations videos).

[218] Latham & Watkins LLP, *Spotify Case Study: Structuring and Executing a Direct Listing*, Client Alert Commentary (June 21, 2018), https://www.lw.com/thoughtLeadership/spotify-case-study-structuring-executing- direct listing.

[219] *See* Dwight S. Yoo and Rakhi I. Patel, *Skadden Discusses Jumping the Gun: Social Media and IPO Communications Issues*, THE CLS BLUE SKY BLOG (Mar. 20, 2013), http://clsbluesky.law.columbia.edu/2013/03/20/skadden-discusses-jumping-the-gun-social-media-and-ipo-communications-issues/.

[220] *See* 15 U.S.C. § 78c(f) (the SEC's mission statement as articulated by Congress).

investors, (ii) maintain fair, orderly, and efficient markets, and (iii) facilitate capital formation.[221]

First, direct listings help protect public investors. As discussed *supra*, the IPO market is full of lemons that unsophisticated investors are unable to distinguish from quality offerings.[222] Underwriters underprice IPOs so that uninformed investors will return to the IPO market.[223] The direct listing process is superior because the companies that utilize it are less likely to be lemons. Companies filing for a direct listing are not in a position where they need an influx of capital, partially demonstrating financial stability. The quality of the listing is likely—but not certainly—better than those of issuers who need to raise capital from investors publicly.

Risk allocation is the paramount reason why direct listings are superior to IPOs for public investors. In the IPO market, unsophisticated investors can invest large amounts of money into risky companies (many of which, again, are lemons). These IPOs, typically, underperform when compared to other companies in an index and compared to other companies with the same market capitalization.[224] There are, of course, companies that over-perform the index, but choosing such companies is incredibly difficult, if not impossible. In a direct listing world, this risk is shifted from ordinary investors wagering their potential retirement savings to accredited investors (e.g., VC firms, angel investors, etc.). If the high-net-worth limited partners of VC firms lose $10,000 on a bad start-up, they still will be financially secure. If Bob the mechanic, whose broker told him about a cool new start-up's IPO, loses $10,000, he may have to work longer before retirement or worse. In a market that prioritizes direct listings, the risk of investment failure is shifted from public investors to accredited investors.

Second, direct listings assist in maintaining fair, orderly, and efficient markets because more companies will be inclined to "go public." The total number of listed companies in the United States fell from 8,000 to 4,100 from 1996 to 2012, while the rest of the world saw an increase from 30,700 to 39,400.[225] From an efficient-market standpoint, public companies are subject to reporting requirements, independent-auditor requirements, corporate governance requirements (i.e., audit committees), and other requirements aimed at ensuring that the company acts in an appropriate manner. SEC Chairman Jay Clayton already addressed the lack of public companies in the United States. While lamenting the fact that fewer companies choose to go public, he said:

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[221] *Id.*

[222] Rock, *supra* note 64, at 187; *see* discussion *supra* p. 9.

[223] *Id.*

[224] Ritter & Welch, *supra* note 7, at 1795.

[225] Craig Doidge et al., *Why Are There So Few Public Companies in the U.S.?*, NATIONAL BUREAU OF ECONOMIC RESEARCH DIGEST ONLINE, Sept. 2015, http://www.nber.org/digest/sep15/w21181.html.

High-quality companies may choose to go public at a later stage, after much of their early growth has already been achieved. Other companies may choose to stay private. This ultimately results in fewer opportunities for Main Street Americans to share in our economy's growth, at a time when we are asking them to do more on their own to save and invest for their future and their children's futures.[226]

Direct listings solve this problem by allowing more companies to go public with lower costs, while taking advantage of superior capital raising in the private market.

Finally, direct listings facilitate capital formation because private investors will be more inclined to invest if a clear exit strategy is available. For example, if a start-up on its third or fourth round of capital raising can tell a VC firm, PE fund, hedge fund, mutual fund, investment bank, or other source of capital that it plans a direct listing within two to five years, the investment becomes more attractive. This is largely because it is much easier to sell these shares on a public exchange than in the private placement market. The same logic largely applies to IPOs, but the direct listing provides no shareholder dilution to the investors.

