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# Secondary Markets for Unlisted Companies

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## 1. Introduction

Traditionally, investments by venture capitalists and angel investors in entrepreneurial companies were illiquid until a firm was ready to be taken public in an IPO or sold to a strategic buyer, typically many years later. In the last few years, however, so called "secondary" marketplaces have sprung up that provide pre-IPO liquidity not only for VCs and angels but also for the many start-up employees who receive part of their compensation in the form of stock or stock options. The most prominent of these are SharesPost and SecondMarket. These marketplaces allow accredited investors to buy (and sell) the shares of privately-held firms with minimal regulatory oversight. This paper will take a law and economics perspective to analyze the likely consequences of this dramatic change in the institutional environment in which U.S. startups and VCs operate.

Secondary markets have emerged against the background of a prolonged slump in the U.S. IPO market in the wake of the bursting of the dot-com bubble in 2000. This slump has been especially severe for the kinds of smaller offerings that are typical among venture-backed companies. The volume of IPOs has fallen from an annual average of more than 400 in the 1990s to around 100 in 2000s, while average IPO size has increased from around $80 million in the 1990s to nearly $350 million in the 2000s.

Alongside this slump in IPO activity, VC holding periods have increased. The National Venture Capital Association estimates that in 2010, the average IPO firm went public 10.4 years after receiving VC funding, up from 2.4 years in 2000. Considering that most VC funds last only 10 to 12 years, it is clear that marketplaces that offer investors pre-IPO liquidity potentially address a growing demand for liquidity among investors in start-up companies. The same goes for founders and employees, who since 2000 have had to wait ever longer for liquidity. In short,

there has been a build-up of pent-up supply of shares in entrepreneurial, pre-IPO companies. As a result, the emergence of secondary marketplaces is a financial innovation that has the potential to contribute to a more efficient allocation of capital and ownership in startups and other privately-held firms.

Secondary markets differ from IPO markets in important ways. First and foremost, secondary markets allow for *selective* liquidity: Individuals and investors who wish to do so, can sell stock without the need for the company to go public. This is important because the liquidity needs of founders and employees are often not aligned with those of their investors or indeed the company's. As a result, we argue that secondary marketplaces have the potential to fundamentally alter the relationship between companies and their employees, and between founders and their investors, in ways that are quite different from an IPO exit. We discuss each relationship in turn.

Founders and employees may have liquidity needs that differ from the firm's. Personal financial circumstances, a desire for diversification, changes in employment, tax considerations, and many other factors impact individuals in unique ways. Selling stock on a secondary market allows individuals to secure the liquidity they need regardless of the issuer's particular needs at that time. This interim liquidity helps reduce exposure to financial risk for the entrepreneurs and their employees and allows them to focus on growing the company, rather than on personal financial issues.

Similarly, the liquidity needs of venture capitalists often differ from the issuer's. Older vintage funds may wish to wind down their investments and return capital to their limited partners. Early-stage venture capitalists may seek to exit from larger companies so they can focus on earlier-stage companies where their skills are more valuable. Funds that have

insufficient reserves for a follow-on round can sell to an investor with the capacity to make the additional investment.

Many of these advantages to sellers can translate into advantages for the issuer. On the labor-economics side, the possibility of pre-IPO liquidity can be used to retain and motivate employees, as the company benefits when, for example, employees are able to focus more on company growth. Similarly, the incentive value of equity compensation can become a stronger motivator when employees are able to cash out a portion of their shares from time to time. However, companies are understandably cautious about allowing existing employees to sell all of their shares. The fear is that employees will lose motivation and as a result, companies may wish to limit sales to some fraction of vested shares. On the other hand, where sales by *former* employees are unrestricted, existing employees may consider leaving, if necessary, to achieve liquidity.

On the capital side, issuers can benefit from pre-IPO liquidity in several ways. They can bring in new investors while allowing older investors to exit. Dissatisfied investors or those who disagree with the company's strategic or operational choices can leave, allowing for better board dynamics. The pressure to exit earlier than the issuer feels appropriate can be reduced if each investor is able to select their own exit timing through the secondary market. The firm's capitalization table can be cleaned up, which is of particular benefit to companies approaching the SEC's 500 shareholder limit (beyond which there are enhanced disclosure and reporting requirements, similar to those of firms that are publicly traded). Secondary transactions can be conducted in concert with primary rounds, bringing in new investors through a secondary transaction who are also able to participate in follow-on primary rounds. The secondary markets can provide pricing validation when a company is negotiating fresh VC funding, employee

compensation packages,[1] or indeed a sale of the firm.[2] Finally, the possibility of pre-IPO liquidity allows companies to stay private for longer, which may help them to protect their trade secrets and remain competitive (as less disclosure is available to competitors) and to focus on growth (rather than shouldering the burden of public-company requirements).

Against these benefits, pre-IPO trading can impose significant costs on firms. Secondary transactions normally require some level of information exchange (often to both buyers and sellers, many of whom are former employees), which can be a concern for issuers with a need for commercial confidentiality. Issuers are also wary of triggering the SEC's 500 shareholder rule, which would require disclosure similar to that of a public company. Prices from secondary transactions may need to be used in 409A valuations (an IRS regulation covering nonqualified deferred compensation, such as options) impacting the level of benefits available to employees.

In this preliminary draft, we outline the economic issues we aim to address. Section 2 begins with an overview of secondary marketplaces. Section 3 discusses the benefits and risks of pre-IPO liquidity to buyers, sellers, and issuers. (A future draft will include a detailed analysis of the regulatory environment within which secondary markets operate and likely regulatory changes in the wake of the JOBS Act, Dodd-Frank, and SEC interest in secondary markets more broadly.) In Section 4, we briefly discuss five case studies of firms that have traded on secondary markets. Section 5 reports preliminary evidence which suggests that secondary-market data contain pricing-relevant information by showing that the level of buyside interest on SecondMarket helps predict post-IPO prices when firms eventually go public. Section 6 concludes.

[1] Brightcove Inc., for example, stated in its August 24, 2011 S-1 filing that both management and the board believe that "secondary transaction made by nonemployee investors" and a "contemporaneous valuation…are the best indicators of the fair value of our common stock" for purposes of valuing certain stock options.

[2] Jive Software indicated in its S-1 filing that the company had adjusted the weighting of certain scenarios in its valuation "due to the increased number of secondary transactions in our common stock." Jive Software relied "more heavily on market indicators as opposed to income approach metrics. Market indicators include both secondary market transactions and estimates of future revenue multiples." Jive Software also made reference to the volume and pricing of specific secondary market transactions.

## 2. Overview of Secondary Marketplaces

Today, a large number of companies are vying for a role in the secondary marketplace for private company shares. Until recently, trading platforms were limited to institutional buyers and most transactions were conducted largely on an ad-hoc basis.[3] Secondary interests in private company shares could be acquired through investment funds or on an individual basis.[4] Shares could be purchased directly from founders, employees, angel investors or general partners of older vintage venture capital funds seeking liquidity.[5]

### *2.1 The Early Days*

In 1990, Nasdaq launched PORTAL (Private Offerings, Resales, and Trading through Automated Linkages) as a private institutional marketplace for 144A securities.[6] 144A is a safe harbor that provides qualified institutional buyers with an exemption from the registration requirements of Section 5 of the Securities Act.[7] A web-based version of PORTAL was approved by the SEC on July 31, 2007 and began operating on August 15, 2007.[8,9] At roughly the same time, several investment banks launched their own trading systems. Goldman Sachs

[3] Jose Miguel Mendoza and Erik P. M. Vermeulen, *The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity*, Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 (May 3, 2011). Available at: http://ssrn.com/abstract=1829835.
[4] *Id*.
[5] Hans Swildens, *Venture Capital Secondary Funds – The Third Exit Option: A smart way to improve fund performance and unlock hidden value*, Industry Ventures LLC White Paper (May 2008). Available at: http://www.industryventures.com/pdf/Venture_Capital_Secondaries_White_Paper.pdf.
[6] *Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Eliminate Rules Related to Nasdaq's PORTAL Market*, Securities and Exchange Commission (Release No. 34-60991; File No. SR-NASDAQ-2009-092) (November 12, 2009). Available at: http://www.sec.gov/rules/sro/nasdaq/2009/34-60991.pdf.
[7] 17 C.F.R. § 230.144A (2012).
[8] *Order Granting The NASDAQ Stock Market LLC's Application for an Exemption Pursuant to Section 36 of the Securities Exchange Act of 1934*, Securities and Exchange Commission (Release No. 34-56176) (July 31, 2007). Available at: http://www.sec.gov/rules/exorders/2007/34-56176.pdf.
[9] *NASDAQ's Electronic Trading Platform for the 144A Private Placement Market is Approved by the SEC: The PORTAL Market Trading System Will Begin Operating On August 15*, The Nasdaq Stock Market, Inc. Press Release (August 1, 2007). Available at: http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=257543.

