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SEC Considers NYSE Proposal to Permit Direct Listings

SEC to Determine Whether to Approve NYSE's Proposal to Permit Listings of Qualifying Private Companies Without Securities Act Registration

SUMMARY

On September 15, 2017, the SEC issued an order instituting proceedings to determine whether to approve or disapprove a proposed rule filed by the NYSE to amend Section 102.01B of the NYSE Listed Company Manual to permit qualifying private companies to list upon effectiveness of a Securities Exchange Act of 1934 registration statement without a concurrent IPO or registration under the Securities Act of 1933. Under the proposal, companies would need to receive an independent valuation of at least $250 million to satisfy the listing requirement. If approved, the proposal would permit the NYSE to create liquid trading markets for large qualifying companies not seeking to raise capital, changing the way companies approach selling shares to the public. Spotify, an online music streaming service most recently valued at $13 billion, is reported to be considering a direct listing of its stock on the NYSE in 2018, rather than pursuing the traditional underwritten IPO route. The SEC indicated that further evaluation of the proposal is appropriate in light of the legal and policy issues raised, including the implications for price discovery, the role of distribution participants, and the availability of information. The SEC is soliciting comments on the proposal through October 12, 2017.

BACKGROUND

The traditional way a company becomes listed on a national exchange is either in connection with a firm commitment underwritten IPO, upon transfer from another market, or pursuant to a spin-off.[1] The NYSE also allows companies to list common equity securities that have been sold in a private placement once a resale registration statement has been filed under the Securities Act of 1933 (the Securities Act) and

declared effective. Currently, NYSE rules do not provide for a company to list its securities in connection with the effectiveness of a Securities Exchange Act of 1934 (the Exchange Act) registration statement, such as a Form 10 or Form 20-F, in the absence of Securities Act registration.

Depending on the type of listing, the NYSE requires a listed company to demonstrate an aggregate market value of publicly held shares of either $40 million or $100 million at the time of listing. To verify this valuation, the NYSE generally relies on written representations from the underwriter, investment banker, or other financial advisor. However, in the case of previously private companies filing Securities Act resale registration statements, the NYSE determines the required $100 million market value of publicly held shares by reference to both (i) an independent third-party valuation and (ii) the most recent trading price for the company's common stock in a private placement market. The lesser of the valuation and trading value is used to determine if the $100 million threshold is satisfied.

DISCUSSION

The NYSE has proposed three changes to Footnote (E) of Section 102.01B of the NYSE Listed Company Manual (the Manual).[2] The first is to explicitly permit the NYSE, on a case-by-case basis, to exercise its discretion to list companies upon effectiveness of a registration statement under the Exchange Act without any concurrent IPO or Securities Act registration, provided the company meets all other listing requirements. Since such companies will be required to meet all of the same quantitative requirements met by other listing companies, the NYSE believes investors and the public interest would be protected.

The second proposed change to Footnote (E) is to provide that, if shares have not been recently traded in a private placement market, the NYSE will determine a company has met its market value of publicly held shares requirement if the company provides a recent independent third-party valuation of at least $250 million.[3] The NYSE's proposal states that the current requirement to rely on private placement market trading in addition to an independent third-party valuation may cause difficulties for companies that are large enough to be suitable for listing but do not have their securities traded on a private placement market prior to going public. In other cases, private placement market trading is too limited to provide a reasonable basis for reaching conclusions about a company's qualification for listing.

The third proposed change to Footnote (E) is to establish certain criteria that would preclude a valuation agent from being considered independent. A valuation agent would not be independent if it or any affiliated person or entity:

- beneficially owns in the aggregate more than 5% of the class of securities to be listed at the time of the valuation (including any right to receive any such securities exercisable within 60 days);
- has provided any investment banking services to the listing applicant within the 12 months preceding the date of valuation; or
- has been engaged to provide investment banking services to the listing applicant in connection with the proposed listing, any related financings, or other related transactions.

According to the NYSE, the proposal protects investors and the public interest because companies that list in this manner will be required to meet the same quantitative requirements as other listing applicants. The SEC, however, has noted a direct listing without prior trading and Securities Act registration may raise a number of unique considerations. These include the role of distribution participants, the extent and nature of pricing information available prior to the commencement of trading, and the availability of information regarding the indicative number of shares that are likely to be made available for sale at the commencement of trading. The NYSE believes its proposal would enable it to compete for listings of companies it says would be able to list on NASDAQ, since NASDAQ has listed a number of previously private companies without a concurrent underwritten public offering, although NASDAQ's existing rules do not explicitly contemplate these listings.

IMPLICATIONS

If approved by the SEC, the proposal would remove an obstacle that currently prevents companies such as Spotify from using direct listings to list on the NYSE and become publicly traded companies. The NYSE's proposal reflects the changing dynamics of the private marketplace, where highly valued start-ups, which desire to provide liquidity for shareholders, have sufficient capital and do not need to raise additional cash associated with a conventional IPO. Direct listings may be a more attractive alternative to a traditional IPO for these firms and would eliminate underwriting fees, dilution to existing holders resulting from newly issued stock, and contractual lockup restrictions for shareholders. Compared to a traditional IPO, however, direct listings pose a greater risk of volatility of share prices since the public float may be limited and there will not be any underwriters with an incentive to make a market in the security.

It is important to recognize that the mere listing of a class of common equity securities under the proposed rule would not ensure the free transferability of the securities. Under Rule 144 under the Securities Act, a non-affiliate may:

- freely sell any common equity securities that have been held continuously by non-affiliates for more than 12 months;
- freely sell any other common equity securities upon the earlier of:
  - 12 months after the securities have been held continuously by non-affiliates; and
  - 90 days after the issuer has been a reporting company so long as at the time of sale the securities have been held continuously by non-affiliates for at least six months.

Affiliates of the issuer would only be eligible to make resales of common equity securities pursuant to Rule 144 90 days after the issuer has been a reporting company and only if at the time of sale the securities have been held continuously for at least six months.

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ENDNOTES

[1] *See* Section 102.01B(E) of the NYSE Listed Company Manual.

[2] Securities Exchange Act Release No. 34-81440 (Aug. 18, 2017), 82 Fed. Reg. 40183, at 40184 (Aug. 24, 2017), *available at* https://www.sec.gov/rules/sro/nyse/2017/34-81440.pdf. On September 15, 2017, the SEC issued an order instituting proceedings to determine whether to approve or disapprove Amendment No. 2 to NYSE's proposal. Securities Exchange Act Release No. 34-81640 (Sept. 15, 2017), 82 Fed. Reg. 44229 (Sept. 21, 2017), *available at* https://www.sec.gov/rules/sro/nyse/2017/34-81640.pdf.

[3] In proposing to adopt a valuation requirement of at least two-and-a-half times the $100 million requirement of Section 102.01B, NYSE notes that this amount "will give a significant degree of comfort that the market value of the company's shares will meet the [$100 million] standard upon commencement of trading on the Exchange", particularly since the valuation "must be provided by an entity that has significant experience and demonstrable competence in the provision of such valuations". Securities Exchange Act Release No. 34-81440 (Aug. 18, 2017), 82 Fed. Reg. 40183, at 40184 (Aug. 24, 2017).

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