Council of Institutional Investors®
The voice of corporate governance

Via Email

October 8, 2020

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File Number SR-NASDAQ-2020-057

Dear Madam Secretary:

I am writing on behalf of the Council of Institutional Investors (CII or Council), a nonprofit, nonpartisan association of U.S. public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families, including public pension funds with more than 15 million participants – true "Main Street" investors through their pension funds. Our associate members include non-U.S. asset owners with about $4 trillion in assets, and a range of asset managers with more than $35 trillion in assets under management.[1]

The purpose of this letter is to respond to the Securities and Exchange Commission (SEC or Commission) notice to solicit comments in response to a Nasdaq Stock Market LLC (Nasdaq) proposed rule change "to (1) adopt Listing Rule IM–5315–2 to permit a company to list in connection with a primary offering in which the company will sell shares itself in the opening auction on the first day of trading on the Exchange (a 'Direct Listing with a Capital Raise'); (2) amend Rule 4702 to add a new order type (the 'Company Direct Listing Order'), which will be used during the Nasdaq Halt Cross for the shares offered by the company in a Direct Listing with a Capital Raise; and (3) amend Rules 4120(c)(9), 4573(a)(3) and 4753(b)(2) to establish requirements for disseminating information, establishing the opening price and initiating trading through the Nasdaq Halt Cross in a Direct Listing with a Capital Raise"[2] (Nasdaq Proposal).

As you are aware, on September 25 the SEC issued an order granting CII's petition for review (CII Petition)[3] and denying New York Stock Exchange LLC's (NYSE) motion to lift the stay to the NYSE's proposed rule change (NYSE Proposal) to amend Chapter One of the Listed Company Manual to modify the provisions

[1] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.
[2] Self-Regulatory Organizations; The Nasdaq Stock Market LLC, Notice of Filing of Proposed Rule Change to Allow Companies To List in Connection with a Direct Listing With a Primary Offering in Which the Company Will Sell Shares Itself in the Opening Auction on the First Day of Treading on Nasdaq and to Explain How the Opening Transaction for Such a Listing Will Be Effected, Exchange Act Release No. 89,878, 85 Fed. Reg. 59,349, 59,350 (Sept. 15, 2020), https://www.govinfo.gov/content/pkg/FR-2020-09-21/pdf/2020-20702.pdf.
[3] Petition of Council of Institutional Investors for Review of an Order, Issued by Delegated Authority, Granting Approval of a Proposed Rule (Sept. 8, 2020), https://www.sec.gov/rules/sro/nyse/2020/34-89684-petition.pdf.

relating to direct listings (NYSE Proposal)[4] For the reasons discussed in the CII Petition and further in this letter, CII believes the SEC should disapprove the Nasdaq Proposal which Nasdaq acknowledges is "similar" to the NYSE Proposal.[5]

SEC Does Not Have A Sufficient Basis to Make an Affirmative Finding

The Commission has indicated that a proposal must be disapproved if the SEC does not have a sufficient basis to make an affirmative finding that a proposed rule change is consistent with Section 6(b)(5) of the Securities and Exchange Act of 1934 which requires, among other things, that the rules of a national securities exchange be designed to *prevent fraudulent and manipulative acts* and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, *to protect investors and the public interest*; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.[6]

CII believes the Nasdaq Proposal to expand direct listings, like the NYSE Proposal that preceded it, falls short with respect to the italicized elements for the following two reasons:[7]

1. The Nasdaq Proposal Compounds Problems Shareowners Face in Tracing their Share Purchases to a Registration Statement.

As explained in the CII Petition:

> Traceability concerns often arise when there have been successive offerings, as shareholders seek to establish their standing to litigate claims under federal securities laws. Section 11 of the Securities Act creates liability if there are material misstatements or

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[4] Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 2, To Amend Chapter One of the Listed Company Manual To Modify the Provisions Relating to Direct Listings, Exchange Act Release No. 89,148, 85 Fed. Reg. 39,246 (June 24, 2020), https://www.federalregister.gov/documents/2020/06/30/2020-14013/self-regulatory-organizations-new-york-stockexchange-llc-notice-of-filing-of-proposed-rule-change.

