Speech

Investing in the Public Option: Promoting Growth in Our Public Markets
Remarks at The SEC Speaks in 2020

Commissioner Allison Herren Lee

Oct. 8, 2020

Thank you, Stephanie [Avakian], for that kind introduction. I look forward to this conference every year because it provides an opportunity for a thoughtful, substantive dialogue between the Commissioners, the agency's expert staff, and a wide range of market participants about the important work the Commission is undertaking on behalf of American investors and markets. This year is no exception, and although we are meeting today in a virtual format rather than the Ronald Reagan Building as in years past, I applaud the event's organizers for their dedication to pressing ahead in the midst the current challenges. This year, perhaps more than most others, it is critical that the Commission and the Commissioners engage with market participants and the public about the challenges facing our markets.[1]

The Benefits to Issuers and Investors of the Public Markets

I want to talk today about the state of public markets and public offerings, as well as some promising recent developments for going public. This is an expansive topic to be sure, but one that sometimes takes a backseat to discussions about how the Commission can expand the private markets. This, despite the seismic shift that has occurred over the last decade in the balance between public and private markets, with roughly 70% of capital now raised in private markets.[2]

Setting that aside for the moment, let me focus on the opportunities afforded by public offerings. As an initial matter, the federal securities laws provide robust registration and reporting requirements, which have created a comparatively level playing field for investors—even the smallest investors—and allowed them to participate in returns in our public markets, often described as the envy of the world.[3] Indeed, the U.S. has a uniquely broad retail investor base for direct equity investments.[4] The principal feature of public offerings that puts smaller investors on a relatively equal footing with larger investors and corporate insiders is disclosure—simple access to standardized, accurate, and reliable information. Audited financial statements in particular provide a cornerstone of confidence in public markets, helping to ensure that investors can rely on the fundamentals of their investment.

In addition to reliable disclosure, investing in the public markets brings myriad other benefits for investors. They typically have more ready access to liquidity in the public markets, for example, either to invest additional capital or to exit an investment when it no longer serves their investment or diversification goals. And, importantly, public offerings provide reliably positive risk-adjusted returns for investors over time.[5] On that point, we often hear that the public market cannot offer the returns that investors, in exchange for heightened risks, may realize in the private market. Increasingly, however, research casts doubt on the extent to which the private market actually offers superior returns for any investors, let alone retail investors.[6] In fact, retail investors can expect to do worse in the private markets due to, among other factors, unequal access to the most lucrative opportunities, information asymmetry, and liquidity and dilution risk.[7] Thus we must protect and preserve public markets for the benefit of all investors, but especially for the benefit of retail investors.

The benefits of public offerings are not, of course, limited to investors. Issuers have traditionally been willing to take on the registration and reporting requirements of public listings because the public market provides them access to a huge pool of capital, the general public. One key trade-off between staying private and going public was fairly clear: an issuer would take on the obligations of a public offering because, among other things, it could raise more money from more investors than in a private offering. Recently, due in part to dramatic changes in the nature and size of the private market, that trade-off is less clear.[8]

The Current State of the Public Markets

Still, the public market is rich with opportunity for both issuers and investors. While there has been much discussion about the declining number of IPOs over the last couple of decades, there is substantial room for debate over whether the simple number of IPOs or number of public companies tells the full story.[9] Deal volume, for instance, indicates investors are putting more money in IPOs in recent years than they were during the dot com boom.[10] And recent data shows that we are currently experiencing a boom in IPOs.[11] Nevertheless, there are fewer IPOs and fewer public companies than there were two decades ago, and particularly fewer smaller IPOs.[12] Fewer smaller IPOs is especially concerning because it reduces opportunities for investors to participate in potentially high growth companies.