launched its GSTrUE (Tradable Unregistered Equity) system in May, 2007. [10,11] A group of five Wall Street firms (Citigroup, Bank of New York Mellon, Lehman Brothers, Merrill Lynch, and Morgan Stanley) formed OPUS-5 (Open Platform for Unregistered Securities) in August 2007 and were later joined by Bank of America, Credit Suisse, and UBS.[12] Several other firms, including JPMorgan Chase and Bear Sterns, launched their own platforms.[13]

In November 2007, Nasdaq and twelve Wall Street firms announced the Portal Alliance.[14,15] The alliance formed to merge several different 144A platforms (including GsTRUE and OPUS-5).[16] The financial difficulties of several of the firms involved, including Lehman Brothers and Bear Sterns, delayed the launch until September 2009 when nine banks agreed to list 144A or private company transactions.[17]

Another marketplace, NYPPEX, has been active in the secondary private markets since 1998.[18] According to the firm, they are "one of the world's leading private equity secondary intermediaries for single interest transactions having a minimum size of $100,000 up to $10 million [and]… help founders, key employees and individual investors achieve superior

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[10] Arleen Jacobius, *Slow start, great hope for Nasdaq private exchange: Pensions & Investments*, SecondMarket (January 14, 2010). Available at: https://www.secondmarket.com/discover/news/slow-start-great-hope-for-nasdaq-private-exchange.
[11] Gregory Zuckerman, *A Hot Idea Falls Short at Goldman*, WSJ.com (April 7, 2011). Available at: http://online.wsj.com/article/SB10001424052748704587004576245101094450490.html.
[12] Elena Schwieger, Comment, *Redefining the Private Placement Market After Sarbanes-Oxley: Nasdaq's Portal and Rule 144A*, 57 Cath. U. L. Rev. 885 (2008).
[13] *Id*.
[14] *About the PORTAL Alliance*, Available at: http://www.portalalliancemarket.com/about_pa_content.aspx.
[15] Anupreeta Das, Nasdaq, *Wall St Firms Join Forces for 144a Market*, Reuters (November 12, 2007). Available at: http://www.reuters.com/article/2007/11/12/sppage012-n12453209-oisbn-idUSN1245320920071112. The initial twelve firms were: Bank of America, Bear Stearns, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan, Lehman Brothers, Merrill Lynch, Morgan Stanley, UBS, and Wachovia.
[16] *Id*.
[17] Arleen Jacobius, *Slow start, great hope for Nasdaq private exchange: Pensions & Investments*, SecondMarket (January 14, 2010) (The nine firms were: Bank of America, Merrill Lynch, Credit Suisse Group, Deutsche Bank AG, Citigroup Inc., Goldman Sachs Group Inc., JP Morgan Chase & Co., Morgan Stanley, UBS AG, and Wells Fargo Securities LLC). Available at: https://www.secondmarket.com/discover/news/slow-start-great-hope-for-nasdaq-private-exchange.
[18] *Our Company*, NYPPEX Private Markets, http://nyppex.com/company.php (2011).

transaction speed and price execution, with minimal market impact." [19] The investment bank Friedman Billings Ramsey also entered the 144A transaction space in 1997 and, according to the firm, "has since been the dominant firm in the Rule 144A equity market. In the last ten years, the firm has completed nearly 10 times as many 144A transactions and raised nearly 10 times as much capital via these transactions as any other investment bank."[20]

While the 144A market has successfully supported larger deals, its focus on institutional investors has meant that few small offerings, such as those of VC-backed firms, have been transacted.[21,22,23] Grant Thorton argues that the absence of "individual investors from the market is likely to undercut its ability to support small offerings, because large populations of small (retail) investors are what historically support liquidity and valuations in small cap stocks."[24]

*2.2 SecondMarket*

SecondMarket, which initially provided a liquidity solution for restricted securities in public companies, began transacting in private company shares in 2008 and launched its private company marketplace in mid-2009.[25] The popularity of Facebook and its early presence in the marketplace has created significant positive publicity for SecondMarket.[26] SecondMarket completed $558 million in private company transactions in 2011 (a 55% increase from the

[19] *Brokerage*, NYPPEX Private Markets, http://nyppex.com (2011).
[20] *Our History*, FBR & Co, http://www.fbr.com/Company/FBR/History.aspx.
[21] Arleen Jacobius, *Slow start, great hope for Nasdaq private exchange: Pensions & Investments*, SecondMarket (January 14, 2010). Available at: https://www.secondmarket.com/discover/news/slow-start-great-hope-for-nasdaq-private-exchange.
[22] Gregory Zuckerman, *A Hot Idea Falls Short at Goldman*, WSJ.com (April 7, 2011). Available at: http://online.wsj.com/article/SB10001424052748704587004576245101094450490.html.
[23] Jay R. Ritter, *Equilibrium in the IPO Market* (April 25, 2011). Available at: http://ssrn.com/abstract=1822542.
[24] David Weild and Edward Kim, *Why are IPOs in the ICU?*, Grant Thornton White Paper. Available at: http://www.gt.com/staticfiles/GTCom/files/GT%20Thinking/IPO%20white%20paper/Why%20are%20IPOs%20in%20the%20ICU_11_19.pdf.
[25] *Company Overview*, SecondMarket Holdings Inc., https://www.secondmarket.com/about-us?t=fl (2012).
[26] According to M. Adam Oliveri, Managing Director – Private Company Market, SecondMarket, as of February 15, 2012, Facebook continued to generate the largest volume of transactions on SecondMarket. M. Adam Oliveri, *Panel - The Secondary Market Big Picturer*, SecondMarket Capitalyze 2012 Conference, New York (February 15, 2012). Video available at: https://www.secondmarket.com/discover/event-replay-capitalyze-east.

previous year) and over $1 billion since 2008.[27] Nearly 15,000 accredited investors are on the platform with over $6 billion in indications of interest in 2011.[28]

SecondMarket earns a fee of at least $2,500 for each completed transaction. The fee is "determined on a case-by-case basis depending on many factors, including, but not limited, to the asset type, value of the asset, and complexity of the transaction."[29,30] The minimum transaction size is $100,000, which SecondMarket feels is necessary to justify the fixed costs involved.[31] In addition to SecondMarket's commission, transaction costs include an opinion letter of the seller's counsel that the private placement exemption from registration applies ($2,500 for small transactions, more for larger) and potentially transfer fees required by the company to cover the administrative costs of transferring shares from seller to buyer.[32]

Initially, SecondMarket did not require the consent of the issuer, but their model has evolved. Now SecondMarket designs "customized liquidity program[s]" for the company and considers the company as their customer.[33,34] Companies are allowed to determine how the marketplace for their shares is structured. The companies decide who may sell to whom (e.g., only former employees to existing shareholders), the number of shares that can be sold, the transaction frequency (e.g., weekly, or, in most cases quarterly or annually), and the pricing structure (e.g., a negotiated one-off

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[27] *SecondMarket's 2011 Year End Private Company Report*, SecondMarket Holdings Inc. (January 19, 2012). Available at: https://www.secondmarket.com/discover/reports/secondmarkets-2011-year-end-private-company-report.
[28] *Id*.
[29] SecondMarket Admin, *How does SecondMarket make money?*, SecondMarket Holdings Inc., http://support.secondmarket.com/entries/351048-how-does-secondmarket-make-money (December 06, 2010).
[30] SecondMarket Admin, *Is there a minimum transaction size for buying securities through SecondMarket?*, http://support.secondmarket.com/entries/350710-is-there-a-minimum-transaction-size-for-buying-securities-through-secondmarket (December 06, 2010).
[31] *Id*.
[32] *Id*.
[33] Jeremy Smith, *Presentation – A Deep Dive into Secondary Market Mechanics*, SecondMarket Capitalyze 2011 Conference, San Francisco. (May 11, 2011). Video available at: https://www.secondmarket.com/discover/capitalyze.
[34] Tom Johansmeyer, *The Differences Between SecondMarket and SharesPost According to Their CEOs*, Business Insider (December 1, 2011). Available at: http://www.businessinsider.com/the-differences-between-secondmarket-and-sharespost-according-to-their-ceos-2011-12.

transaction vs. auction).[35] Each company is audited and required to provide financial information to eligible buyers and sellers through a secure data room.[36]

