Direct Listing or IPO? The Anatomy of the Going-Public Market

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U.S. Direct Listing Innovation

Two important features of the direct listing market

1. Decouple capital-raising from going public: firms can choose to only list existing shares without raising capital.
2. Disintermediation: firms bypass the underwriting process; investment banks only act as financial advisors.

The distinctions between direct listing and IPO markets provide an anatomy of the going-public market

	Market Functions for Firms	The Role of Investment Banks
Initial Public Offering (IPO)	Capital raising + going public	Underwriter + distributor + financial advisor
Direct Listing with Raising capital (DLR)	Capital raising + going public	Financial advisor
Direct Listing without raising capital (DL)	Going public	Financial advisor

Note on the U.S. direct listing market evolution

- Direct listing 1.0: the Securities and Exchange Commission (SEC) approved direct listing on February 2, 2018, where direct listing firms can only list existing shares without the ability to raise capital. It is also called "Selling Shareholder Direct Floor Listing."
- Direct listing 2.0: SEC approved "Primary Direct Floor Listing" on December 22, 2020, which would allow direct listing firms to raise capital.
- In this paper, "DL" generally refers to the Direct Listing market without raising capital. I refer to the Direct Listing market with Raising capital as the "DLR" market.

Research Questions

What underlying economic factors drive DL innovation, does it solve any market inefficiencies, and does it create new ones?

How does it affect firms' going-public decisions, and what are the welfare consequences?

How do policy interventions affect market outcomes?

Theory

A theoretical framework of DL in an environment with adverse selection.

New features

- Firm heterogeneity on "quality" and "optimal firm size"
- Investment bank provides certification and advisory services
- Unbundled roles of capital-raising and going public

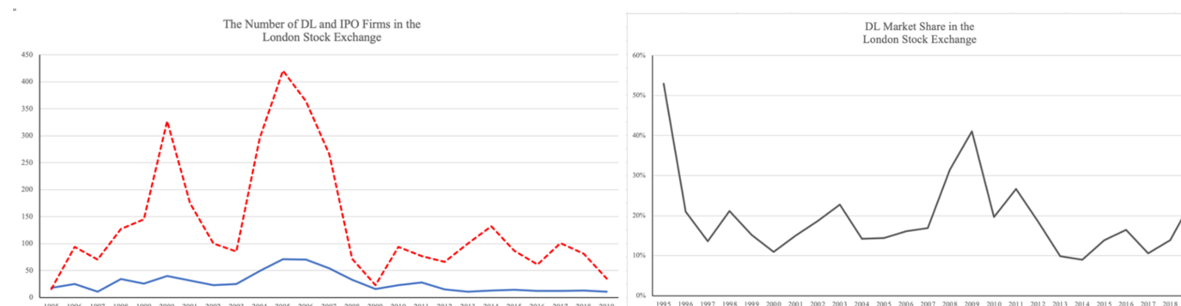
Main results

- *Market-segmentation:* DL and IPO markets cater to different types of firms. DL market attracts late-stage firms, while the IPO market attracts growth firms.
- *Regulation-relevance:* DL market is more vulnerable to breakdown. Imposing certification intermediaries is essential in maintaining a well-functioning DL market, which leads to more firm entry into the public market and improved social welfare.
- *Participant-welfare:* DL firms enjoy welfare gains by going public. Intermediaries enjoy welfare gains by attracting new clientele and earning more fees. Public investors face higher investment risks under loose regulations.

Evidence from U.S. and U.K. Markets

Data sample

- U.S. New York Stock Exchange (NYSE): 2018-
  - Spotify, Slack, Asana, and Palantir went public through DL; no firm has gone public through DLR yet
- U.K. London Stock Exchange (LSE): 1995-
  - Previously called "Introduction" market, changed name to direct listing in 2020
  - DL firms are only allowed to list existing shares
  - An average of ~137 (27) firms go public through IPO (DL) per year. The average DL market share is 17%.



Panel A: The number of DL and IPO firms in the LSE

Panel B: DL market share in the LSE

Methodology and Evidence

- *Market-segmentation:* comparing the characteristics of DL and IPO firms in LSE.
  - Although most firms go public through IPO, DL is a non-negligible part of the going-public market.
  - Cross-sectional tests show that DL firms are much larger, older, have more employees, pay more dividends, and invest less compared to IPO firms.

