



## Direct Listings: A More Certain Path to Nasdaq

### Executive Summary

A structurally compromised IPO market has prevented many deserving companies from going public and enjoying the many benefits associated with having public company status, such as higher valuations, superior access to capital and a stock currency for acquisitions. It needn't be this way. For public-ready companies, there is an alternative to the traditional IPO that is not fraught with the uncertainty that by definition characterizes a firm commitment initial public offering. That alternative is a so-called "direct listing." Unlike the IPO, which combines a public offering and an exchange listing in a single step, the direct listing separates the going public process into two discrete steps – an exchange listing and a subsequent follow-on or alternative registered offering. The direct listing process provides a relatively quick, certain and cost effective way to get access to these capital raising options – all of which can be completed using what is known as a shelf registration – where shares are SEC registered in advance and then sold "off the shelf" when market conditions are most favorable. This white paper explains what a direct listing is, how it works, why it should be considered as an IPO alternative, what capital raising options are available to exchange-listed companies, including and especially those companies that go public through a direct listing, and how today's volatile capital markets are more receptive than ever to registered offerings by already public companies.

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This white paper has been organized in the following sections:

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## **Traditional IPOs Not the Only Option**

### **Following the Smart Money**

In 2006, private equity pioneer and giant Kohlberg Kravis Roberts & Company (“KKR”) announced its intention to list its own shares and raise \$1.25 billion via a traditional IPO, following the example set by the Blackstone Group, its peer. With the leveraged buyout boom at its peak, the irony that the paragons of the “going private” industry were striving to go public was delicious. As co-founder Henry Kravis told *Businessweek*, KKR needed “more control over our destiny” and listing the firm’s shares in the public marketplace would deliver exactly that.<sup>1</sup>

Savvy businessmen have long been aware of the benefits of taking a company public.<sup>2</sup> Going public boosts a firm’s financial position, its credibility and its growth potential. “The smart money already knows to do this,” says Prof. James Brau of BYU.<sup>3</sup> If money can be “smart,” then KKR certainly fits the bill, and their decision was hardly surprising. However, by 2007 the gathering credit crisis overshadowed the planned IPO and dimmed its probability of success, whether measured in either the sum that could be raised or the valuation that might be achieved. Accordingly, the IPO was scrapped at the end of August that year.

As it turns out, smart money can also be persistent. KKR was not about to let market conditions derail its plans to become a public company. In July 2008, the firm declared its intention to list its shares without issuing new stock. In October 2009, KKR & Co. merged with its Channel Islands-based affiliate, KKR Private Equity Investors, which was already trading on the NYSE Euronext in Amsterdam, as a precursor to an eventual listing on the New York Stock Exchange. Finally, on July 16, 2010, KKR upgraded its shares to the Big Board...without raising a single dollar of new capital. Voilà! The firm had just completed a direct listing.

The KKR case study bears an important lesson for entrepreneurs: The initial public offering is not the only way to go public. Now more than ever, firms contemplating a public listing must be aware of the direct listing as a credible and viable alternative to the traditional, firm commitment, underwritten IPO.

### **The Uncertainty of the Traditional IPO**

Leaders of companies that would otherwise like to go public often forego this option because they think that their company may be too small, or the timing imperfect, or Sarbanes-Oxley too costly, or for other reasons. In a related white paper, *Why Go Public?: The \$100 Million Question*, we set the record straight on a number of these myths. But perhaps the biggest objection such leaders have is simply the uncertainty that the IPO may not be successfully priced – what happens then? The prospect of not raising a single dollar, after spending a significant amount of time and company treasure, is hardly enticing when a company’s success story is on the line. A host of factors has steadily raised the IPO bar over the last decade, heightening the uncertainty of a successful transaction, particularly for small issuers, who find it harder than ever to access public equity markets.

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<sup>1</sup> Thornton, Emily. “Can KKR Make Like Berkshire Hathaway?” *Bloomberg Businessweek*, December 10, 2009.

<sup>2</sup> For more information on the merits of going public, please refer to our white paper, *Why Go Public?: The \$100 Million Question*, July 2010.

<sup>3</sup> Cowan, Lynn. “IPOs, It Seems, Are Key To M&A Success.” *Dow Jones Newswires*. July 6, 2010. Accessed from <http://blogs.wsj.com/venturecapital/2010/07/06/ipos-it-seems-are-key-to-ma-success/> on August 10, 2010.

The flaw in this perspective is the underlying assumption that there is only one way to go public. One alternative way to go public is the direct listing, which separates the going public process into two discrete steps – an exchange listing and a subsequent follow-on or alternative registered offering. Compared to the traditional IPO, the direct listing offers a far more certain path to an exchange listing for companies that otherwise meet the exchange listing criteria<sup>4</sup> and are able to meet their business and financial performance targets.

This means that when a company has committed to becoming public, it must first evaluate whether it should pursue a traditional IPO or the direct listing alternative. It should not assume that the traditional IPO is the only viable option.

### **Why a “Firm Commitment” isn’t Firm**

An IPO is by far the best way to go public, providing the issuer is reasonably certain that the transaction can be successfully completed. Nearly all IPOs today are underwritten on a “firm commitment” basis. This means that the investment bank or syndicate buys the shares directly from the issuer and then resells the shares to the public, and is compensated by an “underwriting discount,” generally between 6% and 10% of the offering proceeds, and other forms of compensation, such as underwriter warrants and an expense allowance.

*Question:* How firm is a firm commitment underwriting agreement?

