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INVESTMENT BANKERS AS UNDERWRITERS—BARBARIANS OR GATEKEEPERS? A RESPONSE TO BRENT HORTON ON DIRECT LISTINGS

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I. INTRODUCTION

As an alternative to traditional underwritten initial public securities offerings (IPOs), direct exchange listing by issuers—in which securities are sold on an exchange directly into trading markets without intermediary selling processes, participants, and the substantial expenses that mark firm commitment underwritten offerings—have captured the attention of tech companies.[1] Spotify Technology SA (NYSE: SPOT) and Slack Technologies, Inc. (NYSE: WORK) recently demonstrated the viability of direct listing: each became a public company by carrying out a public offering via direct listing on the New York Stock Exchange (NYSE).[2] The companies made the offerings in compliance with the Securities Act

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1. Brent J. Horton, *Spotify's Direct Listing: Is It a Recipe for Gatekeeper Failure?*, 72 SMU L. REV. 177, 188–91 (2019); Greg Rodgers, Marc Jaffe & Benjamin Cohen, *Evolving Perspectives on Direct Listings After Spotify and Slack*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 17, 2019), https://corpgov.law.harvard.edu/2019/12/17/evolving-perspectives-on-direct-listings-after-spotify-and-slack/ [https://perma.cc/7EJT-VPHY].

2. Maureen Farrell, Alexander Osipovich & Anne Steele, *Spotify's Splashy Debut Pressures Banks*, WALL ST. J. (Apr. 3, 2018, 7:31 PM), https://www.wsj.com/articles/spotify-shares-jump-in-market-

of 1933 (Securities Act) registration statement and offering process requirements, but without the involvement of underwriters, syndicates, traditional road shows, aftermarket stabilization processes, or lock-up restrictions that typify traditional underwritten public offerings.[3] Investment bankers acting as advisers assisted the companies in planning and executing the offerings.[4] Importantly, however, the shares sold in these direct listed offerings were held by existing Spotify and Slack shareholders.[5] Neither company engaged in the capital formation that would normally characterize an IPO, and as such these were not primary offerings by issuer companies.[6]

The NYSE rule for "Selling Shareholder Direct Floor Listing" upon which these companies relied does not cover primary offerings by issuers.[7] The success of the Spotify and Slack direct listed offerings for selling shareholders prompted calls for modification of NYSE listing rules to permit primary direct floor listings by issuers themselves in addition to selling shareholders.[8] The NYSE commenced an initiative to accomplish this by applying to the U.S. Securities and Exchange Commission (SEC) for approval of a rule change amending Chapter 1 of the NYSE Listed Company Manual to modify the provisions relating to direct listings accordingly.[9]

The initial NYSE proposal to the SEC to permit primary direct floor listings was unceremoniously rejected last year.[10] The NYSE continued its initiative, however, with a modified proposal.[11] After nine months of trying, on August 26, 2020, the SEC approved a change to listing requirements, allowing for primary direct listings.[12] The change amended Chapter 1 of the NYSE's Listed Company Manual by offering an alternative to the traditional IPO process for primary

debut-1522773951 [https://perma.cc/8YH9-HRML]; Maureen Farrell & Corrie Driebusch, *Slack Shares Jump in Trading Debut*, WALL ST. J. (June 20, 2019, 6:44 PM), https://www.wsj.com/articles/slack-set-for-its-trading-debut-11561040327 [https://perma.cc/NNK2-J63U].

3. *See* Horton, *supra* note 1, at 189–90. *See generally* Maureen Farrell & Ana Rivas, *Palantir's IPO Shortcut: A Direct Listing*, WALL ST. J. (Sept. 29, 2020, 4:05 PM), https://www.wsj.com/articles/the-ipo-shortcut-a-direct-listing-11560976972 [https://perma.cc/7TG3-FXGZ].

4. Farrell et al., *supra* note 2; Farrell & Driebusch, *supra* note 2; *see also* Horton, *supra* note 1, at 195.

5. *See* Benjamin J. Nickerson, Comment, *The Underlying Underwriter: An Analysis of the Spotify Direct Listing*, 86 U. CHI. L. REV. 985, 986 (2019).

6. Anat Alon-Beck, *Investment Bankers as Underwriters: Barbarians or Gatekeepers?*, FORBES (Oct. 13, 2020, 12:56 PM), https://www.forbes.com/sites/anatalonbeck/2020/10/13/investment-bankers-as-underwriters-barbarians-or-gatekeepers/#48a855504af7 [https://perma.cc/M6EW-G3LZ].

7. *See* Order Approving NYSE Proposed Rule Change to Modify Provisions Relating to Direct Listings, Exchange Act Release No. 34-89684, 85 Fed. Reg. 54,454, 54,458 (Aug. 26, 2020).

8. *See id.*

9. *See id.*

10. Alexander Osipovich, *SEC Rejects NYSE Plan to Expand Direct Listings*, WALL ST. J. (Dec. 6, 2019, 6:21 PM), https://www.wsj.com/articles/sec-rejects-nyse-plan-to-expand-direct-listings-11575674476 [https://perma.cc/8H98-C8AJ].

11. N.Y. Stock Exch. L.L.C., Proposed NYSE Rule Change by a Self-Regulatory Organization (Form 19b-4) (Nov. 26, 2019).

12. *See* Order Approving Proposed Rule Change, 85 Fed. Reg. at 54,455.

offerings.[13] Private companies would thus be able to use direct listings to do IPOs and raise new capital.[14] On September 4, 2020, the Nasdaq Stock Market followed up with its own direct listing proposal,[15] which at the time of writing remains pending.[16]

Changes to permit primary offerings via direct listing will help private companies to overcome some of the obstacles imposed by our securities laws and listing rules.[17] Direct listings have generated much attention in the media and support from prominent venture capitalists such as Bill Gurley.[18] Direct listing has never been advanced as right for every company, and of those which would qualify under the new rules for primary direct listing, many would no doubt still prefer the traditional underwritten public offering.[19] However, direct listing clearly has the potential to meaningfully disrupt the IPO process.[20] First and foremost, primary offerings by direct listing would eliminate the involvement of investment banker underwriters in the offering process, and instead permit issuers to engage the assistance of "financial advisers" who play no traditional underwriter role in the offering.[21] In the traditional IPO process,[22] investment bankers as firm commitment underwriters perform valuation analyses, engage in

13. *Id.*

14. *Id.* The rule changes provide for further changes to the minimum listing value, allowing a company to meet the applicable aggregate market value requirement if either (1) the company will sell at least $100 million in market value of its shares in the Opening Trade; or (2) the aggregate of the Primary Direct Floor Listing amount and the shares that are publicly held immediately prior to the listing is at least $250 million, with the market value calculated using a price per share equal to the lowest price of the price range established by the issuer in its registration statement. *Id.*

15. Notice of Nasdaq Proposed Rule Change Relating to Direct Listing with a Primary Offering, Exchange Act Release No. 34-89878, 85 Fed. Reg. 59,349, 59,349 (Sept. 15, 2020). There are some minor differences between the NYSE and Nasdaq proposed rules with regards to the valuation and flexibility on pricing outside the range indicated in the prospectus. David Lopez, Jeffrey D. Karpf, Helena K. Grannis, Adam Fleisher, Nicolas Grabar & David Parish, *Direct Listings 2.0 – Primary Direct Listings*, CLEARY GOTTLIEB (Sept. 10, 2020), https://www.clearygottlieb.com/news-and-insights/publication-listing/direct-listings-20-primary-direct-listings [https://perma.cc/K62Q-LPKS]. According to a memorandum by Cleary Gottlieb, "Nasdaq would allow an issuer to proceed with a listing at a price up to 20% below the registration statement range, and with no limit above the registration statement range." *Id.* This means that the "likelihood of a failed auction would be lower than under the NYSE rule." *Id.*; *see also* NASDAQ, RULEBOOK: THE NASDAQ STOCK MARKET § IM-5315-1 (2020).