An oft-posited reason for this decline is the presence of “burdensome” regulations.[13] That idea has animated many of the regulatory changes we’ve seen in recent years.[14] In reality, there is a much more complex mix of factors at work. Some research suggests that small companies may find it more beneficial to be acquired by a larger company in the same industry rather than going public; the resulting economies of scale and scope may produce greater returns than the company could expect to generate organically on its own.[15] Moreover, there is evidence that a decline in small company IPOs was triggered by a decrease in demand for small IPOs among the nation’s largest mutual funds, which typically show a strong preference for highly-liquid securities.[16]

My former colleague, Professor Robert Jackson, also explored this issue, presenting compelling evidence that underwriters effectively impose a so-called “middle-market IPO tax” on smaller companies, charging higher fees and consistently underpricing the offerings.[17] The combination of these factors means that mid-market issuers can face a one-two punch when going public—the underpricing may leave a substantial amount of money on the table, and the underwriter may capture an outsize spread of the smaller-than-necessary offering proceeds.[18] Lastly, as I alluded to earlier, compelling scholarship has highlighted how the continued deregulation of private capital-raising undermines incentives to go public.[19] If issuers are able to access nearly unlimited capital in the private markets, there is significantly reduced incentive to undertake the efforts and expense needed to enter the public markets.

Thus, the actual picture of the public markets is more complex than the macro decline in IPOs and public companies would suggest. And the causes of the decline in IPOs and public companies are even more complex. We should therefore proceed with care in the approach we take to promoting public offerings, taking into account this complexity, rather than just reflexively blaming overregulation. There may well be areas in need of reduced regulation, but we should proceed in a balanced manner, with a nuanced understanding of the various dynamics involved, and based on data rather than intuition.[20]

We must also more carefully consider the interplay between public and private markets as we continue to loosen restrictions in both. We have steadily facilitated exempt offerings that are larger and more widely sold, including to the general public.[21] In other words, more like public offerings, but without the investor protections the public markets afford. In the process, we have repeatedly failed to take common-sense steps to gather data about the private markets, steps we proposed in 2013 but failed to complete.[22] As a result, neither the public nor the Commission benefits from reliable data to inform the considerable time and resources spent in this area.

At the same time, in the interests of facilitating public markets, we steadily reduce the relevant disclosure requirements, thus reducing the traditional benefits to investors these markets provide.[23] Thus, we chip away at important distinctions between these two markets from both sides, disincentivizing companies from going public with so much access to capital in the private markets, while at the same time, degrading the features and protections that public offerings provide. If we stay on this path, we may well see a continued decline in both quantity and quality of public offerings, to the detriment of all investors, but especially retail investors whose prosperity is directly linked to the success of public markets.

Promising Innovation

Thankfully, there have been some recent market developments and innovations that have the potential to help issuers address certain of the challenges involved in going public, and therefore enliven public markets and expand investor opportunities. I want to discuss two of those developments today—direct listings and special purpose acquisition companies (or SPACs).

Direct Listings

Direct listings are a relatively recent phenomenon, and they have undoubtedly increased in popularity over the past year.[24] The concept is fairly straight-forward: rather than engaging an underwriter and launching a traditional IPO, a direct listing allows owners of a private issuer's securities to sell their holdings directly on a stock exchange.[25] While this requires the filing of a registration statement with the Commission, it is important to note that direct listings have not to this point involved sales by the issuers themselves, meaning it has not been a capital-raising opportunity for the issuer.[26] More recently, however, proposed changes to certain rules governing direct listings would permit issuers—rather than only selling shareholders—to sell shares in a direct listing.[27]

Without prejudging any such proposed changes, I think it's worth taking a look at some of the potential pros and cons. Direct listings can offer unique advantages to issuers seeking a less expensive path to the public markets. Given the structure of a direct listing, this approach to capital raising has the potential to reduce the costs involved in going public. As an initial matter, a direct listing does not require an underwriter in the same way as a traditional IPO.[28] While an issuer will still require financial advisors and legal counsel to conduct due diligence and prepare required disclosures, it will no longer require an arrangement in which an underwriter or underwriting syndicate agrees to purchase the offering for resale.[29] This can substantially reduce the extent to which the underwriter is exposed to market risk, and should lead to lower expenses for the issuer.