*Answer:* Not firm at all. It is actually a free option a prospective issuer gives to an underwriter: When market conditions are sufficiently favorable, the underwriter exercises the option and “prices” the IPO. This free option is typically contained in a letter of intent between the lead underwriter and the issuer, which gives the underwriter the right, but not the obligation, to price the IPO if all goes well. In return, the issuer commits its people and financial resources to an IPO process that typically takes anywhere from four to six months or more to complete – all without a commitment from the underwriter to complete the IPO. This is a one-way street!

Once the IPO diligence and SEC review process are completed, an underwriter marketing an initial public offering begins building an order book. As a rule of thumb, before pricing a transaction the underwriter will typically want a cushion of indicated orders that are, in aggregate, at least one and one-half to two times greater than the amount to be raised. This cushion is required to: (i) minimize risk to the underwriter; (ii) cover the possibility that potential buyers will fail to follow through on their indications of interest, for whatever reason; and (iii) ensure that the underwriter has dry powder in the form of additional buyers ready to take out IPO “flippers” who, despite the best efforts of underwriters, are a constant feature of every IPO. The firm commitment, therefore, typically comes into effect only after the underwriter and issuer agree on an IPO price that will generate enough interested buyers so that the deal is substantially oversubscribed. If the issuer accepts the underwriter’s offered price, then an underwriting agreement is signed typically only *hours* before the stock is set to begin trading.

So in the firm commitment underwriting, the issuer bears all the risks of completion and pricing until the underwriter has determined it has little or no risk that all the IPO shares will be sold. If the

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<sup>4</sup> We define an “exchange” as: the New York Stock Exchange (NYSE), the Nasdaq (Global, Global Select, or Capital Market), or NYSE Amex Equities (formerly known as the American Stock Exchange). See page 9 for a summary of the principal Nasdaq Capital Market listing requirements.

issuer is not willing to accept the price proffered by the underwriter, it has little choice but to postpone or withdraw the IPO, swallow the significant costs incurred for diligence, prospectus drafting and SEC review (which can exceed \$300,000), and ultimately risk the company's capital markets future. Hardly, a balanced proposition!

In 1990, the average IPO deal size was \$35 million. By the end of 2009, that number had increased to \$292 million. From an underwriter's perspective, it is eight times riskier to underwrite an IPO today than 20 years ago. Not surprisingly, the number of IPOs has shrunk, as is clear from trends in the average number of IPOs: 355 per year in the 1990-1995 pre-Bubble era, 467 per year in the 1996-2000 Bubble period, and only 128 IPOs per year in the 2001-2009 post-Bubble years. And if the post-Bubble years are indicative of what the future holds, issuers will continue to face great uncertainty in completing an IPO with nearly 31% of all IPOs filed during 2001-2009 ultimately being postponed or withdrawn. And through August 2010, while 87 IPOs have been priced, a total of 29 IPOs have been withdrawn, a ratio of roughly three to one.

### **Traditional IPO Alternatives**

Fortunately, there are alternative routes to an IPO. In the U.S.,<sup>5</sup> the two most common alternatives have been the "reverse merger" and the "special purpose acquisition company."

A reverse merger is a technique whereby a private company is merged into either a trading or non-trading public "shell" company. The reverse merger may or may not be accompanied by a private placement financing known as a "private investment in public equity," or PIPE. The reverse merger ceased to be an attractive going public option on February 15, 2008, when changes to Rule 144, which governs when a holder of restricted securities is allowed to freely trade them, took effect. A newly created rule, 144(i), states that if a company was ever once a shell company and is not current with its periodic filing requirements, then its restricted securities cannot be freely tradable. While this is only one limitation the SEC imposed on the use of Rule 144 for shell companies or former shell companies, it reflects the SEC's continued stance that regulation of shell reverse mergers is necessary to protect investors from what it perceives as a means of going public which is fraught with abuse. A reverse merger may be followed by a registered offering, but this does not eliminate the Rule 144 taint, the risk of a defective shell company or the high costs typically associated with the purchase of a trading shell (currently about \$300,000) and legal and accounting services for diligence, transaction execution and SEC report preparation.

The other common alternative is the special purpose acquisition company – a type of publicly-traded shell company that raises money through a public offering, and whose purpose is to acquire an operating company that seeks to obtain both cash and public company status. The number of these transactions grew dramatically in 2005-2007 because they effectively contained a free option to hedge funds that were their principal investors. A stockholder of the acquiring public company can vote against an acquisition transaction it dislikes and have most of its cash invested, hitherto held in trust, returned to it. The vehicle worked reasonably well when hedge funds had more money than good ideas. During the recent financial crisis, hedge fund investors wanted their money back

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<sup>5</sup> Non-U.S. alternatives include: the AIM Market on the London Stock Exchange and Capital Pool Companies trading on the Toronto Venture Exchange. These are perfectly acceptable alternatives if the issuer's end-goal is to list on a foreign senior exchange. As a rule, companies should list their shares alongside their peer group. For instance, the Toronto Stock Exchange is home to 55% of the world's mining companies. Because of the inherent difficulties in repatriating a stock listed on a foreign junior exchange, it follows that the company should list its shares on a "stepping stone" exchange located in the same country as its preferred senior exchange. Source: Koyanagi, Janis. Faegre & Benson 2010 Alternative Securities Markets Conference, July 14, 2010.

because the idea of tying up capital in a free option that was unlikely to bear attractive fruit lost its appeal. This has effectively killed this market for the time being.

The third and least understood alternative to a traditional IPO is the **direct listing**. Although a direct listing involves two principal steps – an exchange listing and a subsequent follow-on or alternative registered offering – there are a number of essential building blocks of a direct listing. These building blocks, discussed in detail below, are:

1. **The private placement.**
2. **The registration statement.**
3. **The exchange listing.**
4. **The follow-on or alternative registered offering.**

It is extremely important to understand that the essential building blocks to complete a direct listing, or a traditional IPO for that matter, are not unique. In fact, with the exception of the private placement, the different methods of creating a liquid, exchange-listed stock simply combine and order the steps in different ways. The major advantage of the direct listing process over the more familiar, traditional, “firm commitment” underwritten IPO is the greater certainty of achieving the desired goal – an exchange-listed stock with the ability to raise capital to fund the company’s growth plans.