Consumer web and social media transactions dominate on SecondMarket, making up 61.4% of transactions in 2011.[37] Figure 1 provides a detailed breakdown of the 2011 transactions by industry. A typical company on the platform has at least $20 million in revenue and a market capitalization of $100 million, is four or more years old, has received at least Series B funding, and has more than fifty shareholders.[38]

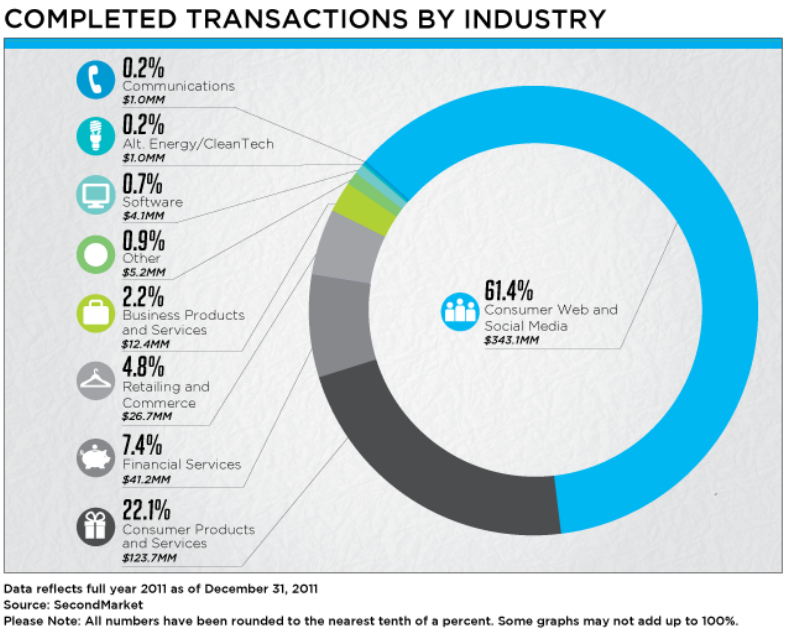



Figure 1[39]

[35] *The Future of Capital Formation: Hearing Before the House Committee on Government and Oversight Reform*, 112th Congress (5/10/11) (statement of Barry Silbert, CEO, SecondMarket). Available at: http://oversight.house.gov/images/stories/Testimony/5-10-11_Barry_Silbert_Capital_Formation_Testimony.pdf.

[36] *The Future of Capital Formation: Hearing Before the House Committee on Government and Oversight Reform*, 112th Congress (5/10/11) (statement of Mary Schapiro, Chairman, Securities and Exchange Commission). Available at: http://oversight.house.gov/images/stories/Testimony/5-10-11_Schapiro_Capital_Formation_Testimony.pdf

[37] *SecondMarket's 2011 Year End Private Company Report*, SecondMarket Holdings Inc. (1/19/12). Available at: https://www.secondmarket.com/discover/reports/secondmarkets-2011-year-end-private-company-report.

[38] Jamie Hutchinson, *Secondary Transaction Mechanics and Primer*, SecondMarket Capitalyze 2012 Conference, New York (2/15/12). Available at: https://www.secondmarket.com/discover/event-replay-capitalyze-east.

[39] *SecondMarket's 2011 Year End Private Company Report*, SecondMarket Holdings Inc. (1/19/12). Available at: https://www.secondmarket.com/discover/reports/secondmarkets-2011-year-end-private-company-report.

Institutional buyers were parties in 72.8% of the $558 million in transactions. Figure 2 provides a more detailed breakdown on the type of institutional buyers on SecondMarket.

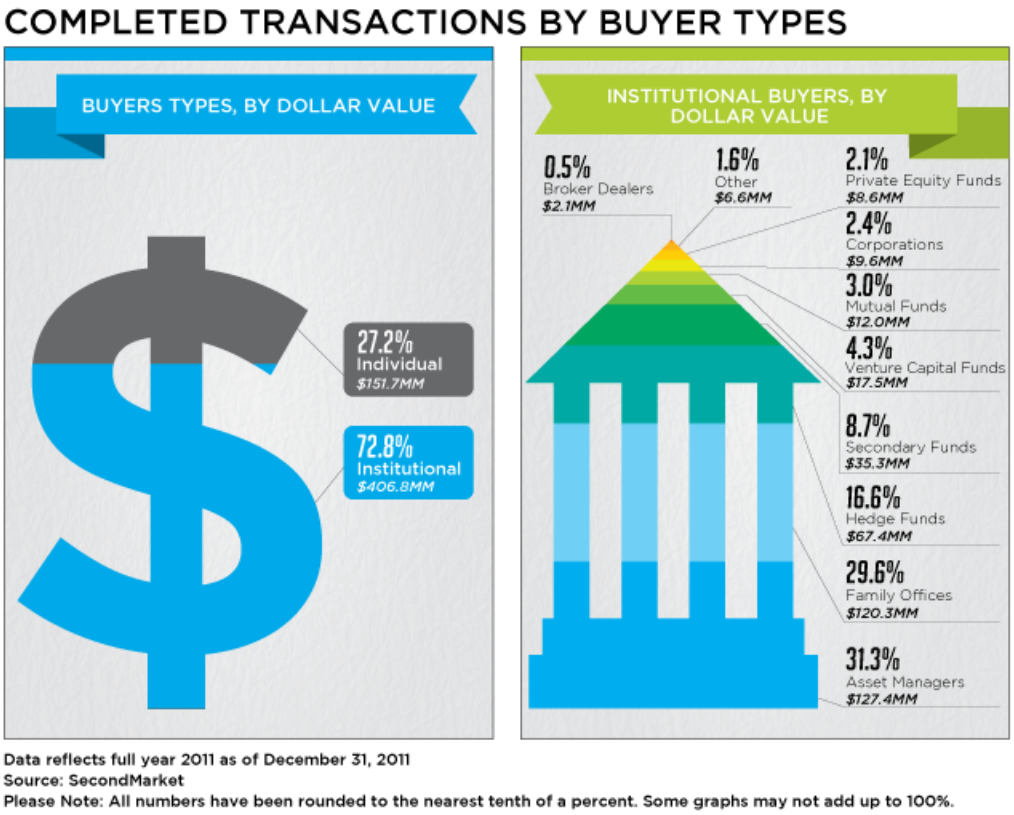



Figure 2[40]

A large majority of sellers in 2011 were ex-employees (79.3% by dollar value). Employees (11.1%), investors (3.7%), founders (0.4%), and others (5.5%) make up the remainder.[41]

In March 2011, SecondMarket launched a "watching" feature to provide investors with a way of tracking companies of interest.[42] As of January 26, 2012, there were 18,716 companies available for watching on SecondMarket; however, fewer than a third (6,011) had one or more watchers.[43] As illustrated in Figure 3, the majority of companies have relatively few watchers.

[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Search Companies,* SecondMarket Holdings Inc., https://www.secondmarket.com/private-company-search.

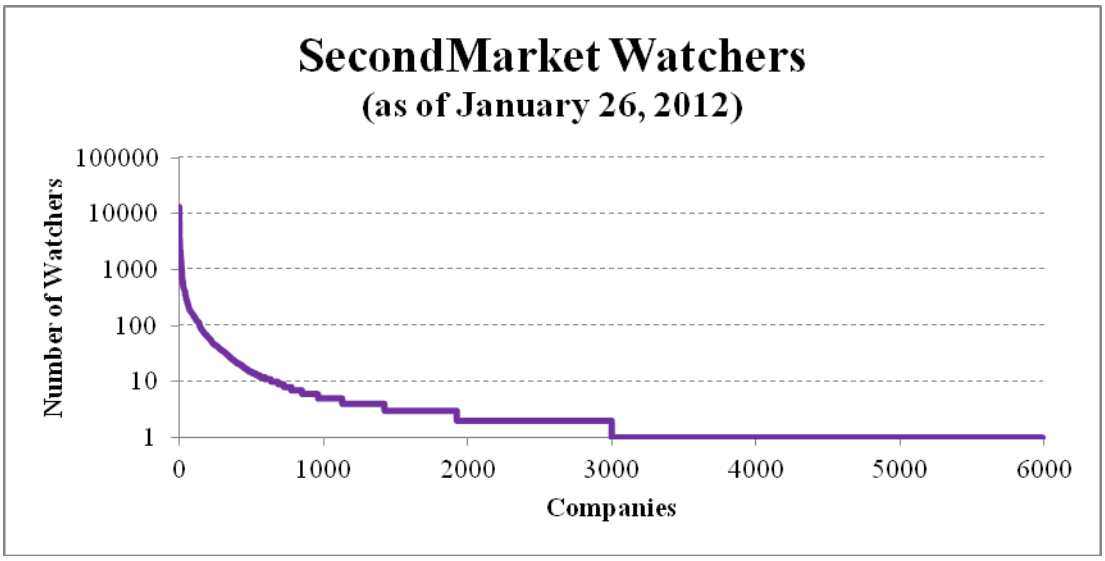



Figure 3[44]