Moreover, the offering of shares directly on an exchange will allow an issuer greater ability to sell at a price that reflects market forces, possibly avoiding or reducing the potential for significant underpricing.[30] And, importantly, the availability of direct listings as an alternative avenue for accessing the public markets may introduce competitive forces to the pricing of underwriting services in the market for traditional IPOs, thus benefitting other issuers that may choose that traditional route.

As the Commission considers these issues, it is also critical that we evaluate all of the ways in which this new approach to going public may affect investors and the markets more broadly. Easing the path to capital in the public markets is an important goal, but to work well, the outcome must benefit both issuers and investors. In this respect, there are two areas that deserve close attention.

First, while the omission of a traditional underwriter has the potential to reduce the cost of going public, it is important that the financial advisors and legal counsel involved in the due diligence process for a direct listing are properly incentivized to perform their role with a great deal of care. In a traditional IPO, an underwriter faces the potential for liability under the Securities Act for material misrepresentations or omissions in the registration statement.[31] This provides a strong incentive for underwriters to be thorough and exacting in the due diligence process. Nevertheless, the breadth of the statutory definition of "underwriter" may, depending on the facts and circumstances, be sufficient to encompass the activities of a financial advisor in a direct listing.[32]

Second, direct listings involving sales by both shareholders and issuers raise important questions about an investor's options for recourse in the event of material misstatements or omissions in a registration statement. Section 11 of the Securities Act imposes liability on an issuer in such cases,[33] but the so called "traceability" requirement for a plaintiff to establish standing in such a lawsuit may present a significant barrier when the secondary market includes shares offered pursuant to multiple registration statements (or a combination of registered and unregistered shares).[34] While this issue is not necessarily unique to direct listings, they may present a higher degree of risk related to traceability. We've seen at least one district court decision thus far determining that Section 11's tracing requirement does not apply to a direct listing,[35] but that issue is currently on appeal.[36] It is unclear how the law may evolve on this point, and it's important for the Commission to consider whether investors are sufficiently protected under Section 11 when it comes to direct listings.

Special Purpose Acquisition Companies

Next, special purpose acquisition companies, or SPACs, present another avenue for private issuers to enter the public markets. While SPACs have been around since the early 1990s, heightened activity in this space over the past couple of years has brought renewed interest and scrutiny to the ways in which SPACs may benefit both issuers and investors. In its simplest form, a SPAC is a shell company that raises capital in the public markets with the sole intention of identifying and merging with a target operating company.[37] The merger transaction provides the operating company with capital that it might otherwise raise in a traditional IPO, and SPAC shareholders become shareholders in the now-public operating company.

Similar to direct listings, SPACs have the potential to bring private issuers into the public market more quickly than would be possible in a traditional IPO.[38] Issuers may avoid much of the advance work involved in a typical IPO—such as an extensive roadshow—by merging with an existing SPAC that is already listed and traded in the public markets. As co-investors in the deal, SPAC sponsors have an economic interest in the long term success of the acquisition target as well as a reputational interest in pursuing and promoting an acquisition that will benefit investors. The entry of established firms in this space may benefit SPAC investors by offering experienced management at the helm of the SPAC in both identifying a worthwhile target and as a potential advisor or executive in the post-merger operating company.

As the Commission continues to evaluate this space, we should focus on how SPACs disclose the relevant risks and sponsor compensation. As a special purpose vehicle, initial investors in a SPAC rely heavily on the sponsor's experience and expertise in identifying a target that will provide meaningful investment returns. In the short term, a SPAC investment acts largely as a blank check, so it is critical that the offering documents clearly disclose the material risks involved, as well as the ways in which the sponsor will be compensated for its services.

Likewise, the Commission should consider whether there are ways to further align the interests of sponsors and investors to ensure that sponsors are incentivized by the quality of any potential target. In most instances, a SPAC is required to return capital to investors if it has not identified a target company within 18 to 24 months of raising capital.[39] A significant source of the sponsor's compensation, however, is comprised of shares in the post-acquisition operating company.[40] The requirement to return capital to investors, therefore, may create an incentive for sponsors to pursue a less-than-ideal acquisition in order to secure that compensation.[41] While the Commission's rules currently require certain holding periods[42] and SPAC governing documents may impose additional terms on sponsors, I hope to hear from investors about whether the Commission should consider additional protections for investors in this space.

