

# The Underlying Underwriter: An Analysis of the Spotify Direct Listing

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*In April 2018, music streaming giant Spotify disrupted the traditional initial public offering model and became a publicly traded company through a novel process known as a direct listing. Eschewing standard Wall Street practice, Spotify did not raise new money through the offering and instead simply made its existing shares available for purchase by the public. Spotify worked throughout 2017 and 2018 alongside legal counsel and investment banks and in communication with the Securities and Exchange Commission to facilitate the unorthodox approach. Major technology companies are now adopting a similar approach.*

*In recognition of these developments, this Comment has two aims: to shed light on the statutory contours of a direct listing and to contribute to the legal understanding of underwriter liability. As this financial innovation unfolds, an important question remains: Who is liable as an “underwriter” in a direct listing for purposes of liability under Section 11 of the Securities Act? This Comment argues that the investment banks Spotify retained as financial advisors qualify as statutory underwriters notwithstanding language in the registration statement to the contrary. By walking through the precise statutory elements of a direct listing and by calling attention to latent liabilities in the process, this Comment seeks to set forth a path for future technology unicorns to follow the Spotify playlist.*

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## INTRODUCTION

On April 3, 2018, global music streaming company Spotify Technology S.A. (Spotify) went public through a direct listing of its ordinary shares on the New York Stock Exchange (NYSE). Rather than raise money by issuing *new* shares to the public through a traditional initial public offering (IPO), Spotify made its *existing* shares available for purchase on the public exchange through the seldom-utilized direct listing process. Spotify worked closely alongside legal counsel and investment banks and in communication with the Securities and Exchange Commission (SEC) throughout 2017 and early 2018 to facilitate the unorthodox listing. This Comment examines the statutory contours of the process and asks whether the investment banks that Spotify retained as “financial advisors” qualify as statutory underwriters notwithstanding Spotify’s claim to the contrary.

Direct listings have the chance to become a new tool in the equity capital markets toolkit. In a direct listing, a company makes its shares available for purchase on a national exchange. The company does not raise new money through the offering as it would in a traditional IPO. Rather, existing shareholders, such as employees and early-stage investors, can simply sell their shares to the general public upon listing. Direct listings allow a company to achieve many of the benefits of being public without incurring the costs associated with a traditional IPO. Shareholders can take advantage of the liquidity that a national exchange provides without first being subject to a lengthy lockup period. The company,

meanwhile, can realize the financial flexibility that public companies typically enjoy without facing the steep fees common to the standard IPO process.

Many legal scholars and financial commentators have remarked on the novelty of the approach, the pecuniary and strategic benefits of the process, and the potential for other “unicorns” to follow Spotify’s lead.<sup>1</sup> Indeed, workplace messaging company Slack has filed confidential materials with the SEC to conduct a direct listing in 2019, making it the first to adopt the model that Spotify pioneered.<sup>2</sup> The NYSE amended its rules to provide a path for direct listings, and the Nasdaq has recently filed a proposal to clarify its direct listing procedures.<sup>3</sup> Now, direct listings are not intended for all companies. The ideal candidate is a company without an immediate need for cash with a strong brand and an easy to understand business model. As more money flows into private markets, direct listings could become a viable path to liquidity for many unicorns.<sup>4</sup> Indeed, major companies have taken the lead. Spotify went public at a valuation exceeding \$26 billion; Slack was recently valued at \$7 billion.<sup>5</sup> As other major technology companies follow the Spotify playlist, it will be essential to understand the precise statutory contours of a direct listing and the latent liabilities that exist in the process.

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<sup>1</sup> A “unicorn” is a company with greater than a \$1 billion valuation based on a recent round of financing. For legal commentary on the Spotify direct listing, see generally, for example, John C. Coffee Jr, *The Spotify Listing: Can an “Underwriter-less” IPO Attract Other Unicorns?* (CLS Blue Sky Blog, Jan 16, 2018), archived at <http://perma.cc/XV4K-ZV2P>. See also generally, for example, Matt Levine, *Spotify’s Non-IPO Really Is Novel* (Bloomberg, Jan 4, 2018), archived at <http://perma.cc/DF7Y-AUXV>.

<sup>2</sup> As of publication, Slack has not yet completed its direct listing. However, the company has filed a registration statement with the SEC. Slack Technologies, Inc., *Form S-1 Registration Statement* (Apr 26, 2019), archived at <http://perma.cc/MV78-MZWY>. See also Maureen Farrell, *Slack Files to Go Public with Direct Listing* (Wall St J, Feb 4, 2019), online at <http://www.wsj.com/articles/slack-files-confidentially-to-go-public-with-direct-listing-11549301336> (visited Apr 29, 2019) (Perma archive unavailable).

<sup>3</sup> For more on the NYSE rule change, see Part II.B.3. In February 2019, Nasdaq proposed changes to the SEC to clarify its direct listing process, presumably in an effort to stay competitive with the NYSE in the listing sphere. See Securities and Exchange Commission Release No 34-85156, 84 Fed Reg 5787 (Feb 22, 2019).

<sup>4</sup> See Jean Eaglesham and Coulter Jones, *The Fuel Powering Corporate America: \$2.4 Trillion in Private Fundraising* (Wall St J, Apr 3, 2018), online at <http://www.wsj.com/articles/stock-and-bond-markets-dethroned-private-fundraising-is-now-dominant-1522683249> (visited Mar 9, 2019) (Perma archive unavailable).

<sup>5</sup> Farrell, *Slack Files to Go Public with Direct Listing* (cited in note 2); Maureen Farrell, Alexander Osipovich, and Anne Steele, *Spotify’s Splashy Debut Pressures Banks* (Wall St J, Apr 3, 2018), online at <http://www.wsj.com/articles/spotify-shares-jump-in-market-debut-1522773951> (visited Jan 19, 2019) (Perma archive unavailable).

As this Comment explains, “going public” and “direct listing” are specific terms that carry certain legal ramifications for the parties involved. A theme that runs throughout the Comment—indeed, one that runs throughout much of securities regulation doctrine—is whether substance prevails over form.<sup>6</sup> Are direct listings functionally equivalent to IPOs, and, therefore, do the same liability rules for material misstatements or omissions in offering materials apply? Or is there a key distinction between the two methods for going public that changes, or should change, where such liability falls?

In the wake of the stock market crash of 1929, the legal regime governing financial securities in the United States shifted from caveat emptor to caveat vendor.<sup>7</sup> With the goal of protecting investors through mandatory disclosure, Congress passed two foundational statutes: the Securities Act of 1933<sup>8</sup> (the Securities Act) and the Exchange Act of 1934<sup>9</sup> (the Exchange Act). The Securities Act governs the initial distribution of securities, while the Exchange Act governs their subsequent trading.<sup>10</sup> Section 11 of the Securities Act<sup>11</sup> imposes strict liability on multiple parties for material misstatements or omissions in offering documents. An underwriter, or “any person who . . . participates” in a distribution of securities, is an enumerated defendant under the statute.<sup>12</sup> The securities regime imposes liability on underwriters in public securities offerings to ensure complete and accurate disclosure of information about the issuer to the public.<sup>13</sup> This Comment

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<sup>6</sup> See, for example, *Securities and Exchange Commission v M & A West, Inc.*, 538 F3d 1043, 1053 (9th Cir 2008) (“The Supreme Court has long instructed that securities law places emphasis on economic reality and disregards form for substance.”); *Tcherepnin v Knight*, 389 US 332, 336 (1967); *Securities and Exchange Commission v W.J. Howey Co.*, 328 US 293, 298–300 (1946).

<sup>7</sup> See Thomas L. Hazen, *Federal Securities Law* 1 (Federal Judicial Center 3d ed 2011). See also *Securities and Exchange Commission v Capital Gains Research Bureau, Inc.*, 375 US 180, 186 (1963) (observing that the securities regulation reforms “substitute[d] a philosophy of full disclosure for the philosophy of *caveat emptor*”).

<sup>8</sup> 48 Stat 74, codified as amended at 15 USC § 77a et seq.

<sup>9</sup> 48 Stat 881, codified as amended at 15 USC § 78a et seq.

<sup>10</sup> See Elisabeth Keller and Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 Ohio St L J 329, 330 (1988).

<sup>11</sup> 15 USC § 77k. For a thorough discussion of § 11 liability, see Part III.A.

<sup>12</sup> 15 USC §§ 77b(a)(11), 77k(a). For a thorough discussion of underwriters generally, see Part III.B.

<sup>13</sup> Investment banks play an important role in promoting the securities to the public and are often referred to as “gatekeepers” or “reputational intermediaries.” For further discussion of this theory and its connection to direct listings, see Part IV.B.

asks whether the investment banks that Spotify retained as financial advisors qualify as statutory underwriters and are therefore subject to liability under § 11 of the Securities Act.

The question requires close attention given the prominent role that investment banks play in both traditional IPOs and direct listings. Imposing underwriter liability on investment banks in a direct listing will likely have the effect of increasing the cost of the process. However, direct listings will still be less expensive than the traditional IPO. This is because there is no underpricing or firm-commitment spread fee in a direct listing.<sup>14</sup> While one of the supposed benefits of a direct listing is its lower cost, imposing underwriter liability on the financial advisors will not erase all of the efficiency gains that direct listings create and will likely have a positive effect on investor protection.

The question is also not entirely foreclosed. Rather, it is quite open to debate. In SEC filings, Spotify asserted that its direct listing did not involve any underwriters.<sup>15</sup> However, as this Comment explains, the statutory definition of underwriter is broad, and courts interpret the term accordingly. Based on the plain text of the underwriter statute, legal precedent evaluating the underwriter status of third-party advisors, and the legislative history of the Securities Act, there is a strong argument that the investment banks that Spotify retained as financial advisors for its direct listing qualify as statutory underwriters. Academic scholarship exploring the breadth of the underwriter definition and the policy rationales for imposing liability on “gatekeepers” of information in a securities offering further support this claim. Moreover, direct listings have yet to be challenged in court.

This Comment proceeds in four parts. Part I describes the structure and characteristics of traditional IPOs to establish the baseline from which the Spotify direct listing departs. Part II discusses the history of direct listings and describes the steps Spotify took to accomplish its direct listing. Part III covers the statutory framework and relevant background law that governs the issuance of securities to the public, including the definition of “underwriter.” Part IV then examines whether the investment banks Spotify retained as financial advisors qualify as statutory underwriters by applying the relevant statutes and case law. This Comment argues that because the financial advisors participated

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<sup>14</sup> For more discussion on the lack of underpricing in a direct listing, see Part II.A.

<sup>15</sup> *Spotify Technology S.A.*, 2018 WL 1531993, \*6 n 1 (“[T]he Financial Advisors are not acting as underwriters in connection with the Registration and Listing.”).

in a distribution of securities, they qualify as statutory underwriters and are therefore subject to § 11 liability. This Comment aims to clarify uncertainties surrounding the direct listing innovation and to propose a path forward for future listings with an eye toward practitioners, regulators, and courts alike.

### I. HOW INITIAL PUBLIC OFFERINGS WORK

In a traditional IPO, a company raises money by selling new securities to the public through a national exchange.<sup>16</sup> To understand why a company would seek an IPO, consider the following example. Company A is looking to raise \$100 million. The company has completed several rounds of financing from venture capital firms through private markets and is ready to access a larger pool of public capital. Early investors are eager to realize a return on their investment, and employees are keen to diversify their holdings. To raise the money in the context of a public offering, the company can issue either or both of two types of securities: debt, typically in the form of bonds, or equity, typically in the form of common stock. Because of the nature of the business, a desire to establish a public market for its existing shareholders, or the need to de-lever its balance sheet,<sup>17</sup> Company A decides to issue new common stock. The new shares will dilute the positions of the existing shareholders, but the increase in liquidity through the newly created public market is a worthwhile tradeoff. The company then works closely with lawyers, accountants, and investment banks over several months to register the securities with the SEC, market the securities through a “road show,” “build a book” of interested investors, and ultimately sell the securities to the public. When done for the first time, this process is called an IPO. Importantly, the investment banks involved in an IPO are liable as underwriters for purposes of § 11 of the Securities Act.<sup>18</sup> This Comment argues that the similarity in roles for investment banks in an IPO and a direct listing supports a finding of underwriter status in the latter context.