The top ten companies watched as of January 26, 2012 were Facebook (13,296 watchers), Twitter (7,254), Foursquare (3,722), Dropbox (3,534), Yelp (2,929), Gilt Group (2,310), Hulu (2,258), Square (2,229), LivingSocial (2,178), and Craigslist (1,962).[45]

*2.3 SharesPost*

SharesPost was founded in early 2009 and, according to the company, connects over 86,000 institutional and individual investors with over $1 billion worth of private company shares.[46] SharesPost is focused exclusively on private company transactions. (SecondMarket, on the other hand, handles several categories of illiquid assets.) As of November 2011, SharesPost was handling four trades per day and had completed transactions for forty different companies in 2011.[47]

[44] Data from *Search Companies*, SecondMarket Holdings Inc., https://www.secondmarket.com/private-company-search.
[45] *Id.*
[46] *About Us*, SharesPost Inc., https://www.sharespost.com/pages/about.
[47] *Interview - Weir Sees `Explosive' Growth in Secondary Markets*, The Washington Post (November 9, 2011). Video available at: http://www.washingtonpost.com/business/weir-sees-explosive-growth-in-secondary-markets/2011/11/09/gIQAjDnt6M_video.html.

SharesPost uses FINRA-registered specialists to assist in consummating transactions. The specialists charge a 3% commission on the transaction value (minimum of $5,000).[48] U.S. Bank is available as escrow agent and charges $1,500 to both buyer and seller for each transaction.[49] The minimum sales price on SharesPost is $25,000.[50] Companies traded on SharesPost are usually valued at $100 million or more, have at least $10 million in revenue, and were founded at least 5 years ago.[51]

Unlike SecondMarket, SharesPost does not require the involvement of the company whose shares are transacted. Companies that choose to be involved are able to control who buys (e.g. only institutional buyers or certain individuals) and who sells, when transactions occur, and on what terms.[52]

SharesPost does not provide reports summarizing the types of companies transacted on its platform. However, based on the data that is provided, SharesPost hosts a large number of cleantech/energy transactions. On January 26, 2012, there were 23 companies with buy or sell offers available on SharesPost. SharesPost categorizes the companies as cleantech/energy (5 listed), consumer (3), software (3), enterprise (2), retail (2), web (2), financial services (2), social (2), advertising & marketing (1), biotech (1), healthcare (0), media & online content (0), and telecom/hardware (0). Facebook is the most commonly traded company on SharesPost. There have been more than 200 Facebook transactions since August 20, 2009.[53]

In addition to providing transaction data via its own website and through Bloomberg terminals, SharesPost has made efforts to provide additional information and transparency

[48] *Sellers FAQs*, SharesPost Inc., https://www.sharespost.com/pages/faqs.
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Sharespost Private Investor Portals*, SharesPost Inc., https://www.sharespost.com/pages/company-benefits (2012).
[53] Data was gathered from SharesPost.com and Bloomberg.

through its "SharesPost Venture-Backed Index" and research reports. The index aggregates transaction data, current posts on the marketplace, and research-based valuation estimates for seven companies.[54] The index provides some basis for determining trends in the secondary marketplace for private company shares. SharesPost also makes available a large number of research reports, which typically include an overview of the company's products, markets, and competitors, financial information, forecasts, and valuations.[55] These reports are designed to assist buyers and sellers with their investment decisions (with disclaimers). However, questions have been raised regarding the independence of these reports.[56] Significant potential issues remain with the level of information provided on all the secondary markets.

*2.4 Xpert Financial*

Xpert Financial was founded in early 2009 with the support of well-known venture capitalist Tim Draper, who is chairman of the company's board.[57,58] Xpert Financial has not disclosed information on its transactions to the extent of SharesPost or SecondMarket and more tightly controls login access to its site (which is limited to shareholders, companies, accredited investors, and qualified institutional buyers).[59,60]

Xpert Financial uses a registered broker-dealer subsidiary, Xpert Securities, to provide an online trading platform called Xpert ATS for transacting in private company shares.[61] The platform supports both primary offerings and secondary trading. Shares are sold through either a

[54] As of March 13, 2012, the index companies are Bloom Energy, Eharmony, Facebook, Gilt Groupe, Linden Lab, Serious Energy, and Twitter.
[55] *Research*, SharesPost Inc., https://www.sharespost.com/research.
[56] Usha Rodrigues, *Who's Buying on SharesPost? Who's Selling? Reply Hazy, Try Again*, The Conglomerate (January 6, 2012). Available at: http://www.theconglomerate.org/2012/01/whos-buying-on-sharespost-we-dont-know.html.
[57] *Xpert Financial*, CrunchBase, http://www.crunchbase.com/company/xpert-financial.
[58] *Leadership*, Xpert Financial, https://www.xpertfinancial.com/about/leadership.html.
[59] *Register for an Account*, Xpert Securities Inc., https://www.xpertsecurities.com/apply.
[60] Matt Bowman, *Interview - Tim Draper unveils the XChange Marketplace*, Vator News (June 1, 2009). Video available at: http://vator.tv/news/2009-05-31-the-rise-of-the-secondary-markets.
[61] *About Us*, Xpert Financial Inc., https://www.xpertfinancial.com/about/about_us.html.

fixed-price offering or a modified Dutch auction.[62] Xpert Financial indicates that by using its "auto-execution technology", transactions can settle and clear in days rather than the weeks or months previously necessary.[63] Companies are given control over the market for their shares, including who can sell and who can buy.[64] However, according to a February 3, 2012 Wall Street Journal article, Xpert Financial may have shifted its focus away from secondary transactions and towards primary.[65] A subsequent Xpert Financial press release appears to have confirmed this shift; all of the examples of companies using its platform focused on primary capital raises (with exception of one that included a purchase from an existing rights holder in conjunction with a primary raise).[66]

*2.5 Recent Entrants*

In 2011, several firms announced plans to provide platforms for trading private company shares. These efforts are likely in response to the success demonstrated by SecondMarket and SharesPost. However, unlike SecondMarket and SharesPost, most of these new entrants are focused solely on institutional investors (with the exception of Wedbush Securities and Gate Technologies, which also service accredited individuals).

In February 2011, Gate Technologies announced the purchase of InfoExchange as a means for providing improved investment research to customers and an aid in its competition with

[62] Xpert Private Offerings, Xpert Financial, https://www.xpertfinancial.com/products/products_xpo.html.
[63] *Private Market Share Transactions Radically Streamlined*, Press Release, Xpert Financial Inc. (April 29, 2011). Available at: https://www.xpertfinancial.com/about/press_release/auto_execute.html.
[64] *Xpert Financial Announces Fully-Electronic Alternative Trading System for Private Company Securities*, Press Release, Xpert Financial Inc. (January 3, 2011). Available at: https://www.xpertfinancial.com/about/press_release/first_sec_registered_ats.html.
[65] Rolfe Winkler, *Facebook's Painful Secondary Impact*, WSJ Online (February 3, 2012). Available at: http://online.wsj.com/article/SB10001424052970204662204577199220078140972.html.
[66] *Xpert Financial Sees Growing Interest In Its Secondary Trading Platform*, PEHUB citing Xpert Financial Press Release, http://www.pehub.com/140013/xpert-financial-sees-growing-interest-in-its-secondary-trading-platform (March 9, 2012).