## **Direct Listings – The Four Building Blocks**

### **The Private Placement**

Companies often do a “pre-public” or “pre-IPO” round of financing to tide them over during the transition from private-to-public status for many reasons. Issuers frequently need to raise capital to cover the expenses associated with achieving public company status. It also behooves an issuer to have a strong balance sheet before commencing a going public transaction of any type (discussed more fully below) because there are few, if any, financing options legally available to issuers having an S-1 registration statement for an IPO on file with the SEC pending review and clearance.

In a typical direct listing, the company will raise capital in a private placement to accredited investors as the initial step in the process. While the amount of this capital raise varies, it is important that sufficient capital be raised to support the company’s growth plans and registration and listing costs until it achieves an exchange listing (typically, within six to twelve months after the private placement offering is completed).

Arguably, private placements in a direct listing may be priced at a higher discount than private offerings completed simultaneous with a reverse merger due to the risk that a direct listing issuer may never become publicly reporting. But, as discussed below, a private placement whose closing is conditioned on the filing of a Form 10 registration statement with audited financial statements should significantly mitigate this risk and eliminate any discount difference.

### **The 1934 Act Registration Statement – Form 10**

A typical condition to the closing of the private placement offering in a direct listing will be the preparation of a Form 10 registration statement under the Securities Exchange Act of 1934, as amended (or “1934 Act”), as well as audited financial statements. Satisfaction of this condition

gives the investor confidence that the company is both committed and capable of going public; thus providing a means ultimately to exit its investment. A 1934 Act registration statement automatically becomes effective 60 days after its filing, as long as all SEC comments are cleared – a deadline that tends to expedite the SEC comment and review process. Upon effectiveness, the issuer becomes a publicly reporting company and must file the periodic reports required under the 1934 Act – providing the immediate transparency also desired by investors. Registration under the 1934 Act also means the company has satisfied one of the principal prerequisites to listing its shares on an exchange.

In a traditional IPO, a company will typically raise capital by issuing new shares of its stock to the public under a Form S-1 registration statement filed under the Securities Act of 1933, as amended (or “1933 Act”). Shares in an IPO cannot be sold to the public until the SEC declares the registration statement effective, which typically takes four to six months (or longer if the SEC has substantial business or accounting comments). While the SEC review process for an IPO and a Form 10 registration statement will likely be comparable, it should be noted the IPO registration is specifically designed to ensure that potential investors receive full disclosure about the risks of purchasing the IPO shares, whereas the Form 10 registration process in a direct listing does not involve the sale of any shares to the public and is merely the means by which the issuer become publicly reporting – a critical step to becoming exchanged-listed.

### **The Exchange Listing**

Most IPO issuers apply for, and obtain, an exchange listing (and ticker symbol) for their shares once the IPO prices. Of course, this assumes the issuer meets the initial listing requirements immediately following the IPO, which is typically the case today as most IPOs raise at least \$25 million. Very few traditional IPOs are completed where the issuer ends up being quoted over-the-counter since most state blue-sky laws provide an exemption from state registrations only if the IPO issuer becomes exchange listed, thus allowing exchange-listed IPOs to avoid an otherwise onerous, expensive and time consuming fifty-state blue-sky registration process.

However, in a direct listing, if an issuer meets the initial listing requirements of an exchange, it applies directly to that exchange for listing and will typically receive its ticker symbol when the Form 10 registration statement becomes effective. Alternatively, for an issuer that does not satisfy all of the listing requirements of an exchange when its Form 10 registration statement becomes effective, it can instead choose to begin trading over-the-counter, either on the Over-the-Counter Bulletin Board (“OTC BB”) or the marketplaces operated by the Pink OTC Markets (“OTC Markets”).<sup>6</sup> Neither the OTC BB nor the Pink Sheets has any formal listing requirements other than having a minimum of around 40 stockholders with freely tradable shares. But to trade on the OTC BB, the issuer must be current with its reporting obligations, while Pink Sheets does not require the issuer to be reporting. In either case, a market-maker is required to file a Form 211 with the Financial Industry Regulatory Authority (FINRA) in order to obtain a ticker symbol.

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<sup>6</sup> Pink OTC Markets categorizes all OTC securities into easily identifiable tiers that help investors readily identify a company's willingness to make disclosure available to investors. The top tier OTCQX marketplace is a quality-controlled market for investor friendly companies that meet the highest financial standards. The next tier is OTCQB, which is designed for smaller U.S. registered and reporting companies that are current in their reporting obligations. Lastly, there is the Pink Sheets for companies that have current, limited or no public disclosure, and provides a speculative trading marketplace that allows broker-dealers to provide high-quality execution services in any OTC traded securities.

Most public-ready firms are able to satisfy the financial requirements for listing on an exchange and, in most cases, issuers pursuing a direct listing will be required to satisfy the exchange governance requirements (e.g., independent board and audit committees) as a condition of the private placement. But many times, direct listing issuers may not have the required stockholder base (e.g., 300 stockholders owning at least 100 shares each for the Nasdaq Capital Market) to qualify for an immediate exchange listing. In these cases, as a stepping stone to a Nasdaq listing, smaller issuers have historically opted to have their shares quoted on either the OTC BB or the OTC Markets in order to increase their stockholder base. In this sense, these over-the-counter venues serve as more of a hotel than a home to these otherwise qualified companies, until they are ready to upgrade to an exchange listing. Of course, an over-the-counter quotation provides the mechanism for liquidity to develop over time, but provides no guarantee that any liquidity will ever develop.

