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Going Public Without An IPO

On April 3, 2018, Spotify made a big board splash by debuting on the NYSE without an IPO. Instead, Spotify filed a resale registration statement registering the securities already held by its existing shareholders. The process is referred to as a direct listing. As most of those shareholders had invested in Spotify in private offerings, they were rewarded with a true exit strategy and liquidity by becoming the company's initial public float.

In order to complete the direct listing process, NYSE had to implement a rule change. NASDAQ already allows for direct listings, although it has historically been rarely used. To the contrary, a direct listing has often been used as a going public method on the OTC Markets and in the wake of Spotify, may gain in popularity on national exchanges as well.

As I will discuss below, there are some fundamental differences between the process for OTC Markets and for an exchange. In particular, when completing a direct listing onto an exchange, the exchange issues a trading symbol up front and the shares are available to be sold by the selling stockholders at prevailing market prices at any time. In an OTC Markets direct listing, a company must work with a market maker to file a 15c2-11 application with FINRA to obtain a trading symbol. For more on the 15c2-11 process, see HERE. Moreover, the registered securities may only be sold by the listed selling shareholders at the registered price, regardless of prevailing market price. However, once a company is trading on the OTCQB or OTCQX tier of OTC Markets, and as long as the offering is not considered an indirect primary offering, the company could amend the registration statement to allow shares to be sold at market price. Generally an offering will be considered indirect primary if more than 30% of the float is being registered for resale.

In a direct listing process, a company completes one or more private offerings of its securities, thus raising money up front, and then files a registration statement with the SEC to register the shares purchased by the private investors. Although a company can use a placement agent/broker-dealer to assist in the private offering, it is not necessary. A benefit to the company is that it has received funds much earlier in the process, rather than after a registration statement has cleared the SEC. The cost of completing an audit and legal fees associated with the registration process is expensive and is usually borne up front prior to receiving investor funds in a traditional IPO process.

Where a broker-dealer assists in the private placement, the commission for the private offering may be slightly higher than the commissions in a public offering. One of the reasons is that FINRA regulates and must approve all public offering compensation, but does not limit or approve private offering placement agent fees. For more on FINRA Rule 5110, which regulates underwriting compensation, see HERE. A second reason a broker-dealer may charge a higher commission is that there is higher risk to investors in a private offering that does not have an immediately available public exit.

The investors take a greater risk because the shares they have purchased are restricted and may only be resold if registered with the SEC or in accordance with an exemption from registration such as Rule 144. Generally a company offers a registration rights agreement when conducting the private offering, contractually agreeing to register the shares for resale within a certain period of time. Due to the higher risk, private offering investors generally are able to buy shares at a lower valuation than the intended IPO price. The pre-IPO discount varies but can be as much as 20% to 30%.

Furthermore, most private offerings are conducted under Rule 506 of Regulation D and are limited to accredited investors only or very few unaccredited investors. As a reminder, Rule 506(b) allows offers and sales to an unlimited number of accredited investors and up to 35 unaccredited investors—provided, however, that if any unaccredited investors are included in the offering, certain delineated disclosures, including an audited balance sheet and financial statements, are provided to potential investors. Rule 506(b) prohibits the use of any general solicitation or advertising in association with the offering. Rule 506(c) requires that all sales be strictly made to accredited investors and adds a burden of verifying such accredited status to the issuing company. Rule 506(c) allows for general solicitation and advertising of the offering.

Accordingly, in a direct listing process, accredited investors are generally the only investors that can participate in the pre-IPO discounted offering round. Main Street investors will not be able to participate until the company is public and trading. Although this raises debate in the marketplace, a debate which has resulted in increased offering exemptions for non-accredited investors such as Regulation Crowdfunding, the fact remains that the early investors take on greater risk and as such need to be able to financially withstand that risk. For more on the accredited investor definition, see HERE.

The private offering, or private offerings, can occur over time. Prior to a public offering, most companies have completed multiple rounds of private offerings, starting with seed investors and usually through at least a series A and B round. Furthermore, most companies have offered options or direct equity participation to its officers, directors and employees in its early stages. In a direct listing, a company can register all these shareholdings for resale in the initial public market.

Although Spotify's shares increased in value since debuting on the NYSE, in a direct listing there is a chance for an initial dip, as without an IPO and accompanying underwriters, there will be no price stabilization agreements. Usually price stabilization and after-market support is achieved by using an overallotment or greenshoe option.

An overallotment option, often referred to as a greenshoe option because of the first company that used it, Green Shoe Manufacturing, is where an underwriter is able to sell additional securities if demand warrants same, thus having a covered short position. A covered short position is one in which a seller sells securities it does not yet own, but does have access to.