16. Amit Katarina, Brian Snyder & John Owen, *Morrison & Foerster Discusses Investor Exits: U.S. Direct Listing Rules in Flux*, CLS BLUE SKY BLOG (Sept. 14, 2020), https://clsbluesky.law.columbia.edu/2020/09/14/morrison-foerster-discusses-investor-exits-u-s-direct-listing-rules-in-flux/ [https://perma.cc/KW6D-X4CK].

17. Allison Herren Lee, Comm'r, Sec. & Exch. Comm'n, Investing in the Public Option: Promoting Growth in Our Public Markets, Remarks at the SEC Speaks in 2020 (Oct. 8, 2020) (transcript available at https://www.sec.gov/news/speech/lee-investing-public-option-sec-speaks-100820 [https://perma.cc/XZ9J-BC4Q]).

18. *See* Ari Levy, *Inside Bill Gurley's Mission to Upend the Tech IPO Market in Favor of Direct Listings*, CNBC (Oct. 6, 2019, 10:28 AM), https://www.cnbc.com/2019/10/06/bill-gurleys-plan-to-move-from-tech-ipos-to-direct-listings.html [https://perma.cc/CJ8Y-85QS].

19. *See* Horton, *supra* note 1, at 188, 201.

20. *See* Rodgers et al., *supra* note 1.

21. *See* Horton, *supra* note 1, at 182–83.

22. *See generally id.*

"book building,"[23] decide (with the issuer) on the price,[24] go on road shows to market the securities,[25] and sell and stabilize the offering.[26] That said, critics, prominently including Professor Brent Horton, see direct listing as a danger to investors; Horton argues that direct listing of primary offerings eliminates the "gatekeeper" role of traditional underwriters and denigrates investor protection.[27]

Horton thoughtfully articulates his concern that financial advisers to a direct listing do not have the same incentives as firm commitment underwriters to act as gatekeepers.[28] The NYSE, on the other hand, persuasively argued that the absence of a traditional underwriter gatekeeper would not compromise investor protection.[29] The SEC agreed.[30] Approving the modified NYSE proposal, the SEC concluded that the existing liability framework under the Securities Act for registered offerings that would apply to all direct listings assured that the NYSE rule is consistent with investor protection.[31]

Notwithstanding the NYSE's successful argument to the SEC on risk reduction stemming from other non-underwriter gatekeepers,[32] these alternative gatekeepers serve vastly different functions than those of a traditional underwriter.[33] Despite the difference in roles, the SEC concluded that "financial advisors' reputational interests" are sufficient to protect investors, combined with "potential liability, including as statutory underwriters."[34] The Commission also concluded that the

23. "Book building" is a term used to refer to the process by which the investment banker, in its role as an underwriter, samples investor interest in the offering and works on determining the price at which the IPO will be offered. Horton, *supra* note 1, at 184; *see also* Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1594 (2006).

24. *See, e.g.*, Horton, *supra* note 1, at 184; *see also* William K. Sjostrom, Jr., *The Untold Story of Underwriting Compensation Regulation*, 44 U.C. DAVIS L. REV. 625, 629–30 (2010); Shane A. Corwin & Paul Schultz, *The Role of IPO Underwriting Syndicates: Pricing, Information Production, and Underwriter Competition*, 60 J. FIN. 443, 448 (2005); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 654 (1988).

25. Horton, *supra* note 1, at 184; *see also* Sean J. Griffith, *Spinning and Underpricing: Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583, 613 (2004).

26. *See* Horton, *supra* note 1, at 205; *see also* Alexander Hamilton Frey, *Federal Regulation of the Over-the-Counter Securities Market*, 106 U. PA. L. REV. 1, 26 (1957); Samuel N. Allen, *A Lawyer's Guide to the Operation of Underwriting Syndicates*, 26 NEW ENG. L. REV. 319, 348–50 (1991); Richard A. Booth, *Discounts and Other Mysteries of Corporate Finance*, 79 CALIF. L. REV. 1053, 1090 (1991).

27. *See generally* Horton, *supra* note 1.

28. *Id.* at 201–04.

29. *See* Letter from Elizabeth K. King, Chief Regul. Officer, Intercont'l Exch., Inc., to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n (Mar. 16, 2020) (on file with SEC) [hereinafter King Letter].

30. Order Approving NYSE Proposed Rule Change to Modify Provisions Relating to Direct Listings, Exchange Act Release No. 34-89684, 85 Fed. Reg. 54,454, 54,460 (Aug. 26, 2020).

31. *Id.* In its approval Release, the SEC stated: "[T]he Commission believes that the financial advisors to issuers in Primary Direct Floor Listings will be incentivized to engage in robust due diligence, notwithstanding the lack of a firm commitment underwriting agreement." *Id.* The SEC observed that a firm commitment underwriting is not necessary to provide adequate investor protection in the context of a registered offering, and that "issuers and other gatekeepers, with their attendant liability, play important roles in assuring that disclosures provided to investors are materially accurate and complete." *Id.*

32. King Letter, *supra* note 29.

33. *See* Horton, *supra* note 1, at 201–02.

34. Order Approving Proposed NYSE Rule Change, 85 Fed. Reg. at 54,460. The Commission declined to denote financial advisors as statutory underwriters, merely stating that they may be

absence of a statutory underwriter would not preclude investors from recovering the same amount of damages as they would via a traditional IPO.[35] It did not address the impracticality of calculating these damages or obtaining the necessary standing to seek such damages, merely stating that, given the requirement to register all Primary Direct Floor Listings under the Securities Act, the existing regulatory framework would be sufficient protection.[36]

II. THE CII ROADBLOCK

Despite SEC approval, progress toward implementation of the approved NYSE listing rule permitting primary direct floor listings has recently halted. On August 31, 2020, in an effort to overturn approval of the NYSE rule change, the Council of Institutional Investors (CII) filed a notice with the SEC to challenge the approval.[37] As reported by the *Wall Street Journal* on September 1, 2020, the SEC's approval is now "on pause after an influential group of institutional investors took an unusual regulatory step in a last-ditch effort to block it."[38] The CII raised several concerns regarding the new rule and focused heavily on the uncertain role of financial advisers and whether investor protection is compromised.[39]

There is a need for clarity on this and other issues. For example, will financial advisers assume responsibilities and liability functionally as underwriters? Will purchasers of securities in direct listed public offerings that involve both primary and secondary sales have standing to bring private actions under Section 11 of the Securities Act,[40] where "tracing" is required?[41] And how will Section 11 damages be determined?

We believe Horton overstates the "danger" to investors posed by direct listings[42] and that the CII is misguided in its concern that investor protection would be

deemed as such and would be appropriately subject to relevant liabilities. *Id.*

35. *Id.*

36. *Id.* at 54,461. The Commission went on to note that in a traditional firm commitment offering, investors may still face difficulties tracing purchases back to registered offerings, adopting the position of not addressing the issue across the board, rather than combating a higher risk. *Id.*

37. Letter from Jeffrey P. Mahoney, Gen. Couns., Council of Institutional Invs., to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n (Aug. 31, 2020) (on file with SEC) (notifying the SEC of CII's intent to petition for review of the Order Approving a Proposed Rule Change).