Direct listings can also make use of the free trading shares of angel or early venture investors to create the initial public float to meet the stockholder base requirement, and provide these investors with liquidity. Unlike some IPOs, direct listings do not have a “resale” component for existing stockholders to sell their shares concurrent with the listing. Nonetheless, existing stockholders in a direct listing issuer may have a unique window of enhanced liquidity once an exchange listing is achieved and as part of an initial aftermarket support campaign. Just as with any new product, a newly listed stock requires extraordinary promotional effort to create a widely held, actively traded and fully valued stock. We discuss this topic more fully below, in the section titled “Direct Listing Challenges” on page 16. Please also see our related white paper, *Aftermarket Support: How to Create a Liquid Public Stock*.

Over the past decade, the structure of the U.S. equity markets has changed dramatically. The losers among the stock exchanges are: the regional stock exchanges, now gone; the American Stock Exchange, which has been absorbed by the New York Stock Exchange; and the Over-the-Counter Bulletin Board, which has not kept pace with the electronic trading infrastructure boom and will likely be sold by its operator, FINRA. The survivors include: The New York Stock Exchange, though far less mighty than it once was; Nasdaq, strong and thriving with three distinct listing tiers; and OTC Markets, which has supplanted the OTC BB and now dominates over-the-counter equity trading in the U.S. A summary of the number of issues traded on each exchange or quotation medium is set forth in **Table 1**.<sup>7</sup>

**Table 1: Number of Companies Listed on U.S. Exchanges or Over-the-Counter**

| Exchange  | # of Issues   |
|---|---------------|
| The New York Stock Exchange (NYSE)                          | 1,669         |
| NYSE Amex Equities (formerly the American Stock Exchange)   | 335           |
| Nasdaq (Includes Global, Global Select, and Capital Market) | 2,588         |
| Over-the-Counter Bulletin Board (OTC BB)                    | 2,352         |
| Pink OTC Markets (formerly the Pink Sheets)                 | 6,029         |
| <b>Total</b>  | <b>12,973</b> |

While a direct listing is possible on any U.S. exchange, Nasdaq is clearly the venue of choice for emerging growth companies because:

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<sup>7</sup> Source: Capital IQ. Number reflects public operating companies only as of September 15, 2010.

- It is a wholly electronic trading platform and isn't burdened by a "specialist" trading system.<sup>8</sup>
- It has developed a reputation as the home of growth companies.
- It has lower annual fees than the NYSE.
- It has less demanding requirements for a listing with three different listing tiers.

In order to initially list on the Nasdaq Capital Market, which generally has the most lenient listing requirements of the exchanges, the company must satisfy **one** of the following financial criteria:<sup>9</sup>

- \$5 million in stockholders' equity; OR
- \$50 million in market value of listed securities;<sup>10</sup> OR
- \$750,000 in net income from continuing operations.<sup>11</sup>

Additionally, it must satisfy **all** of the following so-called "distribution" criteria:

- \$4 bid price; AND
- 300 round lot stockholders; AND
- 1 million publicly held shares;<sup>12</sup> AND
- 3 market makers.

As discussed previously, most public-ready private companies will typically meet these Nasdaq Capital Market listing requirements, with the possible exception of the round lot stockholder requirement.

### **The Follow-on or Alternative Registered Offering**

The final building block in a successful direct listing is the completion of a registered offering once the issuer has become publicly reporting and achieved its exchange listing. With the effects of the credit crisis in 2007 and 2008 still looming, the continued absence of traditional small-cap IPOs, and an otherwise uncertain and volatile IPO market, Wall Street sponsorship has moved to those companies that are already public, have a strong balance sheet, have committed to improving trading liquidity and have an exchange listing. In fact, despite a volatile IPO market, it has never been more efficient for small-cap public companies to raise equity whether in a follow-on offering or one of a number of alternative registered offerings.

As **Table 2** below shows, follow-on offerings are the deepest pool of capital available for small cap issuers<sup>13</sup> measured in terms of both the overall number of transactions and the overall amount of

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<sup>8</sup> A specialist is member of an exchange who is designated to act as the market-maker to facilitate the trading of a given stock, including managing limit orders, executing trades, taking contra-trades to stabilize the stock as necessary, and is otherwise charged with maintaining an orderly market in the stock. Since the advent of electronic trading some 25 years ago, the specialist is now really a relic of a bygone era of primarily floor-based trading.

<sup>9</sup> Nasdaq. "Listing Standards & Fees: March 2010." For a more detailed explanation of Nasdaq Capital Market listing standards, please see the appendix thereto.

<sup>10</sup> Securities listed on Nasdaq or another national securities exchange.

<sup>11</sup> In the latest fiscal year or two of the last three fiscal years.

<sup>12</sup> Defined as total shares outstanding, less any shares held directly or indirectly by officers, directors, or any person who is the beneficial owner of more than 10% of the total shares outstanding.

capital raised. This makes sense because follow-on offerings are, by definition, executed by already public companies and therefore not subject to the special circumstances that characterize IPOs. There also appears to be a strong relationship between gross proceeds raised and market cap – with IPOs representing the largest amount of new capital raised (nearly 40% of pre-money market cap), followed by follow-on offerings (roughly 22%), and then registered directs (about 11%).