B. What Should the SEC Do?

The direct listing is a new, attractive method of going public that will help promote the SEC's stated mission. The SEC should therefore promote direct listings and take the steps necessary to facilitate the process. The SEC took the right step when it approved the NYSE's proposed rule change to allow for direct listings,[227] but it went down the wrong path in some areas, such as by requiring a Securities Act registration statement.

The SEC's decisions on direct listings made to date were made by the Division of Trading and Markets pursuant to delegated authority.[228] The full Commission never considered the topic. These same issues will likely come before the SEC in the near future, when NASDAQ requests approval to allow for direct listings on its Capital Market (i.e., the small-cap market) and Global Market (i.e., the mid-cap market). The Commission should not delegate this rule change and should decide by a vote of the Commissioners.

As discussed above, the Division of Trading and Markets likely forced the NYSE to require a Securities Act registration statement instead

[226] Jay Clayton, Chairman of the Sec. and Exch. Comm'n, Remarks to the SEC Investor Advisory Committee (June 22, 2017), https://www.sec.gov/news/public-statement/clayton-6-22-17.

[227] Release No. 34-82627, *supra* note 93, at 1.

[228] *Id.* at 20.

of solely an Exchange Act registration statement.[229] This had several consequences such as forced SEC review, free-writing prospectus liability, quiet-period (i.e., gun-jumping) requirements, and liability provisions of the Securities Act.

A direct listing, though, is best fit under the Exchange Act. Spotify simply wanted to register as a public company so that its shares could trade on the NYSE. This is what the Exchange Act provides. The only benefit that the Securities Act provided was that shareholders holding their shares for one year or less (and therefore restricted under Rule 144) could sell their shares on the first day of trading. It remains unknown whether any of these shareholders (approximately 31 percent[230]) sold on the first day.[231] A company such as Spotify should have a choice to register only under the Exchange Act. The Division of Trading and Markets raised potential concerns, including:

the role of various distribution participants, the extent and nature of pricing information available to market participants prior to the commencement of trading, and the availability of information indicative of the number of shares that are likely to be made available for sale at the commencement of trading[.][232]

If the Commission believes Form 10 (the Exchange Act registration statement)[233] does not provide this information to the extent necessary, the Commission should promulgate a new Exchange Act registration form for direct listings. This will allow companies to file only under the Exchange Act, while alleviating the concerns raised by the Division of Trading and Markets.

Furthermore, the SEC Commissioners should use their unique position to promote direct listings via speeches, press releases, etc. The Commissioners should let the public and issuers know that the SEC finds direct listings to be a favorable method for going public. This would not have any legal significance, but it would have strong signaling effects to the market. Many of the positive effects of direct listings will be realized only if the market acts and changes current practice. The SEC Commissioners can use their "soft power" to achieve this result.

The SEC staff can, likewise, promote direct listings through various publications, interpretive guidance, comments, and its actions when more companies file for direct listings. If the market believes that the SEC is hostile to direct listings, the current IPO process will continue.

[229] *See* discussion *supra* pp. 14-15.

[230] Spotify F-1, *supra* note 130, at i.

[231] Although it is not known which shareholders decided to sell on the first day, only 29.09 percent of equity float traded on Spotify's first day; thus, it seems unlikely that Spotify would have chosen a Securities Act registration statement given the increased liability. *See* Barinka, *supra* note 183.

[232] Release No. 34-81640, *supra* note 108, at 12–13.

[233] 17 C.F.R. § 249.210. For an excellent analysis of the reasons why a Securities Act registration statement is unnecessary in a direct listing, *see* Cleary Gottlieb Alert Memorandum, *supra* note 111, at 6–8.

Next, as others suggested,[234] the SEC should clarify that the benefits of the JOBS Act for emerging growth companies apply to direct listings, not just to companies going public via a traditional IPO. These benefits include a two-year exemption from internal-controls reports, the ability to provide fewer years of audited financial statements, confidential treatment of filings at the SEC, and reduced gun jumping rules during the quiet period.[235] Congress has demonstrated a belief that these benefits assist growing companies in the process of going public. There is no reason why these same benefits should not extend to companies pursuing a direct listing.