Heterogeneity of DL and IPO Firms in the London Stock Exchange

	Mean (IPO)	Diff (DL vs. IPO)	Diff/Mean (IPO)	*p*-value
	(1)	(2)	(3)	(4)
Market Cap	109.72	266.27	243%	<0.01
Age	6.18	5.83	94%	<0.01
Employee	14.26	21.74	152%	<0.01
Dividend Payout	23.86%	24.90%	104%	<0.01
Investment Rate	21.27%	-11.12%	-52%	<0.01

- *Regulation-relevance:* comparing the DL markets' regulatory and participation differences between LSE and NYSE.
  - LSE requires financial advisors (also called "sponsors") to assess firms' suitability and carry out due diligence. Advisors still play significant certification roles in the DL process.
  - Financial advisors in the NYSE DL market do not carry out due diligence obligations and are not liable for investor lawsuits. Their main role is advisory rather than certification.
  - The model predicts that the LSE (NYSE) DL market is more likely to be in the separating (breakdown) equilibrium.
  - ~27 (1) firms went public through the LSE (NYSE) DL market per year.
- *Participant-welfare:* analyzing the public debates around the DL markets and the comment letters on the NYSE proposal for establishing a DLR market.
  - Startups, venture capitalists, investment banks (e.g., Goldman Sachs, Citigroup), and stock exchanges all support DL markets.
  - Public investors, their associations (e.g., Council of Institutional Investors, American Securities Association), and even SEC Commissioners as regulators express strong concern about weak investor-protection for the DL market. (See references)

Policy Implications

Underlying economic factors that drive DL innovation

- Better-developed private capital market: the increased supply of corporate venture capital, mutual fund venture capital, private equity, and angel investments over recent decades.
- Better-developed stock trading market: stock liquidity has improved, and price discovery has become more efficient over recent decades.

DL market regulation

- Informational frictions in the going-public market is severe, extreme disintermediation could cause market failure.
- U.S. regulators may consider imposing quality assessment requirements and legal liabilities on financial advisors to ensure certifications in the DL market.
- DLR market may not work for the majority of firms because of its similar market functions as the IPO market but weaker certifications.

Conclusion

In a time of rampant disintermediation, it is also crucial to preserve the certification role of intermediaries in maintaining a well-functioning going-public market and protecting public investors.

DL market caters to late-stage firms by decoupling capital-raising from the going-public process. With better-developed private capital and stock trading markets, a well-functioning DL market provides firms more options to go public and helps narrow the "U.S. listing gap."

References: Public Debates around DL

Supports from startups, venture capitalists, investment banks, and stock exchanges on the DL market:

- 2019 San Francisco direct listing meeting backed by startups and venture capitalists: https://de.reuters.com/article/us-tech-venturecapital-ipo-idUSKBN1WG3JO.
- The comment letters from Goldman Sachs, Citigroup, and NYSE to support DL market: https://www.sec.gov/comments/sr-nyse-2019-67/srnyse201967-6788706-208240.pdf; https://www.sec.gov/comments/sr-nyse-2019-67/srnyse201967-6873859-210634.pdf; https://www.sec.gov/comments/sr-nyse-2019-67/srnyse201967-6960395-212779.pdf.
- Bloomberg, 2019, *Morgan Stanley, Goldman Make Their Own Direct-Listing Pitches*, available at https://www.bloomberg.com/news/articles/2019-10-04/morgan-stanley-to-woo-startups-at-its-own-direct-listing-event.

Concerns about investor-protection in the DL market from public investors' associations and regulators:

- Comment letters from the Council of Institutional Investors and the American Securities Association express concerns on fewer investor-protection policies in the DL market: https://www.sec.gov/comments/sr-nyse-2019-67/srnyse201967-7435112-220582.pdf and https://www.sec.gov/comments/sr-nyse-2019-67/srnyse201967-6911312-211231.pdf.
- In a statement, SEC Commissioners Allison Herren Lee and Caroline A. Crenshaw oppose the DLR market and express concerns on weak investor protections in the direct listing market: "*Unfortunately, the rule fails to address very real concerns regarding protections for investors. As a result, we are unable to support this specific approach…Unfortunately, investors in primary direct listings under NYSE's approach will face at least two significant and interrelated problems: Loss of an Underwriter and Corresponding Due Diligence; Diminished Ability for Shareholders to Recover Damages… The Commission did in fact receive public comment asking that we clarify that financial advisors and others involved in a direct listing do incur statutory liability as underwriters, but the Commission has failed to address those concerns and provide clarity on this critical issue.*" See https://www.sec.gov/news/public-statement/lee-crenshaw-listings-2020-12-23.

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