38. Alexander Osipovich, *NYSE Direct Listings Hit Snag as Investor Group Raises Concerns*, WALL ST. J. (Sept. 1, 2020, 6:40 PM), https://www.wsj.com/articles/nyse-direct-listings-hit-snag-as-investor-group-raises-concerns-11599000009 [https://perma.cc/S343-VJ5J].

39. *See* Letter from Jeffrey P. Mahoney, Gen. Couns., Council of Institutional Invs., to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n (Apr. 16, 2020) (on file with SEC) [hereinafter CII Concern Letter].

40. Section 11 of the Securities Act creates a private right of action for any person acquiring securities in a registered public offering to recover damages on account of an information failure in the registration statement. 15 U.S.C. § 77k(a). Section 11 provides for strict liability of the issuer of the securities and for liability of others associated with the offering, specifically including every underwriter, subject to certain "due diligence" defenses. *Id.* § 77k(a)–(b).

41. *See* Ken Cunningham, Grant Thornton, Bruce R. Braun & Neil H. Conrad, *Litigating Section 11's Tracing Requirement: A Practitioner's View of a Powerful Defense*, BUREAU NAT. AFFS. (June 2019), https://www.sidley.com/-/media/publications/bloomberg-lawlitigating-section-11s-tracing-requirement-a-practitioners-view-of-a-powerful-defense.pdf?la=en [https://perma.cc/8VC5-PEJU].

42. *See* Horton, *supra* note 1, at 210–11.

compromised.[43] We applaud, however, Horton's ideas for making direct listings safer for investors as a general matter,[44] and we offer some further thoughts below.

A. FINANCIAL ADVISERS AS UNDERWRITERS AND GATEKEEPERS?

Underwriters in registered public offerings are commonly considered gatekeepers.[45] Underwriters are expressly liable under Section 11 for materially false or misleading statements in a registration statement (the principal part of which is the prospectus used in the offering).[46] Unlike issuer liability, however, underwriter liability is not absolute.[47] A statutory due diligence defense (reasonable investigation) applies to underwriters, from which their gatekeeper role arises by implication.[48] Professor Andrew Tuch has characterized underwriter liability as "perhaps the most complex and difficult to justify."[49] The strategy behind Section 11 of the Securities Act to impose liability on underwriters for the information failures of their issuer clients is meant, at least in theory, to incentivize the underwriters to deter client wrongdoing by conducting due diligence and monitoring (or at least influencing) the conduct of issuers.[50]

In a public offering via direct exchange listing, there is no underwriter.[51] Rather, although not necessarily, issuers engage investment bankers as financial advisers.[52] There is a need for clarity on whether the investment bankers acting as financial advisers face Section 11 liability in the new direct listing process. If the answer to this question is yes, then the investment bankers will theoretically have the same incentives as in a traditional IPO to conduct due diligence in connection with the preparation of the registration statement and execution of the offering. If the answer is no, then the CII can argue that, due to the reduced risk of liability in a direct listing, underwriters will be less effective as gatekeepers under the new rule—an argument the SEC Division of Trading and Markets rejected.[53]

Financial advisers in direct listed offerings may well fall outside the express underwriter liability scheme of Section 11 of the Securities Act. They are not the firm commitment underwriter fairly envisioned in Section 11.[54] But acting in the role of financial adviser to the issuer in a direct listed public offering fairly connotes active participation with the issuer and others associated with the issuer in carrying out the offering. There are ample bases for liability under antifraud provisions of the federal securities laws to purchasers of the securities when the

43. *See* CII Concern Letter, *supra* note 39; Osipovich, *supra* note 10.
44. *See* Horton, *supra* note 1, at 211–12.
45. *E.g.*, Nickerson, *supra* note 5, at 988 n.13.
46. 15 U.S.C. § 77k(a)(5).
47. *See* Nickerson, *supra* note 5, at 1007; Andrew F. Tuch, *The Limits of Gatekeeper Liability*, 73 WASH. & LEE L. REV. ONLINE 619, 631–32 (2017).
48. *See* Tuch, *supra* note 47, at 631.
49. *Id.* at 619.
50. *Id.* at 631–32.
51. Horton, *supra* note 1, at 179.
52. *Id.* at 180.
53. Order Approving NYSE Proposed Rule Change to Modify Provisions Relating to Direct Listings, Exchange Act Release No. 34-89684, 85 Fed. Reg. 54,454, 54,460 (Aug. 26, 2020).
54. *See* Nickerson, *supra* note 5, at 1008–09.

financial adviser plays an active, facilitative role coupled with knowledge of information failures or such recklessness as to support a finding of culpability under antifraud provisions.[55] As the SEC pointed out in its approval of the NYSE primary listing rule, there is no requirement that there be an underwriter in a public offering.[56] That does not mean, however, that application of federal securities laws' general antifraud provisions as the basis for both private actions by purchasers of securities in an offering and SEC enforcement actions is in any way affected or its impact lessened. This includes the incentive for financial advisers playing an active role to exercise the same kind of due diligence that would be front and center in defending against Securities Act Section 11 claims against a traditional underwriter.[57]

Horton argues that the investment banker acting as financial adviser rather than underwriter does not face "statutory pressure" to act as a gatekeeper.[58] "It is unlikely," he states, "that a financial advisor [in a direct listed public offering] would be considered a statutory underwriter" and thus would not face liability under Securities Act Section 11.[59] In fact, depending on facts and circumstances, the financial adviser in a direct listed public offering could clearly be identified as a "statutory underwriter." "Statutory underwriter" is a term of art attached to Securities Act Section 2(a)(11), which defines underwriter to include any person who "participates or has a direct or indirect participation" in a distribution of any security.[60] A financial adviser in a direct listed offering could easily fit the bill. Statutory underwriter status under Section 2(a)(11) has enormous liability consequences for violations of the registration statement and offering process requirements in Section 5 of the Securities Act.[61] However, such status is not relevant in determining the Section 11 liability of an actual underwriter identified and contractually committed as such in a registered public offering for materially false or misleading information in a registration statement.[62] By and large, courts have not sustained Section 11 liability claims for misstatements and omissions in a registration statement made against one who is alleged only to be a statutory underwriter under the definition in Section 2(a)(11).[63] However, recently, in a decision of first impression, the Northern District of California found as a matter of law that Section 11 liability may not be purely inescapable within the context of a direct listing.[64] The Ninth Circuit has agreed to hear an appeal, but it remains

55. *Id.* at 1015–16.

56. Order Approving Proposed NYSE Rule Change, 85 Fed. Reg. at 54,460.

57. *See* Nickerson, *supra* note 5, at 1020.

58. Horton, *supra* note 1, at 203 chart 5.

59. *Id.*

60. 15 U.S.C. § 77b(a)(11).

61. *See id.* §§ 77b(11), 77d(a)(1). Falling within the "underwriter" definition of Section 2(a)(11) precludes reliance on the transaction exemption for sales of securities in Section 4(a)(1) of the Securities Act for sales by persons other than an issuer, underwriter, or dealer. *See id.* §§ 77b(11), 77d(a)(11).