**Table 2: Small Cap Registered Offerings<sup>14</sup>**  
(all \$ in millions)

| Metric                       | 2009      |            |                   | YTD 2010 <sup>15</sup> |           |                   |
|------------------------------|-----------|------------|-------------------|------------------------|-----------|-------------------|
|                              | IPO       | Follow-on  | Registered Direct | IPO                    | Follow-on | Registered Direct |
| Number of Transactions       | 25        | 232        | 112               | 55                     | 169       | 60                |
| Total Dollar Amount Raised   | \$2,204.4 | \$12,927.1 | \$1,880.3         | \$4,235.5              | \$7,326.7 | \$799.4           |
| Average Dollar Amount Raised | \$88.2    | \$55.7     | \$16.8            | \$77.0                 | \$43.4    | \$13.3            |
| Average Market Cap           | \$224.5   | \$237.0    | \$142.4           | \$203.2                | \$203.2   | \$118.2           |
| Gross Proceeds/Market Cap    | 39.3%     | 23.5%      | 11.8%             | 37.9%                  | 21.3%     | 11.3%             |

Now the better news for those private companies unwilling to take the uncertain IPO path, the direct listing process provides a relatively quick, certain and cost effective way to get access to capital raising options – all of which can be completed by eligible issuers using what is known as a shelf registration, where shares are SEC registered in advance and then sold “off the shelf” when market conditions are most favorable. And, of course, the direct listing issuer who has achieved an exchange listing will also be attractive to PIPE investors, but we believe that the pricing and other terms and conditions of these follow-on and alternative registered offerings are likely to be more favorable to an issuer compared to PIPE offerings. It is also important to point out that smaller public companies tend to gravitate to the registered directs and raise a corresponding smaller amount of capital. As such, any issuer considering a direct listing should ideally start with a follow-on offering after achieving its exchange listing, which will effectively be its initial public offering anyway.

### **Capital Markets Strategies for Exchange Listed Issuers**

#### **Historical Perspective**

Recent turmoil in the capital markets has caused public companies of all kind to become more flexible and creative than ever in order to satisfy their equity financing requirements. To put this in better context, let’s take a brief look at the history of small-cap offerings over the last 20 years.

<sup>13</sup> For this discussion and the related table, small cap issuer means an issuer with a market capitalization of \$500 million or less.

<sup>14</sup> Source: Capital IQ. Includes U.S. exchanged-listed, operating companies with market capitalizations of \$500 million or less. Excludes REITs and closed-end funds. Transactions less than \$5 million in value excluded.

<sup>15</sup> Through September 22, 2010.

During the dot.com bubble years, boutique investment banking firms were able to underwrite sub-\$50 million IPOs for many venture-backed companies. However, the dot.com crash, coupled with a number of other structural changes in the IPO market, brought a quick end to small IPOs, with little hope that this market will ever return except for the most qualified, public-ready companies in the best market conditions.

Following the dot.com bubble, follow-on offerings (i.e., publicly marketed registered offerings after a company's IPO) became popular for those worthy public companies that were able to survive the tech crash. This period also saw the rise of traditional PIPE offerings where accredited investors acquired unregistered shares of public companies at a discount to the market in streamlined transactions. Largely funded by hedge fund investors, these PIPE transactions began to implode when small issuers (many of which were created by reverse mergers) simply did not have the stock liquidity (i.e., daily trading volume) to absorb the "overhang" created in the market when these shares eventually became registered and freely tradable. So like many other structured finance programs developed prior to the financial and credit crisis of 2008, PIPEs suffered a similar fate as only the most liquid investments were left unscathed.

In the aftermath of the recent financial crisis, Wall Street was once again challenged to develop suitable equity financing opportunities for small-cap issuers. At the same time, as part of the SEC's initiatives to increase access to the capital markets for smaller public companies, new regulations were enacted that allowed any exchange-listed company, regardless of size, to use the simpler Form S-3 shelf registration statement to sell registered, freely tradable shares. As a result, in addition to follow-on offerings, exchange-listed companies can now participate in the following types of registered offerings which we refer to as "alternative registered offerings":

- Registered directs;
- Confidentially marketed public offerings, a hybrid of the registered direct and the traditional follow-on offering, that we refer to as an "overnight public offering" or "overnight public;" and
- At-the-market offerings.

### **Follow-on Offerings**

Historically, the most common way for already public companies to raise public equity was through a follow-on offering. In a typical follow-on offering, the issuer files an S-1 registration statement and engages an underwriter to sell new shares of its stock to the public, almost always on a "firm-commitment" basis.<sup>14</sup> The marketing of follow-on offerings is very similar to a traditional IPO with a road show to create broad marketing exposure. But like the traditional IPO, the follow-on offering also carries the "underwriting risk," or uncertainty that the offering will never price. Nonetheless, an already public company that is able to complete a follow-on offering should do so – as this is the most effective way to assure that an issuer's stock becomes widely held, actively traded and fully valued.

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<sup>14</sup> Follow-on offerings may also be registered on a Form S-3 registration statement if the issuer meets the S-3 eligibility requirements. S-3 filers must generally be exchange listed or have a public float greater than \$75 million, must have been subject to the reporting requirements under the 1934 Act for at least 12 months, and must have timely filed its 1934 Act periodic reports during the last 12 months. A follow-on offering registered on Form S-3 will also be subject to the general limitations on S-3 offerings discussed elsewhere in this white paper.

Follow-on offerings may also be used to sell shares held by early investors to the public – an option not available for registered offerings filed on a Form S-3 which are limited to primary offerings of newly issued shares. This may be important to early investors who would prefer to sell their shares at a fixed price to the public rather than market sales as trading volume permits. Of course, any sales by existing stockholders in a follow-on offering will be largely dictated by the underwriters and the strength of the order book.