The SEC should likewise clarify which, if any, gun jumping provisions apply to direct listings if it continues to require the filing of a Securities Act registration statement. The answer is far from clear, and the SEC has provided no public guidance.[236] Gun-jumping rules should not apply to direct listings because such companies are not trying to sell shares to the public. There is no difference between Tim Cook appearing on CNBC to talk about Apple's earnings—thereby potentially causing some investors to buy Apple stock on the secondary market—and Spotify's CEO appearing on news shows to talk about the company before investors can buy stock on the secondary market, if information is fully disclosed to the public.

A more drastic move by the SEC—but one that would support direct listings—would be to eliminate, shorten, or create an exception to the Rule 144 one-year holding period for Regulation D offerings.[237] This change would need to happen only if the SEC reverses its past decision and allows companies to file only an Exchange Act registration statement. This change would presumably need to be made only for accredited investors, as VC and PE firms hold the vast majority of these shares. The SEC already reduced these holding periods in 2008,[238] but it should further shorten or eliminate the holding period. Currently, if a VC firm invests in a company under Regulation D, it must hold these shares for one year before it is allowed to sell under Rule 144.[239] Spotify was able to evade Rule 144 by filing a complete Securities Act registration statement that allowed for the sale of these shares in its "Plan of Distribution."[240] If VC firms know that they can sell their shares in the public market before one

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[234] Pozen et al., *supra* note 88.

[235] SEC, *Emerging Growth Companies* (Nov. 30, 2017), https://www.sec.gov/smallbusiness/goingpublic/EGC.

[236] *See* discussion *supra* pp. 29–30.

[237] 17 C.F.R. § 230.144(d)(1)(ii).

[238] SEC, Revisions to Rules 144 and 145, Securities Act Release No. 33-8869, 72 Fed. Reg. 71, 546 (Dec. 17, 2007).

[239] 17 C.F.R. § 230.144(d)(1)(ii).

[240] Spotify F-1, *supra* note 130, at 185–86.

year, in the event the company goes public, they will be more willing to invest. The Commission could shorten, eliminate, or create an exception to this rule using its inherent rule-making power.

The SEC is likely to face strong pushback from Wall Street underwriters if it promotes direct listings; however, given that direct listings can be advantageous to investors, issuers, and VC/PE firms, the SEC should use all its resources to promote and foster such listings.

CONCLUSION

In the recent past, if a company wanted to raise a large amount of capital, largely the only way to do so would be through the public market. The same cannot be said today. A company with high potential for growth can raise almost unlimited amounts of money in the private market. VC firms and angel investors frequently seed early-stage companies. As the company grows, it attracts investments from PE funds, hedge funds, investment banks, investment companies (e.g., mutual funds) and any number of funding sources in the private market. But as the company grows larger and larger, there comes a time to go public. The company could reach the 2,000-shareholder limit for nonreporting companies, or the company's shareholders could begin exerting pressure to exit their investments through the public market. The traditional method for going public was the IPO, a process that results in new capital for the company but can come with high underwriting fees and other drawbacks. In addition to fees, underwriters frequently underprice the shares of the company so that issuers "leave money on the table"—i.e., proceeds that could go to the issuer but instead go to the allocated shareholders.

One company, Spotify, skipped the IPO process and instead listed its already-issued shares on the NYSE. The company had to convince the NYSE to change its rules and the SEC to approve this rule change, but ultimately the shares were listed soon after SEC approval. Spotify avoided underwriting fees, dilution to existing shareholders, lock-up periods, and other costs associated with a traditional IPO. The process, though, was not seamless and was still relatively expensive for the company. In the end, Spotify's shares traded on the exchange at 13 percent above the price shareholders would have received on the private placement market—leading most commentators to regard the process as a success.

Given Spotify's success, the SEC should take steps to facilitate, promote, and streamline the direct listing process so that more companies can go public via direct listings. The SEC can take several concrete steps to achieve this goal. Most importantly, the SEC should reverse its decision to require a Securities Act registration statement instead of an Exchange Act registration statement.

Uber. WeWork. Airbnb. It remains to be seen whether these and similar pre-IPO companies will follow the traditional IPO path or will follow

Spotify's lead and go directly to the exchange without passing the underwriters.