Client Alert

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Direct-to-Consumer Equity Offerings: Are Loyal Customers Happy Shareholders?

"Direct-to-consumer" offerings enable companies to raise capital directly from their customers, with or without the use of underwriters or other financial intermediaries. Direct-to-consumer offerings have garnered attention recently given the ability to conduct offerings using a "crowdfunded" approach; however, companies have conducted direct-to-consumer offerings for years. With the amendments to Regulation A (commonly referred to as "Regulation A+") and the adoption of Regulation Crowdfunding by the Securities and Exchange Commission (the "SEC"), companies have now become more acutely focused on broadening their investor base by soliciting interest in offerings of their securities from their customers. In this alert, we discuss the history of direct-to-consumer offerings, current approaches, the applicable SEC requirements, and considerations for companies undertaking such offerings.

A Brief History

Direct-to-consumer offerings are not a novel financing method. Companies have undertaken direct-to-consumer offerings for years and in both registered and unregistered formats.

Registered Offerings

Perhaps the best past example of a successful direct-to-consumer offering is the Boston Beer Company offering. In 1995, as part of its IPO, Boston Beer Company placed consumer applications for equity shares in its six-pack packaging. The first 30,000 consumer applicants were awarded the opportunity to purchase one unit of 33 shares of the company's common stock for $495, or $15 per share. This price was set at $5.00 less than the public offering price to larger investors in the IPO. One quarter of the pool of available IPO shares was set aside for consumers. As of 2012, the majority of the original consumer shareholders had maintained their investment in the Boston Beer Company.[1]

Another example of a direct-to-consumer offering is the IPO undertaken by Vonage Holdings Corp. ("Vonage"), an Internet phone company. In 2006, as part of its IPO, Vonage set aside 4.2 million shares of common stock for a directed share plan for consumers to participate at the public offering price. As part of the directed share program, the lead underwriters helped consumers establish limited purpose brokerage accounts for their share purchases. However, following the IPO, Vonage faced litigation and SEC scrutiny relating to the execution of the directed share program. Allegedly, Vonage had failed to include an active prospectus hyperlink on both the website describing the directed share program and the email to consumers advertising the program, which were filed with the SEC as free writing prospectuses ("FWPs"). Vonage also advertised the direct-to-consumer offering through voice messages to consumers which, in violation of Rule 134 under the Securities Act, did not include the name and address of persons from whom a copy of the prospectus may have been obtained. Due to technical

[1] *See* Jeff Sommer, "No Bitter Aftertaste From This Stock Offering," *The New York Times* (Feb. 18, 2012), *available at*: http://www.nytimes.com/2012/02/19/your-money/an-ipo-process-that-is-customer-friendly.html.

glitches, the directed share program was oversubscribed, and some consumer orders were not executed until after trading had begun and the stock price had fallen significantly.

Exempt Offerings

Companies have also conducted direct-to-consumer offerings made in reliance on certain offering exemptions. The classic example is Ben & Jerry's, which in 1984 utilized old Regulation A in order to raise $750,000 from over 1,600 consumers. Companies have also issued unregistered "free stock" to consumers to generate brand loyalty. In 1998, Travelzoo.com, a travel website, offered 2.6 million shares of unregistered common stock for free to 700,000 of its registered users. The shares issued to consumers provided them with voting rights and the opportunity to attend online shareholder meetings. Travelzoo.com's promotion was extremely successful and sparked interest in such offerings among other private companies. For example, in 1999, Simplystocks.com, a website providing financial data, attempted to issue free unregistered shares of common stock to registered users over a 180-day period. Simplystocks.com approached the staff of the SEC's Division of Corporation Finance (the "Staff") for no-action letter relief with respect to registration of the shares. However, the Staff indicated that the proposed free stock offering required a valid registration statement or an exemption from registration.[2] In the Staff's view, the shares issued to registered users were issued in consideration for website traffic and thus were "sales" within the meaning of Section 2(a)(3) of the Securities Act. As a result of the Staff's position, unregistered free stock offerings to consumers have become less common.

Recent Direct-to-Consumer Offerings

In recent years, companies have increasingly chosen to allocate a portion of the shares offered in their IPOs for purchase by consumers. Some consumer offerings have relied on the services of a broker-dealer, sometimes participating in the IPO as a co-manager, to assist with establishing and administering the directed share programs. Consumers are usually informed of the directed share program through a direct email from the company (with a copy filed with the SEC as an FWP). Consumers can typically purchase shares at the public offering price and invest in amounts ranging from $100 to $2,500. The directed share programs are also typically disclosed on the front cover of the IPO prospectus and described in more detail in the prospectus summary and underwriting sections of the prospectus. In addition, the following information is usually provided: (1) the number of shares and purchase price for the consumer distribution, (2) the manner in which the shares can be purchased, (3) whether shares will be available for purchase by consumers after the IPO through the same broker-dealer, (4) where additional information can be found regarding the offering, and (5) any parties who cannot purchase shares through the platform.