SecondMarket and Sharespost.[67] Gate Technologies hoped to centralize transactions through its electronic platform. However, a recent Wall Street Journal article indicates the company has had difficulty gaining traction. [68,69] Also in February, Mission Markets, a social impact investment firm, announced its first secondary offering of private company stock.[70]

In October 2011, Cantor Fitzgerald, a financial services firm, announced that it was forming the Cantor Private Markets Group to offer clients the opportunity to invest in private company stock (as well as REITs and private equity and hedge fund interests).[71] Liquidnet, a global institutional trading network, also announced in October 2011 that it was entering "the fast-growing market in private-company shares trading."[72] Liquidnet indicated that it will focus on large institutional investors seeking access to high-growth companies and will work directly with private companies to establish liquidity programs.[73] However, the executive hired to run Liquidnet's private company program resigned after just three months raising questions about the status of their program.[74]

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[67] Nina Mehta and Jeff Kearns, *Gate Buys InfoEx as Private-Trading Rivalry Grows*, Bloomberg (February 7, 2011). Available at: http://www.bloomberg.com/news/2011-02-07/gate-buys-infoex-as-private-trading-rivalry-grows-correct-.html.
[68] *Id*.
[69] Rolfe Winkler, *Facebook's Painful Secondary Impact*, WSJ Online (February 3, 2012). Available at: http://online.wsj.com/article/SB10001424052970204662204577199220078140972.html.
[70] *Mission Markets First to Facilitate Secondary Liquidity for Impact Investing Markets*, Business Wire (February 15, 2011). Available at: http://www.businesswire.com/news/home/20110215005230/en/Mission-Markets-Facilitate-Secondary-Liquidity-Impact-Investing.
[71] *Cantor Fitzgerald & Co. Announces the Expansion of Its Private Securities Business with the Formation of Cantor Private Markets*, Press Release, Cantor Fitzgerald & Co. (October 6, 2011). Available at: http://www.cantor.com/press_releases/Cantor_Fitzgerald__Co_Announces_the_Expansion_of_Its_Private_Securities_Business_with_the_Formation_of_Cantor_Private_Markets_.html.
[72] Liquidnet Launches Global Institutional Platform for Fast Growing Private-Company Shares Trading, Press Release, Liquidnet Holdings Inc. (October 17, 2011). Available at: http://liquidnet.com/docs/liquidnetBuzz/pressReleases/2011/Kerner%20Announcement%20FINAL.pdf.
[73] *Id*.
[74] Ari Levy and Chris Dolmetsch, *Lou Kerner Departs Liquidnet After Three Months on the Job*, BusinessWeek (January 24, 2012). Available at: http://www.businessweek.com/news/2012-01-24/lou-kerner-departs-liquidnet-after-three-months-on-the-job.html.

On December 1, 2011, Wedbush Securities, a full-service investment firm, announced the expansion of its Private Shares Group, which focuses on the social media space.[75] Wedbush creates tailored programs that allow existing and former employees, venture capitalists, private equity, and other investors to sell their shares. [76] Services are offered to both institutional and accredited investors. [77] Also in early December, the brokerage firm GFI Group announced that it launched a private shares group and will focus on the institutional side of the market.[78] Later in December, Knight Capital Group, a global financial services firm, announced that it had established a relationship with GreenCrest Capital Management, a research firm, to improve its ability to offer institutional clients access to trading in private companies. [79]

*2.6 Indirect Investment Opportunities for Unaccredited Investors*

The secondary market ecosystem has broadened to allow unaccredited investors an opportunity to invest indirectly. Unaccredited investors have access through a layer of professional investors.[80] For example, GSV Capital Corp. formed in September 2010 "as an externally managed, non-diversified closed-end management investment company", had its initial public offering on May 3, 2011, and now trades on Nasdaq (GSVC).[81] GSV Capital invests primarily in shares of private companies. GSVC Capital's January 6, 2012 Form N-2 lists the following companies in its portfolio: Bloom Energy, Chegg, Control 4, DreamBox Learning,

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[75] *Wedbush Securities Expands Private Shares Group, Welcomes Emerging Growth, Internet, and Social Media Veteran*, Press Release, Wedbush Securities (December 1, 2011). Available at: http://www.wedbush.com/sites/default/files/pdf/2011.12.1.PRESS_.HiringOfThomasWyman.FINAL_.pdf.
[76] *Id*.
[77] *Id*.
[78] Telis Demos, *GFI launches private shares group*, The Financial Times (December 1, 2011). Available at: http://www.ft.com/intl/cms/s/0/7c10dfa0-1a00-11e1-b9d7-00144feabdc0.html#axzz1fIKA2nDR.
[79] Liquidnet Launches Global Institutional Platform for Fast Growing Private-Company Shares Trading, Press Release, Liquidnet Holdings Inc. (October 17, 2011). Available at: http://liquidnet.com/docs/liquidnetBuzz/pressReleases/2011/Kerner%20Announcement%20FINAL.pdf.
[80] Adam Oliveri, *Panel - The Secondary Market Big Picturer*, SecondMarket Capitalyze 2012 Conference, New York (February 15, 2012). Video available at: https://www.secondmarket.com/discover/event-replay-capitalyze-east.
[81] GSV Capital Corp., Quarterly Report (Form 10-Q) (November 10, 2011). Available at: http://www.sec.gov/Archives/edgar/data/1509470/000114420411063020/v239794_10q.htm.

DropBox, Facebook, Gilt Groupe, Grockit, Groupon, Kno, debt tied to the value of Zynga, Serious Energy, SharesPost, Silver Spring Networks, StormWind, The EchoSystem, The rSmart Group, TrueCar, Twitter, ZocDoc, and Zoom Systems. GSVC's share price has remained relatively stable since its IPO (see Figure 4).

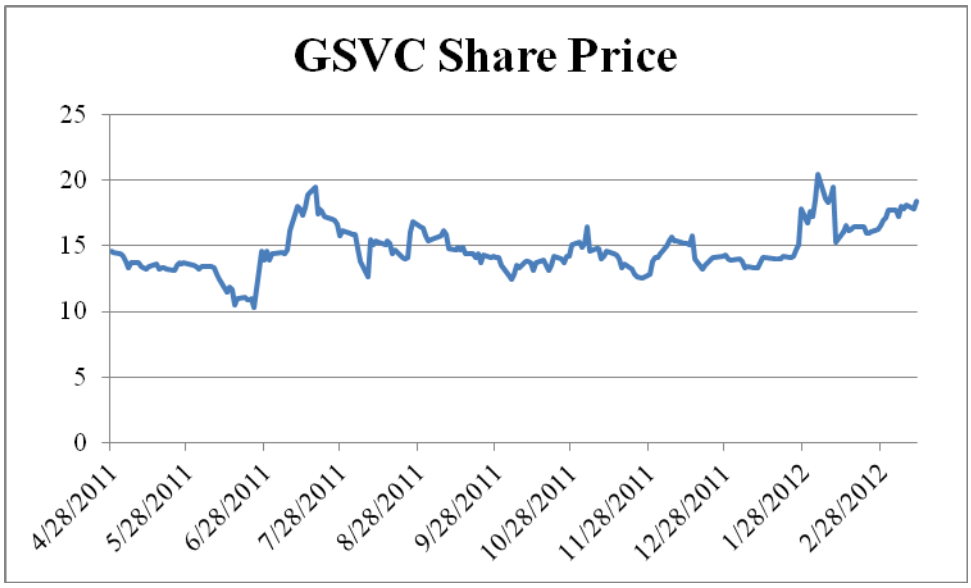



Figure 4[82]

In December 2011, Keating Capital also began trading on Nasdaq (KIPO).[83] Keating is a business development company focusing on pre-IPO investments in high growth companies.[84] Figure 5 illustrates the sectors and companies in which Keating Capital has invested. It has more recently invested in private companies Zoosk and Agilyx.[85,86]

[82] *GSV Capital Corp (GSVC)*, Yahoo! Finance, http://finance.yahoo.com/q/hp?s=GSVC+Historical+Prices.
[83] *Keating Capital Lists Shares on Nasdaq*, Press Release, Keating Capital Inc. (December 12, 2011). Available at: http://keatingcapital.com/wp-content/uploads/2011/09/Nasdaq-Listing-Press-Release-12-09-11-FINAL.pdf.
[84] *Business Development Company with Pre-IPO Focus*, Keating Capital Inc., http://keatingcapital.com.
[85] Keating Capital Inc., Current Report (Form 8-K) (January 31, 2012). Available at: http://www.sec.gov/Archives/edgar/data/1444706/000115752312000377/a50149844.htm.
[86] *Pre-IPO Investor Leads Agilyx Financing*, Press Release, Keating Capital Inc. (December 19, 2011). Available at: http://keatingcapital.com/wp-content/uploads/2011/09/Press-Release-Agilyx-Investment-12-15-11-FINAL.pdf.