In sum, I hope we will see continued innovation in our public markets – innovation that redounds to be the benefit of both issuers and investors. But we must do more than hope. We must focus carefully on the interplay between the actions we take in the private markets and how those actions may affect incentives to go public. As I mentioned, our public markets are often described as the envy of the world. This does not happen by chance, but by deliberation, expertise, and data driven policies. The Commission can serve the public and investors—especially retail investors—well by focusing on issues that support and help grow healthy public markets.

[1] The views I express today are my own and do not represent the views of my fellow Commissioners or the staff.

[2] In 2019, exempt offerings accounted for approximately $2.7 trillion of new capital, compared to $1.2 trillion in registered offerings. *See* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Proposed Rule, Securities Act Release No. 10763, 8 (Mar. 4, 2020).

[3] *See Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment: Hearing Before the H. Comm. on Fin. Servs.*, 116th Cong. (Sept. 11, 2019) (written testimony of Elisabeth de Fontenay, Professor, Duke University School of Law at 2-3), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-defontenaye-20190911.pdf ("Testimony of Elisabeth de Fontenay") (providing that the "public markers were specifically designed to create an even playing field for retail investors relative to corporate insiders and sophisticated investors" and noting that "U.S. public securities markets have been the envy of the world for decades"). *See also* Selective Disclosure and Insider Trading, Final Rule, Securities Act Release No. 7881 (Aug. 15, 2000) (adopting a prohibition against selective disclosure and explaining that "[i]nvestors who see a security's price change dramatically and only later are given access to the information responsible for that move rightly question whether they are on a level playing field with market insiders" and that "regulation will place all analysts on equal footing with respect to competition for access to material information").

[4] Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Va. L. Rev. 1025, 1072 (2009) ("The United States is the only country in the world with a truly broad and active retail investor base for direct equity investment.").

[5] *See The Pyramid of Equity Returns: Almost 200 Years of U.S. Stock Performance*, Advisor Channel (Visual Capitalist/New York Life Investments) Sept. 17, 2020, https://advisor.visualcapitalist.com/historical-stock-market-returns/ ("While equities can have high volatility, returns have historically followed a positively-skewed bell curve distribution. From 1825-2019, the average total annual return was 8.25%. In fact, over 70% of total annual returns have been positive over the same timeframe.").

[6] *See* Testimony of Elisabeth de Fontenay, *supra* note 3, at 6 ("Contrary to the received wisdom, the most recent and comprehensive studies show that the returns from investing in the public and private markets have been converging over time, and any excess returns in the private markets have mostly dissipated today."). *See also* Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?*, 14 J. Inv. Mgmt. 14, 15 (2016) ("In this paper, we use cash flow data derived from the holdings of almost 300 institutional investors to study over 1,800 North American buyout and venture capital funds. Average buyout fund returns for all vintage years but one before 2006 have exceeded those from public markets; averaging about 3% to 4% annually. Post-2005 vintage year returns have been roughly equal to those of public markets. We find similar performance results for a sample of almost 300 European buyout funds. Venture capital performance has varied substantially over time. North American venture funds from the 1990s substantially outperformed public equities; those from the early 2000s have underperformed; and recent vintage years have seen a modest rebound.").

[7] Erik Gerding, *The Cost to Retail Investors and Public Markets of "Harmonizing" Securities Offering Exemptions*, The CLS Blue Sky Blog (Oct. 1, 2019), https://clsbluesky.law.columbia.edu/2019/10/01/the-cost-to-retail-investors-and-public-markets-of-harmonizing-securities-offering-exemptions/ ("Investing in private securities would pose considerable additional risks for retail investors, relative to investing in public securities, and existing research suggests that these additional risks would not be sufficiently offset by higher expected returns. In fact, if retail investors are given more direct access to the private markets, they are likely to earn *lower* risk-adjusted returns overall than they do in the public markets, for several reasons."). *See also* SEC, Report to Congress on Regulation A / Regulation D Performance 104 (Aug. 2020), https://www.sec.gov/files/report-congress-regulation-a-d.pdf ("Based on an analysis of a small subset of public companies with Regulation D offerings, in line with prior studies, we find such companies tend to be smaller, less profitable, and more financially constrained than public companies conducting registered offerings. The small subset of public companies relying on Regulation D grew faster one year after the offering but had lower profitability and stock returns, compared to public companies undertaking registered offerings.").

