



Cooley

10 Key Considerations in Preparing for a Direct Listing

1. Avoiding dilution versus fundraising

A critical consideration in any IPO, but particularly when the IPO price is lower than recent private valuations or expectations, is the significant dilution associated with the shares sold by the company to the public. For companies with a strong balance sheet, this dilution can be avoided through a direct listing in which only secondary shares are sold into the market by pre-listing stockholders and the company does not raise any proceeds. However, for companies that need to raise capital, IPOs are often a significant and necessary funding event. The SEC has approved rules for both NYSE and Nasdaq to allow for direct listings with a concurrent capital raise, although no company has attempted this yet. A company in need of capital could still forego an IPO and raise cash prior to a direct listing – at potentially more favorable valuations – or after being public following a business milestone or in favorable market conditions.

2. Price discovery

In an IPO, the company determines the price at which to sell its stock (on behalf of the company, its stockholders, or both), based on discussions with its investment bankers and meetings with potential investors before and during its “roadshow.” In a direct listing, the company lists its securities on the exchange and individual stockholders sell their shares in the market as soon as they determine the price is sufficient. The benefit is that free market pricing dynamics determine the trading price based on more democratic supply and demand realities. Pre-listing shares are not locked out of the market, banks do not stabilize the

trading valuations and mutual fund investors have the same ability as the rest of the market to obtain shares and impact pricing. This can create better price matching in early trading but can also create challenges in determining the initial “reference price” to inform early trading. Companies may want to consider facilitating secondary sales shortly prior to a direct listing to help determine valuation and the reference price for listing.

3. Negotiated pricing and investor selection versus market pricing

Part of the theory underpinning direct listings is the ability to effectively match the selling demand to the buying demand in the market immediately following the listing. Because companies in direct listings do not conduct investor roadshows to gauge Wall Street interest in the company, they rely on unfettered market dynamics without the benefit of any stabilization efforts by underwriters or traditional 180-day lock-up limitations on sales of stock. Consequently, there is less control over the flow of stock into the market but arguably more accurate pricing. While IPO companies will often seek to allocate significant shares to long-only mutual funds that they believe will be good stewards of that stock in the aftermarket, in a direct listing, the company cannot direct the placement of its shares. To date, the few companies that have done direct listings have experienced aftermarket volatility similar to larger IPO companies, so any impact from the absence of stabilization efforts has not been evident. In addition, trading volume immediately following the direct listings has been higher than the average IPOs (higher volume generally helping longer term to even out potentially significant trading swings). However, without a recent/concurrent private placement to place shares in

10 Direct Listing Considerations

the hands of specific mutual funds, direct listing companies have less ability to curate their stockholder base to include desirable investors than those doing IPOs.

4. Avoiding lock-up agreements

In IPOs, virtually all of the company's securityholders, including directors, officers and other insiders, are subject to "lock-up" agreements that prevent those holders from selling shares in the market for a period of time after the IPO – typically 180 days. In a direct listing, as they have been structured to date, most of the securities are available for sale immediately. Though it could undermine some of the efficient pricing dynamics, companies completing direct listings could explore including contractual lock-up agreements in their transactions as traditional IPOs if they wish to help stabilize against large sales. A company considering a direct listing could seek to lock-up some portion of its pre-listing stock, or certain holders, for some period of time post-listing in any manner that the company, together with its financial advisors, determines may be beneficial to its post-listing trading by supporting demand and/or decreasing volatility. If the company determines that the market may react negatively to early sales by insiders, then lock-up agreements may be an effective way to avoid those pitfalls.