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<sup>16</sup> For a detailed guide on the IPO process, see generally Carl W. Schneider, Joseph M. Manko, and Robert S. Kant, *Going Public: Practice, Procedure, and Consequences*, 27 *Vill L Rev* 1 (1981).

<sup>17</sup> To de-lever is to pay down debt.

<sup>18</sup> 15 USC § 77k(a)(5).

### A. The IPO Process

The registration, marketing, and sale procedure consists of three stages: the prefiling period, the waiting period, and the post-effective period.<sup>19</sup> The prefiling period begins when an issuer, like Company A, engages in preliminary discussions with an investment bank about a potential offering. The conversations generally cover the strengths and weaknesses of the company, the desired size of the offering, and the type of security to be issued.

The key law governing the prefiling period is § 5 of the Securities Act.<sup>20</sup> Section 5(c) prohibits any offer to buy or sell a security without a registration statement.<sup>21</sup> The prohibition's underlying purpose is to prevent parties from "conditioning the market," or "jumping the gun," without first providing full disclosure of information about the company and offering.<sup>22</sup> Registration statements are long, detailed documents accompanied by a prospectus, and they must conform with SEC regulations.<sup>23</sup> Notable sections include information about the offering, a description of the company, a listing of critical risk factors, and audited financial statements.

The waiting period begins once the issuer files the registration statement with the SEC and ends when the registration statement becomes effective. While SEC staff review the registration statement, the issuer works with investment banks over several months to conduct what is known as a "road show."<sup>24</sup> Road shows are the primary way an issuer generates interest in its offering. Often a company seeking to undergo an IPO has not made details about its business strategy, growth prospects, and financial metrics available to institutional investors, such as large pension funds, mutual funds, or hedge funds. During the road show, the company and its investment bank advisors travel across the country to promote the offering and "build a book" of interested

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<sup>19</sup> For a comprehensive account of the regulatory regime, see Louis Loss, Joel Seligman, and Troy Paredes, 1 *Fundamentals of Securities Regulation* 126–221 (Wolters Kluwer 6th ed 2011).

<sup>20</sup> 15 USC § 77e.

<sup>21</sup> 15 USC § 77e(c).

<sup>22</sup> See generally Securities and Exchange Commission Release No 33-5180, 36 Fed Reg 16506 (Aug 21, 1971).

<sup>23</sup> See 17 CFR §§ 210, 229.

<sup>24</sup> 17 CFR § 230.433(h)(4) (defining a road show as "a presentation regarding an offering by one or more members of the issuer's management").

investors.<sup>25</sup> In the context of a direct listing, road shows are not necessary because there is no bookbuilding process; the purpose of the direct listing is to sell the securities directly to the public. Nonetheless, Spotify conducted what it labeled an “Investor Day” to inform the public about the offering.<sup>26</sup> The Investor Day is relevant to the underwriter analysis because it qualified as a statutory road show for purposes of 17 CFR § 433 and is discussed further in Part IV.<sup>27</sup>

## B. Traditional Underwriting

By the conclusion of the road show, the investment banks have built a book of interested investors who intend to purchase the securities in the offering.<sup>28</sup> There are then two primary ways in which the sale to these investors occurs: a “firm commitment” underwriting or a “best efforts” underwriting.<sup>29</sup>

In a firm commitment underwriting, the offering unfolds in two steps. First, the underwriter purchases the securities from the issuer at a discounted, fixed price. The underwriter then resells the securities to the interested buyers at a public offering price that the underwriter sets. In this scenario, the underwriter assumes the risk of setting the right public offering price. To account for this risk, the underwriter receives compensation in the form of a spread—the difference between the price the underwriter paid for the securities and the public offering price. The spread is often between 7 and 10 percent.<sup>30</sup>

Best efforts underwritings are simpler but less common because of the uncertainty involved in the pricing. In a best efforts

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<sup>25</sup> See Securities and Exchange Commission Release No 33-8565, 70 Fed Reg 19672, 19674–75 (Apr 13, 2005) (“Bookbuilding refers to the process by which underwriters gather and assess potential investor demand for an offering of securities and seek information important to their determination as to the size and pricing of an issue.”). See also J. Robert Brown Jr. and Allison H. Lee, *The Regulation of Corporate Disclosure* § 4.03[D][3] (Aspen 4th ed 2019) (describing the role of road shows and bookbuilding in public offerings).

<sup>26</sup> *Investor Day—March 2018* (Spotify), online at <http://investors.spotify.com/events/investor-day-march-2018> (visited Mar 7, 2019) (Perma archive unavailable).

<sup>27</sup> See note 170 and accompanying text.

<sup>28</sup> These investors are typically institutional investors, including large pension funds, mutual funds, or hedge funds.

<sup>29</sup> The third way is the seldom-used “standby” underwriting. See Loss, Seligman, and Paredes, 1 *Securities Regulation* at 97–126 (cited in note 19). See also Arnold S. Jacobs, 5 *Disclosure and Remedies under the Securities Laws* § 3:9 (Thomson Reuters 2018) (describing types of underwriting arrangements).

<sup>30</sup> Loss, Seligman, and Paredes, 1 *Securities Regulation* at 108 (cited in note 19).

underwriting, the traditional underwriter does not purchase any securities from the issuer at a fixed price. Rather, the underwriter contractually agrees to use its best efforts to sell as many securities as possible at the market price. The underwriter then receives a flat commission as compensation instead of a spread.<sup>31</sup> For purposes of underwriter liability pursuant to § 11, the type of underwriting has little impact.<sup>32</sup>

### C. Aftermarket Features of an IPO

After the securities are distributed to the public, there are two important elements of IPOs that are not present in direct listings: price stabilization and lockup periods. When a company first comes into the public market, many investors know little about its prospects. To help mitigate volatility in the share price in the days after an IPO, underwriters often have what is known as an overallotment or greenshoe option. This provides the underwriter with the opportunity to buy back shares in an offering for the purpose of reducing the supply of stock on the market and stabilizing the price.<sup>33</sup> The financial advisors in the Spotify direct listing did not have an overallotment option because there was no firm underwriting.<sup>34</sup>

The second common IPO feature is a lockup period.<sup>35</sup> In most IPOs, underwriters require that employees of the company and other early investors be restricted from selling their securities for what is typically a six-month period. Lockup periods are intended as an assurance to investors who purchase in an IPO that the remainder of the company's shares will not flood the market and lower the price. Accordingly, the company's existing shareholders

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<sup>31</sup> See *id.* at 110. Liability in the case of a best efforts underwriting is still unresolved. The Second Circuit has, on occasion, looked to the agency relationship between the issuer and underwriter to determine who is liable. See, for example, *Demarco v Edens*, 390 F2d 836, 844–45 (2d Cir 1968) (holding that an issuer was not liable in a best efforts underwriting because the underwriter was not acting as an agent of the issuer). See also Ernest L. Folk III, *Civil Liabilities under the Federal Securities Acts: The BarChris Case Part II—The Broader Implications*, 55 Va L Rev 199, 205 (1969) (summarizing *Demarco*).

<sup>32</sup> Jacobs, 5 *Disclosure and Remedies under the Securities Laws* § 3:9 (cited in note 29).

<sup>33</sup> For a description of overallotment options, see James D. Cox, Robert W. Hillman, and Donald C. Langevoort, *Securities Regulation: Cases and Materials* 119–20 (Wolters Kluwer 8th ed 2017).

<sup>34</sup> See Part II.B.

<sup>35</sup> See Cox, Hillman, and Langevoort, *Securities Regulation: Cases and Materials* at 120 (cited in note 33). See also generally Alon Brav and Paul A. Gompers, *The Role of Lockups in Initial Public Offerings*, 16 Rev Fin Stud 1 (2003).

are prevented from selling in the time period immediately following the offering. Providing shareholders with the opportunity to sell without a lockup period is one of several important goals of direct listings. There was no lockup period in the Spotify direct listing.<sup>36</sup>

## II. HOW DIRECT LISTINGS WORK

In principle, a direct listing is similar to an IPO in that both involve a company making its securities available for purchase on a national exchange. In each process, the issuer works with attorneys and investment banks to prepare and file a registration statement with the SEC. However, after filing, the processes diverge. In a direct listing, the road show can be abbreviated, and there is no bookbuilding, price stabilization, or lockup period. Thus, direct listings allow a company to gain the benefits of being a public company without the major costs associated with the process. This Part first discusses the brief history of direct listings. The Part then walks through the Spotify direct listing and explains why it is particularly noteworthy.

### A. Direct Listings Generally

A company's motivations for going public drive the difference in methods used to achieve this end. One primary motivation for being a public company is to create a market for existing shareholders to sell their shares. When a company is privately held, there may not be a robust liquid market for its shares because of restrictions on the sale of privately held securities. Once a company has access to a public exchange, such as the NYSE, liquidity increases dramatically, which raises the value of the shares by increasing the number of potential buyers. Another benefit relates to the company's future financing decisions. For example, a public company can issue new shares to raise additional funds quickly. A company can also conduct mergers and acquisitions by using its stock rather than cash or debt to make purchases. Moreover, a company can repurchase its shares through a buyback program. Indeed, in November 2018, Spotify announced a \$1 billion share repurchase program of up to 10 million ordinary shares.<sup>37</sup>

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<sup>36</sup> See Part II.B.

<sup>37</sup> Spotify Technology S.A., *Form 6-K* (Nov 5, 2018), archived at <http://perma.cc/492G-TEHC>.

A direct listing allows a company to achieve each of these ends—market creation and financing flexibility—more efficiently than it could with an IPO. In this regard, direct listings are an efficiency story. First, a direct listing provides liquidity without the dilution that comes with a new securities offering. There is no need to issue new shares to create a market; the existing shares simply *become* the market, so existing shareholders are not diluted. Second, the expenses incurred are not as high. Underwriting fees are lower because there is no need to pay a spread to an investment bank for incurring the risk of holding the securities on their books.<sup>38</sup> Nor does the company incur as significant road show expenses because the company does not build a book of investors; the buyers are the public, which could—but does not have to—include institutional investors.<sup>39</sup> Lastly, existing shareholders are not subject to a lockup period. Rather, the issuer's existing shareholders can simply sell their shares on a national exchange pursuant to the exchange's rules.

The other major cost saving in a direct listing is the lack of underpricing.<sup>40</sup> In a firm commitment IPO, underwriters purchase the securities from the issuer and resell them to the book of interested investors. In many IPOs, the share price “pops” on the first day, generating a return for the investors who purchased from the underwriter at the lower price.<sup>41</sup> Between 2001 and 2016,

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<sup>38</sup> For a discussion of traditional IPO expenses, see Schneider, Manko, and Kant, 27 *Vill L Rev* at 29–33 (cited in note 16). Note that this source should be read for ordinal rather than nominal amounts due to inflation.

<sup>39</sup> The only road show expenses Spotify incurred were presumably related to its online Investor Day.

<sup>40</sup> In a conversation with TechCrunch, notable IPO expert Professor Jay Ritter stated this observation in clear terms. Arman Tabatabai, *TechCrunch Conversations: Direct Listings* (TechCrunch, Jan 19, 2019), archived at <http://perma.cc/4T3W-6JST> (“The big advantage of a direct listing is that it reduces the two big costs of an IPO—the direct cost of fees paid to investment bankers . . . and the indirect cost of selling shares at an offer price less than what the stock subsequently trades at.”).

<sup>41</sup> SEC Commissioner Robert Jackson recently referred to this phenomenon as a “tax” on the IPO process. See generally Robert J. Jackson Jr., *The Middle-Market IPO Tax* (Securities and Exchange Commission, Apr 25, 2018), archived at <http://perma.cc/B5VU-5KJE> (describing issues with IPO underpricing). For further discussion on the topic, see Jay R. Ritter, *Equilibrium in the Initial Public Offerings Market*, 3 *Ann Rev Fin Econ* 347, 348–54 (2011) (presenting data on underpricing and surveying academic theories); Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 *Cardozo L Rev* 711, 714–16, 724–26, 733–36 (2005) (discussing underpricing and the role of underwriters). See also generally Sean J. Griffith, *Spinning and Underpricing—A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 *Brooklyn L Rev* 583 (2004); Randolph P. Beatty and Jay R. Ritter, *Investment Banking, Reputation, and the Underpricing of Initial Public Offerings*, 15 *J Fin Econ* 213 (1985).

over 96 percent of midsize IPOs featured a spread of exactly 7 percent.<sup>42</sup> Spotify, while larger than the typical midsize IPO,<sup>43</sup> was keen to avoid this expense in their direct listing.<sup>44</sup>

Direct listings have historically been used in spin-offs of private subsidiaries of a public company, the emergence of a public company from Chapter 11 bankruptcy, and the listing of a public foreign company on a US exchange.<sup>45</sup> However, no direct listings have occurred on the scale of Spotify's.