[5] 85 Fed. Reg. at 59,352 ("In that regard, the Commission recently approved a similar proposal to allow a Direct Listing with a Capital Raise on the New York Stock Exchange.").

[6] *See* National Securities Exchanges § 6(b)(5), 15 U.S.C. §78(f)(b)(5) (1934), *available at* https://www.law.cornell.edu/uscode/text/15/78f ("The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the exchange").

[7] *See* Petition of Council of Institutional Investors for Review of an Order, Issued by Delegated Authority, Granting Approval of a Proposed Rule at 7 ("The proposal at issue here falls way short with respect to the highlighted elements, which involve investor protection.'). We note that investor protections in direct listings may be particularly vulnerable during a down or volatile market. *See* Crystal Tee & Katie Roof, Direct Listings Fall from Favor with Tech Cash Crunch Deepening, Bloomberg (Mar. 25, 2020) (on file with CII) ("the loose framework make it difficult to guide investors in an unstable market"); Cromwell Schubarth, The Funded: Direct listings, 'blank check' IPOs look less likely in age of COVID-19, Silicon Valley Bus. J. (Mar. 25, 2020), https://www.bizjournals.com/sanjose/news/2020/03/25/the-funded-direct-listings-blank-check-ipos-look.html ("current market volatility makes it too hard to guide investors on the proper pricing and valuation of companies that skip traditional investor road shows before they trade").

omissions in connection with securities offered in a registration statement, in which event any person purchasing "such security" may sue. The key phrase is "such security," and courts have generally read "such security" to require that a plaintiff must trace his or her purchase to a specific registration statement. In the seminal case in this area, the U.S. Court of Appeals for the Second Circuit upheld a settlement involving claims that arose under registration statements issued in 1961 and 1963, and the settlement limited recovery to claimants who could trace their purchases to the 1963 offering. *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967). The court (per Friendly, J.) reasoned that section 11's reference to "such security" should be given a narrow reading, one that is limited to securities offered pursuant to a specific registration statement, and not a broader reading that would cover company securities generally.

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Investor concerns about the traceability of shares in a direct listing were drawn into sharp focus in current litigation involving the Slack Technologies direct listing, one of the first two such listings. In a case of first impression, the Slack defendants sought dismissal of a section 11 claim on the ground that plaintiffs could not trace their purchases to Slack's registration statement, because once Slack registered the employee-held shares, a shareholder could not establish whether he or she bought shares that had been registered or unregistered shares that had been sold by an insider once the registration statement took effect (again assuming eligibility to sell those shares under Rule 144 standards).

The district court denied that motion, finding that the narrow reading of section 11 liability was not warranted when dealing with direct listings. Recognizing the significance and the novelty of the issue, however, the district court certified the legal question to the U.S. Court of Appeals for the Ninth Circuit, which agreed to hear the matter.

It is far from clear whether the Ninth Circuit will uphold the district court's reasoning. That Court has explicitly endorsed the narrow reading of "such liability" in *In re Century Aluminum Securities Litigation*, 729 F.3d 1104 (9th Cir. 2013), so it is at best uncertain whether that court will overrule or distinguish that precedent. Moreover, as several commentators have noted, "many of the concerns expressed by the District Court are similar to other situations where courts have uniformly declined to dispense with the existing standing requirements of the Securities Act, including secondary offerings." A ruling by the Ninth Circuit against shareholder standing in the Slack case could have an outsized impact on securities markets, given the number of tech startups and "unicorns" that are located in Silicon Valley and elsewhere in the Ninth Circuit and that may opt for a direct listing when they are ready to go public.

Independently of what may happen in the Slack case, [it] . . . raises important investor issues that the Commission should consider before opening U.S. capital markets to what could turn out to be a vastly increased number of direct listings. . . .