62. *See* Nickerson, *supra* note 5, at 1014, 1016.

63. *See* Pirani v. Slack Techs., Inc., 445 F. Supp. 3d 367, 378 (N.D. Cal. 2020).

64. *See id.* at 379, 381; *see also* Nicolas Grabar, David Lopez & Andrea Basham, *A Look Under the Hood of Spotify's Direct Listing*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 26, 2018), https://corpgov.law.harvard.edu/2018/04/26/a-look-under-the-hood-of-spotifys-direct-listing/

in early stages.[65] Nevertheless, the financial adviser participating in a direct offering faces ample exposure to liability and concomitant pressure under other antifraud provisions. Horton, and by extension, the CII, are perhaps right that financial advisers have no Section 11 liability incentive to be gatekeepers, but we believe there is, in fact, ample incentive under other provisions for those who take on the active role of a financial adviser.

B. INVESTOR PROTECTION?

Do direct listings provide less investor protection than traditional IPOs? If the entire focus is on the availability of the private remedy in Section 11 of the Securities Act, critics have a point. For example, consider that issuers may choose, like Slack, to structure their direct listings so that the shares available for trading on the first day include not only shares that are part of the registered offering, but also shares being resold pursuant to Rule 144.[66] The strict tracing requirement of Section 11 makes it difficult for some plaintiffs to establish standing for their Section 11 claim because they must trace the shares they purchased to those that were part of the registered offering.[67] However, once standing is shown, the liability of an issuer under Section 11 is strict, and thus easier for plaintiff purchaser to plead and prove.[68] Those investors who do not have standing under Section 11 are free to seek recovery under other general antifraud provisions, the most obvious being Securities Exchange Act Section 10(b) and SEC Rule 10b-5, which are not constrained by any Section 11 requirements.[69] As a practical matter in class action litigation, claims under both Securities Act Section 11 and Securities Exchange Act Section 10(b) and Rule 10b-5 are almost invariably asserted in the same action.[70] Issuers and other offering participants may escape Section 11 claims based on strict tracing, but will not escape broader antifraud claims simply because a mix of shares are sold coincident with the direct listed registered public offering.

There are other challenges for investors seeking to enforce Section 11 liability for direct listed offerings, such as limitations on recovery of damages. Under Section 11(g) the amount recoverable is limited to the offering price.[71] What does this limitation mean in the context of a direct listing? What is the price at which the security was "offered" to the public? Even if investor plaintiffs can demonstrate standing by tracing their securities to the registration statement or otherwise

[https://perma.cc/V2PZ-449T].

65. *See* Grabar et al., *supra* note 64.

66. *Id.*

67. *In re* Century Aluminum Co. Sec. Litig., 729 F.3d 1104, 1106–07 (9th Cir. 2013).

68. *See* Nickerson, *supra* note 5, at 1006.

69. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2020).

70. John J. Clark, Jr., Robert D. Weber & Kellin M. Chatfield, *Securities Litigation: Class Actions Arising from IPOs*, THOMSON REUTERS: PRAC. L., https://1.next.westlaw.com/Document/I7670357512f211e798dc8b09b4f043e0/View/FullText.html?transitionType=Default&contextData=(sc.Default)&OWSessionId=276059a268cb4c7c834ad8125986e602&isplcus=true&fromAnonymous=true&firstPage=true&bhcp=1 [https://perma.cc/H4AK-BLN6].

71. 15 U.S.C. § 77k(g) ("In no case shall the amount recoverable . . . exceed the price at which the security was offered to the public.").

overcome the tracing requirement, what are the damages? There is no public offering price as such, only a reference price which serves as the basis for initiation of bids at the time the shares are listed.[72]

C. WHY DIRECT LISTING? RISE IN PRIVATE PLACEMENTS & NEW LIQUIDITY MECHANISMS

Unicorn firms are now deliberately choosing to stay private and wait longer before they decide to do an IPO.[73] According to empirical research by Jay Ritter, in the past, venture capital (VC)-backed startups would do an IPO or trade sale within four years,[74] but now they are staying private longer than eleven years.[75] Unicorns are able to stay private longer because they can raise large amounts of capital from non-traditional investors, as well as use new legal mechanisms that allow investors to liquidate their investments.[76]

In the last few years until the recent COVID-19 pandemic, new, non-traditional, deep-pocketed market actors were pouring money into large private technology firms which were historically dominated by VC investors.[77] Institutional and high net-worth investors, such as SoftBank, mutual funds, hedge funds, corporate venture capitalists, private equity, and sovereign wealth funds (together, alternative venture capital (AVC)) were turning their attention to private markets in hopes of capitalizing on the high returns of unicorn firms before they go public.[78] AVCs focused on financing unicorn firms because of their potential to disrupt the market, transform entire industries, and add value to their

72. *See* Horton, *supra* note 1, at 201.

73. Begum Erdogan, Rishi Kant, Allen Miller & Kara Sprague, *Grow Fast or Die Slow: Why Unicorns are Staying Private*, MCKINSEY & CO. (May 11, 2016), https://www.mckinsey.com/industries/technology-media-and-telecommunications/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private [https://perma.cc/X6HL-AAP2].

74. *See* JAY R. RITTER, INITIAL PUBLIC OFFERINGS: MEDIAN AGE OF IPOS THROUGH 2019, tbl. 4 (2020), https://site.warrington.ufl.edu/ritter/files/2020/02/IPOs2019Age.pdf [https://perma.cc/MS59-CYLD].

75. Erdogan et al., *supra* note 73.

76. *See* Steven Davidoff Solomon, *The Risk of a Billion-Dollar Valuation in Silicon Valley*, N.Y. TIMES (Sept. 22, 2015), https://www.nytimes.com/2015/09/23/business/dealbook/the-risk-of-a-billion-dollar-valuation-in-silicon-valley.html [https://perma.cc/BDN9-5MHK].

77. *See* Erdogan et al., *supra* note 73.

78. *See* Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 88 TENN. L. REV. (forthcoming 2020); Jamie Hutchinson, PowerPoint Presentation for the SEC Committee on Small and Emerging Companies (Feb. 15, 2017) (available on the SEC website at https://www.sec.gov/info/smallbus/acsec/hutchinson-goodwin-presentation-acsec-021517.pdf [https://perma.cc/WD87-YKSJ]) (PowerPoint Presentation entitled "Why Are More Companies Staying Private?"); *see also* Erdogan et al., *supra* note 73; Matt Levine, *Unicorn Buybacks and Securities Law*, BLOOMBERG (Feb. 16, 2017, 8:33 AM), https://www.bloomberg.com/view/articles/2017-02-16/unicorn-buybacks-and-securities-law [https://perma.cc/37S6-VS5J]; Craig Doidge, G. Andrew Karolyi & René M. Stulz, *The U.S. Left Behind? Financial Globalization and the Rise of IPOs Outside the U.S.*, 110 J. FIN. ECON. 546, 569 (2013) [hereinafter Doidge et al., *The U.S. Left Behind?*]; Craig Doidge, G. Andrew Karolyi & René M. Stulz, *The U.S. Listing Gap*, 123 J. FIN. ECON. 464, 472 (2017) [hereinafter Doidge et al., *The U.S. Listing Gap*]; Craig Doidge, Kathleen M. Kahle, G. Andrew Karolyi & René M. Stulz, *Eclipse of the Public Corporation or Eclipse of the Public Markets?* 11–12 (Eur. Corp. Governance Inst., Working Paper No. 547, 2018) [hereinafter Doidge et al., *Eclipse of the Public Corporation*]; Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1690 (2013).

overall portfolios.[79] Unicorn founders were eager to get in bed with AVCs because it provided the ability to stay private longer by raising large amounts of capital. It should be noted that unicorn founders also have an incentive to continue to control their firm[80] and to not subject themselves, their management teams,[81] trade secrets, or strategy to public market scrutiny.[82] For them, AVC financing is a new and very attractive path to maintain control over the firm while raising capital for growth. So why do a direct listing?