[8] Renee M. Jones, *The Unicorn Governance Trap*, 166 U. Pa. L. Rev. Online 165, 171 (2017) ("A series of developments in the market for private company shares has relieved the demand for liquidity that previously pushed start-ups toward an IPO.").

[9] *See* Ernst & Young LLP, Looking Behind the Declining Number of Public Companies: An Analysis of Trends in US Capital Markets 1 (May 2017), https://www.sec.gov/spotlight/investor-advisory-committee-2012/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf ("A lower number of IPOs than during a boom-bust cycle should not automatically be viewed as problematic. There is ample evidence that today's IPOs are creating stronger, healthier companies than at any time in the past.").

[10] *See* Ronald Orol, *Elizabeth Warren, SEC's Clayton Clash Over Health of IPO Market*, The Street (Sept. 26, 2017), https://www.thestreet.com/markets/mergers-and-acquisitions/elizabeth-warren-sec-s-clayton-clash-over-health-of-ipo-market-14320616. *See also* Ernst & Young LLP, *supra* note 9, at 1 ("US public companies are fewer in number today than 20 years ago but much larger by market capitalization. They are also more stable, and delisting rates are much lower than immediately following the dot-com boom.").

[11] *See* Ben Winck, *Record IPO Frenzy Will Continue Through October, NYSE President Says*, Business Insider (Sept. 30, 2020), https://markets.businessinsider.com/news/stocks/record-ipo-month-october-outlook-nyse-president-cunningham-public-market-2020-9-1029637063.

[12] FCLT Global, Public Markets for the Long Term: How Successful Listed Companies Thrive (Jan. 2019), https://www.fcltglobal.org/resource/public-markets-for-the-long-term-how-successful-listed-companies-thrive/.

[13] *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 Hastings L. J. 445, 464 (2017) ("Taken as a whole, the federal securities statutes and regulations impose a formidable disclosure burden on U.S. public companies. This heavier burden could plausibly explain issuers' recent reluctance to raise equity capital publicly. Much of the post-Sarbanes-Oxley commentary takes precisely that approach. In particular, many have interpreted both the rise of going private transactions and the decline in foreign issuers cross listing on U.S. exchanges as evidence of the excessive burden of mandatory disclosure and other securities law requirements for public companies. In this view, the decline of the public markets is a tragic yet predictable story of regulatory overreach."); Jones, *supra* note 8, at 171 ("Many observers attribute the decline in the number of IPOs to increased regulation of public companies.").

[14] *See, e.g.*, Amendments for Small and Additional Issues [sic] Exemptions Under the Securities Act, Final Rules, Securities Act Release No. 9741 (Mar. 25, 2015); Crowdfunding, Final Rule, Securities Act Release No. 9974 (Mar 25, 2015); Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Final Rules, Securities Act Release No. 9415 (July 10, 2013). *See also* Jumpstart Our Business Startups ("JOBS") Act, Pub. L. No. 112-116 (Apr. 5, 2012) (directing the Commission to adopt rules with scaled regulatory requirements for emerging growth companies in order to spur smaller companies to go public).

[15] *See* Xiaohui Gao et al., Where Have All the IPOs Gone? 48 J. Fin. & Quantitative Analysis 1663, 1677–79 (2013).

[16] *See* Robert P. Bartlett III et al., The Small IPO and the Investing Preferences of Mutual Funds, 47 J. Corp. Fin. 151 (2017).