## B. The Spotify Direct Listing

The Spotify direct listing was a novel and innovative event. There was little precedent for direct listings, especially for a company of Spotify's size.<sup>46</sup> Before answering the question whether the investment banks that Spotify retained as financial advisors to help prepare the registration statement and conduct the listing qualify as statutory underwriters, it is important to understand each element of the direct listing. Spotify first filed a registration statement with the SEC.<sup>47</sup> The NYSE then amended its rules around listing requirements to permit direct listings.<sup>48</sup> Spotify

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<sup>42</sup> See Jackson, *The Middle-Market IPO Tax* (cited in note 41).

<sup>43</sup> The Spotify valuation has been compared to the size of Snap Inc at the time of its IPO. See, for example, Maureen Farrell, *Spotify Disrupted the Music World, Now It's Doing the Same to Wall Street* (Wall St J, Jan 15, 2018), online at <http://www.wsj.com/articles/spotify-disrupted-the-music-world-now-its-doing-the-same-to-wall-street-1516024778> (visited Jan 19, 2019) (Perma archive unavailable).

<sup>44</sup> See Barry McCarthy, *IPOs Are Too Expensive and Cumbersome* (Spotify, Aug 8, 2018), archived at <http://perma.cc/E6KZ-SDRF>.

<sup>45</sup> See Marc D. Jaffe, Greg Rodgers, and Horacio Gutierrez, *Spotify Case Study: Structuring and Executing a Direct Listing* n 2 (Harvard Law School Forum on Corporate Governance and Financial Regulation, July 5, 2018), archived at <http://perma.cc/V34K-CFXZ>. Other commentators note that direct listings have historically been limited to small-capitalization biotechnology and life sciences companies. See, for example, Erin Griffith, *How Will Spotify's Direct Listing Work* (Fortune, July 31, 2017), archived at <http://perma.cc/6WJP-6ACA>. One notable example of a foreign direct listing is the DaimlerChrysler direct listing in 1998. See generally Nicholas D.S. Brumm, *The DaimlerChrysler Revolution*, 18 Intl Fin L Rev 19 (1999). For discussion of direct listings and their use in over-the-counter markets, see generally *Going Public without an IPO* (Anthony L.G., PLLC, May 10, 2018), archived at <http://perma.cc/3BAV-Q4MH>.

<sup>46</sup> See Levine, *Spotify's Non-IPO Really Is Novel* (cited in note 1); Farrell, Osipovich, and Steele, *Spotify's Splashy Debut Pressures Banks* (cited in note 5).

<sup>47</sup> Spotify Technology S.A., *Amendment No. 3 to Form F-1 Registration Statement* (Mar 23, 2018), archived at <http://perma.cc/ES4F-D9YW>.

<sup>48</sup> See generally Securities and Exchange Commission Release No 34-82627, 83 Fed Reg 5650 (Feb 2, 2018) (amending § 102.01B of the NYSE Listed Company Manual).

then received a no-action letter from the SEC concerning communication in the days leading up to the offering<sup>49</sup> and ultimately listed its securities on the NYSE.

1. The company and role of the financial advisors.

Spotify is a Luxembourg limited liability company based in Sweden and founded in 2006. The company offers the world's largest music streaming subscription service and generated €4.09 billion in revenue in 2017.<sup>50</sup> As of December 2017, the platform consisted of 157 million monthly active users, including 71 million premium subscribers.<sup>51</sup>

In early 2017, Spotify began the process of becoming a public company.<sup>52</sup> Spotify had several goals it wished to accomplish through the direct listing. First, the company wanted to offer greater liquidity to its existing shareholders, including the opportunity to sell over a national exchange. Second, the company wanted to provide equal access to all buyers and sellers of its stock with no lockup period. Lastly, Spotify wanted to enable price discovery through a transparent, market-driven process rather than through a firm commitment underwriting.<sup>53</sup>

To undergo the listing, Spotify entered into engagement letters with three investment banks:<sup>54</sup> Goldman Sachs, Morgan Stanley, and Allen & Company (the financial advisors).<sup>55</sup> In particular, the financial advisors provided "advice and assistance to [Spotify] with respect to [Spotify]'s (i) defining of objectives with respect to the Registration and Listing, (ii) drafting of the

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<sup>49</sup> *Spotify*, 2018 WL 1531993 at \*2–4 (stating that the Division of Trading and Markets will not recommend that the SEC take enforcement action in connection with the Spotify direct listing pursuant to Regulation M of the Exchange Act).

<sup>50</sup> *Spotify, Amendment No. 3 to Form F-1* at \*2 (cited in note 47). This was approximately \$4.90 billion as of December 2017.

<sup>51</sup> *Id.* at \*1.

<sup>52</sup> See Part II.B.3 for discussion of the contemporaneous NYSE rule changes that also made the direct listing possible.

<sup>53</sup> See Jaffe, Rodgers, and Gutierrez, *Spotify Case Study* at \*1–3 (cited in note 45).

<sup>54</sup> *Spotify*, 2018 WL 1531993 at \*9–10.

<sup>55</sup> *Spotify, Amendment No. 3 to Form F-1* at \*186 (cited in note 47). Morgan Stanley, Goldman Sachs, and Allen & Company are also the three investment banks that are linked to the potential Slack direct listing. Farrell, *Slack Files to Go Public with Direct Listing* (cited in note 2). According to the Thomson Reuters 2017 League Tables, Morgan Stanley, Goldman Sachs, and Allen & Company were each top-rated US IPO underwriters. *Global Equity Capital Markets Review: Managing Underwriters Full Year 2017* \*5 (Thomson Reuters), archived at <http://perma.cc/9A44-7LLW>.

Form F-1 and (iii) drafting of public communications and investor presentations in connection with the Registration and Listing.”<sup>56</sup>

Spotify incurred nearly \$46 million in expenses related to the direct listing.<sup>57</sup> This amount included fees paid to the SEC, auditors, attorneys, and, notably, the financial advisors. In particular, the financial advisors’ fee was \$35 million.<sup>58</sup> According to a J.P. Morgan Capital Markets report, an equivalent fee for a firm commitment underwriting for a company with a similar valuation to Spotify would be between \$80 and \$120 million.<sup>59</sup> Thus, Spotify was able to go public at roughly one-third of the cost of a similar IPO because of the lack of a firm commitment spread fee.

In multiple SEC filings, Spotify stated that the financial advisors were not “acting as underwriters” in connection with the direct listing.<sup>60</sup> As Part III.B explains, underwriters are parties who participate in a distribution of securities. Two activities that contribute to underwriter status include marketing the company’s securities to investors during a road show and conducting sales of such securities. In the Spotify direct listing, Spotify emphasized that the financial advisors were not “engaged to participate in investor meetings or to otherwise facilitate or coordinate price discover [sic] activities or sales of [ ] ordinary shares.”<sup>61</sup> This language was presumably an intentional effort to distinguish the duties of the financial advisors from those of traditional underwriters. However, the financial advisors were retained to draft the registration statement and investor materials for a one-time “Investor Day” online presentation to the public. In March 2017, Spotify held a live presentation streamed over the internet to educate investors on the company and investment opportunity, which it called its Investor Day.<sup>62</sup> The Investor Day lasted more

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<sup>56</sup> Id.

<sup>57</sup> See Spotify, *Amendment No. 3 to Form F-1* at \*187 (cited in note 47).

<sup>58</sup> See id.

<sup>59</sup> *Corporate Finance Advisory Trending Topics: A 1H 2018 Compendium* \*14 (J.P. Morgan, Apr 16, 2018), archived at <http://perma.cc/X3L2-UW3T>. Commentators also have compared the Spotify direct listing to the traditional IPO that messaging company Snap undertook in 2018 at a similar valuation. Snap paid \$100 million in underwriter fees for its public offering. See, for example, Maureen Farrell, *Spotify Disrupted the Music World* (cited in note 43).

<sup>60</sup> See, for example, Spotify, 2018 WL 1531993 at \*6 n 1.

<sup>61</sup> Spotify, *Amendment No. 3 to Form F-1* at \*186 (cited in note 47).

<sup>62</sup> *Investor Day—March 2018* (cited in note 26). For coverage of the Investor Day, see generally Maureen Farrell, et al, *Live Analysis: Spotify’s IPO Investor Day* (Wall St J, Mar 15, 2018), online at <http://www.wsj.com/livecoverage/spotify-ipo> (visited Feb 12, 2019) (Perma archive unavailable).

than two hours, which was nearly double the time of a traditional IPO road show meeting, and included presentations from the full executive team rather than just the chief executive officer and chief financial officer.<sup>63</sup> Approximately ten thousand unique viewers streamed the presentation.<sup>64</sup>

Moreover, the SEC neither affirmed nor rejected Spotify's underwriter assertion in its no-action letter. Rather, the SEC's Division of Trading and Markets recommended that the agency would not take any action against Spotify for this arrangement.<sup>65</sup> Thus, the question remains: Do the financial advisors qualify as statutory underwriters?

## 2. Registration statement.

To achieve its goal of providing liquidity to existing shareholders while complying with securities law, Spotify registered some of its securities with the SEC under a Form F-1 resale shelf registration statement.<sup>66</sup> Spotify submitted its first confidential draft in December 2017, and the SEC ultimately declared its registration statement effective on March 23, 2018.<sup>67</sup> Upon registration, Spotify had 178,112,840 ordinary shares outstanding.<sup>68</sup> Of these ordinary shares, Spotify registered 55,731,480 shares—or approximately 31 percent—under the registration statement.<sup>69</sup> To understand which shareholders were eligible to participate in the direct listing and why Spotify registered only 31 percent of its shares, it is helpful to sort Spotify's shareholders into three groups.

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<sup>63</sup> See Jaffe, Rodgers, and Gutierrez, *Spotify Case Study* at \*5 (cited in note 45).

<sup>64</sup> Id at \*3 n 5.

<sup>65</sup> *Spotify*, 2018 WL 1531993 at \*4 (“Accordingly, based on the facts and representations that you have made in the Request Letter, *but without necessarily concurring in your analysis*, the Division will not recommend that the Commission take enforcement action.”) (emphasis added).

<sup>66</sup> Spotify used the Form F-1 rather than the traditional Form S-1 because it is a foreign issuer. The company also could not file the traditional resale shelf registration statement, a Form F-3, because it had not been subject to reporting requirements for at least twelve months. See generally Spotify, *Amendment No. 3 to Form F-1* (cited in note 47). See also Jaffe, Rodgers, and Gutierrez, *Spotify Case Study* at \*3 n 7 (cited in note 45). For further discussion of SEC registration requirements, see Part III.A.

<sup>67</sup> See Jaffe, Rodgers, and Gutierrez, *Spotify Case Study* at \*3 (cited in note 45). The company filed an updated prospectus shortly after. Spotify Technology S.A., *Prospectus* (Mar 23, 2018), archived at <http://perma.cc/S7ZD-9K6G>.

<sup>68</sup> Spotify, *Amendment No. 3 to Form F-1* at \*49, 150, 173 (cited in note 47).

<sup>69</sup> Spotify, *Prospectus* (cited in note 67).