Thanks to AVCs, unicorn founders didn't need the traditional public markets to raise capital, but they discovered that they needed to provide liquidity in order to continue to attract, engage, and retain smart, skilled, and talented employees, as explained below.[83] Therefore, the direct listing was a perfect new alternative to the traditional IPO.

The direct listing was intended to grant employees and early investors an opportunity to gain liquidity, while also allowing founders to maintain control[84] over the management of their company.[85] But, despite the hype of direct listings,

79. *See* Alon-Beck, *supra* note 78.

80. *See* Michael Ewens & Joan Farre-Mensa, *The Deregulation of the Private Equity Markets and the Decline in IPOs*, 33 REV. FIN. STUD. (forthcoming 2020) (manuscript at 4), https://authors.library.caltech.edu/103419/1/hhaa053.pdf [https://perma.cc/32TZ-P36T].

81. For a discussion on the motives to go public, see Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79, 89–92 (1997), and James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. FIN. 399 (2006) (surveying CFOs on the decision to go public).

82. *See* Les Brorsen, *Looking Behind the Declining Number of Public Companies*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 18, 2017), https://corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies/ [https://perma.cc/2ZF2-HNPN]; Sergey Chernenko, Josh Lerner & Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns* 29, 32 (Harv. Bus. Sch. Working Paper, Paper No. 18-037, 2017), https://hbswk.hbs.edu/item/mutual-funds-as-venture-capitalists-evidence-from-unicorns [https://perma.cc/T8CA-PGFG]; MCKINSEY & CO., THE RISE AND RISE OF PRIVATE MARKETS: MCKINSEY GLOBAL PRIVATE MARKET REVIEW 2018, at 26 (2018); Levine, *supra* note 78; *see also* Andrew Nussbaum, Steve Cohen & Karessa Cain, *Private Equity—Year in Review and 2020 Outlook*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 8, 2020), https://corpgov.law.harvard.edu/2020/02/08/private-equity-year-in-review-and-2020-outlook/ [https://perma.cc/2XFL-WNHB].

83. *See* Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107, 117 (2018).

84. *See* Grabar et al., *supra* note 64.

85. Before direct listing, tech founders used dual-class stock. For more on dual-class stock and "minority controlling shareholders," see Lucien A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 594–95 (2017) ("[T]here has been an upward trend in the adoption of dual-class stock since Google went public with a dual-class structure in 2004 and was followed by well-known tech companies, such as Facebook, Groupon, LinkedIn, Snap, Trip Advisor, and Zynga. Indeed, according to data-provider Dealogic, '[m]ore than 13.5 percent of the 133 companies listing shares on United States exchanges in 2015 have set up a dual-class structure . . . compare[d] with . . . just 1 percent in 2005.'") (second and third alterations in original). For a detailed account of the history of dual-class structures in the United States, see Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693–707 (1986). For new legislation authorizing dual-class listing, see NYSE, LISTED COMPANY MANUAL § 313.00 (2020) (permitting the issuance of multiple classes prior to the IPO), and Notice of Proposed Nasdaq Rule Change, Exchange Act Release No. 34-59663, 74 Fed. Reg. 15,552, 15,552 (Mar. 31, 2009). For a criticism of dual-class structures, see Press Release, Council of Institutional Invs., Institutional Invs. Oppose Stitch Fix Dual-Class Structure but Welcome Sunset Provision (Nov. 16, 2017), https://advisornews.com/oarticle/institutional-investors-oppose-stitch-fix-dual-class-structure-but-welcome-sunset-provision#.W-TKzZNKjIU [http://perma.cc/8SGE-4Z4L] [hereinafter Council Press Release].

many firms continued to go public by using the traditional IPO model[86] due to design flaws in the old direct listing model.

First and foremost, companies could not use direct listing to raise cash from the public.[87] Second, a direct listing can be very risky for newcomers such as early-stage start-up firms, for example.[88] It is mostly suitable for unicorn firms, such as Spotify and Slack, which have broad household name recognition.[89] Third, some critics have questioned whether direct listings actually align the interests of the employees and the firm.[90] Fourth, questions remain as to whether direct listings can facilitate an adequate price discovery process. Unlike a traditional IPO, a direct listing has no book building and the financial advisers do not facilitate the price discovery (except on the opening price).[91] One thing is clear: even notorious unicorns that recently went public did not choose to pursue the direct listing strategy, and the future for the new direct listing model is still unclear.[92]

D. SECONDARY MARKETS

AVCs are able to invest in unicorn firms thanks to the development of new, dynamic secondary markets.[93] Unicorn firms developed new liquidity alternatives because of the prolonged timeline to IPO or trade sale, which can be longer than eleven years.[94] Liquidity practices allow unicorn shareholders to liquidate their investments as an alternative to traditional exit mechanisms.[95] These new

86. *See* Lizzy Gurdus, *Saudi Aramco and Alibaba Made for a Great 2019 in IPO Market Despite Uber, Lyft Busts*, CNBC (Dec. 29, 2019, 9:44 AM), https://www.cnbc.com/2019/12/29/saudi-aramco-alibaba-among-biggest-ipos-of-2019.html [https://perma.cc/69BR-6QFT].

87. *See The Rise of Direct Listings: Understanding the Trend, Separating Fact from Fiction*, FENWICK (Dec. 5, 2019), https://www.fenwick.com/insights/publications/the-rise-of-direct-listings-understanding-the-trend-separating-fact-from-fiction [https://perma.cc/HD99-FE5V].

88. *See* Maureen Farrell & Alexander Osipovich, *Bankers Begone! Spotify to Get Clearance for an 'Underwriter-Less' IPO*, WALL ST. J. (Dec. 21, 2017, 5:33 AM), https://www.wsj.com/articles/bankers-begone-spotify-to-get-clearance-for-an-underwriter-less-ipo-1513852210 [https://perma.cc/H56Z-BUDX].

89. *See* Horton, *supra* note 1, at 189.

90. *See generally* Grabar et al., *supra* note 64.

91. *See id.* Traditionally, companies use the book building price discovery mechanism. *Id.*

92. *See* John C. Coffee, Jr., *The Spotify Listing: Can an "Underwriter-less" IPO Attract Other Unicorns?*, CLS BLUE SKY BLOG (Jan. 16, 2018), http://clsbluesky.law.columbia.edu/2018/01/16/the-spotify-listing-can-an-underwriter-less-ipo-attract-other-unicorns/ [https://perma.cc/W6ZX-RLVN].

93. There are several distinctions between secondary and primary markets. First, in the primary market, a company issues securities (stock or bonds) for the first time directly to investors. When the investors then sell the securities to a third party, these transactions occur on the secondary markets. *See* J. WILLIAM HICKS, INTERNATIONAL DIMENSIONS OF U.S. SECURITIES LAW § 2:6 (2020). Second, the proceeds from the sale of securities on the primary market go to the issuing company, whereas the proceeds from the sale of securities on secondary markets go to the selling investor and not the company that initially issued the stock. *See* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 193–94, 227 (2012).