Issuers choosing the direct listing path will not be eligible to use the simpler S-3 registration (for either a follow-on or alternative registered offering) until twelve months after they first become a publicly reporting company. This means that they will be limited to an S-1 registered follow-on offering until the first anniversary of their Form 10 registration statement effectiveness. And while capital raising uncertainty is greatest for underwritten IPOs and follow-on offerings, we believe there are some distinct advantages for companies that pursue a follow-on offering as part of a direct listing when compared to private companies attempting an IPO. We believe the direct listing issuer enjoys the following advantages, each of which will be positively embraced by underwriters:

- The issuer has already cleared any SEC comments in its Form 10 registration statement to become publicly reporting which should facilitate the follow-on offering registration process, preparation and SEC review, including potential cost savings and expedited timing.
- The issuer is already listed on an exchange or is otherwise trading, or may be in an advanced stage of achieving approval from an exchange for its listing.
- The issuer has demonstrated to Wall Street that it is capable of meeting the regulatory requirements through the timely filing of its periodic reports.
- The issuer has demonstrated its commitment to the business of being public with a planned aftermarket support program designed to build the stockholder base, improve stock liquidity and attract institutional investors.
- The issuer should be rewarded for delivering a strong balance sheet (which includes the direct listing's pre-public private placement funding) and strengthening its balance sheet.

The marketing of follow-on offerings is very similar to a traditional IPO with a road show taking place to ensure the broadest marketing exposure and to build the strongest order book possible. However, a follow-on offering may carry significant “market risk” between announcement and pricing – meaning the risk that the issuer’s stock price may be adversely impacted in the market during the pendency of an announced public offering. Other advantages and disadvantages of follow-on offerings include:

- **Pros:** Similar to a traditional IPO, in a follow-on offering shares are sold all at once, “locking in” a single market price. The offering allows for the broadest distribution possible, and is not limited to existing investors. As such, the offering is the most effective way to assure that an issuer’s stock becomes widely held, actively traded and fully valued. The average discount to the last trade price prior to follow-on’s announcement has ranged from 3% to 8% during the fourteen quarters through June 30, 2010.<sup>15</sup> There is no exchange-mandated stockholder approval requirement for widely distributed follow-on offerings, as is the case for certain limited distribution alternative registered offerings discussed below. In

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<sup>15</sup> Source: Dealogic ECM Analytics. Excludes SPACs, closed-end funds and REITs.

- addition, for follow-on offerings registered on Form S-1, there are no eligibility or size restrictions as in the case for alternative registered offerings which are registered on Form S-3.
- **Cons:** Follow-on offerings require a significant upfront commitment of time and money, and there is no certainty of success with respect to either issuing price or gross proceeds raised. Unless the issuer is S-3 eligible, and willing to accept the size limitations for S-3 offerings, follow-on offerings must be filed on an S-1 registration statement which is substantially more involved and lengthier than an S-3. And while there is “market risk” between announcement and pricing, issuers do benefit from the broadest marketing effort of all financing options available for direct listing issuers.

### **Alternative Registered Offerings**

While registered directs, overnight public offerings and at-the-market offerings are not new, their availability to already public companies was significantly expanded by the SEC in 2008. Now, any exchange-listed company, regardless of size, can use the simpler Form S-3 shelf registration statement to sell freely tradable shares in an alternative registered offering – a process that typically results in an SEC notice of acceptance or review within one week of filing and, if reviewed, a four to six week review period. Under the new rules, OTC BB listed companies are also eligible to use Form S-3 but only if they have a public float greater than \$75 million. For this reason, the timing and success of the direct listing approach is predicated on the issuer achieving an exchange listing (either directly or via an over-the-counter upgrade).

Issuers must also have been subject to the reporting requirements under the 1934 Act for at least twelve months, and must have timely filed their 1934 Act periodic reports during the last twelve months, before they can use Form S-3 for an alternative registered offering.

Exchange-listed companies also enjoy increased flexibility to sell freely tradable shares when market conditions permit, and at times and under conditions that are most suitable for them, with fewer regulatory requirements. For instance, an eligible issuer can register securities prior to planning any specific offering and, once the registration is effective; can offer securities in one or more tranches for up to three years. And while there is never any certainty in any capital markets transaction unless and until it is completed, the securities offering process for exchange listed companies provides more certainty for a public-ready, private company, especially when compared to the traditional IPO process where the firm commitment underwriting only actually becomes firm as and when there is a priced IPO. Further, this added flexibility may allow already public issuers to avoid a PIPE offering altogether which, under current market conditions, is likely to price at a significantly greater discount to the issuer’s market price due to liquidity risks (i.e., shares issued in a PIPE are not registered and freely tradable, while those issued in an alternative registered shelf offering are).

One drawback of the new Form S-3 rules is the limited amount of capital that can be raised under a shelf registration for smaller exchange-listed companies (i.e., those with a public float less than \$75 million). These smaller companies will only be allowed to sell up to one-third of their public float over any twelve-month period. Thus, to sell \$15 million of registered securities over twelve months, the issuer needs a public float of at least \$45 million, which should generally be the case for most direct listing issuers that have a proven track record of revenue or earnings growth.

In addition, certain exchanges will treat limited distribution, alternative registered offerings as private offerings which could trigger an exchange-mandated stockholder approval if the offering is priced at a discount to market and constitutes more than 20% of the issuer's outstanding shares. For an offering that may be subject to this stockholder approval requirement, exchange-listed issuers must carefully navigate other important considerations. First, an exchange may integrate tranches taken down in a shelf offering within a six month period for purposes of the 20% limitation. It is also possible that an entire offering may be aggregated for the 20% test. These integration rules regularly trip up companies because they inadvertently either exceed the 20% test, or they do not do a public distribution, or they may sell too much to one person, potentially triggering a different exchange rule entirely regarding change of control.