The first group of shareholders consisted only of Chinese social media company Tencent, which owned approximately 9 percent of Spotify's ordinary shares.<sup>70</sup> Tencent was subject to an earlier lockup agreement unrelated to the direct listing and thus was not eligible to participate in the listing.<sup>71</sup>

The second group consisted of nonemployees that had held shares for at least one year. This group held approximately 60 percent of Spotify's ordinary shares and were eligible to resell to the public at any time without registration under SEC Rule 144.<sup>72</sup> Thus, these shareholders, if they chose to sell their shares during the listing, did not need to do so under the registration statement's terms.<sup>73</sup>

The third group—the remaining 31 percent—consisted of (i) employees and (ii) nonemployees that had held their shares for less than one year.<sup>74</sup> These shareholders had no other direct option for public resale and were thus the primary intended beneficiaries of the direct listing. By registering these remaining shares, Spotify allowed its shareholders to resell immediately in the direct listing, which likely increased the value of the stock by fostering the development of a public market.

### 3. NYSE rule changes.

In June 2017, the NYSE proposed three changes to its listing requirement rules that would enable a company to undergo a direct listing on the exchange.<sup>75</sup> While the proposal did not explicitly

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<sup>70</sup> Tencent held 16,152,440 ordinary shares. *Id.* at \*150.

<sup>71</sup> *Id.* at \*8, 49.

<sup>72</sup> 17 CFR § 230.144. Rule 144 is a safe harbor that allows holders of restricted securities to resell such securities to the public without registration subject to certain timing, manner of sale, volume, and notice constraints. Under Rule 144(b)(1), nonaffiliates of an issuer who have held for at least one year are permitted to resell without complying with the Rule 144 requirements. 17 CFR § 230.144(b)(1). Rule 144(a)(1) defines “affiliate” as “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.” 17 CFR § 230.144(a)(1). For a detailed discussion of Rule 144 and its resale requirements, see Loss, Seligman, and Paredes, 1 *Securities Regulation* at 576–87 (cited in note 19). Spotify expected that 106,228,920—or approximately 60 percent of its 178,112,840 ordinary shares—were held by nonaffiliates and eligible for public resale without registration under Rule 144. See Spotify, *Prospectus* at 173 (cited in note 67).

<sup>73</sup> Nevertheless, they certainly benefited from the listing. Without access to the NYSE, there was no market for public resale.

<sup>74</sup> This group included the remaining 55,731,480 shares.

<sup>75</sup> Securities and Exchange Commission Release No 34-80933, 82 Fed Reg 28200 (June 20, 2017) (proposing changes to § 102.01B of the NYSE Listed Company Manual).

mention Spotify, it was widely understood to contemplate the Spotify direct listing.<sup>76</sup> Prior to the changes, the NYSE could list companies that were not registered with the SEC—like Spotify—on a case-by-case basis if the company had (i) a \$100 million valuation and (ii) several months of sustained trading history in private markets.<sup>77</sup> The proposed changes included (i) removing the private market trading requirement if the company could provide a valuation from an independent third party of at least \$250 million, (ii) requiring the company to hire an independent financial advisor to work with a designated market maker (DMM) to determine the opening day price, and (iii) eliminating the need for the company to file a Securities Act registration statement in connection with the listing. In February 2018, the SEC approved a revised proposal that included only the first two proposed changes, effectively clearing the path for the Spotify direct listing.<sup>78</sup>

The first change eliminated the private markets trading history requirement if the company can provide a valuation by an independent valuation agent of at least \$250 million.<sup>79</sup> While Spotify had some private trading history, it was not enough to satisfy the requirement.<sup>80</sup> The SEC concluded that by increasing the valuation threshold and implementing additional independence requirements, the amended rules will support the “maintenance of fair and orderly markets thereby protecting investors and the public interest.”<sup>81</sup> Spotify retained Morgan Stanley, one of its financial advisors, to act as its independent valuation agent in connection with the listing.<sup>82</sup>

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The NYSE is a self-regulatory body that has the ability to amend its rules with SEC approval pursuant to § 19(b)(1) of the Exchange Act. 15 USC § 78s(b)(1). The NYSE competes against other stock exchanges such as the Nasdaq, TSX, and London Stock Exchange for company listings.

<sup>76</sup> See, for example, Alexander Osipovich and Maureen Farrell, “*Spotify Rule*” *Would Help New York Stock Exchange Woo Unicorns* (Wall St J, May 26, 2017), online at <http://www.wsj.com/articles/spotify-rule-would-help-new-york-stock-exchange-woo-unicorns-1495791000> (visited Feb 12, 2019) (Perma archive unavailable) (referring to the NYSE rule change as “the Spotify rule”).

<sup>77</sup> See Jaffe, Rodgers, and Gutierrez, *Spotify Case Study* at \*6–7 (cited in note 45).

<sup>78</sup> See generally 83 Fed Reg 5650 (cited in note 48).

<sup>79</sup> To satisfy the independence requirements, the valuation agent must not (i) own more than 5 percent of the class of securities to be listed and (ii) have provided any investment banking or underwriting services to the company within the twelve months preceding the date of the valuation or in connection with the proposed listing. *Id.* at 5650–52.

<sup>80</sup> Spotify, *Amendment No. 3 to Form F-1* at 185 (cited in note 47).

<sup>81</sup> 83 Fed Reg at 5654 (cited in note 48).

<sup>82</sup> Spotify, *Amendment No. 3 to Form F-1* at 185 (cited in note 47). Note that the precise valuation was not disclosed. If a court were to find that Morgan Stanley acted as a

The second change instituted a requirement that a company seeking to undergo a direct listing retain both a financial advisor and a DMM to work together to determine the opening day price based on prelisting buy and sell orders.<sup>83</sup> DMMs are trading specialists who execute the opening trades of stocks on national exchanges.<sup>84</sup> The financial advisor, meanwhile, is intended to utilize its knowledge of the company and market to consult with the DMM to set the opening price. The financial advisor is meant to “have an understanding of the status of ownership of outstanding shares in the company and would have been working with the issuer to identify a market for the securities upon listing.”<sup>85</sup> The financial advisor will then “provide input to the DMM regarding expectations of where such a new listing should be priced, based on pre-listing selling and buying interest and other factors that would not be available to the DMM through other sources.”<sup>86</sup>

In its release approving the NYSE proposal, the SEC noted a direct parallel between financial advisors in a direct listing and underwriters in an IPO: the DMM requirement to consult with a financial advisor “is based in part on Nasdaq Rule 4120(c)(9), which requires that a new listing on Nasdaq that is not an IPO

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statutory underwriter in connection with the listing for its role as a financial advisor, its status as an independent valuation agent would potentially be implicated because the amended version of § 102.01B of the NYSE Listed Company Manual requires that the independent valuation agent not have “provided any . . . underwriting services to the company . . . in connection with the proposed listing.” For more discussion, see notes 89–91 and accompanying text.

<sup>83</sup> 83 Fed Reg at 5650 (cited in note 48). Spotify retained Citadel Securities as the DMM and Morgan Stanley as the financial advisor to the DMM. Notably, Spotify also retained Morgan Stanley to serve as one of the three financial advisors to advise on the offering, including drafting the registration statement and Investor Day materials. Unfortunately (for purposes of clarity), the roles are different, but the names are the same. Alexander Osipovich, *Spotify Picks Citadel Securities to Handle NYSE Debut* (Wall St J, Mar 7, 2018), online at <http://www.wsj.com/articles/spotify-picks-citadel-securities-to-handle-debut-at-nyse-1520439264> (visited Jan 19, 2019) (Perma archive unavailable); Spotify, *Amendment No. 3 to Form F-1* at 185 (cited in note 47).

<sup>84</sup> For a discussion of historic changes to the DMM role, see generally Jennifer V.C. Dean, *Paradigm Shifts & Unintended Consequences: The Death of the Specialist, the Rise of High Frequency Trading, & the Problem of Duty-Free Liquidity in Equity Markets*, 8 FIU L Rev 217 (2012). See also Jeremy Schara, Note, *Knowledge Is Salvation: Informing Investors by Regulating Disclosures to Safeguard Best Execution*, 43 Hofstra L Rev 1231, 1240–43 (2015) (describing the role of DMMs in managing corporations’ stock).

<sup>85</sup> 83 Fed Reg at 5652 (cited in note 48).

<sup>86</sup> *Id.* The NYSE noted that the DMM would not be “bound by the input” of the financial advisors. *Id.* at 5652 n 35.

have a *financial advisor willing to perform the functions performed by an underwriter* in connection with pricing an IPO.”<sup>87</sup> This statement is particularly relevant because it further suggests that the financial advisor who supports the DMM performs the same functions as an underwriter in a traditional IPO. In approving the proposal, the SEC concluded that the DMM and financial advisor requirement is “reasonably designed to protect investors and the public interest and promote just and equitable principles of trade for the opening of securities listed under the new standards.”<sup>88</sup>

The NYSE contemplated a third change—eliminating the need for a Securities Act registration statement—but ultimately did not include it in its final proposal.<sup>89</sup> However, this amendment would have had significant implications on underwriter liability. The initial proposal would have permitted a direct listing without a Securities Act registration statement.<sup>90</sup> Had this change been adopted, it would have greatly expedited the listing process. It also would have raised a serious question about whether Securities Act liability falls on the relevant parties due to the lack of a registration statement. However, the NYSE ultimately removed this proposed amendment from its final proposal. Presumably, this proposal revision was the result of a compromise between the SEC and NYSE in the interest of disclosure and liability.<sup>91</sup>

Two further points are worth addressing concerning the rule changes and how they relate to underwriter liability. First, the amended rules require that the independent valuation agent has not provided “investment banking services,” including “acting as an underwriter,” in connection with the listing.<sup>92</sup> Importantly, this requirement is based on a legal conclusion about underwriter

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<sup>87</sup> Id at 5652 n 33 (emphasis added), citing Securities and Exchange Commission Release No 34-81440, 82 Fed Reg 40183, 40185 (Aug 18, 2017).

<sup>88</sup> 83 Fed Reg at 5654 (cited in note 48).

<sup>89</sup> Id at 5651 & n 11 (noting that the Exchange removed the proposed change that would have allowed a company to list without a Securities Act registration).

<sup>90</sup> 82 Fed Reg at 28201 (cited in note 75).

<sup>91</sup> In particular, the SEC noted the NYSE rule changes must “be designed to promote just and equitable principles of trade . . . and, in general, to protect investors” and that a direct listing without a Securities Act registration “may raise a number of unique considerations, including with respect to the role of various distribution participants.” Securities and Exchange Commission Release No 34-81640, 82 Fed Reg 44229, 44231 (Sept 21, 2017).

<sup>92</sup> 83 Fed Reg at 5652 n 25 (cited in note 48). There is an inherent contradiction here between not “acting as an underwriter” but also being willing to “perform the functions performed by an underwriter” per the Nasdaq guidelines upon which the NYSE rule is based. See note 87 and accompanying text.

status. “Underwriter” is a legal term defined under the Securities Act,<sup>93</sup> and fulfilling the NYSE listing requirement should not be interpreted to mean that a financial advisor has not otherwise fulfilled the requirements to qualify as a statutory underwriter for purposes of § 11 liability. As Part III discusses, courts have looked at similar independent valuation agents and found them to be underwriters.<sup>94</sup> Second, with respect to determining the opening price, the registration statement states that the price would be based in part on Morgan Stanley’s “understanding of the ownership of [Spotify’s] outstanding ordinary shares and pre-listing buying and selling interest in [Spotify’s] ordinary shares that it becomes aware of from potential investors and holders.”<sup>95</sup> This point is addressed further in Part IV, but the reliance on Morgan Stanley’s acute awareness of the market and understanding of potential investors provides a strong justification for holding the bank liable as an underwriter.<sup>96</sup> If Morgan Stanley is collecting interest from public investors and relaying such information to the DMM, who then accepts bids to set an opening price, then perhaps a court may be willing to step the two pieces together and find the process is, in substance, bookbuilding even though in form it is not.

#### 4. SEC no-action letter.

Spotify also sought guidance on the direct listing from the SEC in the form of a no-action letter.<sup>97</sup> In particular, Spotify inquired about the application of an Exchange Act rule—Regulation M—that limits issuer communications in the time period around a securities offering to prevent market manipulation.<sup>98</sup> Due to the nontraditional nature of the Spotify direct listing, it was unclear

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<sup>93</sup> 15 USC § 77b(a)(11).

<sup>94</sup> See notes 145–51 and accompanying text.

<sup>95</sup> Spotify, *Amendment No. 3 to Form F-1* at 185 (cited in note 47).