94. The timeline to IPO used to be four years. *See* RITTER, *supra* note 74; Levine, *supra* note 78; *see also* Erdogan et al., *supra* note 73; Hutchinson, *supra* note 78. For more information on the decline in the U.S. IPO market, see generally Doidge et al., *The U.S. Left Behind?*, *supra* note 78; Doidge et al., *Eclipse of the Public Corporation*, *supra* note 78; Doidge et al., *The U.S. Listing Gap*, *supra* note 78; and Gao et al., *supra* note 78.

95. *See* Katie Roof, *SoftBank's Big Investment in Uber Comes to a Close*, TECHCRUNCH (Dec. 28, 2017, 12:51 PM), https://techcrunch.com/2017/12/28/softbanks-big-investment-in-uber-comes-to-

practices include secondary sales, structured liquidity programs (private tender offers), and other liquidity alternatives.[96]

The alternatives aim to allow shareholders to gain liquidity, while allowing founders to maintain control[97] over the management of their company. The development of electronic secondary markets has increased liquidity for individual investors but has also raised several legal issues for the issuers.[98] A number of unicorns allow their employees and capital investors to sell their shares on secondary markets, using electronic platforms such as NASDAQ Private Market (formerly SecondMarket), SharesPost, and Forge Global.[99]

There are advantages and disadvantages to this new development. On the one hand, "[t]he direct market is improving the liquidity of start-up stock for locked-in investors by lowering the[] transaction costs."[100] On the other, these markets can expose non-accredited investors to risks and uncertainties due to current contractual arrangements, and securities and tax laws.[101]

Both the sellers of the shares and the unicorn firm are subject to the risk of lawsuits by buyers due to omissions and misstatements under the securities law.[102] The trading can also trigger public registration under Section 12(g), which would force the unicorn into an IPO due to an increase in the number of shareholders.[103] Unicorns are private and according to a new study by Professors Gornall and Strabulaev, their valuations are uncertain.[104] These developments have

a-close/ [https://perma.cc/7LZ8-AFE5] ("Shareholders including employees and early investors like Benchmark Capital and Menlo Ventures are expected to sell shares in the deal, turning paper money into cash. Uber has largely restricted the selling of shares until this point."); *see also* Greg Bensinger & Liz Hoffman, *SoftBank Succeeds in Tender Offer for Large Stake in Uber*, WALL ST. J. (Dec. 28, 2017, 8:55 PM), https://www.wsj.com/articles/softbank-succeeds-in-tender-offer-for-large-stake-in-uber-1514483283 [https://perma.cc/4AEY-P2HA].

96. *See* Dawn Belt, *Pre-IPO Liquidity for Late Stage Start-Ups*, LEXISNEXIS: PRAC. ADVISOR 2, 7 (2018), https://www.fenwick.com/FenwickDocuments/Pre-IPO-Liquidity-for-Late-Stage-Start-Up.pdf [https://perma.cc/Q69B-2KLL].

97. *See* Grabar et al., *supra* note 64.

98. Pollman, *supra* note 93, at 203–06.

99. *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 36–39 (2012).

100. *Id.* at 22.

101. *See* Adi Osovsky, *The Curious Case of the Secondary Market with Respect to Investor Protection*, 82 TENN. L. REV. 83, 130 (2014) ("[T]he democratization of Secondary Market transactions exposes non-accredited investors to new risks and uncertainties."); *see also* Pollman, *supra* note 93, at 207–11 (identifying and analyzing the information issues in the new online secondary markets).

102. Alon-Beck, *supra* note 83, at 173.

103. *Id.* at 173–74.

104. *See* William Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, J. FIN. ECON. 120, 121 (2019). The other restriction concerns companies that use a method of buybacks. *See* Richard Lieberman, *2017 Tax Act Impact on Employee Benefits and Executive Compensation*, LEXISNEXIS: PRAC. ADVISOR (Apr. 18, 2018), https://www.lexisnexis.com/lexis-practice-advisor/the-journal/b/lpa/archive/2018/04/18/2017-tax-act-impact-on-employee-benefits-and-executivecompensation.aspx ("The deferral election is also not available if the issuing corporation bought back any outstanding stock in the preceding calendar year."); *New Tax Act Provides Tax Deferral Opportunity for Private Company Equity Compensation Awards*, DAVIS POLK & WARDWELL LLP 4 (Jan. 8, 2018), https://www.davispolk.com/files/2018-01-08_tax_act_provides_deferral_opportunity_private_company_equity_compensation_awards.pdf [https://perma.cc/AQ4P-S25X] ("The legislative history for the TCJA is silent on why Section 83(i) restricts share repurchases; however, a sponsor of the Empowering Employees through Stock Ownership Act, which is very similar to Section 83(i), described employee stock ownership as 'a key tool for startups, allowing cash-poor innovators to recruit top talent.'"); *see also* Sarah Frier & Eric

implications for corporate governance mechanisms.

E. CORPORATE GOVERNANCE IMPLICATIONS

Equity ownership is changing, and the time may be ripe for the development of corporate governance principles for unicorn firms as equity ownership increasingly moves away from retail investors to institutional players. With the unique capital and ownership structures remaining in place following direct listings, whether a board of directors is able to sufficiently monitor and oversee management practices is a practical governance question that must be answered before direct listings can be solidified as a practical alternative to the traditional IPO process. These governance-related implications present risks to existing and potential shareholders in the near-term and in the long-term.

Founders of unicorn firms are often able to control the board of directors with super voting rights or other dual stock arrangements, which enhances their power within the firm.[105] Founders of unicorns that have dual-class share structures might try to push for more influence over their management and firms.[106] Professors Broughman and Fried have further shown that the ex-ante likelihood of founders reacquiring control via IPO is extremely low, especially if the focus is on control that is both strong (founders have enough voting power to ensure they remain in the saddle) and durable (control lasts at least three years).[107]

Regardless of the SEC's intentions in changing the new direct listing rule, the actual effects must be considered within the context of implementation. Even in such a short period of time, these effects may be seen with the recent direct listing of Palantir (NYSE: PLTR), Asana (NYSE: ASAN), and the nature of their capital structures.[108] At the time of its listing, Palantir's three founders retained almost

Newcomer, *The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies*, BLOOMBERG (Mar. 17, 2015, 8:00 AM), https://www.bloomberg.com/news/articles/2015-03-17/the-fuzzy-insane-math-that-s-creating-so-many-billion-dollar-tech-companies [https://perma.cc/8XHN-4D2D] ("For the most mature startups, investors agree to grant higher valuations, which help the companies with recruitment and building credibility."); Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 584–89 (2016); Abraham J.B. Cable, *Fool's Gold? Equity Compensation & the Mature Startup*, 11 VA. L. & BUS. REV. 613, 635 (2017).

105. *See* Alon-Beck, *supra* note 83, at 179.

106. *See* Joann S. Lublin & Spencer E. Ante, *A Fight in Silicon Valley: Founders Push for Control*, WALL ST. J. (July 11, 2012, 11:50 AM), https://www.wsj.com/articles/SB10001424052702303292204577519134168240996 [https://perma.cc/L8MJ-KWCG].

107. Brian Broughman & Jesse M. Fried, *Do Founders Control Start-Up Firms that Go Public?* 2, 22 (Eur. Corp. Governance Inst., Working Paper No. 405, 2018).