A typical overallotment option is 15% of the offering. In essence, the underwriter can sell additional securities into the market and then buy them from the company at the registered price, exercising its overallotment option. This helps stabilize an offering price in two ways. First, if the offering is a big success, more orders can be filled. Second, if the offering price drops and the underwriter has oversold the offering, it can cover its short position by buying directly into the market, which buying helps stabilize the price (buying pressure tends to increase and stabilize a price, whereas selling pressure tends to decrease a price).

Direct Listing on OTC Markets

There are some fundamental differences between the direct listing process for OTC Markets and for an exchange. In particular, when completing a direct listing onto an exchange, the exchange issues a trading symbol upfront and the shares are available to be sold by the selling stockholders at prevailing market prices at any time. In an OTC Markets direct listing, a company must work with a market maker to file a 15c2-11 application with FINRA to obtain a trading symbol. For more on the 15c2-11 process, see HERE.

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Overall the direct listing process is a little less expensive and little quicker than a direct IPO process. The reason for this is that the company can work with a market maker to apply for a trading symbol immediately upon effectiveness of the S-1 as opposed to having to wait until after an offering has been sold and closed out.

The following is a summary of the direct listing process for an OTC Markets listing. To begin, a company should retain its team including legal, accounting and auditor. The company will also need a transfer agent and EDGAR agent. Our firm often makes referrals and recommendations as to various other service providers. Moreover, a company may use a broker-dealer placement agent in the private offering phase.

Generally, counsel will prepare a full transaction checklist including who is responsible for what items from the beginning until completion of the direct listing. The beginning of the process includes gathering due diligence and completing any corporate cleanup or reorganization that may be necessary in advance of a public listing. All companies need some level of cleanup, which can include amending articles of incorporation and bylaws to make them public company-friendly; creating employee stock option plans; entering into employment contracts with key officers; ensuring that licensing agreements and intellectual property rights are secure; adding board members and committees such as an audit committee; and establishing corporate governance including an insider trading policy.

While the company's accounting and auditing are being completed, legal counsel will complete corporate cleanup and begin to draft the private offering documents, if the company is completing a new private offering round (sometimes a company begins the process after several prior rounds of offerings and will not need to complete another). In addition, legal counsel, together with the investment bankers if any, and other advisors will work with the company to determine valuation and the best structure for the private offering and the registration statement pricing. The final registration statement pricing will not need to be determined until the final pre-effective amendment is filed with the SEC.

Ultimately a company will be registering common stock and that common stock will trade on the OTC Markets, but the private placement investment itself can take many forms, including convertible preferred stock, units consisting of current equity in the form of common and/or preferred stock and options or warrants, or units consisting of any combination of debt and equity. For more on the form of an investment and various options, see HERE. Furthermore, private offerings often include registration rights agreements to require the company to file a resale registration statement within a certain period of time.

In structuring the private offering(s) and subsequent resale registration statement, thought must be given to the public trading markets, including obtaining a trading symbol, qualifying for various tiers of OTC Markets, and hopefully, having an active trading market. Part of this process includes planning for the Form 211 Application, which will be filed by a market maker after effectiveness of the S-1 registration statement.

When reviewing a market maker's Form 211 application for the issuance of a trading symbol, FINRA conducts an in-depth review of the company, its shareholders and capitalization. See HERE. One matter which FINRA reviews in determining whether to grant a trading symbol is "concentration of ownership." FINRA will not grant a trading symbol unless there are enough non-affiliated shareholders holding freely tradeable shares, to establish a public float. Although there is no rule on this, my experience indicates that an initial float must be comprised of a minimum of 30 shareholders with more being better. FINRA will also consider the percentage of the company owned by these non-affiliated shareholders. Again, although there is no hard rule, in order to obtain a trading symbol, at least 20% or greater of the company's common stock, on a fully diluted basis, should be in the hands of the public float.

Likewise, OTC Markets now considers concentration of ownership in determining whether to grant an application to trade on the OTCQB or OTCQX tiers. OTC Markets generally follows the same parameters as FINRA, though if other red flags

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or negative factors exist, such as recent shell company status, at least 25%-30% of the company common stock, on a fully diluted basis, will need to be in the hands of the public float in order to trade on these higher tiers.

Furthermore, counsel must be sure to assist with any blue sky compliance in the process. For more on blue sky compliance, see my two-part blog HERE and HERE.

Once all private offerings are completed and the company has its intended capital structure and number of shareholders, and the company audit is completed, the S-1 registration statement will be drafted and filed with the SEC. A company can choose to file confidentially but will need to make all filings public at least 15 days prior to the registration statements effectiveness. For more on confidential filings, see HERE.

Within 30 days of filing the S-1 registration statement, the company will receive initial comments from the SEC. The comment and review process will continue with the SEC for approximately 3-4 months, at which time the SEC will clear the S-1 to be declared effective. When a company is trading on a national exchange, they have generally timed the application with the exchange so that the shares begin trading shortly after the S-1 is declared effective and in particular, upon filing and effectiveness of a Form 8-A to complete the full registration process for the company. A Form 8-A is discussed further below.