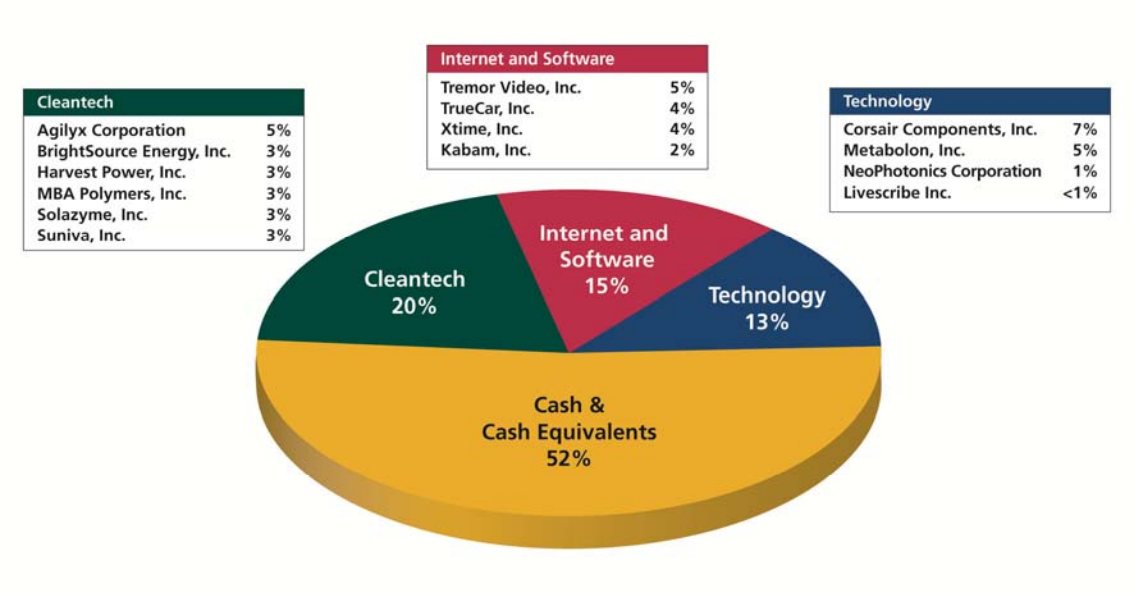



Figure 5 (source: Keating Capital, Inc.)[87]

## 3. Benefits And Risks of Pre-IPO Liquidity

The rapid growth in secondary markets for private company shares is due in large part to the benefits available to both buyers and sellers. Secondary transactions can provide liquidity for shareholders at a time when the issuer is not ready for an exit. Buyers gain access to an alternative investment class. The benefits to both buyers and sellers, as well as the risks and benefits to the issuer, are discussed below.

### *3.1 Sellers*

The liquidity needs of founders and employees are often not aligned with a company's needs. Personal situations, a desire for diversification, changes in employment, tax considerations and many other factors impact individuals in unique ways.[88] Sale through a secondary market allows

[87] *Portfolio Company Investment Allocation – Q4 2011*, Keating Capital Inc., http://keatingcapital.com/portfolio-companies/portfolio-by-industry (2012).
[88] Ken Sawyer, Zack Scott and Balazs Veress, *A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies*, Saints Capital (2010). Available at: http://www.saintsvc.com/wp-content/uploads/2011/11/Secondary_Marketing_Booklet_FINAL_VERSION-9.7.11.pdf.

individuals to secure the liquidity they need regardless of the issuer's particular needs at that time. This interim liquidity reduces the risk for the entrepreneurs and allows them to focus on growing the company, rather than personal financial issues.[89]

The liquidity needs of venture capitalists also often differ from those of the issuer. Older vintage funds may wish to wind down their investments and return capital to their limited partners.[90,91] Early stage venture capitalists may seek to exit from larger companies so they can focus on earlier stage companies where they provide more value add. [92] A fund may have insufficient reserves for a follow-on round and can sell to an investor with the capacity to make the additional investment.[93] A venture capitalist may disagree with a board's strategic direction or the fund's area of focus may have shifted.[94]

*3.2 Buyers*

Buyers in the secondary markets benefit from access to investments that might not otherwise be available to them. Existing investors may wish to increase their stake in a company.[95] New investors may desire access that was not available in primary rounds. [96] Transaction costs are reduced allowing for more efficient allocation of buyers' capital.

*3.3 Issuers*

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[89] Paul Deninger, *Panel – The Secondary Market vs. Going Public*, SecondMarket Capitalyze 2011 Conference, San Francisco. (May 11, 2011). Video available at: https://www.secondmarket.com/discover/capitalyze.
[90] Ken Sawyer, Zack Scott and Balazs Veress, *A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies*, Saints Capital (2010). Available at: http://www.saintsvc.com/wp-content/uploads/2011/11/Secondary_Marketing_Booklet_FINAL_VERSION-9.7.11.pdf.
[91] Hans Swildens, *Venture Capital Secondary Funds – The Third Exit Option: A smart way to improve fund performance and unlock hidden value*, Industry Ventures LLC White Paper (May 2008). Available at: http://www.industryventures.com/pdf/Venture_Capital_Secondaries_White_Paper.pdf.
[92] Duncan Davidson, *Panel - The Secondary Market Big Picturer*, SecondMarket Capitalyze 2012 Conference, New York (February 15, 2012). Video available at: https://www.secondmarket.com/discover/event-replay-capitalyze-east.
[93] Ken Sawyer, Zack Scott and Balazs Veress, *A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies*, Saints Capital (2010). Available at: http://www.saintsvc.com/wp-content/uploads/2011/11/Secondary_Marketing_Booklet_FINAL_VERSION-9.7.11.pdf.
[94] *Id.*
[95] *Id.*
[96] *Id.*

When handled appropriately, many of the advantages to sellers can translate into advantages for the issuer. Secondary transactions can be used to retain and motivate employees.[97] The company benefits when employees are able to focus on company growth rather than personal financial concerns. [98] The incentive value of equity compensation can become a stronger motivator when employees are able to cash out a portion of their shares. However, companies are understandably cautious about allowing existing employees to sell all of their shares. The fear is that employees will lose motivation and therefore companies limit sales to a percentage of vested shares.[99,100] On the other hand, where sales by former employees are unrestricted, existing employees may consider leaving if necessary to achieve liquidity. [101]

Issuers can benefit in several ways by bringing in new investors and removing old. Unhappy investors can leave allowing for better board dynamics.[102] The pressure to exit earlier than the issuer feels appropriate can be reduced if each investor is able to select their own timeline through the secondary market.[103] The capitalization table can be cleaned up, which is of particular benefit for companies approaching the SEC's 500 shareholder limit (beyond which there are enhanced reporting requirements similar to those of going public).[104,105] Secondary

[97] *Id*.
[98] *Panel – The Secondary Market vs. Going Public,* SecondMarket Capitalyze 2011 Conference, San Francisco. (May 11, 2011). Video available at: https://www.secondmarket.com/discover/capitalyze.
[99] Tom Sansone, *Panel - The Secondary Market – The Value Proposition,* SecondMarket Capitalyze 2012 Conference, New York (February 15, 2012) (limit liquidity to 10-25% of the vested amount). Video available at: https://www.secondmarket.com/discover/event-replay-capitalyze-east.
[100] Annemarie Tierney, *Panel - Secondary Transaction Mechanics and Primer,* SecondMarket Capitalyze 2012 Conference, New York (February 15, 2012) (SecondMarket listed its own shares and allowed existing employees to sell up to 20% of their holdings. There were no limitations on the amount sold by ex-employees). Video available at: https://www.secondmarket.com/discover/event-replay-capitalyze-east.
[101] Ken Sawyer, Zack Scott and Balazs Veress, *A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies*, Saints Capital (2010). Available at: http://www.saintsvc.com/wp-content/uploads/2011/11/Secondary_Marketing_Booklet_FINAL_VERSION-9.7.11.pdf
[102] *Id*.
[103] *Id*.
[104]Michael Pitts, *The Secondary Market – The Value Proposition,* SecondMarket Capitalyze 2012 Conference, New York (2/ 15/12). Available at: https://www.secondmarket.com/discover/event-replay-capitalyze-east.

transactions can be conducted in concert with primary rounds, bringing in new investors through a secondary transaction who are also able to participate in follow-on primary rounds. [106]

Transactions in the secondary markets can bring added credibility to private companies that could raise the likelihood of later merger and acquisition transactions.[107] The secondary markets can provide pricing validation and can also include a vetting process that has the potential to act as a preliminary filter for those seeking acquisition targets. The secondary markets can also allow companies to stay private longer, which can allow them to remain competitive (less disclosure is available to competitors) and focused on growth (rather than meeting public company requirements). [108]

Secondary transactions normally require some level of information exchange (often to both buyers and sellers, many of whom are former employees), which can be a concern for issuers. Issuers also need to be wary of the SEC's 500 shareholder rule, which, if triggered, would require reporting similar to that of a public company.[109] Prices from secondary transactions may need to be used in 409A valuations (an IRS regulation covering nonqualified deferred compensation, such as options) impacting the level of benefits available to employees.[110] These risks associated with secondary transactions are mitigated by the increasing level of company control over transactions.