While we believe that these alternative registered offerings add flexibility and certainty compared to underwritten IPOs or follow-on offerings, there is potential overhang and uncertainty associated with an active and open-ended shelf registration that may adversely impact an issuer's stock price. Despite these concerns, however, the shelf filing should not, in and of itself, adversely affect a public issuer's stock price, and recent data show there has been little market reaction to the filing of shelf registration statements.

In the remainder of this section, we will address some of the structural and marketing aspects of the registered direct, overnight public and at-the-market offerings, and the advantages and disadvantages of each.

### ***1. Registered Directs***

In a registered direct offering, the issuer typically sells registered (freely tradable) securities “off the shelf” to a small number of sophisticated investors. The offering is typically marketed by a placement agent, on a confidential and best efforts basis, to investors believed to be well suited for the offering, and which are brought “over the wall” similar to the marketing of a PIPE (i.e., receive material, non-public information about an issuer's capital raising plans).

- **Pros:** The shares are registered in advance and placed on the shelf, which means the shares are freely tradable when issued. Hence, the discount to the market price of the stock at announcement (ranging from 7% to 12% during the six quarters ended June 30, 2010)<sup>16</sup> will be significantly smaller than in a PIPE, which is typically in the range of 15% to 25% for small cap issuers. The consummation of a registered direct is under the issuer's control and pricing is usually announced the night before funding. This allows the issuer to “stealth” market the deal with no “announcement risk” (i.e., the risk of downward market pressure on the issuer's stock price that typically accompanies the announcement and disclosure of plans to conduct a traditional underwritten offering). The registered direct is also faster to complete than follow-on offerings, is generally less costly and generally has the greatest execution certainty.
- **Cons:** The issuer must be eligible to use Form S-3 (i.e., generally must be listed on an exchange, or if quoted on the OTC BB must have a public float greater than \$75 million). In the case of an exchange-listed issuer with less than \$75 million of public float, the registered direct offering cannot exceed one-third of the issuer's public float value. In addition, certain exchanges may consider a registered direct offering to be a private offering which could

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<sup>16</sup>Sagient Research Placement Tracker. Excludes SPACs, closed end funds and REITs.

trigger an exchange-mandated stockholder approval if the offering is priced at a discount to market and constitutes more than 20% of the issuer's outstanding shares. Also, some investors may not want to go "over the wall" and, as a result, potential interested investors may be missed. Registered direct offerings are also more likely to include investor warrants.

## ***2. Overnight Public Offerings***

Overnight public offerings, also known as confidentially marketed public offerings, are really a hybrid which combines the speed and confidentiality of a PIPE with an underwritten shelf-based follow-on. Overnight public offerings start like a traditional registered direct with confidential marketing to so-called "wall crossed" investors to build the initial order book. Then the offering is switched to a publicly marketed, underwritten offering with a broader marketing effort handled by co-managers and syndicate members. The public selling process commences after the stock market closes and typically concludes by the opening of the market the next day.

- **Pros:** Similar to registered direct offerings, the shares in an overnight public offering are registered in advance, placed on the shelf and are freely tradable when issued. The funding of an overnight public offering is also under the issuer's control, and the issuer can wait until market conditions are favorable. This offering allows the syndicate to build a stronger and broader order book than the registered direct. An overnight public offering is also generally faster to complete than a follow-on, which typically involves a road show following the announcement and before pricing. The exchange-mandated stockholder approvals may not apply to overnight public offerings depending on the extent of public distribution, the offering's pricing relative to market price, and the number of shares involved.
- **Cons:** Like registered direct offerings, the issuer must be eligible to use Form S-3 and, if the issuer has less than \$75 million of public float, the overnight public offering cannot exceed one-third of the issuer's public float value. However, unlike registered direct offerings, there may be a limited "market risk" once the switch to a publicly marketed offering is announced if the deal is not priced by the opening of the market the day after the announcement. For this reason, the sooner the broader marketing effort is concluded and the deal is priced, the better.

## ***3. At-the-Market Offerings***

At-the-market offerings ("ATMs") allow Form S-3 eligible issuers to sell registered shares off the shelf pursuant to Rule 415(a)(4) and into the market. Unlike registered direct offerings, ATMs are typically conducted over an extended period of time and are generally "taken down" when market conditions are favorable as determined by the issuer. Also, unlike registered direct offerings, shares in an ATM offering must be sold at the prevailing market prices (i.e., without discount),<sup>17</sup> and no shares may be sold when the insider trading window is closed, typically around earnings announcements. Since shares in ATMs are being sold into the market by a registered broker-dealer, the issuer must maintain an updated prospectus, and Regulation M requirements may come into play.

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<sup>19</sup> ATMs may also be structured as a put arrangement, commonly referred to as an "equity line", where usually a single investor agrees to purchase a specified dollar amount of shares at a price based on a pre-determined discount to the current market price, subject to certain minimum trading volumes over a recent number of days. For this reason, ATMs are somewhat of a misnomer since shares can be sold at a discount to market in a limited distribution, which may trigger exchange-mandated stockholder approvals. For purposes of this white paper, our discussion of ATMs excludes equity lines and other limited distribution put arrangements.

- **Pros:** Similar to registered directs and overnight publics, the shares in ATMs are registered in advance, placed on the shelf and are freely tradable when issued. The shares are sold at the prevailing market (without discount) which means that the offering typically has little or no market impact on the stock price. ATMs are a remarkably flexible option for raising equity capital, and selling shares on a limited, continuous basis allows an issuer to precisely control both the price and quantity at its discretion. Exchanges treat these offerings as “public offerings,” which means there are no stockholder approval requirements.
- **Cons:** Like registered directs and overnight publics, the issuer must be eligible to use Form S-3 and, if the issuer has less than \$75 million of public float, the ATM offering cannot exceed one-third of the issuer’s public float value during a twelve month period. ATMs must be conducted in the public eye, but – and this is critical – they can be confidentially marketed to institutional investors. However, there is generally no certainty as to the amount raised or the ultimate timing of proceeds from an ATM offering.