The loss of investor protections in direct listings has been acknowledged, even praised. Indeed, proponents of direct listings have trumpeted the loss of investor protections as an "important advantage" of direct listings, given the "potential to deter private plaintiffs from bringing claims under Section 11 of the Securities Act of 1933." Latham & Watkins, *Complex and Novel Section 11 Liability Issues of Direct Listings*, Corporate Counsel, at 1 (Dec. 20, 2019), available at https://www.lw.com/thoughtLeadership/section-eleven-liability-direct-listings. That law firm acted as counsel to Spotify and Slack in their direct listings, and the cited firm memorandum bluntly states that that "few (if any) purchasers will be able to trace their stock to the challenged registration statement" when "both registered and unregistered stock are immediately sold into the market in a direct listing." *Id.* at 2.

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> The point . . . is not to start a debate about the wisdom of direct listings at an abstract policy level. The Council believes – and has long believed – that traceability problems of the sort raised here should impel the Commission to update its "proxy plumbing" regulations *before* any liberalization of direct listing regulations.
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> Given the traceability problems of the sort identified above, it would be contrary to the standards set out in Exchange Act § 6(b)(5) for the Commission to make it *easier* for companies to initiate direct listings, at least until the Commission has approved some basic proxy plumbing reforms to make traceability less of a concern.[8]

We note that in its analysis of the CII Petition, the corporate law firm Cleary Gottlieb agreed that our above referenced concerns over "liability and investor protection . . . *are clearly areas for further discussion, litigation, and jurisprudence.*"[9] As indicated, those concerns are equally applicable to the Nasdaq Proposal.

2. The Nasdaq Proposal May Lead to a Decline in Effective Governance at U.S. Public Companies.

CII believes effective corporate governance serves the best long-term interests of companies, shareowners and other stakeholders.[10] Effective corporate governance helps companies achieve strategic goals and manage risks by ensuring that shareowners can hold directors to account as their representatives, and in turn, directors can hold management to account, with each of these constituents contributing to balancing the interests of the company's varied stakeholders.[11] Our belief is informed by the significant body of empirical evidence connecting improved firm performance and risk mitigation with shareholder-friendly corporate governance practices.[12]

We are concerned that SEC approval of the Nasdaq Proposal (or the NYSE Proposal) would result in a significant increase in the use of direct listings.[13] And more direct listings may lead to a decline in the effective corporate governance of U.S. public companies to the detriment of long-term investors and the capital markets generally.

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[8] Petition of Council of Institutional Investors for Review of an Order, Issued by Delegated Authority, Granting Approval of a Proposed Rule 8-13 (footnotes omitted).

[9] Adam Fleisher et al., Cleary Gottlieb, Direct Listings 2.0 – Primary Direct Listings (Sept. 10, 2020), https://www.google.com/search?q=Cleary+Gottlieb%2C+Direct+Listings+2.0+%E2%80%93+Primary+Direct+Listings&rlz=1C1GCEU_enUS886US886&oq=Cleary+Gottlieb%2C+Direct+Listings+2.0+%E2%80%93+Primary+Direct+Listings&aqs=chrome..69i57.3076j0j4&sourceid=chrome&ie=UTF-8.

[10] *See* Council of Institutional Investors, Corporate Governance Practices, Preamble (updated Sept. 22, 2020), https://www.cii.org/files/policies/09_22_20_corp_gov_policies.pdf ("CII believes effective corporate governance and disclosure serve the best long-term interests of companies, shareowners and other stakeholders.").

[11] *Id.*

[12] *See* Lucy Nussbaum & Glenn Davis, Council of Institutional Investors, Empirical Research on ESG Factors and Engaged Ownership, A Bibliography 1-8 (Aug. 2020), https://www.cii.org/files/publications/misc/09-24-20-Final-Bibliography.pdf,

[13] *See* Adam Fleisher et al., Cleary Gottlieb, Direct Listings 2.0 – Primary Direct Listings, Cleary Gottlieb ("One reason that direct listings may not have proved as popular as the initial interest in Spotify and Slack implied is the inability of the issuer to raise funds by issuing stock for its own account."); Preston Brewer, ANALYSIS; Easing Director Listing Rules Expectation, Unease, Bloomberg L. (Sept. 30, 2020) (on file with CII) ("If implemented, the NYSE's new rule would increase the attractiveness of direct listings, principally by allowing issuers to raise capital in the public offering.").