[17] Commissioner Robert J. Jackson Jr., SEC, The Middle-Market IPO Tax (Apr. 25, 2018), https://www.sec.gov/news/speech/jackson-middle-market-ipo-tax ("Middle-market businesses are crucial to the long-term health of our economy, employing 48 million Americans across the Nation. Providing these firms with access to capital allows them to make the investments in research, development, and people that build our communities for the long term. Requiring these companies to pay a 7% tax before they can access our public markets—a tax that larger companies often avoid—risks holding back those investments. Addressing that tax will go a long way toward creating a level playing field in the IPO process—and keeping small, growing companies in our public markets.").

[18] *Id.*

[19] *See* de Fontenay, *supra* note 13, at 448 ("Today, private companies can raise ample, cheap capital with relative ease. Public company issuers therefore benefit significantly less from their disclosure obligations and can justifiably complain of a regulatory bait-and-switch. Thus, while critics blame the increase in regulation for the decline of public equity, the ongoing deregulation of private capital raising arguably played the greater role. That is, even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately."). Professor de Fontenay's analysis focuses on how changes to and expansions of the various exemptions from registration have undermined the traditional balance of interests between public and private companies. *See id.* The expansion of access to capital in the private markets has not only coopted what was once an exclusive benefit of the public markets—*i.e.*, access to an enormous amount of public investor capital—but it has also shifted the competitive landscape between public and private issuers. While the historical restrictions on private capital raising meant that public and private companies once competed for different investors—largely because investors and customers value the availability of information in the market—loosening those restrictions has meant that private issuers are able to benefit from the mandatory disclosure requirements in the public markets when competing for investors and customers without any corresponding benefit for public issuers. *See id.* at 487-490. The benefit of going public, therefore, has not only eroded, but the disclosure requirements are effectively a tax on public companies that operates to subsidize their private competitors. *See id.* at 498.

[20] *See* Commissioner Allison Herren Lee, Statement on Amendments to Registered Debt Disclosure Rules (Mar. 2, 2020), https://www.sec.gov/news/public-statement/statement-lee-amendments-registered-debt-disclosure-2020-03-02 ("More importantly, today's release, as with certain other proposals and rules under the Disclosure Effectiveness Initiative, rests on a kind of 'regulatory intuition' . . . .").

[21] *See, e.g.*, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Proposed Rule, Securities Act Release No. 10763 (Mar. 4, 2020); Amendments for Small and Additional Issues [sic] Exemptions Under the Securities Act, *supra* note 14; Crowdfunding, *supra* note 14; Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, *supra* note 14.

[22] *See* Amendments to Regulation D, Form D, and Rule 156, Proposed Rules, Securities Act Release No. 9416, 1 (July 10, 2013) ("These proposed amendments are intended to enhance the Commission's ability to evaluate the development of market practices in Rule 506 offerings and to address concerns that may arise in connection with permitting issuers to engage in general solicitation and general advertising under new paragraph (c) of Rule 506.").

[23] Financial Disclosures about Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities, Final Rule, Securities Act Release No. 10762 (Mar. 2, 2020) (asserting that, as a result of reducing disclosure obligations for registered debt securities, "issuers may be encouraged to offer guaranteed or collateralized securities on a registered basis"); Amendments to the Accelerated Filer and Large Accelerated Filer Definitions, Proposed Rules, Exchange Act Release No. 85814 (May 9, 2019) (asserting that exempting more companies from the requirement that auditors attest to management's assessment of the effectiveness of the issuer's internal control over financial reporting "may be a positive factor in the decision of additional companies to register their offering or a class of their securities"); Smaller Reporting Company Definition, Final Rules, Securities Act Release No. 10513 (June 28, 2018) (asserting that making smaller reporting company status—and the corresponding reduced disclosure requirements—available to more registrants "could encourage capital formation because companies that may have been hesitant to go public may choose to do so if they face reduced disclosure requirements.").

