Davis Polk

Direct Listings: A Viable Alternative to Traditional IPOs

With the IPO and SPAC markets effectively shut down, Israeli companies seeking a U.S. listing may want to consider the direct listing route

The "traditional" IPO model continues to be the "gold standard" for Israeli companies going public in the United States, but the IPO market has been effectively shut down for almost a year. For a while, Israeli companies looked to SPAC mergers as an alternative, but that market has also been effectively shut down. One option that companies can also consider is a "direct listing," where a company is listed on an exchange without a capital raising transaction, and instead files a registration statement to facilitate a listing and permit existing shareholders to sell into the market without a formal offering. For an Israeli company, direct listings can take two distinct forms: (i) an initial listing by a private company, which is focused on discovering a market price for the company's securities and creating liquidity for the company's shareholders, and which we refer to as a "Direct Listing IPO" and (ii) a second U.S. listing by a company that is listed outside the United States, such as on the TASE, which is focused on creating a U.S. market for the company to facilitate future capital raises and increase liquidity, which we refer to as a "Secondary Direct Listing."

Each of these types of direct listings has its own distinct process as well as advantages and disadvantages, but they provide Israeli companies with valuable optionality to provide their shareholders with more liquidity, particularly in tough equity markets. The key drawback to both of these options has been that they do not provide the opportunity for a primary capital raise in connection with the listing, but recent rulemaking developments have begun to address issues that may result in the ability to raise primary proceeds in a Direct Listing IPO.

DIRECT LISTING IPO

A Direct Listing IPO can be distinguished from a traditional IPO in that there is no "underwritten offering" – that is to say, the traditional marketing process of a company or its shareholders selling a block of securities to institutional investors through one or more investment banks that act as underwriters at a price determined through a book-building process run through the underwriters, is absent. Instead, the company's outstanding shares are listed on one of the stock exchanges and existing shareholders are then free to sell shares at market prices determined by the exchange. Because this is normal trading activity, it can be accomplished even when the IPO market is shut down. While there is no need for the participation of underwriters in a Direct Listing IPO, investment banks are still needed to advise the company.

A Direct Listing IPO provides certain important advantages to private companies aiming to go public. Some of the key advantages include:

Market-driven Price Discovery – In a Direct Listing IPO, the opening price for the stock on the day of listing is determined based on the buy and sell orders submitted through the facilities of the exchange. This is in contrast to the traditional IPO where underwriters collect orders from their institutional investor clients,

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which then form the basis of the sale price. The entire block of shares are then sold to those institutional investors at that price and those investors turn around and sell some or all of the shares they purchased once the stock opens on the stock exchange; and it is these sales by the institutional investors, and not the sales by the company's existing shareholders that provide the supply of shares in the stock exchange. As you might expect, this suggests that the price that the existing shareholders receive is set at a discount from what the institutional investors expect to be able to receive when they resell the shares on the exchange. By contrast, in a secondary Direct Listing IPO, the company's existing shareholders can sell at any time after the stock opens on the exchange at the then current market price. The flexibility of order sizes and the broader potential market of buyers suggest that the price at which shares are sold in a Direct Listing IPO should, at least theoretically, be a more accurate market price than in a traditional IPO, and should also avoid the "IPO discount" found in a traditional IPO.

More Liquidity for Existing Shareholders – In a traditional IPO, the institutional investors that purchase the shares sold in the offering often expect that safeguards will be put in place such that there will not be a competing supply of shares when they turn around to resell the shares on the stock exchange. As a result, lock-up agreements are typically signed between the company and existing shareholders and the underwriters whereby the company and the existing shareholders are restricted from making additional sales for a period of 180 days post-IPO. In a Direct Listing IPO, lockups are not required and, therefore, existing shareholders are free to sell their shares as soon as the stock is listed, subject only to restrictions placed by the company.

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Lower Fees – Because there are no underwriters in a Direct Listing IPO, the selling shareholders do not bear the cost of an "underwriting discount" – the difference in the price at which shares are sold to the underwriters and the price at which the underwriters resell the shares to the institutional investor purchasers. As noted above, this does not mean that investment banks are not involved in Direct Listing IPOs, and the company will bear the cost of paying for the services of those investment banks, which act as financial advisors to the company. That being said, the number of investment banks that typically advise on a Direct Listing

IPO is smaller than the number of underwriters involved in a typical traditional IPO and, therefore, total costs of the process tend to be lower.