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[105] Ken Sawyer, Zack Scott and Balazs Veress, *A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies*, Saints Capital (2010). Available at: http://www.saintsvc.com/wp-content/uploads/2011/11/Secondary_Marketing_Booklet_FINAL_VERSION-9.7.11.pdf

[106] *Id*.

[107] Michael Pitts, *Panel - The Secondary Market – The Value Proposition*, SecondMarket Capitalyze 2012 Conference, New York (February 15, 2012). Video available at: https://www.secondmarket.com/discover/event-replay-capitalyze-east.

[108] Ken Salgado and Ellen S. Bancroft, *The Benefits—and Risks—of Secondary Markets for Private Shares*, NVCA Today (October 24, 2011). Available at: http://nvcatoday.nvca.org/index.php/from-our-sponsors/the-benefitsand-risksof-secondary-markets-for-private-shares.html.

[109] *Q&A: Small Business and the SEC*, U.S. Securities and Exchange Commission, http://www.sec.gov/info/smallbus/ qasbsec.htm (November 14, 2009).

[110] *409A Nonqualified Deferred Compensation Plans*, IRS (May 4, 2011) http://www.irs.gov/retirement/article/0,,id=186222,00.html.

## 4. Five Brief Case Studies

There have been relatively few companies traded in the secondary marketplace that have gone IPO. For the five companies for which data is available, SharesPost, IPO, and subsequent Nasdaq prices are presented. [111] As illustrated below, there is no clear path that share price takes through the process. The secondary market price is becoming a more important factor in pricing shares (particularly for option grants); several companies have made reference to secondary market prices in their registration statement (Form S-1) filings with the SEC.

### *4.1 Tesla Motors*

Tesla Motors was one of the first companies to transition from secondary to public market. The path of Tesla Motor's share price through the transition is illustrated in Figure 7. The roughly $10 secondary market price was followed by a $17 IPO. The company then traded well above the IPO price for several days, dipped slightly below, then increased.

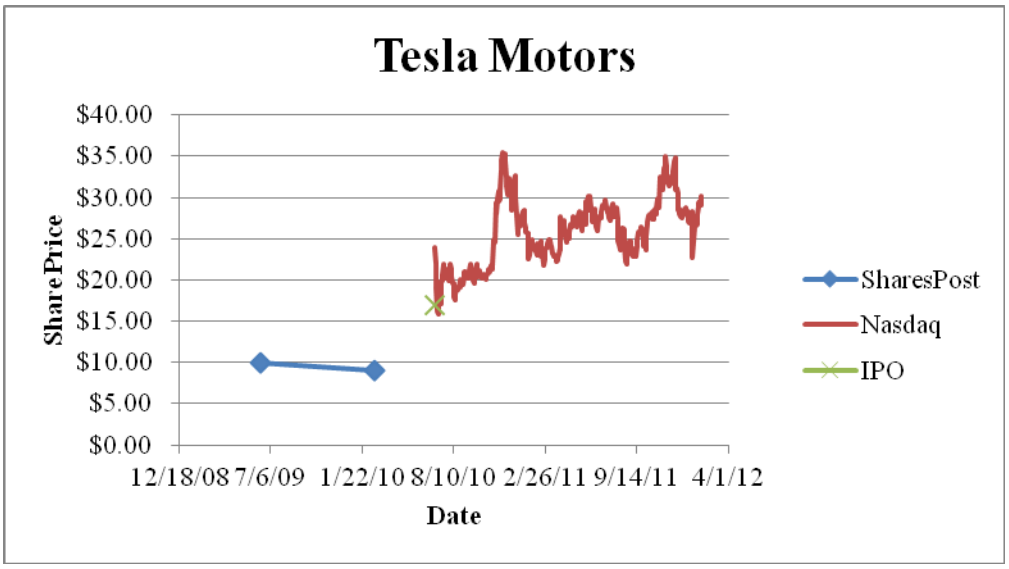



Figure 7

### *4.2 LinkedIn*

[111] SharesPost is the only private company secondary marketplace that makes a significant portion of its transaction data available. SharesPost data was supplemented with information from Bloomberg and Internet searches.

LinkedIn represents another successful secondary to public market transition, as illustrated in Figure 8. The secondary market price increased steadily to over $30, the IPO was priced above at $45, and then the Nasdaq price increased dramatically, closing at over $94 the first day (some would argue, a case of too much underpricing).[112]

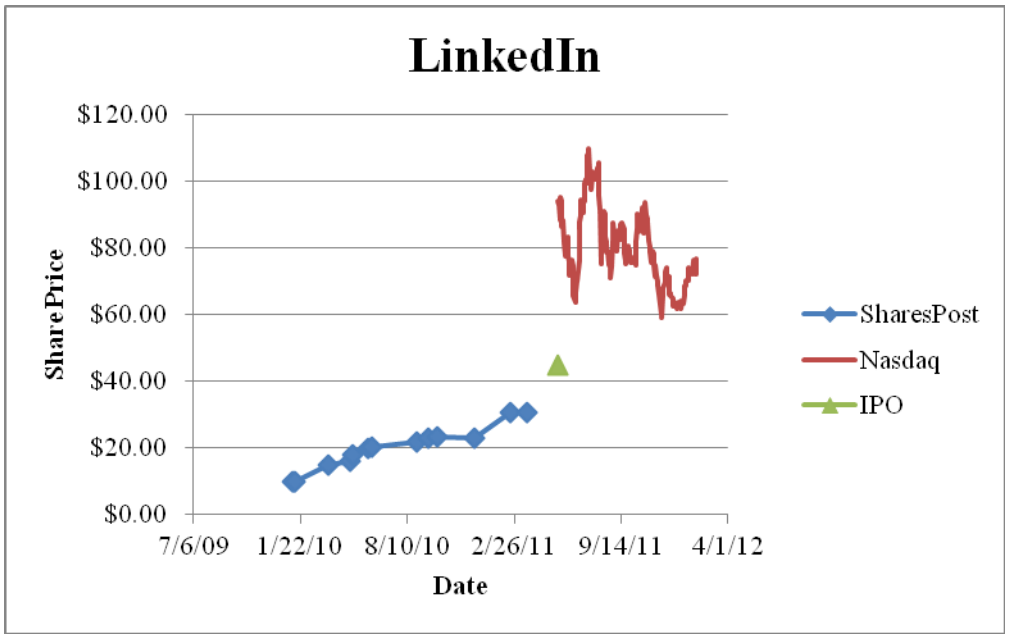



Figure 8

*4.3 Fusion-io*

Fusion-io followed a path similar to LinkedIn (see Figure 9). The company traded at $15 in the secondary marketplace, went IPO at $19, and closed it first day at $22.5.

[112] Joe Nocera, *Was LinkedIn Scammed?*, New York Times (May 20, 2011). Available at: http://www.nytimes.com/2011/05/21/opinion/21nocera.html?_r=1.

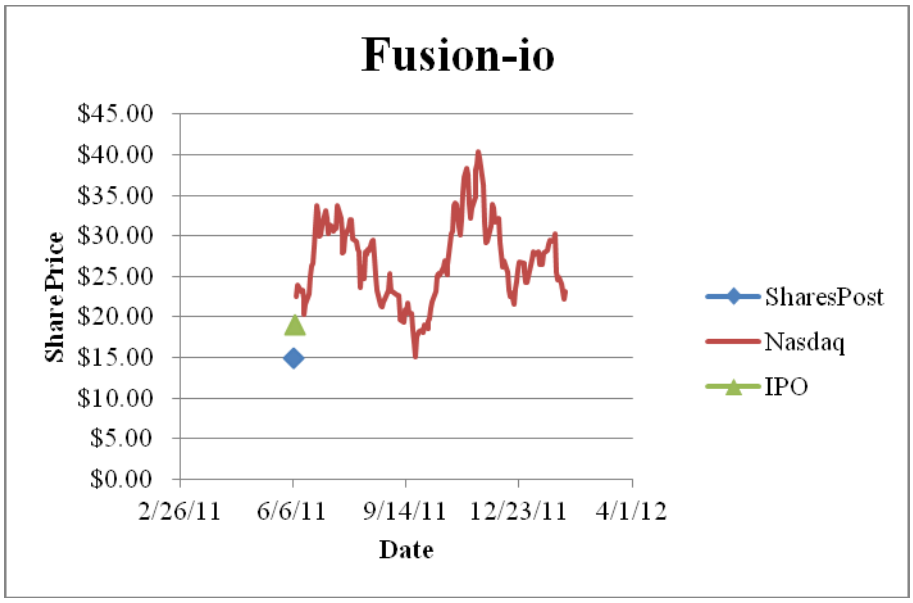



Figure 9

*4.4 Jive Software*

Jive Software's IPO was priced at $12, below its secondary market price of $12.50 roughly six months earlier (see Figure 10). Unfortunately, secondary market prices closer to the IPO were unavailable. Following the IPO, the company's price jumped to over $15.