Our concern is reflected in the following comments of law professor Steven Davidoff Solomon in response to the recent direct listing of Palantir Technologies Inc. (Palantir) with a dual-class stock structure that is viewed by many market participants as inconsistent with effective governance:[14]

> The outcry over Palantir's unusual share structure misses the point. *Its successful market debut shows that a direct listing allows a company to sidestep governance checks that usually come during the I.P.O. stage. It will encourage others to push the envelope.*
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> Palantir's governance is a variation on the founder-control playbook. Its three founders (Alex Karp, Stephen Cohen and Peter Thiel) hold Class F shares, which give them just under half of the company's votes as long as they collectively own about 6 percent of Palantir's shares. They currently own more than 30 percent.
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> Palantir provides voting control even if the founders sell most of their shares, and there are no sunset provisions. *By going public via a direct listing, Palantir's founders were able to set up this governance structure without pushback.*
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> Recall that the Snap founder, Evan Spiegel, faced significant resistance from investors about dual-class stock, which gave no votes to the public. Since Snap's 2017 I.P.O., banks and underwriters have pushed companies to reduce the impact of multi-class shares to make investors happier. If Palantir had gone public in the traditional way, its structure probably would have raised questions from bankers and complaints from investors.

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[14] *See* Richard Waters, Palantir Goes Public but Founders Will Have Control For Life, Fin. Times, Sept. 29, 2020 (on file with CII) ("The twists and turns in Palantir's official disclosures have highlighted controversial governance arrangements that go to even greater lengths than usual to entrench the control of the company's founders."); Lizette Chapman, Peter Theil Tightens His Grip on Palantir Ahead of Stock Listing, Bloomberg (Sept. 29, 2020), *available at* https://finance.yahoo.com/news/peter-thiel-tightens-grip-palantir-110012008.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAANrSaa8lyOxGSKXmY3XdjylzM7je9wH_P0vyDpQ-xOlOCt7i71KXRbiV2kmHMK1iAXvfbhUxumUaDiBt_jb4uaykJZiBCekDPnbcCrx_0LaNKs1j4UjNdO9PFxriLONXgZUAseT9odu5SYYLQBlSSs2fQm6ynjUq5ixB_ZQuJe3I ("good-governance advocates say that handing so much power to a limited group of people could undermine the standards of accountability meant to be enforced by the market, making it harder for smaller shareholders to exert their will in cases where they believe a company is being poorly run"); Letter from Amy Borrus, Executive Director, Council of Institutional Investors to Co-founder and Chairman Peter Theil, Palantir Technologies et al. (Sept. 3, 2020), https://www.cii.org/files/issues_and_advocacy/correspondence/2020/CII%20lettter%20to%20Palantir%20Technologies.pdf ("We respectfully ask why Palantir is contemplating a capital structure that in large part emulates the power dynamic of those firms, in contrast with American corporate governance norms."); *see also* Rick Fleming, Investor Advocate, Speech at ICGN Miami Conference, Miami, Florida: Dual-Class Shares: A Recipe for Disaster (Oct. 15, 2019), https://www.sec.gov/news/speech/fleming-dual-class-shares-recipe-disaster ("The end result [of dual class stock structures] is a wave of companies with weak corporate governance."); Letter from Ash Williams, Chair, CII to John Zecca, Senior Vice President, General Counsel North America and Chief Regulatory Officer, NASDAQ Stock Market 4-5 (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024%20NASDAQ%20Petition%20on%20Multiclass%20Sunsets%20FINAL.pdf ("In recognition both of evolving market practice and academic research suggesting that multi-class structures become problematic five to nine years after IPO, we request in this petition a sunset of seven years or less.").

> A direct listing bypassed that. . . . *Palantir has shown that anything is possible in corporate governance with a direct listing. Expect other companies to take notice*.[15]

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For either of the above reasons, we respectfully request that the Commission disapprove the Nasdaq Proposal. Thank you for considering our views on this matter. Please contact me with any questions.

Sincerely,

Jeffrey P. Mahoney
General Counsel

[15] Andrew Ross Sorkin et al., DealBook Newsletter: Take It or Leave It, N.Y.Times, Oct. 1, 2020, https://www.nytimes.com/column/dealbook-newsletter.