<sup>96</sup> See notes 193–95 and accompanying text.

<sup>97</sup> SEC staff write no-action letters in response to requests by companies seeking guidance on a particular securities matter. When approved affirmatively, the letter will state that the relevant division will not recommend enforcement given the facts presented. See generally Thomas P. Lemke, *The SEC No-Action Letter Process*, 42 Bus Law 1019 (1986).

<sup>98</sup> See *Spotify*, 2018 WL 1531993 at \*6–12 (requesting clarification on the applicability of Regulation M of the Exchange Act). Regulation M is designed to prevent market manipulation by prohibiting issuers, selling security-holders, and other distribution participants from certain communication activities during a distribution. See 17 CFR §§ 242.100–05. In a traditional IPO setting, Regulation M is assumed to apply. However, in a direct listing, there is no pricing period, so it was unclear whether a Regulation M restricted period applied, and if so, for how long.

whether the prophylactic measures of the rule applied, which would restrict Spotify's ability to communicate with investors in the period immediately before and after the listing date.

In its no-action letter, the Division of Trading and Markets stated that it would not recommend enforcement against Spotify, the financial advisors, or the shareholders if the parties refrained from communication within five days of the opening through the second day after the listing.<sup>99</sup> Critically, the letter does not concede that the listing constituted a distribution for Securities Act purposes, nor does it address the underwriter status of the financial advisors. Rather, the letter focuses solely on communications around the listing date and is otherwise limited in scope.

### III. RELEVANT SECURITIES LAW FOR UNDERWRITER LIABILITY

The Securities Act and Exchange Act aim to protect investors through a mandatory disclosure regime. To serve this aim, Congress established the SEC to oversee the substantial increase in regulation of a wide range of market participants.<sup>100</sup> The SEC has two competing policy objectives: requiring disclosure for the sake of protecting investors and fostering capital formation without imposing overly burdensome costs on companies seeking to raise money from investors.<sup>101</sup> As disclosure demands increase, the compliance cost to companies looking for investors increases as well. This Part discusses the sections of the Securities Act relevant to the Spotify direct listing: specifically, § 11, which imposes significant liability on parties involved in a securities offering, and § 2(a)(11), which defines the term "underwriter."<sup>102</sup>

#### A. Section 11 Liability

The purpose of the Securities Act is to protect investors by requiring complete and accurate disclosure from companies issuing securities. To ensure compliance with the disclosure requirements by all parties involved in an offering, the SEC provides purchasers of securities issued under a registration statement with

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<sup>99</sup> *Spotify*, 2018 WL 1531993 at \*2.

<sup>100</sup> See Hazen, *Federal Securities Law* at 4 (cited in note 7).

<sup>101</sup> See, for example, 15 USC § 77b(b) ("Whenever . . . the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.").

<sup>102</sup> 15 USC §§ 77b(a)(11), 77k.

an express private right of action for material misstatements or omissions in the registration statement.<sup>103</sup> The policy goal is deterrence rather than just compensation.<sup>104</sup> In particular, § 11 of the Securities Act provides:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, *any person acquiring such security* (unless it is proved that at the time of such acquisition he knew of such untruth or omission) *may*, either at law or in equity, in any court of competent jurisdiction, *sue*.<sup>105</sup>

To bring a successful § 11 claim, a plaintiff must first point to a material misstatement or omission in a registration statement. A plaintiff need not show that she relied on the material misstatement when purchasing the security; instead, reliance is presumed under the “fraud-on-the-market” theory.<sup>106</sup> A plaintiff also need not have purchased the security in the actual offering to have standing.<sup>107</sup>

Rather, a plaintiff must “trace” the security to the registration statement to have standing.<sup>108</sup> The tracing requirement is easily met in a traditional IPO because all shares issued are sold pursuant to the registration statement. In direct listings, however, plaintiffs may have a much harder time with the tracing analysis. Due to the way brokers hold securities for purchasers, it can be difficult to track which specific share one owns.<sup>109</sup> In a

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<sup>103</sup> 15 USC § 77k.

<sup>104</sup> See Cox, Hillman, and Langevoort, *Securities Regulation* at 488 (cited in note 33). See also *Laventhol, Krekstein, Horwath & Horwath v Horwitch*, 637 F2d 672, 676 (9th Cir 1980) (“In extending liability to underwriters and those who prepared misleading statements, the purpose of the Act is regulatory rather than compensatory.”).

<sup>105</sup> 15 USC § 77k(a) (emphases added).

<sup>106</sup> For the seminal case on reliance and fraud-on-the-market, see *Basic v Levinson*, 485 US 224, 241–49 (1988) (holding that fraud-on-the-market operates as a rebuttable presumption of reliance when stock prices reflect all material information about the company). For an example of a defendant successfully rebutting the *Basic* presumption, see *International Brotherhood of Electrical Workers Local 98 Pension Fund v Best Buy Co*, 818 F3d 775, 782–83 (8th Cir 2016).

<sup>107</sup> See *Hertzberg v Dignity Partners, Inc*, 191 F3d 1076, 1080 (9th Cir 1999).

<sup>108</sup> *Id* at 1080 n 4.

<sup>109</sup> See Cox, Hillman, and Langevoort, *Securities Regulation* at 490 (cited in note 33).

direct listing, some shares are sold under the registration statement while others are not.<sup>110</sup> Moreover, courts have rejected statistical analyses purporting to prove tracing in favor of an actual tracing requirement, which requires that a plaintiff show her share was purchased pursuant to a registration statement.<sup>111</sup> As discussed in Part II.B, Spotify registered only 31 percent of its shares under the registration statement.<sup>112</sup> This could create a challenging hurdle for a plaintiff to overcome given the lack of a record behind share ownership. Nonetheless, the risk of § 11 liability should still serve the SEC's deterrence goal of preventing misleading offer documents.

Congress expressly enumerated five parties subject to § 11 liability: issuers; officers and directors; accountants and other “experts,” and underwriters.<sup>113</sup> Issuers are strictly liable for any material misstatements or omissions in a registration statement. The other potential defendants are able to assert what is known as a “due diligence” defense,<sup>114</sup> which can be invoked by parties who did not have knowledge of the misstatement and conducted a sufficiently detailed level of investigation. The required level of investigation varies depending on the role of the defendant and the type of information at issue. For example, underwriters have a “general liability for what appears in [the] document.”<sup>115</sup> For an underwriter's due diligence defense to succeed, the underwriter must have conducted a “reasonable investigation” and have had a “reasonable ground” to believe in the accuracy of the registration statement.<sup>116</sup>

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<sup>110</sup> See Part II.B.2.

<sup>111</sup> See, for example, *Krim v pcOrder.com*, 402 F3d 489, 502 (5th Cir 2005).

<sup>112</sup> See text accompanying note 69.

<sup>113</sup> 15 USC § 77k(a)(1)–(5). For discussion of “expertized” portions of a registration statement, which are beyond the scope of this Comment, see Louis Loss, Joel Seligman, and Troy Paredes, 2 *Fundamentals of Securities Regulation* 1605–09 (Wolters Kluwer 6th ed 2011).

<sup>114</sup> See 15 USC § 77k(b)(3), (c). For the leading case on the “due diligence” defense, see *Escott v BarChris Construction Corp.*, 283 F Supp 643, 682–703 (SDNY 1968) (establishing standards of “reasonable” diligence for lawyers, accountants, and underwriters as a defense to § 11 claims). See also Ernest L. Folk III, *Civil Liabilities under the Federal Securities Acts: The BarChris Case Part I—Section 11 of the Securities Act*, 55 Va L Rev 1, 19–49 (1969) (summarizing due diligence defenses under the Securities Act).

<sup>115</sup> Folk, 55 Va L Rev at 52 (cited in note 114). Defenses for the other parties are beyond the scope of this Comment.

<sup>116</sup> See *BarChris*, 283 F Supp at 697 (“[T]he phrase ‘reasonable investigation’ must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of ‘dat[a] presented’ to them by the company. . . . [T]he underwriters must make some reasonable attempt to verify the data submitted to them.”). For

Assuming the claim survives, the potential scope of § 11 liability is important for the parties to consider. It is worth noting first that these types of claims are common. Between 2009 and 2017, 19.5 percent of IPOs faced a core federal securities class action filing.<sup>117</sup> Statutory damages are equal to the difference between the public offering price of the securities and the price at the time of sale or the suit.<sup>118</sup> According to one study, the median estimated statutory damages amount for Securities Act claims between 2008 and 2017 was \$83.3 million.<sup>119</sup> Moreover, 84 percent of settled cases had an underwriter named as a defendant.<sup>120</sup> For plaintiffs who filed claims under the Exchange Act as well, the median estimated statutory damages amount over the same time period was \$315.5 million.<sup>121</sup>

#### B. Section 2(a)(11) Underwriter Definition

The investment banks that Spotify retained as financial advisors played a critical role in the direct listing process.<sup>122</sup> Because of the key role that underwriters play in the offering process, underwriters are one of the enumerated defendants under § 11. Courts interpret the underwriter definition broadly to include “all persons who might operate as conduits for securities being placed into the hands of the investing public.”<sup>123</sup> Underwriters come in

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a full discussion of the underwriter due diligence defense, see Folk, 55 Va L Rev at 49–58 (cited in note 114). For a discussion of the impact of underwriter liability on the capital formation process, see Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 Va L Rev 776, 792–96 (1972).

<sup>117</sup> *Securities Class Action Filings—2018 Year in Review* \*25 (Cornerstone Research, 2018), archived at <http://perma.cc/UV3R-ZDYV>. The study defines “core filings” as federal securities class actions excluding merger and acquisition-related filings. *Id.* at \*39–40.

<sup>118</sup> 15 USC § 77k(e).

<sup>119</sup> Laarni T. Bulan, Ellen M. Ryan, and Laura E. Simmons, *Securities Class Action Settlements—2017 Review and Analysis* \*9 (Cornerstone Research, 2018), archived at <http://perma.cc/RNW6-ZR7M>. The median settlement amount for such suits was \$4.5 million. *Id.*

<sup>120</sup> *Id.* at \*10.

<sup>121</sup> *Id.* at \*9. The median settlement amount for such suits was \$12.8 million. *Id.* Rule 10b-5 of the Exchange Act provides an implied private remedy for fraudulent misstatements or omissions in connection with the purchase or sale of any security. Cox, Hillman, and Langevoort, *Securities Regulation* at 698–99 (cited in note 33); 17 CFR § 240.10b-5. Rule 10b-5 damages are cumulative with § 11 claims. See *Herman & MacLean v Huddleston*, 459 US 375, 386–87 (1983).

<sup>122</sup> See Part II.B.1.

<sup>123</sup> *Securities and Exchange Commission v Lybrand*, 200 F Supp 2d 384, 393 (SDNY 2002), quoting Thomas L. Hazen, *The Law of Securities Regulation* 431 (West 4th ed 2002). See also, for example, *Securities and Exchange Commission v Platform Wireless International*

two forms: traditional underwriters and statutory underwriters. Traditional underwriters are generally considered to be investment banks that engage in a firm commitment underwriting on behalf of an issuer.<sup>124</sup> Pursuant to the statutory definition, statutory underwriters meanwhile include any party that is necessary to a distribution of securities.

Section 2(a)(11) defines “underwriter” as follows:

[A]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.<sup>125</sup>

As the definition makes clear, the underwriter definition turns on the relationship between the relevant party and the offering.<sup>126</sup> Any person who performs one of the enumerated functions in the definition in connection with an offering becomes a statutory underwriter.

The plain language of § 2(a)(11) thus establishes three types of statutory underwriters: (1) any person who purchases from an issuer “with a view to” the distribution of a security; (2) any person who offers or sells for an issuer “in connection with” the distribution of a security; and (3) any person who “participates” in any such undertaking.<sup>127</sup> This Section addresses each type of statutory underwriter in turn. The latter two types are particularly relevant to the Spotify direct listing.

1. Persons who have purchased with a view to distribution.

This type of statutory underwriter is typically a traditional investment bank engaged in a firm commitment underwriting.<sup>128</sup> Under such arrangements, the bank works with the issuer to prepare the registration statement, conducts the road show, and then

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*Corp*, 617 F3d 1072, 1086 (9th Cir 2010) (“The definition of ‘underwriter’ in the Securities Act is expansive.”).