108. According to their S-1 Registration Statement, Palantir plans on going public with two classes of stock, with Class A retaining one vote and Class B with ten. Palantir Tech., Inc., Registration Statement (Form S-1/A) (Sept. 21, 2020). The firm intendeds to add a third, Class F with variable votes, to be held by the three co-founders in voting trust:

> Following the authorization and issuance of our Class F common stock, our Founders and their affiliates will hold approximately 49.999999% of the voting power of our outstanding capital stock, our directors and executive officers and their affiliates will hold approximately 50.8% of the voting power of our outstanding capital stock, and holders of our Class A common stock will hold approximately 3.4% of the voting power of our outstanding capital stock (based on shares of Class A common stock outstanding as of June 30, 2020).

complete control of the firm, coming just shy of a majority in voting power despite failing to control a majority of the shares.[109] Immediately preceding its direct-listing, Palantir faced pressure to amend its S-1 and finally, on its final amendment, the firm erased the language on "Stockholder Party Excluded Shares" which allowed the founders to nearly unilaterally adjust their total voting power.[110] Even with the removal of this language, the founders can continue to reduce their current equity holding to a bare minimum and retain this near majority control.[111] This pattern is not unusual in dual-class arrangements,[112] but it is arguably facilitated by going public via a direct listing instead of a traditional IPO.

These newer direct listings could aptly be renamed as "Dual-Class 2.0." With direct listings, there is no capability to force sunset provisions into these structures—a method the CII views as a potential avenue for limiting founder power post-IPO.[113] The CII has long opposed dual-class structures, endorsing the position of "one share, one vote" as one of their core focuses since their founding in the 1980s.[114] At the same time, there is pressure on unicorn companies that are going public via traditional IPOs with dual-class shares to include mandatory sunset provisions in their charters, which can terminate the dual-class structure after seven years.[115] Such mandatory structures, however, have faced criticism.[116] There has been very little correlation between the time period of sunset provisions and any actual value stemming from allowing the founders to maintain such a level of control.[117] As seen with the Viacom and Redstone family litigation, there is clearly some benefit to having these founders eventually lose control.[118] However, after seven and fifteen years respectively, the founders of Facebook and Google still retain control and continue to demonstrate their ability to create value for their shareholders.[119] Mandatory structures also create "problematic incentive structures" for founders, incentivizing them to use their control to

Id.

109. Graham Rapier & Troy Wolverton, *Palantir Just Officially Laid Out Its Plans to Go Public in a Direct Listing*, BUS. INSIDER (Aug. 25, 2020, 4:37 PM), https://www.businessinsider.com/palantir-direct-listing-s-1-prospectus-revealed-ahead-public-trading-2020-8 [https://perma.cc/6PGR-6E8G].

110. Danny Crichton, *Following TechCrunch Reporting, Palantir Rapidly Removes Language Allowing Founders to 'Unilaterally Adjust Their Total Voting Power'*, TECHCRUNCH (Sept. 21, 2020, 3:30 PM), https://techcrunch.com/2020/09/21/palantir-unilateral-voting-power/?guccounter=1 [https://perma.cc/TVG7-5DE7].

111. *See id.*; Danny Crichton, *In Its 5th Filing with the SEC, Palantir Finally Admits It Is Not a Democracy*, TECHCRUNCH (Sept. 21, 2020, 9:56 AM), https://techcrunch.com/2020/09/21/palantir-is-not-a-democracy/ [https://perma.cc/F8JZ-FT5D].

112. *See* Bebchuk & Kastiel, *supra* note 85, at 592.

113. *See* Council Press Release, *supra* note 85.

114. *Dual-Class Stock*, COUNCIL OF INSTITUTIONAL INVS., https://www.cii.org/dualclass_stock [https://perma.cc/G8WQ-UNWA].

115. *See* Annie Gaus, *Tech IPOs with Dual-Class Shares Start to Face Meaningful Pushback*, STREET (Apr. 8, 2019, 1:58 PM), https://www.thestreet.com/investing/silicon-valley-ipos-unicorns-dual-class-governance-14918723 [https://perma.cc/68BQ-TJYZ]; Jill Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, 99 B.U. L. REV. 1057, 1080 (2019).

116. *See* Bebchuk & Kastiel, *supra* note 85, at 590.

117. Fisch & Solomon, *supra* note 115, at 1081.

118. Bebchuk & Kastiel, *supra* note 85, at 588.

119. Fisch & Solomon, *supra* note 115, at 1081.

engage in short-term excessive risk taking to maximize personal economic gain as they approach the date of their loss of control.[120] Boards of directors would be powerless to stop founders from simply draining the coffers and running.

While there remains disagreement regarding how best to eliminate dual-class equity structures, institutional investors, academics, and others have long agreed that they need to be addressed and their continued allowance remains a controversial subject.[121] Even key policy makers within the SEC have expressed opposition to such structures, including former Commissioner Robert J. Jackson, Jr.[122] and Investor Advocate Rick Fleming.[123] Commissioner Jackson noted that while the vast majority of companies going public fail to include dual-class structures, of those that do, "nearly half . . . gave corporate insiders outsized voting rights in perpetuity," requiring investors to not just trust visionary founders, but their descendants as well.[124] Controllers face few negative risks for their actions and remain well-insulated from the "disciplinary force of the market" they would face if they lacked voting control.[125] There is even evidence to suggest that dynastic ownership of firms leads to underperformance relative to other firms.[126] A later empirical study of dual-class companies published after Commissioner Jackson's remarks found that in over 80% of firms with such a structure, controllers needed less than a 10% equity stake to maintain their control over these firms, with many requiring less than 5%.[127] Fleming argued that dual-class structures may result in a "wave of companies with weak corporate governance" and force investors into the same game as "late-stage venture capitalists . . . willing to pay astronomical sums while ceding astonishing amounts of control to founders."[128]

The ability of firms to direct list with little to no pressure will do nothing to address these concerns while allowing for potentially significant damage to public marketplaces, the effects of which cannot be accurately predicted. During a traditional IPO, such structures would likely draw criticism from potential investors and questions from underwriting investment banks. However, with direct listings, there is little need for compromise. There remains little need to

120. *Id.* at 1083.

121. *See generally id.*; Bebchuk & Kastiel, *supra* note 85; Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class, and the Limits of Judicial Review*, 120 COLUM. L. REV. 941 (2020).

122. Robert J. Jackson Jr., Comm'r, Sec. & Exch. Comm'n, Perpetual Dual-Class Stock: The Case Against Corporate Royalty, Remarks at University of California, Berkley (Feb. 15, 2018) (transcript available at https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty [https://perma.cc/YX69-SZ34]) [hereinafter Jackson Remarks].

123. Rick Fleming, Inv. Advoc., SEC, Dual-Class Shares: A Recipe for Disaster, Remarks at ICGN Miami Conference, Miami, Florida (Oct. 15, 2019) (transcript available at https://www.sec.gov/news/speech/fleming-dual-class-shares-recipe-disaster [https://perma.cc/E24K-BHMK]) [hereinafter Fleming Remarks].

124. Jackson Remarks, *supra* note 122. "Furthermore, dual-stock structures may enable the transfer of a lock on control to an heir of the founder, who might not be as able, talented, skilled, or driven as her predecessor. This problem is known in the economic literature as the problem of the 'idiot heir.'" Bebchuk & Kastiel, *supra* note 85, at 605.