In an OTC Markets listing, a Form 211 Application must be filed with FINRA to receive a ticker symbol and begin trading. The Form 211 is filed by a market maker. Generally, a company will begin to speak with a market maker shortly before the filing. The FINRA process will take a minimum of two weeks and can go on for several months. Preparation of an organized and complete file will make a big difference in the timing of the process.

Concurrent with the Form 211 process, the company will apply to OTC Markets and determine which tier it qualifies for. Once FINRA issues a ticker symbol, the company can trade; however, to gain liquidity the company will also need to obtain DTC eligibility. The market maker that assists with the Form 211 Application can submit the DTC application as well. The stockholders listed in the S-1 registration statement are free to sell their registered shares at the price registered with the SEC.

Direct Listing on NASDAQ

NASDAQ has allowed for a direct listing although historically it has rarely been used. The process to achieve a direct listing on NASDAQ is substantially the same as OTC Markets with some key differences. This section will only discuss the differences. The biggest difference is that when completing a direct listing onto an exchange, the exchange issues a trading symbol upon effectiveness of the registration statement and filing of an 8-A, and the shares are then available to be sold by the selling stockholders at prevailing market prices.

An S-1 registration statement is a registration statement filed under the Securities Act of 1933. In order to qualify to trade on a national exchange, a company must also be registered under the Securities Exchange Act of 1934. This is not a requirement for OTC Markets. A Form 8-A is a simple (generally 2-page) Exchange Act registration form used instead of a Form 10 for companies that have already filed the substantive Form 10 information with the SEC (generally through an S-1). When the Form 8-A is for registration with a national securities exchange under Section 12(b) of the Exchange Act, the 8-A becomes effective on the later of the day the 8-A if filed, the day the national exchange files a certification with the SEC confirming the listing, or the effective date of the S-1 registration statement.

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Direct Listing on NYSE

An NYSE direct listing follows the same process on NASDAQ; however, previously NYSE rules required an underwriter to determine or at least sign off on valuation in connection with an initial public offering. On February 2, 2018, the SEC approved a proposed rule change by the NYSE to allow a company that had not previously been registered with the SEC and which is not being listed as part of an underwritten initial public offering, to apply for and if qualified, trade on the NYSE. The amended rules modify the provisions relating to qualification of companies listing without a prior Exchange Act registration in connection with an underwritten initial public offering and amend Exchange rules to address the opening procedures on the first day of trading of such securities.

The rule amendments modify the determination of market value such that the NYSE has discretion to determine that a company meets the minimum market value requirements for a listing based on an independent third-party valuation.

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Securities attorney Laura Anthony and her experienced legal team provides ongoing corporate counsel to small and mid-size private companies, OTC and exchange traded issuers as well as private companies going public on the NASDAQ, NYSE MKT or over-the-counter market, such as the OTCQB and OTCQX. For nearly two decades Legal & Compliance, LLC has served clients providing fast, personalized, cutting-edge legal service. The firm's reputation and relationships provide invaluable resources to clients including introductions to investment bankers, broker dealers, institutional investors and other strategic alliances. The firm's focus includes, but is not limited to, compliance with the Securities Act of 1933 offer sale and registration requirements, including private placement transactions under Regulation D and Regulation S and PIPE Transactions as well as registration statements on Forms S-1, S-8 and S-4; compliance with the reporting requirements of the Securities Exchange Act of 1934, including registration on Form 10, reporting on Forms 10-Q, 10-K and 8-K, and 14C Information and 14A Proxy Statements; Regulation A/A+ offerings; all forms of going public transactions; mergers and acquisitions including both reverse mergers and forward mergers, ; applications to and compliance with the corporate governance requirements of securities exchanges including NASDAQ and NYSE MKT; crowdfunding; corporate; and general contract and business transactions. Moreover, Ms. Anthony and her firm represents both target and acquiring companies in reverse mergers and forward mergers, including the preparation of transaction documents such as merger agreements, share exchange agreements, stock purchase agreements, asset purchase agreements and reorganization agreements. Ms. Anthony's legal team prepares the necessary documentation and assists in completing the requirements of federal and state securities laws and SROs such as FINRA and DTC for 15c2-11 applications, corporate name changes, reverse and forward splits and changes of domicile. Ms. Anthony is also the author of SecuritiesLawBlog.com, the OTC Market's top source for industry news, and the producer and host of LawCast.com, the securities law network. In addition to many other major metropolitan areas, the firm currently represents clients in New York, Las Vegas, Los Angeles, Miami, Boca Raton, West Palm Beach, Atlanta, Phoenix, Scottsdale, Charlotte, Cincinnati, Cleveland, Washington, D.C., Denver, Tampa, Detroit and Dallas.

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