<sup>124</sup> See Loss, Seligman, and Paredes, 1 *Securities Regulation* at 97–126 (cited in note 19).

<sup>125</sup> 15 USC § 77b(a)(11).

<sup>126</sup> See Loss, Seligman, and Paredes, 1 *Securities Regulation* at 458 (cited in note 19) (“[T]he term underwriter is defined not with reference to the particular person’s general business but on the basis of his or her relationship to the particular offering.”).

<sup>127</sup> 15 USC § 77b(a)(11).

<sup>128</sup> See Loss, Seligman, and Paredes, 1 *Securities Regulation* at 100–09 (cited in note 19) (discussing firm commitment underwriting).

*purchases* the securities from the issuer for resale to the book of institutional investors. In the Spotify direct listing, the investment banks had a role in the first two parts of the process but did not actually *purchase* any Spotify securities in the offering. Thus, this definition of underwriter does not apply.

## 2. Persons offering to sell or selling for an issuer.

This type of statutory underwriter includes any person who solicits an exchange of securities on behalf of an issuer.<sup>129</sup> This is commonly seen in “best efforts” underwritings, in which an investment bank is compensated not by the spread but rather by a commission.<sup>130</sup> This relationship shares many similarities to the arrangement between Spotify and its financial advisors. To qualify as underwriters pursuant to this part of the definition, the financial advisors must have played a necessary role in the distribution of the Spotify ordinary shares.

The leading case on this type of underwriter is one in which the court looked to substance over form and attached underwriter status notwithstanding the lack of a contractual relationship between the party and the issuer. In *Securities and Exchange Commission v Chinese Consolidated Benevolent Association*,<sup>131</sup> the Second Circuit considered whether a charitable association that promoted the sale of Chinese government war bonds qualified as an underwriter when it offered to sell the Chinese securities to American investors.<sup>132</sup> In particular, the association marketed the securities to members of Chinese communities in New York, New Jersey, and Connecticut through meetings and newspaper advertisements.<sup>133</sup> The association then exchanged funds that it collected for the securities and distributed them to its members.<sup>134</sup> The association had no contractual relationship with

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<sup>129</sup> For a full discussion of “selling for an issuer” and relevant case law, see *id.* at 461–63.

<sup>130</sup> See Edward F. Greene, *Determining the Responsibilities of Underwriters Distributing Securities within an Integrated Disclosure System*, 56 Notre Dame L Rev 755, 762 n 35 (1981) (“Although a person distributing securities on a best efforts basis technically is not underwriting the issue, he is subsumed within the definition of ‘underwriter’ set forth in § 2(11).”). For a discussion of best efforts underwriting, see Part I.B.

<sup>131</sup> 120 F2d 738 (2d Cir 1941).

<sup>132</sup> *Id.* at 740–41.

<sup>133</sup> *Id.* at 739.

<sup>134</sup> *Id.*

the Chinese government and received no compensation for its actions.<sup>135</sup> However, the court determined that the association qualified as an underwriter because the language of the statute should be read “as covering continual solicitations . . . which normally would result in a distribution of [securities].”<sup>136</sup> The court continued to state that the definition includes any person who “engaged in steps necessary to the distribution of securit[ies].”<sup>137</sup> Many courts continue to follow the *Chinese Consolidated* rule today, which makes the definition relevant to consider in the direct listing context.<sup>138</sup>

### 3. Persons participating in any such undertaking.

This type of statutory underwriter turns on the proper interpretation of “participates” and “any such undertaking.”<sup>139</sup> Courts have taken several approaches to defining these terms. Some courts look to whether the public relies on a party’s expertise when purchasing the securities. Others consider whether the party’s actions were necessary to the distribution, similar to the *Chinese Consolidated* approach. More broadly, some ask whether the party’s actions were simply distribution related. This Comment addresses each interpretation in turn to consider the role of the Spotify financial advisors.

First, several courts focus on whether the public relies on the expertise of the party in evaluating the registration statement. According to this approach, if the public relies on the party’s expertise, then that party may be considered to have participated in a distribution and qualify as an underwriter. In *McFarland v Memorex Corp.*,<sup>140</sup> the court considered whether institutional investors that exercised registration rights in a securities offering

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<sup>135</sup> *Chinese Consolidated*, 120 F2d at 739.

<sup>136</sup> *Id.* at 741.

<sup>137</sup> *Id.*

<sup>138</sup> See, for example, *In re Enron Corporation Securities, Derivative & “ERISA” Litigation v UBS PaineWebber, Inc.*, 238 F Supp 3d 799, 866 (SD Tex 2017) (“Statutory underwriters include any person who is ‘engaged in steps necessary to the distribution of security issues.’”), quoting *Chinese Consolidated*, 120 F2d at 741; *Securities and Exchange Commission v Kern*, 425 F3d 143, 152 (2d Cir 2005).

<sup>139</sup> 15 USC § 77b(a)(11). For a full discussion of “participation in an underwriting” and a collection of relevant case law, see Loss, Seligman, and Paredes, 1 *Securities Regulation* at 471–74 (cited in note 19).

<sup>140</sup> 493 F Supp 631 (ND Cal 1980), modified on other grounds, 581 F Supp 878 (ND Cal 1984).

“participated” in a distribution and thereby became statutory underwriters.<sup>141</sup> The court concluded that institutional investors were not underwriters because they did not have control over the registration statement and the public did not rely on their expertise when making investment decisions.<sup>142</sup> The court observed that “underwriters are subjected to liability because they hold themselves out as professionals who are able to evaluate the financial condition of the issuer.”<sup>143</sup> Thus, this case demonstrates the importance of considering the role the financial advisors had in drafting the registration statement when analyzing underwriter status in the Spotify direct listing.<sup>144</sup>

Second, other courts consider whether the person’s role was “necessary to the distribution.”<sup>145</sup> This is an expansion of the *Chinese Consolidated* approach. In *Harden v Raffensperger, Hughes & Co*,<sup>146</sup> the Seventh Circuit considered whether a qualified independent underwriter was subject to § 11 liability as a statutory underwriter.<sup>147</sup> Firstmark Corporation, a financial services company, issued debt securities through a subsidiary. According to industry rules, Firstmark was required to retain a “qualified independent underwriter” to perform due diligence on the registration statement and recommend a minimum yield for the offering.<sup>148</sup> The court rejected the defendant’s argument that it was not an underwriter solely because it did not purchase the

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<sup>141</sup> Id at 644.

<sup>142</sup> Id at 646.

<sup>143</sup> Id. See also *In re Activision Securities Litigation*, 621 F Supp 415, 424 (ND Cal 1985) (“[U]nderwriters who participate in the preparation of the registration statement are liable [under § 11].”). For further discussion of *McFarland* and *Activision*, see Jennifer O’Hare, *Institutional Investors, Registration Rights, and the Specter of Liability under Section 11 of the Securities Act of 1933*, 1996 Wis L Rev 217, 239–45.

<sup>144</sup> See Part IV.B.

<sup>145</sup> See, for example, *Kern*, 425 F3d at 152–53 (holding a corporation who “engaged in steps necessary to the distribution” to be a statutory underwriter), quoting *Chinese Consolidated*, 120 F2d at 741. See also, for example, *Securities and Exchange Commission v Universal Major Industries Corp*, 546 F2d 1044, 1046–47 (2d Cir 1976) (holding that an attorney who wrote letters in connection with transfers of unregistered stock that expressed his opinion that such transfers were legal violated § 5 of the Securities Act). But see *Securities and Exchange Commission v North American Research and Development Corp*, 424 F2d 63, 71–72 (2d Cir 1970) (observing that “joining in the common effort” to sell unregistered shares subjects one to “the injunctive and other powers of the SEC and the federal courts”).

<sup>146</sup> 65 F3d 1392 (7th Cir 1995).

<sup>147</sup> Id at 1394.

<sup>148</sup> Id at 1394–95. A minimum yield on a bond offering is similar to a minimum price on an equity offering.

issuer's securities.<sup>149</sup> Instead, the court held that the third party Firstmark retained had "participated" in the distribution—and was therefore a statutory underwriter—because its actions were "necessary to the distribution."<sup>150</sup> This case has important implications for the underwriter status of the financial advisors in the Spotify direct listing.<sup>151</sup>

In contrast to other circuits, the Second Circuit takes a narrower approach and looks to whether the party engaged in distribution-related activities. In *In re Lehman Brothers Mortgage-Backed Securities Litigation*,<sup>152</sup> the Second Circuit concluded that credit rating agencies involved in structuring mortgage-backed securities did not "participate" in a distribution because their activities were not "distribution-related."<sup>153</sup> The plaintiffs averred that the rating agencies qualified as underwriters because their actions were a "necessary predicate to the securities' distribution."<sup>154</sup> The court, in rejecting the plaintiffs' argument, distinguished between entities "who provide services that facilitate a securities offering" and those who "participate in the statutorily specified distribution-related activities."<sup>155</sup> The court interpreted § 2(a)(11) to mean that the underwriter definition encompasses only activities that are "related to the actual distribution of securities."<sup>156</sup> The rating agencies merely facilitated the participation of others in the offering; they did not participate in the offering themselves and were therefore not statutory underwriters. Even under this narrow reading of the statute, this Comment argues that Spotify's financial advisors may qualify as statutory underwriters.

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<sup>149</sup> Id at 1400.

<sup>150</sup> *Harden*, 65 F3d at 1400–01, quoting *Securities and Exchange Commission v Holschuh*, 694 F2d 130, 139 n 13 (7th Cir 1982). The Ninth Circuit takes a similarly broad approach. See generally, for example, *Platform Wireless*, 617 F3d at 1086 (interpreting the underwriter definition to include "[a]ny intermediary between the issuer and the investor that is an essential cog in the distribution process") (citation omitted).

<sup>151</sup> See Part IV.A.2.

<sup>152</sup> 650 F3d 167 (2d Cir 2011).

<sup>153</sup> Id at 176, 182.

<sup>154</sup> Id at 175. In addition to passively evaluating the credit risk of each pool of mortgage-backed securities, the rating agencies allegedly aided in the structuring and securitization process. Id at 172–73.

<sup>155</sup> Id at 176.

<sup>156</sup> *Lehman Brothers*, 650 F3d at 176. In reaching its conclusion, the court looked to *In re Refco, Inc Securities Litigation*, 2008 WL 3843343, \*4 (SDNY 2008) ("While the definition of 'underwriter' is indeed broad and is to be interpreted broadly, it must be read in relation to the underwriting function that the definition is intended to capture.").

#### IV. THE UNDERWRITER STATUS OF THE FINANCIAL ADVISORS

The underwriter designation carries significant liability under § 11 of the Securities Act. As a consequence, a court finding underwriter status for the financial advisors in the Spotify direct listing would potentially increase the costs associated with a direct listing. Yet as this Part demonstrates, such liability would not be fatal to the direct listing innovation. This Part draws from precedent, legislative history, and academic scholarship to argue that these advisors were statutory underwriters who “participated” in a distribution of Spotify’s ordinary shares to the public and are liable under § 11 of the Securities Act.

As Part III describes, there are three types of statutory underwriters under § 2(a)(11). The latter two—persons who offer securities for sale for an issuer and persons who participate in a distribution—require careful consideration in the context of the Spotify direct listing. The financial advisors were explicitly retained to define the objectives of the registration statement, draft the registration statement, and draft public communications and investor presentations.<sup>157</sup> While the financial advisors did not conduct a firm commitment underwriting nor provide price stabilization, their extensive involvement in the process is still sufficient to warrant underwriter status. The total cost of a direct listing will still necessarily be less than a traditional IPO because investment banks will not be taking a spread fee or aftermarket pricing risk. Moreover, the increased specter of liability will ensure investor protection and align with SEC policy goals.

##### A. Legal Precedent Supports Underwriter Status

As Part III.B describes, courts have interpreted the plain language of § 2(a)(11) differently. This Part aims to demonstrate that the financial advisors in the Spotify direct listing likely qualify as statutory underwriters under either the “offer” or “participate” parts of the underwriter definition. The Comment applies the *Chinese Consolidated* analysis to the former and the *Harden* and *Lehman Brothers* analyses to the latter to support finding underwriter status.