Below we describe four recent direct-to-consumer offerings (Square, Blue Buffalo, Dave & Buster's, and T-Mobile).

Square

Square Inc. ("Square"), a mobile payment processing company, established a directed share program in connection with its IPO in November 2015.[3] Five percent of the IPO shares (1,350,000 shares, representing a total dollar value of $12.2 million) were reserved for the directed share program. Through the directed share program, over 14,000 registered users participated in the IPO, with over 97 percent of these investors still holding Square stock after the first day of trading. Following the IPO, over 6,000 additional consumers purchased Square stock.

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[2] *See* Simplystocks.com, SEC No-Action Letter (Feb. 4, 1999).
[3] The IPO prospectus is available at https://www.sec.gov/Archives/edgar/data/1512673/000119312515382249/d937622d424b4.htm and the FWP for the email offer is available at https://www.sec.gov/Archives/edgar/data/1512673/000119312515371912/d68668dfwp.htm.

Blue Buffalo

Blue Buffalo Pet Products ("Blue Buffalo"), a pet food manufacturer, established a directed share program in connection with its IPO in July 2015.[4] Under the directed share program, employees were also given the opportunity to subscribe for stock, but at no cost. Five percent of the IPO shares were reserved for the directed share program (1,693,375 shares, representing a total dollar value of $33.9 million), with 35,000 shares specifically reserved for employees at no cost. Although the direct-to-consumer offering had a free stock component, the Staff did not object to the directed share program. However, after the IPO, the Staff requested that Blue Buffalo expand its capitalization disclosure to account for the free stock offering to employees.

Dave & Buster's

Dave & Buster's Entertainment Inc. ("Dave & Buster's"), a restaurant retail chain, established a directed share program in connection with its IPO in September 2014.[5] Under the directed share program, employees were also given the opportunity to subscribe for stock, but at the public offering price. Two and a half percent of the IPO shares were reserved for the directed share program (147,059 shares, representing a total dollar value of $2.4 million). Upon completion of the IPO, over 58,000 shares were allocated under the directed share program to over 3,400 individuals. 78 percent of these investors held onto their stock 30 days after the IPO.[6]

T-Mobile

In June 2016, T-Mobile USA, Inc. ("T-Mobile"), a national wireless carrier, launched its "Stock Up™ Rewards Plan."[7] The program, which is the first of its kind, provides an existing consumer with the opportunity to purchase one share of T-Mobile stock, as well as the opportunity to earn additional shares by referring others to choose T-Mobile as their mobile provider.[8] Under the stock rewards program, consumers do not receive new shares; instead, T-Mobile purchases existing shares in the open market and reallocates these shares directly to consumers. In order to participate, consumers must open a brokerage account with the broker-dealer administering the program, but there are no fees charged to investors for buying and selling shares. Whereas most directed share programs, including those discussed above, have been undertaken in conjunction with IPOs or larger underwritten equity offerings, the T-Mobile stock is offered exclusively through a designated brokerage channel. In addition, in contrast to the use of emails in other directed share programs, including those discussed above, for informing consumers, T-Mobile utilized a simulcast via the Internet and social media. Given the unique nature of the stock rewards program, T-Mobile provided a more thorough disclosure of the program in the prospectus filed with the SEC. In addition to a specific description of the stock rewards program, including eligibility requirements and applicable restrictions, specific risk factors were provided to warn consumers of the risks relating to participation in the program.

SEC Requirements

Historically, the SEC has taken a keen interest in novel direct-to-consumer offerings that diverge from traditional procedures with respect to public disclosure. These offerings initially emerged during the dot.com bubble as web-based companies sought creative means of generating consumer interest. As mentioned above, in the late 1990s, the Staff indicated that free stock offerings, which provide consumers with equity in exchange for a distinct marketing purpose, were subject to the same registration requirements under Section 5 of the Securities Act as traditional equity offerings.