### **Direct Listing Challenges**

While the direct listing, coupled with the financing options available to exchange-listed issuers, can potentially be a viable financing alternative to a traditional IPO, there are two important challenges that need to be understood before pursuing such a transaction:

1. **Can’t Raise Money Later.** An issuer that goes public through a direct listing in the hopes of raising capital later may simply prove unsuccessful despite the many different offerings available to already public, exchange-listed companies. In that case, an issuer would have the worst of all worlds – the costs and burdens of going and being public without one of the principal corresponding benefits, namely superior access to capital. In the case of a traditional IPO, the successful issuer is, by definition, at least sure to raise money since a failed IPO in itself does not cause an issuer to become publicly reporting. The direct listing issuer is best protected against this risk by completing a round of “pre-public” financing, getting exchange-listed and implementing an aftermarket support program. Not only does the “pre-public” financing give the issuer some of the money it needs before filing to become publicly reporting, but, more importantly, the successful financing provides a test of the issuer’s appeal with institutional investors.
2. **Illiquid Stock.** The other principal challenge that potential direct listing issuers face is the aftermarket. Public companies can enjoy many benefits, not the least of which can be significantly higher valuations and superior access to capital, compared to privately owned businesses. These benefits, however, are conditional on the existence of a “liquid” market for the company’s shares. For a smaller public issuer, the lack of liquidity can prevent its stock from achieving the higher valuation enjoyed by its peer group, thereby negating one of the primary benefits of being public in the first place. The goal of any publicly traded company should be to have its stock become widely held, actively traded and fully valued. Moreover, ideally there should be research coverage by at least one equity research analyst. Underwriter support in the traditional IPO typically provides a built-in mechanism for generating liquidity and analyst coverage automatically from the outset. In the case of a direct listing, however, issuers have to work proactively, tirelessly and cleverly in order to create this liquidity. For a complete discussion of this very important subject please see our related white paper, *Aftermarket Support: How to Create a Liquid Public Stock*.

**Conclusion: Direct Listings Must be Considered as an Alternative to Traditional IPOs**

While the underwritten follow-on offering should always be the preferred option for a direct listing issuer, the recent volatility in the U.S. capital markets has made investment bankers and issuers wary of underwritten public offerings. To avoid the upfront time and cost commitment, the execution uncertainty and the market risks associated with a follow-on underwriting, the alternative registered offerings have been gaining popularity with small cap issuers and their advisers. Among these alternatives, the at-the-market offering probably has the next highest level of execution uncertainty, but the simplicity of this agent-sponsored program cannot be ignored, especially where the company's trading volume is relatively high and its financial results are driving a favorable stock price trend.

But what if the risk-averse direct listing issuer is not interested in either the underwritten follow-on or the ATM offering? For such an issuer, the registered direct offering provides the greatest execution certainty and a fast track way to raise capital confidentially without market risk. And the bonus for the risk-adverse issuer is, if the "wall crossed" investors show substantial interest, the ability to flip the confidential registered direct deal to an overnight public offering with few additional regulatory or exchange requirements.

So before we close, why should a private company consider the direct listing in addition to the traditional IPO? The direct listing process provides a simple, cost effective way for a private company to become publicly reporting and exchange listed in a relatively short time. Once that it is done, an issuer can pursue an underwritten follow-on offering. Or, the issuer can take advantage of three alternatives to raise capital, each of which provides immediate liquidity to the investor and, collectively, provides far more certainty in today's volatile capital markets. And as recent data suggests, Wall Street bankers appear to be favoring financings for high quality, already public, small cap companies as a way to lessen reliance on the cyclical, and more volatile, IPO market. These financings for already public companies are perfectly suited for a direct listing issuer.

So when should an issuer pursue a traditional IPO – a path with only a single financing option – where the underwriter determines if market conditions are right and is sufficiently oversubscribed to eliminate its risk? Only when the company's growth plans will not be derailed by delay or postponement of its capital market plan; or when there is certainty, or at least relative certainty, of being able to price the IPO! Certainty is a commodity in very short supply in today's volatile and fickle capital markets. Ultimately, the goal for any public company is to have widely held, actively traded and fully valued exchange listed stock. Of all the paths available that are alternatives to the IPO, the direct listing is the preferred and most certain solution.

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### **About Keating Investments:**

Keating Investments, LLC is a Denver-based SEC registered investment adviser founded in 1997, and is the investment adviser to Keating Capital, Inc. ([www.KeatingCapital.com](http://www.KeatingCapital.com)). Keating Capital is a business development company that specializes in making pre-IPO investments in innovative, high growth private companies that are committed to becoming public. Keating Capital provides individual investors with the ability to participate in a unique fund that invests in a private company's late stage, pre-IPO financing round — an opportunity that has historically been reserved for institutional investors.

### **About the author:**

Rick M. Schweiger is a member of the Investment Committee of Keating Investments. From 1999 to March 2010, Mr. Schweiger was the owner of Garisch Financial, Inc., a firm providing business and financial consulting services to private companies, including private operating companies interested in raising private or public financing as part of a going public strategy. Prior to founding Garisch Financial, Inc., Mr. Schweiger spent nearly 15 years advising middle market companies in various capacities including as a corporate attorney, mergers and acquisition adviser, chief financial officer and investment banker. Mr. Schweiger received a B.B.A. in Accounting from the University of Notre Dame, a J.D. degree from Marquette University and a Master of Laws in Taxation degree from New York University. He can be reached at (630) 692-0640 or at [rs@keatinginvestments.com](mailto:rs@keatinginvestments.com).

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