5. Attracting investors

For many companies, an IPO is an introduction to a significantly broader audience of investors than they have access to as a private company. Testing-the-Waters meetings and the "roadshow" provide most IPO companies with unprecedented access to potential new investors – many of whom may not have known much about the company and its business and financial results prior to those meetings. In a direct listing, companies will conduct an "Investor Day" to address anticipated investor concerns and present their business fundamentals. However, the information shared is generally more limited and the interaction with investors less intimate than the extensive meetings held during an IPO. To date, the companies that have done direct listings have been well-known technology companies with which many institutional investors were

already familiar or invested. As companies that are less well-known consider going public through a direct listing, it will be particularly important that they have a strong investor relations team and strong story to ensure that, even with fewer opportunities to spend time with a broad set of potential investors, they can effectively create significant interest in the stock.

6. Publicity concerns remain

Even though the company is not offering its own stock in a direct listing, all of the legal concerns over "gun jumping" and "hying the stock" (and the associated SEC scrutiny) continue to apply. Companies pursuing direct listings still need to be mindful that they are "in registration" once they pick financial advisors and determine to move forward with the listing and, accordingly, those communications with media and third parties, as well as interactions with investors, continue to be subject to strict parameters to avoid the risks of gun jumping and the possibility that the SEC could delay the process. As with a traditional IPO, it is important that companies coordinate closely with outside counsel and their PR/IR teams to ensure that they standardize public communications to establish a track record, and develop consistent processes for external communications, including review of press releases by outside counsel.

7. Change in financial guidance

In an IPO, companies are effectively prohibited from including specific financial results guidance in the registration statement or during the offering. Instead, they develop long-term financial projections and a "financial model" that they share with the research analysts from the investment banks in the IPO syndicate, who then influence broader market expectations among potential investors. By contrast, in a direct listing, the company does not have the ability to provide this long-term financial model but instead provides shorter term financial guidance to the market broadly, in the same manner as a public company, prior to the direct listing in order to control the message and more directly align market expectations with future guidance. This guidance is a critical aspect of the price discovery process and market demand following the

10 Direct Listing Considerations

listing, so companies have a singular interest in shaping the form and scope of this message. It is worth noting that not all companies intend to provide guidance even after they become a reporting company, and they may want to reconsider that approach if they decide to pursue a direct listing where at least some financial guidance may be expected by investors.

8. Similar diligence and liability

As with an IPO, legal liability continues to apply to the accuracy of the disclosure in the Form S-1 governing the shares eligible for immediate resale in the public market. However, unlike in an IPO, there are no underwriters to share in that liability. Although companies should always be vigilant to ensure the completeness and accuracy of disclosure, underwriter participation in preparing disclosure in order to satisfy their own diligence defense can serve an important function in that process. It is important for companies pursuing a direct listing to involve their financial advisors, lawyers, accountants and large selling stockholders in crafting disclosure to investors that tells a complete story of the business, including disclosure of all the associated risks.

9. Need to be ready for immediate trading

In direct listings, companies need to prepare carefully for immediate trading of the stock following the listing. Unlike in an IPO, where lock-up agreements prevent sales for some period of time and there is often no immediate registration of shares for resale, in a direct listing, stockholders will need to settle immediate trades, and many institutional investors will want to process distributions to limited partners. Add to this complexity any RSUs that may be settled and available for immediate sale, conversion of preferred stock or debt securities, and other aspects of being ready at listing for open trading in the stock. We advise companies to work closely with their counsels and stock transfer agents to prepare early.

10. Financial advisors and expenses

Going public is a costly endeavor. There are a number of potential cost efficiencies associated with direct listings when compared to IPOs, chief among them the fees that companies pay to their financial advisors in connection with the transaction. In an IPO, the issuer and/or any selling stockholders pay a commission to the underwriters (typically 7%, but sometimes less for larger offerings) based on the number of shares sold in the IPO to the public. This means that the company is selling its stock at a discount to the value that it thinks it may be worth at the time of the IPO. In a direct listing, there are no commissions but rather financial advisory fees paid by the company to investment banks to help guide them through the process. The amount of these fees is based on the deal specifics and will vary and, while still significant, will almost certainly be less than IPO commissions.

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