IPOs, SPACs, and Direct Listings, Oh My!

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May 21, 2021

Ding, dong, the IPO is dead? Although sung more often as a funeral dirge than a celebratory ditty, this refrain has echoed often over the past twenty years. But last year, something was different: U.S. exchanges experienced the largest increase in public listings since the late 1990s.

While the hot stock market undoubtedly played a role in the uptick, alternatives to traditional initial public offerings (IPOs) have been making it easier for companies to take the plunge. As NYSE President Stacey Cunningham put it, for public listings, "[t]here's been more innovation in the last two years than in the last two decades."

Yet, as is often the case, this innovation has been the subject of scrutiny. On May 24, 2021, the House Financial Services Subcommittee on Investor Protection, Entrepreneurship and Capital Markets is holding a hearing entitled, "Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections." Plainly, the hearing's title contemplates the need for more "investor protection," also known as regulation. While investors should have accurate information about their investments, additional regulatory requirements can quickly do more harm than good, especially where investors benefit from more paths to public listing.

It's been clear for years that the traditional IPO process fails as a "one-size-fits-all" approach, with many companies choosing to remain private rather than run the IPO gauntlet. In a traditional IPO, a company taps the public market to raise capital. For a hefty fee, investment bankers underwrite the offering, promote the company, and figure out the price at which to sell the shares. The review by the Securities and Exchange Commission takes about four to six months, but companies often spend a year or more preparing. And company insiders are usually not permitted to sell their shares until six months after the IPO. In addition to the direct costs in fees and time, many companies see money left on the table, as the stock's price often is intentionally set below what the market is expected to bear.

Direct listings, by contrast, appeal to companies who want to save on investment banking fees, have their price set by the market, and let their insiders sell shares. A number of tech companies have taken this route since 2018, including Spotify and Coinbase. Direct listings offer a startup's out-of-the-garage-era employees and angel investors the opportunity to reap a greater return on their relatively high-risk investments.

Until recently, a company could only list already existing shares to be traded, meaning that a direct listing was only an option for a company that did not need of new capital. But newly approved rules permitting companies to raise capital through a direct listing may make this path to public trading more attractive to a wider group.

Special purpose acquisition vehicles (SPACs) are another IPO alternative that has become increasingly popular. A SPAC is formed to raise money to complete a merger with a private company, and the private company assumes the SPAC's place as a publicly traded company. While the SPAC itself goes through a traditional IPO process, that process is far simpler when there is no operating business to evaluate. And the private company avoids the costly and time-consuming process altogether by merging with the SPAC afterwards. SPACs are also a capital raising event for the private company, who benefits from the SPAC's funding and other investors interested in the soon-to-be-public company.

A merger also affords private companies more flexibility to talk about their business, particularly their expectations for the future, than an IPO. In this way, a SPAC merger can be an attractive option for private companies who have yet to turn a profit, but have high hopes and capital raising needs pinned on technological advancement or other innovations.

All of these options are not just good for companies; they are good for investors too. Where more and more firms have looked to the regulatory landscape and chosen to remain private for longer, reversing this trend would benefit the broader American economy, not just financial-industry insiders. Direct listings and SPACs may encourage companies to go public that otherwise have spent their high growth years private, out of reach of most retail investors.

Of course, there's no guarantee that all of the companies that join the publicly traded ranks will be successful — that's true regardless of the route taken. But even if potential returns are no more robust, encouraging more companies to join the public markets gives investors more choice.

Instead of setting sights on further regulating innovation in public listings, the focus should be on understanding why many companies have preferred to stay private rather than go through a traditional IPO. Making the traditional IPO a more attractive option can only benefit investors and businesses, who should not have to follow the one yellow brick road to the public markets.

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