There are, however, some important considerations that mitigate some of the perceived advantages of a Direct Listing IPO. These include:

No Primary Capital Raise – All of the Direct Listing IPOs that have been completed to date have been secondary offerings where the supply of shares in the market is provided by existing shareholders of the company and not by the company itself. This is because of regulatory limitations, and while there has been some positive movement lately in the regulatory framework, it still remains unclear how feasible primary capital raises will be in Direct Listing IPOs.

Potential Volatility and Illiquidity in the Stock – In order to meet minimum listing requirements and, more importantly, in order to ensure there is sufficient liquidity in the stock, a company considering a Direct Listing IPO must have a wide pre-IPO shareholder base with sufficient desire for liquidity. In particular, companies going public must have several hundred holders of round lots of stock (although this can be solved by gifting stock to employees to achieve this level). A lack of sell-side supply can act as an anchor for the market price of a public company's stock. Similarly, a successful Direct Listing IPO company should have sufficient buy-side demand following listing. This could be challenging if the company is a lesser known name, particularly if research analysts do not pick up coverage once the company is listed. It is important to note that one of the key advantages of a traditional IPO is that the entire underwriting syndicate, which, as discussed, is broader than the financial advisor group in a Direct Listing IPO, participates in investor education through the IPO process and then provides research coverage following the IPO. A company with a smaller following that pursues a Direct Listing IPO may not have the benefit of that research coverage or investor education support, which may aggravate any demand issues. Additionally, traditional IPOs have built-in mechanics that are intended to reduce volatility – namely the 15% overallotment option that allows underwriters to provide support for the stock if it trades down after opening and the lockup agreements that help manage post-listing supply – both of which are absent in a Direct Listing IPO.

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Regular IPO Documentation - One might think that because there is no underwritten offering in a Direct Listing IPO the documentation requirements would be less burdensome. Unfortunately, that is not the case. Regulatory requirements mandate the filing of a registration statement under the Securities Act of 1933 with the SEC in connection with a Direct Listing IPO. As a result, the public disclosure that a company prepares for a Direct Listing IPO will be the same as what it would be required to prepare for a traditional IPO. Additionally, the existence of Securities Act liability (the contours of which will be litigated in the U.S. Supreme Court this term) and the question about whether any such liability extends to the financial advisors in a Direct Listing IPO means that, practically speaking, financial advisors will require the same customary due diligence process as in a traditional IPO, including comfort letters and legal opinions.

These considerations make clear that a Direct Listing IPO may not be the right choice for every private company. However, we have seen Direct Listing IPOs be a valuable alternative to companies that are well suited – namely, companies

with a larger following and widely held pre-IPO equity. For example, the Spotify Direct Listing IPO, which is one of the Direct Listing IPOs in which Davis Polk was involved, saw lower volatility and higher trading volume on listing day than many comparable traditional IPOs of the last decade.

SECONDARY DIRECT LISTING

The second type of direct listing that an Israeli company may consider is a secondary listing in the United States once the company already has a listing outside the United States, such as on the TASE. The process for this form of direct listing is much simpler and involves lower costs than a Direct Listing IPO. However, like a "traditional" Direct Listing IPO, a Secondary Direct Listing does not include a primary capital raising transaction. Rather, the key advantage of a Secondary Direct Listing is that it gives existing shareholders the benefit of the liquidity provided by the U.S. capital markets and sets up the company to be in a position to take advantage of the U.S. capital markets for future primary raises.

In a Secondary Direct Listing, a company that is already listed on another exchange applies to list its stock on one of the U.S. stock exchanges. Additionally, the company must file a registration statement under the Securities Exchange Act of 1934 with the SEC. This registration statement includes factual information about the company's business and operations and includes financial statements prepared under IFRS, as issued by the IASB, or U.S. GAAP. In general, a TASE-listed company can modify its Israeli prospectus or annual report into a U.S. registration statement relatively easily. While the registration statement would be subject to securities law liability, importantly, and unlike in a Direct Listing IPO, there is no Securities Act registration statement that could form the basis for Securities Act liability for an investment bank, and often companies that pursue Secondary Direct Listings are not advised by investment banks, which means that there is no need for a costly IPO-style due diligence process involving comfort letters and legal opinions. Once the registration statement is declared effective and the listing application is approved, the stock will open for trading on the relevant exchange, and its opening price will be based on the price of the stock on its primary exchange.

