

Investment Banking

One of Wall Street's Most Lucrative Businesses Is at Risk

Venture capitalists are embracing direct listings and curbing fees for bankers.

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They flew in from across the U.S.—venture capitalists and entrepreneurs—to discuss a new way to sell stock to the public and keep more money for themselves. The venue, appropriately, was a landmark hotel nicknamed “The Bonanza Inn.”

Not invited: the bankers who’ve long dominated initial public offerings.

For much of that September day at San Francisco’s Palace Hotel, investors behind many of Silicon Valley’s biggest unicorns took turns railing against Wall Street. Some fumed over the hefty fees bankers collect for ushering companies onto the stock market. Many criticized IPOs for being priced too low—shortchanging the company owners—so banks could deliver quick profits for big money managers.

Such complaints have been around for decades, but now there might be a solution. In 2018 a technique called a direct listing proved that technology can glide a company onto a stock market as smoothly as an expensive fleet of Wall Street underwriters.

Two of the dominant U.S. IPO underwriters, Goldman Sachs Group Inc. and Morgan Stanley, are helping to develop the direct listing system in a bet that they can keep a place for themselves in the process. But the San Francisco gathering made it clear that much of Silicon Valley wants to limit the involvement of banks.

Instead, the Valley crowd is giving a bigger role to Citadel Securities, a Chicago-based firm with little stake in the existing IPO underwriting market, for its market-making technology.

Bringing privately held, capital-hungry companies to the exchange for a public offering of stock is one of Wall Street’s oldest and proudest functions.

Bankers advise startups on how much they can raise and when to go to market. Once conditions are ripe, the companies embark on a roadshow to drum up investor interest and price the new stock. On the big day, a syndicate of banks—sometimes numbering in the dozens—buys up blocks of stock to parcel out to money manager clients. The typical 7% fee on the money raised in a U.S. IPO has withstood competition for the deals, though some of the most high-profile debuts get discounts. Last year, global IPO fees surpassed \$7 billion, with the top three banks each bringing in more than \$500 million, according to data compiled by Freeman & Co.

Companies have tried alternatives. In 2004, Google Inc. (now Alphabet Inc.) famously opted for a so-called Dutch auction, in which investors submit bids and the final price is the highest at which the entire offering can be sold. Low demand forced the company to cut the offering in half and sell at the bottom of the price range it had sought. But the stock popped on the first day, and then the shares kept climbing. There’s been debate ever since over whether Google could have gotten more money with a traditional IPO.

A direct listing moves a company’s stock onto the public market, allowing venture capitalists and employees to cash out, without raising new capital. It does away with the order-building phase, relying on software to match private shares and public demand on the fly. The risk is that supply and demand fall out of whack, leading to violent price swings or even a trading halt, potentially inflicting major damage. Bankers try to keep that from happening by gauging investor interest.

In 2018, Stockholm-based music-

streaming company Spotify Technology SA became the first high-profile startup to go public through the technique. Its stock swooned as much as 11% from the opening price of \$165.90 and remains below that level today. The company paid about \$35 million to Goldman Sachs, Morgan Stanley, and Allen & Co. By contrast, if Spotify had raised \$2.4 billion in a traditional IPO—selling about 10% of the company—it would have paid \$75 million even at a discounted 3% fee. For its part of the process, Citadel Securities was paid by the stock exchange.

Slack Technologies Inc. followed in 2019. On an overcast morning in June, as a jazz band played in front of the New York Stock Exchange’s massive columns, startups across the country watched to see if the technology would succeed in matching a supply of closely held shares with a flood of investor bids in real time. Everything hummed.

The opening stock price valued Slack at more than double its latest private funding round valuation. (It has since fallen, on a depressed outlook for company revenue.) Trading volume at the open was the third-highest for any debut in the U.S., the New York Stock Exchange said. Slack, which paid advisers \$22 million, probably reduced its costs by about a third compared with a typical IPO, according to bankers involved in the deal, who said they immediately started talking to other companies interested in direct listings.

When venture capitalist John O’Farrell lingered on the trading floor, it wasn’t to see the bankers. Instead, he waited next to a booth occupied by Citadel Securities, the market-maker majority owned by billionaire hedge fund investor Ken Griffin, to introduce himself to a pair of low-key executives steeped in the deal’s

wiring. It was their computers that had handled the deluge—and \$1 billion of their firm’s own money facilitated 1 out of every 5 trades. Citadel Securities wouldn’t say if it earned profits on those trades.

O’Farrell was clearly impressed. His firm, Andreessen Horowitz, an early investor in Facebook Inc. and Twitter Inc., among others, wields immense clout in deciding how Silicon Valley stock offerings are carried out. If an era of direct listings is commencing, the starting point may be that afternoon he spent with Joseph Mecane, Citadel Securities’ head of execution services, and Peter Giacchi, head of floor trading, on the floor of the NYSE.

“Everything we design in the first couple of days is about smooth performance,” Mecane would say later at a Citadel Securities office near the stock exchange. “We feel like we have our brand and reputation on the line with this business.”

Mecane, the former head of electronic equities trading at Barclays Plc, jumped to Citadel Securities in 2017 and has been busy building a team to ensure smooth trading in the more than 1,400 listed entities for which the firm serves as designated market maker. Citadel Securities aims to expand that client set by helping more companies go public. In that sense, the listing business is just an entry point for potential future revenue. Citadel Securities says its goal is to work with banks on listings and not to compete with

them.

Mecane’s counterpart on the trading floor is Giacchi, who’s been making markets for more than 20 years, watching machines replace the functions of hundreds of people. Direct listings put the emphasis on traders and their role in price discovery, a development Giacchi welcomes.

“It’s given the floor a renewed sense of value,” he says. Now, helped by technology, there is “the ability to process information quickly and reinvent yourself on the floor.”

Just a few months after O’Farrell’s trip to the trading floor, his firm would help lead the charge in San Francisco to tell the other attendees about the promise of direct listings.

In June, famed venture capitalist Bill Gurley at Benchmark Capital encouraged his more than 400,000 Twitter followers



Fig. 1 To track trading in Slack just after it listed, type {WORK US IGPC} and use the edit menu to change the date range to June 20 to June 21.

to call Citadel Securities and Morgan Stanley and pursue their own direct listings. “Other banks want to position direct listings as ‘exceptional’ or ‘rare,’” Gurley wrote.

Five more companies may pursue direct listings in 2020, according to Morgan Stanley.

Still, it may yet take years for IPOs to give way entirely to direct listings, says M.G. Siegler, a partner at Google Ventures, another major backer of startups. But “I’m not writing it off that it could be the majority of listings moving forward.”

Basak covers Wall Street for Bloomberg News, television, and radio in New York.