125. Bebchuk & Kastiel, *supra* note 85, at 602.

126. *Id.* at 605.

127. Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 GEO. L.J. 1453, 1457 (2019).

128. Fleming Remarks, *supra* note 123.

generate interest in new shares, allowing companies like Palantir to show "anything is possible in corporate governance with a direct listing."[129]

This new practice might become a liability for unicorn firms because it alters the traditional corporate governance arrangements and monitoring practices of management and founders. Therefore, corporate law must evolve and take these new developments into account when deciding on how to interpret the board of directors' fiduciary duty in cases involving unicorn firms. Courts, including Delaware's, need to take into account that there are new shareholder groups with divergent interests and new, complex governance matters and contractual arrangements, regardless of whether they will eventually expire or continue into perpetuity.

In addition to the considerations resulting from dual or multiclass structures, we can already see that the intended liquidity effects of the direct listing's supposed greater efficiency can be artificially constrained. While the three notable examples of direct listings, Spotify, Slack, and most recently Asana, did not include lock-up periods for existing shareholders, Palantir has already designated a significant lock-up period lasting until shortly after their December quarterly earnings report, and restricting these sales to a limited, unspecified portion of their holdings.[130] Some have taken this as an attempt to avoid rapid departures of investors given the firm's apparent inability to find a path towards profitability.[131] Since their direct listings on September 30, 2020, both Asana and Palantir saw their shares trade above reference prices.[132] However, they have continued to trend downwards in the recent days of trading.[133] While it is too early to tell the long-term implications of these early trading results, it is nonetheless a stark reminder that these companies and their shareholders lack a safety net without the stabilization mechanisms associated with a traditional IPO. The initial unknowns surrounding firms which have conducted direct listings highlight the need to shed light on unicorn firm operations or enforce strong corporate

129. Steven Davidoff Solomon, *Deal Professor: How Palantir Got Away with It*, N.Y. TIMES (Oct. 1, 2020), https://www.nytimes.com/2020/10/01/business/dealbook/palantir-direct-listing.html [https://perma.cc/8TC9-8EN4].

130. Anita Balakrishnan & Ari Levy, *Most of Spotify's Investors Can Cash Out at Any Time*, CNBC (Feb. 28, 2018, 4:44 PM), https://www.cnbc.com/2018/02/28/spotify-ipo-has-limited-lock-up-period.html [https://perma.cc/NV7C-DV87]; Ellen Huet, *Slack CEO Says No Lockup, No Cash Drew Company to Direct Listing*, BNN BLOOMBERG (June 20, 2019), https://www.bnnbloomberg.ca/slack-ceo-says-no-lockup-no-cash-drew-company-to-direct-listing-1.1276149 [https://perma.cc/Y9MU-75YD]; Eric J. Savitz, *Asana Ends First Day at Session High After Pricing at $27 in Direct Listing*, BARRON'S (Sept. 30, 2020, 3:38 PM), https://www.barrons.com/articles/asana-reference-price-set-at-21-ahead-of-direct-listing-on-wednesday-51601415269 [https://perma.cc/K642-8C7W]; Rapier & Wolverton, *supra* note 109.

131. *See* Rapier & Wolverton, supra note 109.

132. Savitz, *supra* note 130; Eric J. Savitz, *Palantir Ended Its First Day with a $21 Billion Market Value. What Its COO Says.*, BARRON'S (Oct. 1, 2020), https://www.barrons.com/articles/palantir-sets-7-25-reference-price-ahead-of-nyse-direct-listing-51601413783 [https://perma.cc/SRZ7-DAUP].

133. *See* Eric J. Savitz, *Asana Stock Is Overvalued, Bernstein Analyst Says. Its Software 'Does Not Stand Out.'*, BARRON'S (Oct. 9, 2020, 1:06 PM), https://www.barrons.com/articles/asana-stock-is-overvalued-bernstein-analyst-says-51602263205k [https://perma.cc/HM4V-XRTD]; Chris Tyler, *Put a Cool-Sounding Palantir Stock on Ice for Now*, INVESTORPLACE (Oct. 21, 2020, 12:04 PM), https://investorplace.com/2020/10/put-a-cool-sounding-palantir-stock-on-ice-for-now/ [https://perma.cc/96U6-LFN9].

governance mechanisms.[134] Unicorns should develop new corporate governance guidelines, compliance policies, and procedures. However, if the four examples of major unicorn direct listings continue to succeed in driving investor demand and in future attempts to raise capital, there may be little incentive for other unicorns looking to go public to ever develop these policies and procedures.

III. CLOSING THOUGHTS

The market for direct listings will undoubtedly continue to fluctuate in the coming years as companies and exchanges continue to search for viable alternatives to the traditional IPO process. While the SEC believes the recent changes to the NYSE rules sufficiently protect investors from the risks associated with direct listings,[135] Professor Horton raises valid concerns over the lack of an equivalent to the gatekeeper underwriters associated with a traditional IPO.[136] Even if the risks stemming from the lack of such a gatekeeper were addressed in provisions beyond the typical securities law sections, there is still some evidence that the process may result in significant risk to investors in a broader range of areas.

Until we see further use of the direct listing process, there will be an unknown aspect as to whether these financial advisers have transitioned from gatekeepers to "barbarians at the gate." While this may be representative of an increase in risk to the investors in the public markets, we believe that direct listings present a viable alternative to the traditional IPO process and will provide an important alternative method of capital fundraising and liquidity for companies seeking to gain access to the public capital markets. We merely believe that regulators should address the concerns raised by Professor Horton and ourselves in this piece to ensure that the investor risks we brought attention to can be mitigated to the best of their ability.

Should courts, or even the SEC itself, find that underwriter liability can apply to the financial advisers used in direct listings, there are still serious practical concerns in the ability to seek remedies from the actually culpable actors and calculate damages. Furthermore, the concerns associated with unicorns staying private longer and failing to provide their investors with liquidity may be able to be addressed more safely via the development of secondary markets. While these markets carry with them their own independent set of risks, particularly related to disclosure pre-liquidity event, this may serve as a better method to address these investor concerns without jeopardizing the broader public markets. Finally, the

134. *See* Mary Jo White, Chair, Sec. & Exch. Comm'n, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016) (transcript available at https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html [https://perma.cc/JML6-SJAJ]) ("The IPO process is not just about raising capital. . . . The securities laws and relevant listing standards, for example, require a company to form an audit committee; it must establish disclosure controls and procedures and create internal controls over financial reporting; the CEO and CFO must certify to the adequacy of those controls; and the company must be audited by a PCAOB registered firm.").

135. *See* Order Approving NYSE Proposed Rule Change to Modify Provisions Relating to Direct Listings, Exchange Act Release No. 34-89684, 85 Fed. Reg. 54,454, 54,460–61 (Aug. 26, 2020).

136. *See* Horton, *supra* note 1, at 203.

lack of an underwriter in the initial process may imply significant risks beyond the initial liquidity and capital raising event.

The larger governance concerns which have longer lasting implications for the overall structure of a company have already begun to manifest in recent direct listings. Particularly concerning is an inability to address complex dual-class equity structures which allow founders to continue to retain control nearly indefinitely. Investors run into both short and long-term risks if the rules around direct listings are left as they currently stand: largely undefined and filled with unknowns. Without regulatory action, companies will continue to push the boundaries of what is possible with such filings, with investors along for the ride, for better or for worse.