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[4] The IPO prospectus is available at https://www.sec.gov/Archives/edgar/data/1609989/000119312515261312/d734898d424b4.htm and the FWP for the email offer is available at https://www.sec.gov/Archives/edgar/data/1609989/000119312515248081/d13593dfwp.htm.
[5] The IPO prospectus is available at https://www.sec.gov/Archives/edgar/data/1525769/000119312514369557/d735753d424b4.htm and the FWP for the email offer is available at https://www.sec.gov/Archives/edgar/data/1525769/000119312514357385/d735753dfwp.htm.
[6] Source: Loyal3.
[7] The IPO prospectus is available at https://www.sec.gov/Archives/edgar/data/1064735/000119312516613692/d198015d424b5.htm and the FWP for the simulcast offer is available at https://www.sec.gov/Archives/edgar/data/1283699/000119312516613700/d204815dfwp.htm.
[8] T-Mobile only registered 1 million shares in connection with the stock rewards program.

Many recent direct-to-consumer offerings have been conducted as part of IPOs. As such, the SEC has required much of the same disclosure for the direct-to-consumer offerings that is required for traditional underwritten offerings. In addition to the registration statement for the IPO and the related prospectus and, if applicable, prospectus supplement, a company must file with the SEC as an FWP pursuant to Section 17(b) of the Securities Act each communication (oral and written) with investors and prospective investors relating to the direct-to-consumer offering. The SEC has interpreted Section 17(b) of the Securities Act to cover emails, letters, automated voice messages, and other electronic communications, which could include communications disseminated through social media.

Issuers are well advised to take caution in fully disclosing direct-to-consumer offerings. These offerings, whether part of a larger underwritten offering or an exclusive offering to consumers, should be described in detail in the relevant prospectus, including specific information regarding the marketing, pricing, and capitalization of the offering. However, as direct-to-consumer offerings become increasingly popular, it remains to be seen whether additional disclosure requirements will be introduced by the SEC, particularly in light of the increasing use of social media to communicate with consumers.

Considerations

Registered Offerings

Registered direct-to-consumer offerings offer a number of advantages. First, direct-to-consumer offerings provide consumers, who are generally small, individual investors, a unique opportunity to access an IPO market that historically has been reserved for wealthy and institutional investors. Second, companies can utilize direct-to-consumer offerings to help build consumer loyalty and expand their investor base by including a new demographic, one that has demonstrated a higher rate of retention of shares than the traditional IPO investor. On average, 35 percent of consumers who purchase IPO shares state their intention to buy additional shares from that company in the next year.[9] Third, by spreading out ownership over a larger pool of investors, companies may be better able to retain control of their operations, rather than have ownership concentrated among a small number of institutional investors whose interests may diverge from those of management and the board. Finally, if well subscribed and successful, direct-to-consumer offerings provide companies with a consistent and efficient source of capital.

However, while direct-to-consumer offerings have attracted considerable interest recently, there are a number of risks. First, even in a purely electronic environment, there are enhanced costs to companies relating to the administration of directed share programs and the execution of thousands of individual trades in order to deliver shares to consumers. Second, Loyal3 and other similar distribution platforms have a relatively short track record in administering direct-to-consumer offerings. Third, by merging their consumers with their existing investor base, companies run the risk of losing both in a down economy, as an underperforming stock could lead to general consumer dissatisfaction. Fourth, novice consumers lacking prior investment experience may be ill equipped to make sound investment decisions. Last, the prominence of these offerings in the media enhances the regulatory risk under current law, in addition to any post-JOBS Act regulations in this arena.

Exempt Offerings

Exempt direct-to-consumer offerings offer many of the same advantages (for issuers and consumers) and disadvantages (for issuers) as registered direct-to-consumer offerings. However, direct-to-consumer offerings made in reliance on Regulation A, which have become increasingly popular, pose a number of different considerations for consumers. First, the companies relying on Regulation A are likely to be at an earlier stage in their development, which is also likely the case in the context of traditional private placements. Second, Regulation A offerings are often marketed to consumers as IPOs although technically they are not. This is somewhat misleading and suggests to consumers that there will be a liquid secondary market for the securities,

[9] Source: Loyal3.

but typically little or no effort is made to explain to consumers that Regulation A may not in fact involve a listing (it is not technically required). Also, there may be no opportunity for consumers to resell their securities and obtain liquidity after the Regulation A offering since the company is still private and there may be little or no market for the company's securities. Third, there may not be a broker-dealer or underwriter involved in a Regulation A offering as issuers often issue securities directly to investors without any financial intermediation. As a result, there may not be anyone making a judgment or providing advice regarding the suitability to a consumer of an investment in an earlier stage company or in an illiquid investment, etc. This same concern would also apply in the context of a traditional private placement. In conclusion, there are greater risks for consumers in the context of an exempt direct-to-consumer offering using Regulation A, which might be balanced against how likely the company is to conduct an IPO in the future or how likely a secondary market in its securities will develop.

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