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<sup>157</sup> *Spotify*, 2018 WL 1531993 at \*9–10.

1. The financial advisors likely offered securities for sale under a *Chinese Consolidated* analysis.

Under § 2(a)(11), the underwriter definition includes any person who “offers . . . for an issuer in connection with[ ] the distribution of any security.”<sup>158</sup> The relevant inquiry is thus whether the financial advisors solicited sales of the Spotify securities in the direct listing. The controlling case for this type of underwriter is *Chinese Consolidated*.<sup>159</sup> In *Chinese Consolidated*, the charitable association involved in the offering had no contractual relationship with the Chinese government nor received “any compensation from any source.”<sup>160</sup> However, the court determined that the association became an underwriter when it solicited offers to buy the Chinese government bonds because the association engaged in “continual” behavior that “culminated in a distribution.”<sup>161</sup> The association held meetings, distributed flyers through the mail, and transferred the funds and securities between the Bank of China and the purchasers.<sup>162</sup>

The question then becomes whether the financial advisors engaged in an analogous type of continual behavior. On an initial read, the answer may appear to be no. The financial advisors did not hold meetings or accept monies or securities on behalf of a purchaser or issuer. However, the financial advisors’ role in the investor education raises an interesting question. In March 2017, Spotify held a live presentation streamed over the internet to educate investors on the company and investment opportunity, which it called its Investor Day.<sup>163</sup> The Investor Day lasted more than two hours, which was nearly double the time of a traditional IPO road show meeting, and included presentations from the full executive team rather than just the chief executive officer and chief financial officer.<sup>164</sup> Approximately ten thousand unique viewers watched the presentation live.<sup>165</sup> The dissent in *Chinese Consolidated* raises the possibility that under the majority’s reading of § 2(a)(11), “a single solicitation of an offer to buy would be

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<sup>158</sup> 15 USC § 77b(a)(11). See notes 123–27 and accompanying text.

<sup>159</sup> See notes 131–38 and accompanying text.

<sup>160</sup> *Chinese Consolidated*, 120 F2d at 739.

<sup>161</sup> *Id.* at 740–41.

<sup>162</sup> *Id.* at 739.

<sup>163</sup> *Investor Day—March 2018* (cited in note 26). For coverage of the Investor Day, see Farrell, et al, *Live Analysis: Spotify’s IPO Investor Day* (cited in note 62).

<sup>164</sup> See Jaffe, Rodgers, and Gutierrez, *Spotify Case Study* at \*5 (cited in note 45).

<sup>165</sup> See *id.* at \*3 n 5.

equally within the language [of the statute].”<sup>166</sup> Was the Investor Day sufficient to attach underwriter status?

Based on the significant role of the financial advisors in preparing the presentation materials and the expansive nature of the presentation, the Investor Day is likely sufficient. Spotify disclosed that one of the services to be performed by the financial advisors included the “drafting of public communications and investor presentations in connection with the Registration and Listing.”<sup>167</sup> This almost certainly included the Investor Day materials.<sup>168</sup> Spotify was careful, though, to state that this role was limited to drafting, not active participation.<sup>169</sup> However, this distinction seems tenuous and may draw close scrutiny from a court. First, Spotify stated to the SEC that the Investor Day qualified as a road show for purposes of the Securities Act.<sup>170</sup> Second, there is evidence suggesting that the Investor Day was not a singular event either, making it even more consistent with a road show.<sup>171</sup> Given the emphasis courts place on substance over form in this context, a factual inquiry may be required to determine the extent of the financial advisors’ involvement in the Spotify direct listing or in any subsequent direct listings. The aim of the Securities Act is to make complete and accurate informative materials available for investors, and this objective can be satisfied if the drafters of such materials—regardless of whether they have a role in the actual presentation of the material—are held liable for any misstatements or omissions.

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<sup>166</sup> *Chinese Consolidated*, 120 F2d at 742 (Swan dissenting).

<sup>167</sup> *Spotify*, 2018 WL 1531993 at \*9. See also text accompanying note 56.

<sup>168</sup> See Jaffe, Rodgers, and Gutierrez, *Spotify Case Study* at \*5 (cited in note 45).

<sup>169</sup> *Spotify*, 2018 WL 1531993 at \*9 (“Notably, the Advisory Engagement Letters . . . expressly provide that the Financial Advisors will not further assist . . . [Spotify] in the planning of, or actively participate in, investor meetings.”).

<sup>170</sup> *Id.* at \*8 (“The Investor Day presentation will be treated by . . . [Spotify] as a ‘road show’ for purposes of Section 6(e)(1) of the Securities Act.”).

<sup>171</sup> In its letter, Spotify reserved that it “may engage in potential additional investor education activities. . . including possible follow-up Investor Days and individual meetings with investors.” *Id.* Indeed, Spotify posted four additional decks on its website. *Investor Day—March 2018* (cited in note 26).

2. The financial advisors likely participated in a distribution under either a *Harden* or *Lehman Brothers* interpretation of § 2(a)(11).

Under § 2(a)(11), the underwriter definition also (perhaps more expansively) includes any person who participates in a distribution of securities. The question to consider is thus whether the financial advisors participated in the distribution of Spotify securities. However, as Part III describes, courts are divided over the proper interpretation of the statute. Indeed, there is a burgeoning circuit split on the matter between the Seventh and Second Circuits. This Comment argues that the financial advisors nonetheless qualify as statutory underwriters under either regime.

The relevant provision of § 2(a)(11) defines an underwriter as any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or *participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.*<sup>172</sup>

The Seventh Circuit has interpreted the statute to read that “participates” means to engage in actions “necessary to the distribution.”<sup>173</sup> The key issue in *Harden* was whether a third party who performed due diligence on a registration statement and recommended a minimum yield on a bond offering qualified as a statutory underwriter. In the court’s view, these actions were “necessary to the distribution” and therefore sufficient to conclude that the independent third party qualified as an underwriter.<sup>174</sup>

The Second Circuit, meanwhile, has adopted a narrower reading. Rather than consider whether the actions were necessary to a distribution, the *Lehman Brothers* court considered whether the party itself engaged in a distribution.<sup>175</sup> The court concluded that credit rating agencies involved in structuring mortgage-backed securities did not “participate” in a distribution because their activities were not “distribution-related.”<sup>176</sup> The

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<sup>172</sup> 15 USC § 77b(a)(11) (emphasis added).

<sup>173</sup> *Harden*, 65 F3d at 1400–01, quoting *Holschuh*, 694 F2d at 139 n 13. For further discussion on the breadth of the “participates in an underwriting” language, see Cox, Hillman, and Langevoort, *Securities Regulation* at 345–46 (cited in note 33).

<sup>174</sup> *Harden*, 65 F3d at 1400–01.

<sup>175</sup> *Lehman Brothers*, 650 F3d at 182.

<sup>176</sup> *Id* at 176.

court distinguished the facts from *Harden* by separating those “who provide services that facilitate a securities offering” from those who “participate in the statutorily specified distribution-related activities.”<sup>177</sup> Because the rating agencies merely facilitated the participation of *others* in the offering, as opposed to directly engaging in the purchase or sale of the securities, they did not qualify as statutory underwriters.

Under either the *Harden* or *Lehman Brothers* approaches, the financial advisors are likely statutory underwriters. Under the *Harden* rule, the financial advisors in the Spotify direct listing would likely qualify as statutory underwriters because their activities were necessary to the public listing. Without the financial advisors, Spotify’s shareholders would have been unable to sell their shares on the NYSE. Like the third party in *Harden*, the financial advisors played a critical part in preparing the registration statement. The registration statement is the vehicle through which the SEC enforces its disclosure regime and accordingly holds the drafting parties liable.

The strongest argument against a finding of liability for the financial advisors under *Harden* is the fact that the third party in *Harden* assumed underwriter liability.<sup>178</sup> However, we do not know whether the investment banks in the Spotify listing assumed or expressly waived liability. Assumption nonetheless seems secondary to the purpose for imposing liability: to ensure complete and accurate disclosure. The financial advisors were involved in multiple steps of the offering. First, they helped draft the registration statement. Second, they prepared the investor material. Third, one advisor also provided an independent valuation and worked with the DMM to determine the opening price.<sup>179</sup> The multiple touchpoints in the process weigh in favor of holding parties liable for any material misstatements or omissions.

The argument for a finding of liability also likely succeeds under a *Lehman Brothers* interpretation. The financial advisors were much closer to the actual sale of securities in the Spotify direct listing than the credit rating agencies were in *Lehman Brothers*. In *Lehman Brothers*, the court emphasized that the credit rating agency defendants merely facilitated the distribution by others. While perhaps necessary to the ultimate sale of

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<sup>177</sup> *Id.*

<sup>178</sup> *Harden*, 65 F3d at 1402–03.

<sup>179</sup> This Advisor was Morgan Stanley. Spotify, *Amendment No. 3 to Form F-1* at 46, 185 (cited in note 47).

the mortgage-backed securities, the evaluation of credit risk was not inherent to the sale because the Second Circuit saw, in formalist terms, the process of creating the security as distinct from the process of selling it. In discussing the relevant precedent, the court emphasized that its analysis was “consistent with” *Kern’s* language about “essential” roles in a distribution.<sup>180</sup> Here, the financial advisors both prepared the full registration statement under which the securities were registered and drafted the investor education materials. Presumably, the registration statement could not have been prepared without investment banking support because companies rely on bankers’ expertise in marketing securities to the public.<sup>181</sup> This behavior would fall under the “statutorily specified distribution-related activities” requirement of the *Lehman Brothers* court.<sup>182</sup> Moreover, Spotify acknowledged that the price determination would be based, in part, on Morgan Stanley’s understanding of Spotify’s ownership and prelisting buying interest.<sup>183</sup> The registration statement and pricing analysis have a much more direct role in “distribution activities” than, say, helping to amend the NYSE rules that later facilitated the distribution. Therefore, because the financial advisors were necessary to the distribution and because they were much closer to the actual sale of securities than credit rating agencies, underwriter liability should attach.

Importantly, the reading of § 2(a)(11) that this Comment proposes is not so broad as to cover the nonbank entities involved in the process. Rather, the definition remains properly confined to those who participate in the statutorily defined distribution activities. This Comment is not calling for general advisor liability but instead for modestly ensuring that the safeguards in the registration process continue to exist.

#### B. Underwriter Status Is Consistent with Congressional Intent and Achieves the SEC Policy Goal of Investor Protection

Based on the foregoing analysis, the financial advisors are likely liable as underwriters in the Spotify direct listing. Although this may appear at first blush as if it would have a negative impact on the future viability of direct listings, this Comment posits

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<sup>180</sup> *Lehman Brothers*, 650 F3d at 177–78 & 178 n 7.

<sup>181</sup> See Part IV.B.

<sup>182</sup> See *Lehman Brothers*, 650 F3d at 176.

<sup>183</sup> See text accompanying notes 95–96.

otherwise. From a policy perspective, holding financial advisors in a direct listing liable as underwriters can benefit the investing public while still capturing the efficiency benefits of a direct listing. The twin aims of the Securities Act are to protect investors through disclosure while fostering capital formation.<sup>184</sup> If one accepts the premise that public companies are a net positive for the US economy,<sup>185</sup> and if one accepts that direct listings are an efficient way of creating public companies by lowering the cost and increasing the speed at which companies can go public,<sup>186</sup> then one must be careful to not lose the benefits of direct listings by imposing additional liability on the process.

It is important to keep in mind that the risk of material misstatement or omissions in a registration statement is no lower in a direct listing than it is in a traditional IPO.<sup>187</sup> After all, Spotify used the same form used in IPOs.<sup>188</sup> Why should the liability rules be any different with respect to preparing information for the same filing form? The incentives are slightly different. In a traditional IPO, the underwriter is compensated in large part based on the spread between the offer price and sale price to the public, so there exists an incentive to cause the price to be as high as possible. In the direct listing, there is no premarket pricing, but the reputation of the investment banks and issuer are still important factors to consider. Moreover, there is no reason why § 11 liability would not attach to the issuer, Spotify.<sup>189</sup> Additionally, the investment banks retain their *BarChris* due diligence defense. This Comment posits that the marginal increase in cost from imposing liability on underwriters does not offset the gains

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<sup>184</sup> *Regulation of Securities*, S Rep No 47, 73d Cong, 1st Sess 1 (1933) (“The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.”).