[24] *See* Betsy Atkins, *Direct Listings: An Alternative to the IPO*, Forbes (Oct. 14, 2019), https://www.forbes.com/sites/betsyatkins/2019/10/14/direct-listings-an-alternative-to-the-ipo/ ("The Direct Listing is emerging as a popular alternative to the IPO, and while it does not come with the "safety net" of an IPO it does have many benefits.").

[25] *See* Fenwick & West LLP, The Rise of Direct Listings: Understanding the Trend, Separating Fact from Fiction (Dec. 5, 2019), https://www.fenwick.com/insights/publications/the-rise-of-direct-listings-understanding-the-trend-

separating-fact-from-fiction ("In a direct listing, a company does not sell stock directly to investors and does not receive any new capital. Instead, it facilitates the re-sale of shares held by company insiders such as employees, executives and pre-IPO investors. Investors in a direct listing buy shares directly from these company insiders.").

[26] *Id. See also* Morrison & Foerster LLP, Client Alert: PE & VC Exits: U.S. Direct Listing Rules in Flux (Sept. 4, 2020), https://www.mofo.com/resources/insights/200904-investor-exits.html ("To date, direct listings have been available only for sales by the company's shareholders.").

[27] *See* Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 2, to Amend Chapter One of the Listed Company Manual to Modify the Provisions Relating to Direct Listings, Exchange Act Release No. 89148, File No. SR-NYSE-2019-67 (June 24, 2020) (proposing to modify existing exchange rules related to direct listings "to permit a primary offering in connection with a direct listing and to specify how a direct listing qualifies for initial listing if it includes both sales of securities by the company and possible sales by selling shareholders"); Notice of Filing of Proposed Rule Change to Allow Companies to List in Connection with a Direct Listing with a Primary Offering In Which the Company Will Sell Shares Itself In the Opening Auction On the First Day of Trading on Nasdaq and to Explain How the Opening Transaction for Such a Listing Will be Effected, Exchange Act Release No. 89767, File No. SR-NASDAQ-2020-057 (Sept. 15, 2020) (proposing to adopt a listing rule to permit a company to list in connection with a primary offering in which the company will sell shares itself in the opening auction on the first day of trading).

[28] *See* Cydney Posner, *Order Approving NYSE Rule Change Stayed*, Cooley PubCo, Cooley LLP (Sept. 2, 2020), https://cooleypubco.com/2020/09/02/nyse-primary-direct-listing-order-stayed/ ("Essentially, a 'direct listing' involves a registered sale directly into the public market with no intermediary underwriter, no underwriting commissions (just advisory fees) and no roadshow or similar expenses. The initial pricing is set during the opening auction, not by agreement among the company and underwriters, as in a traditional IPO.").

[29] *Id.* In addition to supplanting the traditional "firm commitment" underwriting arrangement described above, a direct listing could also serve as a replacement for a "best efforts" arrangement.

[30] *See* Morgan Stanley, What to Know About Direct Listings—From a Banker (Nov. 21, 2019), https://www.morganstanley.com/ideas/what-to-know-about-direct-listings-from-a-banker (listing price discovery as one of the reasons that an issuer would select a direct listing rather than an IPO and stating, "Instead of marketing a set number of shares in a fixed price range for an IPO, a direct listing conducts a live auction of undefined size and price on the morning of the listing.").

[31] *See generally* Securities Act of 1933, Sections 11-12, 15 U.S.C. 77k-77l.

[32] *See* Securities Act of 1933, Section 2(a)(11), 15 U.S.C. 77b(a)(11) ("The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.").

[33] *See* Securities Act of 1933, Section 11, 15 U.S.C. 77k.