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Following the listing, the company becomes an SEC registrant and will be required to file annual reports, which look very similar to the registration statement filed in connection with the Secondary Direct Listing, but only cover the most recent year, and also current reports on Form 6-K when required to make public disclosures pursuant to the law of the home country or stock exchange rules. In addition, market practice is for U.S. public companies, including Israeli companies, to report interim results every quarter and file unaudited financial statements with the SEC.

Importantly, as a U.S. public company, a company that undertakes a Secondary Direct Listing would be able to more easily access the U.S. capital markets in the future. The company's reporting history with the SEC and its U.S. listing is likely to increase the company's profile with U.S. investors and, one year following the listing, the company would be eligible to use the "shelf registration process," which is a process available to seasoned issuers under SEC rules that allows them to access the capital markets in a faster and more cost-efficient manner by avoiding regulatory preapproval at the time of the transaction. Additionally, the

added liquidity provided by the U.S. listing may be helpful to existing shareholders and lead to a more efficient market price for the stock.

Secondary Direct Listings, however, are not free from challenges. The main issue, similar to what Direct Listing IPOs face, is a potential lack of familiarity with the company in the U.S. market at the time of listing. A company that faces this issue could find itself without sufficient research analyst coverage, which can exacerbate the problem. Without a sufficient following, the stock could face low volumes in the relevant U.S. exchange, at least initially, which could make sales in the U.S. more difficult and could lead to volatility in the stock.

We have found that Israeli listed companies, including Israeli companies, are able to find benefits in a Secondary Direct Listing. This includes recent examples, such as the Secondary Direct Listing of Nayax on which Davis Polk advised the company.

PRIMARY DIRECT LISTING IPOS

As noted above, one of the key disadvantages of Direct Listing IPOs to date has been that due to regulatory limitations, Direct Listing IPOs have not included primary capital raises. Recently, the New York Stock Exchange and the Nasdaq have adopted rules intended to facilitate primary Direct Listing IPOs. However, regulatory hurdles that reduce the desirability of primary Direct Listing IPOs remain.

The basic framework for how primary Direct Listings are intended to work is that the company must identify in its registration statement the number of shares that it wants to sell and a price range in which it expects to sell such shares. Under the modified stock exchange rules, the opening auction must (i) include all of the shares that are offered on the registration statement and (ii) clear a price up to 20% below or 80% above the disclosed price range in registration statement. Unfortunately, the current rules do not provide flexibility to change the number of shares being offered or to have larger deviations from the price range included in the registration statement without filing an amendment to the registration statement with the SEC, which is subject to SEC review, and effectively means the stock cannot open for trading on the intended date. This can create issues when there is not sufficient demand for the number of shares being offered at a permissible clearing price and reduces flexibility for the company when the demand is higher than what the company originally offered, and the company would have liked to take advantage of such demand. The framework also reduces some of the advantages found in secondary Direct Listing IPOs as it requires that all of the shares being sold by the company be sold at the same price. Additionally, the modified rules do not solve all of the regulatory obstacles to primary Direct Listing IPOs, including the absence of no-action relief under Regulation M to permit Direct Listing IPOs with both a primary and secondary component. This means that until the SEC provides such relief, primary Direct Listing IPOs could only be conducted without a secondary component, which eliminates many of the advantages of Direct Listing IPOs for existing shareholders. ■

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Prominent Israeli corporations look to Davis Polk for advice on M&A, capital markets, tax, litigation, finance, restructuring, private equity and intellectual property matters.

Over the past three years, our market share of U.S. IPOs by Israeli companies is approximately 41%. With a 25% market share in Israeli M&A, our team advised on deals valued at approximately $40 billion over the past five years.

Our Hebrew-speaking team includes lawyers with Israeli law school degrees and career experience at Israel's most prestigious law firms.

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