<sup>185</sup> See generally Frank Partnoy, *The Death of the IPO* (The Atlantic, Nov 2018), archived at <http://perma.cc/M6T6-R7DW> (discussing the economic growth a robust public market creates); David Weild IV and Edward Kim, *A Wake-Up Call for America* (Grant Thornton LLP, Nov 2009) (discussing the decline in IPOs and its negative impact on jobs); Ted Kaufman, *Kaufman Calls Decline in IPOs “Choke Point” to Job Creation, Economic Recovery* (University of Delaware Library, Dec 16, 2009), archived at <http://perma.cc/RK7V-ES5D>.

<sup>186</sup> See Part II.A.

<sup>187</sup> This Comment does not allege that there are any material misstatements or omissions in the Spotify registration statement.

<sup>188</sup> The Spotify registration statement contained a “Plan of Distribution” section rather than an “Underwriting” section. See Spotify, *Amendment No 3 to Form F-1* at 185 (cited in note 47).

<sup>189</sup> See 15 USC § 77k(a)(1).

direct listings create. By potentially increasing the quality of information disclosed, such a threat could make direct listings even more attractive going forward by making the product safer for investors.

Since 1997, the number of companies listed on US exchanges has declined by more than 50 percent.<sup>190</sup> Professor Frank Partnoy has suggested some potential reasons for this trend, including the high costs of going public and the steady deregulation of private markets.<sup>191</sup> As private investments become less regulated, more money has flown to private markets. Direct listings have the ability to reduce the cost of going public directly by eliminating the direct underwriting spread fee.<sup>192</sup> It also provides the liquidity solution without dilution or a lockup period. But does a direct listing make it easier for companies to take advantage of unsophisticated investors? Underwriter liability can ensure this does not become the case.

The first argument for underwriter status follows from the role that the registration statement serves in an offering. It is the primary document on which investors rely when considering an investment. In the House report accompanying the Securities Act, Congress explicitly stated its intent to impose § 11 liability on those who are “responsible for” the disclosure in registration statements.<sup>193</sup> Indeed, Congress sought to ensure that persons “who sponsor the investment of other people’s money [are] held up to the high standards of trusteeship.”<sup>194</sup> Because the financial advisors were explicitly retained to prepare the registration statement in the Spotify direct listing, liability is justified given Congress’s clear statement of intent.

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<sup>190</sup> For an explanation attributing this decline to growing incentives for small firms to sell to a larger organization, see Xiaohui Gao, Jay R. Ritter, and Zhongyan Zhu, *Where Have All the IPOs Gone?*, 46 *J Fin and Qualitative Analysis* 1663, 1690 (2013) (“[F]ewer firms are going public and staying independent because greater value is created in a sale to a strategic buyer in the same or a related industry.”).

<sup>191</sup> Private assets under management were under \$1 trillion in 2000 but surpassed \$5 trillion in 2017. Partnoy, *The Death of the IPO* (cited in note 185); Eaglesham and Jones, *The Fuel Powering Corporate America* (cited in note 4).

<sup>192</sup> Commissioner Jackson calls these fees a “middle-market tax” that can deter small and midsize companies from going public. Jackson, *The Middle-Market IPO Tax* (cited in note 41). See also notes 41–44 and accompanying text.

<sup>193</sup> *Securities in Interstate Commerce*, HR Rep No 85, 73d Cong, 1st Sess 5 (1933) (“[The] essential characteristic [underlying § 11 liability] consists of a requirement that all those *responsible for* statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary.”) (emphasis added).

<sup>194</sup> *Id* at 3.

As Professor Jennifer O'Hare points out, and cases such as *Chinese Consolidated* support, control over a registration statement can result from a party's involvement in a distribution absent any formal contractual obligation.<sup>195</sup> In her article, O'Hare argues that underwriter liability should not attach to institutional investors who exercise registration rights in an offering because such investors are not responsible for and do not have contractual control over the contents of a registration statement.<sup>196</sup> Applying O'Hare's analysis to the Spotify direct listing supports finding underwriter status for the financial advisors. They clearly played a significant contractual role in drafting the registration statement and Investor Day materials. While the financial advisors did not provide capital as they would have done in a traditional underwriting, their expertise and opinions likely shaped how Spotify marketed its business to the public, which further supports finding underwriter status.

A second, related argument in favor of underwriter liability follows from the "gatekeeper" theory pioneered by Professors Ronald Gilson and Reinier Kraakman.<sup>197</sup> Gilson and Kraakman refer to traditional underwriters as "reputational intermediaries" that the public trusts when evaluating investment opportunities, particularly innovative ones.<sup>198</sup> First-time issuers, such as Spotify, face a series of costs when going to the market, including a lack of capital to invest in a reputation, a lack of time to build a

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<sup>195</sup> O'Hare, 1996 Wis L Rev at 254 (cited in note 143); *Chinese Consolidated*, 120 F2d at 740–41.

<sup>196</sup> O'Hare, 1996 Wis L Rev at 252–54 (cited in note 143), citing HR Rep No 85 at 5 (cited in note 193).

<sup>197</sup> Ronald J. Gilson and Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va L Rev 549, 613–21 (1984) (discussing the role of investment banks as reputational intermediaries between issuers and investors). For different variations on this theory, compare generally John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 BU L Rev 301 (2004) (arguing for a strict liability regime limited by claim size), with Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 Wash U L Q 491 (2001) (arguing for a strict liability regime with a rule change option). For a dissenting view, see Saul Levmore, *Efficient Markets and Puzzling Intermediaries*, 70 Va L Rev 645, 657–59 (1984) (challenging the Gilson and Kraakman hypothesis).

<sup>198</sup> Gilson and Kraakman, 70 Va L Rev at 618 (cited in note 197):

If distribution and risk sharing do not adequately account for the investment banker's function, some additional factor must be at work. Our analysis suggests that investment bankers play a third role, that of an information and reputational intermediary, *which is particularly important in the context of new issues and other innovations.*

(emphasis added).

reputation, and a “lingering suspicion” from prospective buyers.<sup>199</sup> Because investment banks are repeat players in the capital markets industry and therefore do not face the same bonding costs as first time issuers, investment banks can lower the cost of the offering by “rent[ing]” their reputation to the issuer.<sup>200</sup> Professor Michael Dooley connects this point to liability and registration statements:

[T]he underwriter’s self-interest in avoiding liability and preserving its own reputation may go a long way toward ensuring the accuracy of the registration statement and prospectus. The managing underwriter occupies a position with respect to the issuer which is both semi-adverse and not without clout, because withdrawal of the [underwriter] may effectively eliminate the chances of a successful offering.<sup>201</sup>

This role is only amplified in cases of innovations, such as Spotify’s direct listing. In the registration statement, Spotify expressly names the financial advisors.<sup>202</sup> Putting these names out into the world signals to investors that large financial institutions with strong reputations have kicked the tires on Spotify’s financials. While the banks did not participate in a traditional road show or build a book of potential investors, they still helped prepare the financial statements on which the public is presumed to rely for § 11 liability purposes. There is little doubt that the financial advisors’ role, however defined, provided some level of comfort to investors around the offering.<sup>203</sup> Gilson and Kraakman

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<sup>199</sup> Id at 619–20. One of the reasons Spotify chose to do a direct listing was because it had a “well-known brand, global scale, a relatively easily understood business model, and a transparent company culture.” Jaffe, Rodgers, and Gutierrez, *Spotify Case Study* at \*2 (cited in note 45). Presumably this helped to reduce the need to do a firm commitment underwriting. Nonetheless, the financial advisors likely helped lower the remaining investor education bonding costs by drafting the registration statement and Investor Day materials.

<sup>200</sup> Gilson and Kraakman, 70 Va L Rev at 620 (cited in note 197) (“In essence, the investment banker rents the issuer its reputation. The investment banker represents to the market . . . that it has evaluated the issuer’s product and good faith and that it is prepared to stake its reputation on the value of the innovation.”).

<sup>201</sup> Dooley, 58 Va L Rev at 786 (cited in note 116) (citations omitted).

<sup>202</sup> Spotify, *Amendment No. 3 to Form F-1* at 186 (cited in note 47). While Spotify makes clear that the financial advisors were not acting as underwriters and does not feature Morgan Stanley, Goldman Sachs, and Allen & Company prominently on the cover page, the banks’ substantial role in the process likely had some positive impact on prospective investors.

<sup>203</sup> For discussion of this theory in the context of the Spotify direct listing, see Maureen Farrell, *Private Trades in Spotify Shares to Play Key Role in Upcoming Debut* (Wall St J, Feb 19, 2018), online at <http://www.wsj.com/articles/private-trades-in-spotify>

also point out that a “sizable percentage” of typical underwriting compensation goes to participants who do not actually participate in the selling of securities, suggesting there are other purposes the underwriters serve.<sup>204</sup>

The consequences of underwriter liability in a direct listing are the increased costs of going public. This could make direct listings less attractive, which matters on the margin if one considers them to be a more efficient way of going public. Even so, direct listings will still be cheaper than a traditional IPO. The largest component of an underwriters’ fee is the spread that it realizes when it resells the securities in a firm commitment offering. Because that process is necessarily lacking in a direct listing, this new product will be cheaper.<sup>205</sup> However, courts should not be willing to sacrifice investor protection for efficiency. If direct listings serve the purpose of getting securities into the hands of common investors more quickly and through fewer intermediaries, then ensuring accuracy becomes even more essential. Moreover, imposing liability on underwriters will not destroy the efficiency gains because of (i) tracing challenges when there are both registered and unregistered securities and (ii) the due diligence defense. Thus, while litigation costs may increase, there are sufficient hurdles in place to prevent overdeterrence.

#### CONCLUSION

The Spotify direct listing represents a potentially significant shift in securities capital markets. There are many established

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-shares-to-play-key-role-in-upcoming-debut-1519041600 (visited Mar 8, 2019) (Perma archive unavailable) (“[T]he company and its banks are expected to have a role in helping guide the market to a price and connecting buyers and sellers initially.”).

<sup>204</sup> Gilson and Kraakman, 70 Va L Rev at 617 (cited in note 197). Another question that presents itself is whether this direct listing was just a “backdoor IPO.” Only 31 percent of the shares were not eligible to be sold to the public. The other 60 percent of the Spotify shares, excluding the 9 percent subject to a lockup agreement, already were eligible to be sold without registration. Yet there was no public market into which those shares could be sold. The direct listing created a market, presumably at a lower cost than a traditional IPO. The SEC has expressed concern about these types of “too clever by half” maneuvers. See generally, for example, Erik P.M. Vermeulen, *High-Tech Companies and the Decision to “Go Public”: Are Backdoor Listings (Still) an Alternative to “Front-Door” Initial Public Offerings?*, 4 Penn St J L & Intl Aff 421 (2015).

<sup>205</sup> Indeed, one commentator has remarked on the potential for direct listings to drive down underwriting fees significantly. See Matt Levine, *Bankers Can’t Feel Great Helping Slack Go Public* (Bloomberg, Feb 5, 2019), online at <http://www.bloomberg.com/opinion/articles/2019-02-05/bankers-can-t-feel-great-helping-slack-go-public> (visited Feb 12, 2019) (Perma archive unavailable).

technology companies that have had tremendous success in raising capital in private markets and are now looking to go public. Will others follow the path? Or will the specter of § 11 liability keep unicorns away? Maybe not. Slack has already filed a registration statement with the SEC in pursuit of a direct listing for Spring 2019. Slack is also reportedly using the same three investment banks that Spotify retained as financial advisors—parties that this Comment asserts qualify as underwriters for purposes of § 11. Are there underlying underwriters in the Slack process? To borrow language from the late Professor Louis Loss, § 11 liability is not likely to become the “bête noire” of direct listings,<sup>206</sup> and clarity around the specter of such liability will lower uncertainty for future unicorns, reduce verification costs for prospective investors, and ultimately provide higher returns to shareholders.

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<sup>206</sup> See Loss, Seligman, and Paredes, 2 *Securities Regulation* at 1599 (cited in note 113).