[34] *See* Adam M. Apton, *Pleading Section 11 Liability for Secondary Offerings*, American Bar Association Practice Points (Jan. 4, 2017), https://www.americanbar.org/groups/litigation/committees/securities/practice/2017/pleading-section-11-liability-for-secondary-offerings/ ("A critical component of pleading any Section 11 claim, whether it be in connection with an initial or secondary offering, is standing. In order to adequately allege a Section 11 claim, a plaintiff must allege facts sufficient to show that he or she purchased shares that were registered under the allegedly misleading registration statement. The precise requirement is that the plaintiff must be able to 'trace' his or her shares to the registration statement at issue."). In the context of an IPO, a plaintiff can typically trace their

shares to the registration statement with relative ease, given the fact that the issuer's shares had not previously been registered and insiders' holdings of unregistered shares are generally subject to resale restrictions for a period of time after the initial offering. As there are no other shares in the secondary market, a shareholder can thus typically establish standing based on the logical presumption that their shares are traceable to the only registration statement on record. However, in the event of a secondary offering or when insiders sell their own (unregistered) holdings, tracing can be substantially more difficult, if not impossible. This is largely due to the way in which ownership of securities is transferred from one person to the next. In most cases, shareholders do not own *particular* shares of a company, but rather have an interest in a "fungible bulk" of shares held by the DTC and sharing the same CUSIP. Once an issuer conducts a follow-on offering, any shares purchased after that date are generally indistinguishable—meaning that an investor could not trace their particular holding back to an single registration statement. In the context of a primary direct listing, this complication has the potential to arise immediately when shares are initially offered. This is because in certain primary direct listings, issuers will sell pursuant to a registration statement simultaneously with insiders who are selling unregistered shares. Because the issuer's and insiders' shares will share the same CUSIP, purchasers of the offering could be held to lack legal standing if they cannot prove that their shares originated with the issuer.

[35] *See Pirani v. Slack Techs., Inc.*, 445 F. Supp. 3d 367, 381 (N.D. Cal. 2020) ("Therefore, this Court finds that in this unique circumstance—a direct listing in which shares registered under the Securities Act become available on the first day simultaneously with shares exempted from registration—the phrase 'such security' in Section 11 warrants the broader reading: 'acquiring a security of the same nature as that issued pursuant to the registration statement.' Accordingly, the Court DENIES defendants' motion to dismiss for lack of Section 11 standing." (internal citations omitted)).

[36] *See Pirani v. Slack Techs., Inc.*, 2020 U.S. Dist. LEXIS 99282 (N.D. Cal. 2020) (granting Slack's motion to certify order for interlocutory appeal regarding the applicability of Section 11's tracing requirements in the context of direct listings).

[37] Congressional Research Service, SPAC IPO: Background and Policy Issues 1 (Sept. 29, 2020), https://crsreports.congress.gov/product/pdf/IF/IF11655 ("A special purpose acquisition company (SPAC) is a type of 'blank-check' company that raises capital through initial public offerings (IPOs) with the intention to use the proceeds to acquire other companies at a later time. Unlike traditional IPOs, SPACs do not have commercial operations at the time of the IPO, explaining why they are referred to as blank-check or 'shell' companies.").

[38] PwC, How Special Purpose Acquisition Companies (SPACs) Work: Observations from the Front Lines, https://www.pwc.com/us/en/services/audit-assurance/accounting-advisory/spac-merger.html ("This approach offers several distinct advantages over a traditional IPO, such as providing companies access to capital, even when market volatility and other conditions limit liquidity. SPACs could also potentially lower transaction fees as well as expedite the timeline to become a public company.").

[39] *See* E. Ramey Layne et al., Vinson & Elkins LLP, *Special Purpose Acquisition Companies: An Introduction* 14 (Summer 2020) ("SPACs are required to either consummate a business combination or liquidate within a set period of time after their IPO. Stock exchange rules permit a period as long as three years, but most SPACs designate 24 months from the IPO closing as the period.").

[40] *Id.* at 7.

[41] *See* Congressional Research Service, *supra* note 37, at 2 (Sept. 29, 2020) ("SPAC sponsors' promote is typically high and not contingent upon meeting financial targets. Some believe that because of the pressure to construct a deSPAC within a specified period of time, some SPAC sponsors, in order to book the promote, may be more interested in getting any deal done (rather than getting a good deal done).").

[42] *See* Rule 144(i)(2), 17 C.F.R. 230.144(i)(2) (restricting the resale of SPAC securities in reliance on Rule 144 for a period of one year from the time of the relevant de-SPAC transaction).