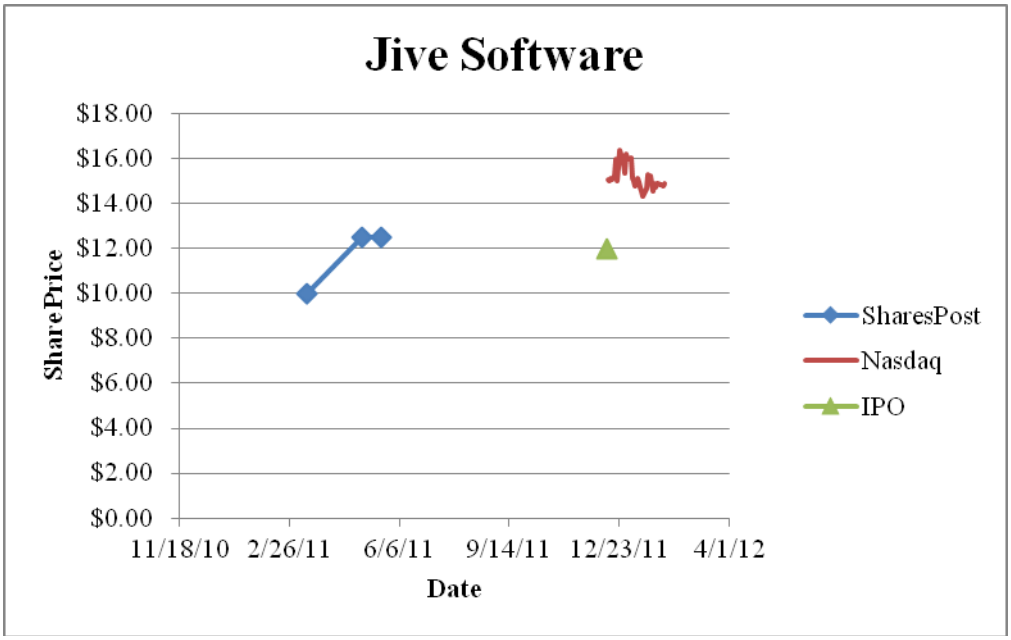



Figure 10

*4.5 Zynga*

Zynga's IPO price was set substantially below its secondary market price. After steadily rising to $20 on SharesPost, Zynga went IPO at $10, and then had a $9.50 first day close on Nasdaq, as illustrated in Figure 11.

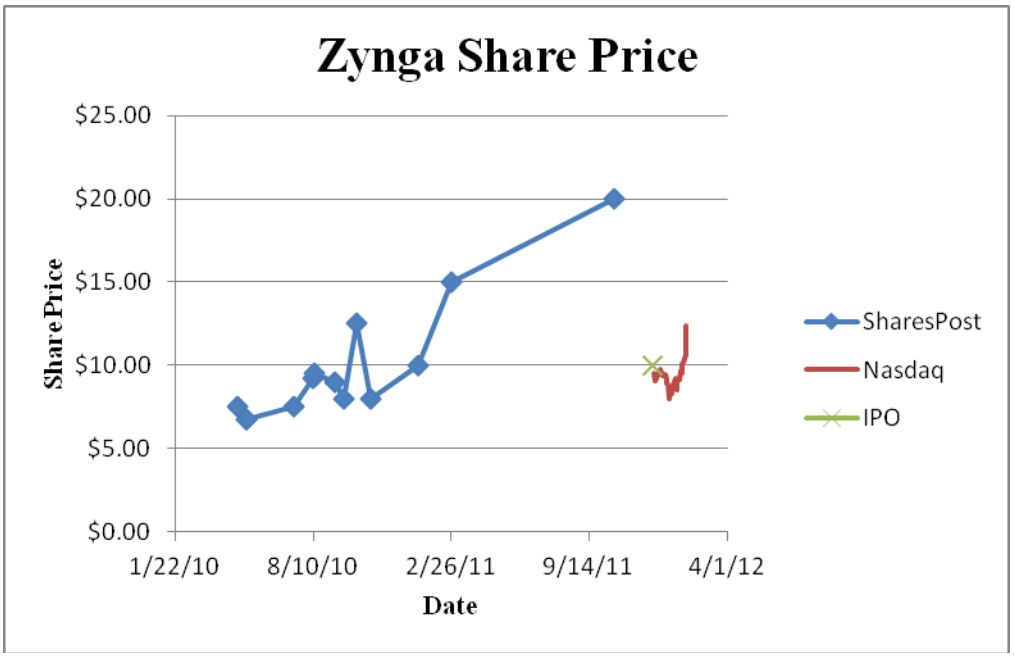



Figure 11

## 5. From Secondary Market to Primary Market

The increasing importance of secondary markets makes them a potentially useful source of data for predicting the pricing of companies' IPOs. As discussed above, in March 2011 SecondMarket launched its "watcher" feature to provide investors with a way of tracking companies of interest. To examine the links between the secondary markets (i.e., SecondMarket) and the primary markets (i.e., the IPO market), we regress the first-day initial return on the natural logarithm of one plus the number of watchers.

There were 42 venture-backed IPOs in the United States in 2011 and another 13 in the first quarter of 2012. SecondMarket began its watcher program in March 2011, so we focus on the 41 venture-backed companies that went public between April 2011 and March 2012. Monthly watcher data for these companies was provided by SecondMarket.[113]

The regression yields the following estimates:

1-day initial return = 0.0619 + 0.0893 log(watchers+1)

The *p*-value for the coefficient on the number of watchers is <0.001. Figure 14 plots the 1-day initial return and log(watchers+1).

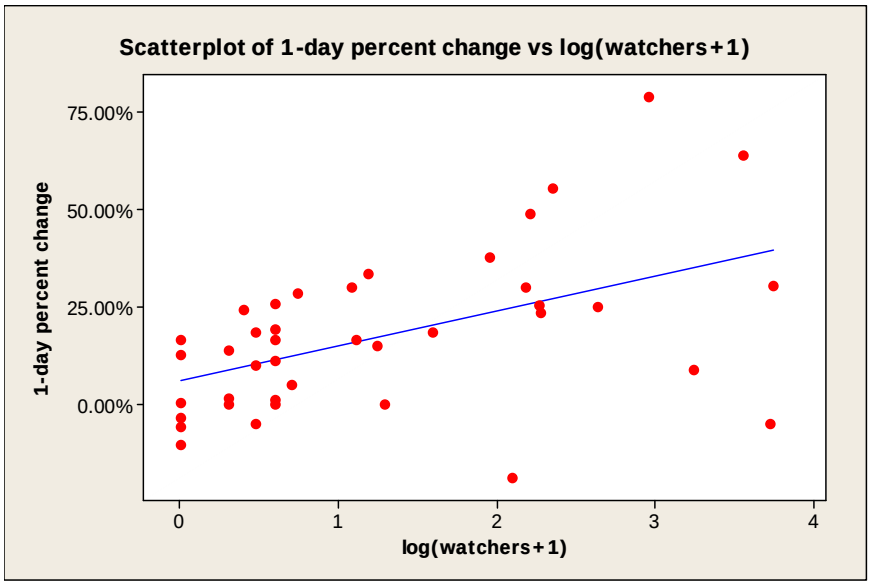



Figure 14

The significant correlation between the number of watchers and the first-day change in price suggests that the level of buyer interest in secondary markets such as SecondMarket contains useful information for investment banks to consider when setting a company's IPO price. The fact that secondary market interest correlates so strongly with IPO underpricing suggests that investment banks are not currently incorporating these data.

[113] A special thanks to Aishwarya Iyer of SecondMarket for providing the monthly watcher data.

## 6. Conclusion

The rapidly evolving marketplace for private company shares has seen the emergence of many new players in the last few years. This trend is expected to continue, particularly as regulatory issues are addressed and changes to the legislative framework are considered. Secondary marketplaces will likely play a key role in companies' decisions whether and when to go public. Transaction prices and other secondary-market data are expected to become a more critical factor in IPO pricing and in valuing options for 409A purposes.