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Private Trading Platforms for Restricted Securities



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The recent growth of interest by investors in both primary offerings and resales of “restricted securities” (that is, securities that have been sold by the issuer without registration under the Securities Act of 1933) has been remarkable. Analysts estimate that the resale market reached approximately \$5.0 billion dollars in 2011,² and is estimated to grow to almost \$10 billion by 2013.³ There are a number of factors contributing to this growth, including (i) relaxed SEC rules regarding private market resale transactions under Rule 144 and (ii) the number of start-up companies that have skyrocketing valuations but that have not entered the public markets. These dynamics have helped spur demand for the restricted securities of rapidly growing but still-private companies, and have given rise to a number of internet-based trading platforms for trading of restricted securities, such as SecondMarket and SharesPost. With this increased activity, there remains a substantial question as to whether increased SEC regulation is necessary to mitigate the potential abuses that may arise when investors buy private, restricted securities without the informational and other protections of a public trading market.

I. Resales of restricted securities under SEC Rule 144.

A. Background to Rule 144.

1. Section 5(a) of the 1933 Act makes it unlawful for any person to offer to sell or offer to buy any security absent registration or an exemption.
2. Section 4(1) of the 1933 Act exempts transactions by any person “other than an issuer, underwriter, or dealer” from Section 5’s restriction on security sales.
3. Section 2(a)(1) broadly defines an “underwriter” as “any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in such undertaking.”
4. The 1933 Act does not provide specific guidance as to when a person has purchased securities with “a view to...the distribution” of those

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² HighStep Capital, *Private Company Secondary Markets*, <http://www.slideshare.net/jjones23/private-company-secondary-markets-january-2012-markum-breakfast>.

³ Millennium Technology Value Partners, *New Trends Shaping the Future of the Venture Capital Ecosystem*, <http://mtvlp.com/files/resources/MillenniumFiveForecasts2011.pdf>

securities. This makes complying with the Section 4(1) exemption difficult absent the Rule 144 safe harbor.

- B. Rule 144's History.** Restricted securities cannot be resold without an exemption from registration under the Securities Act. Rule 144 is a safe harbor under Section 4(1) of the 1933 Act, originally adopted in 1972 and amended several times since then, that permits the public or private resale of restricted securities if certain conditions are met, including the satisfaction of applicable holding periods.
- C.** A 2007 amendment to Rule 144 reduced the required holding period for the resale of restricted securities held by non-affiliates to only one year.⁴
- D. Affiliate vs. non-affiliate.** Rule 144 has different requirements depending on the status of the security holder as an affiliate or non-affiliate.
- 1. Affiliate.** An affiliate is a person who “directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.”⁵ SEC guidance has indicated that the test for an affiliate is based on the facts and circumstances, but an issuer’s executive officers, directors and significant holders (greater than 10%) are generally considered affiliates.⁶
 - 2.** Affiliates of private issuers who hold restricted securities of the issuer have additional resale requirements other than the one-year holding period. These include selling the securities through an ordinary brokers’ transaction, ensuring that adequate public information about the issuer is available, limiting the volume of shares sold, and filing a Form 144 for notice of certain transactions with the SEC.⁷
 - 3. Non-Affiliates.** To meet the requirements of the Rule 144 resale safe harbor, a non-affiliate holder of restricted securities of a non-reporting company must merely hold the shares for one year prior to resale.⁸ No

⁴ Rule 144 (b)(1)(ii) (exempting sales of restricted securities of all other Rule 144 requirements other than the holding period); see also Rule 144(d)(1)(ii) (condition for a one-year holding period for a non-affiliate holder of restricted securities in a non-reporting company).

⁵ Rule 144(a)(1).

⁶ *Rule 144: Selling Restricted and Control Securities*, U.S. Securities and Exchange Commission, (accessed May 12, 2011), <http://www.sec.gov/investor/pubs/rule144.htm>

⁷ Rule 144(b)(2).

⁸ Rule 144(a)(1). For shares acquired through the exercise of employee stock options, the holding period does not begin until the date that the option is exercised. Conversely, for shares obtained through the exercise of options and warrants that were purchased for cash or property, the holding period begins on the date the options or warrants were purchased, so long as the exercise of the options or warrants was not conditioned on a further payment of cash or property.

other SEC requirements apply from the perspective of the holder of the restricted shares.⁹

- E. While Rule 144 provides a safe harbor for resales of restricted securities by non-affiliates, private issuers may wish to impose additional restrictions on resale, so as to limit proliferation of shareholders through resales. Issuers can restrict resales of restricted securities through a number of means, including (i) limiting resales of restricted securities to sales to current shareholders, (ii) permitting holders of restricted securities to resell their securities only if they sell all of their current holdings, and/or (iii) granting the company a right of first refusal.¹⁰ The majority of private companies, however, impose no formal restrictions on resale of their shares.¹¹

II. Market drivers have led to increased interest and activity in the private market for restricted securities.

- A. The lingering recession of recent years has resulted in a relative dearth of initial public offerings and limited opportunities for liquidity of investments in private companies:
1. For example, at the end of the tech bubble in 1999 and 2000 there were hundreds of venture capital-backed initial public offerings. 1999 had 273, whereas 2000 had 261.
 2. Following a dramatic decrease to 12 venture capital backed initial public offerings in 2009, the IPO market has shown signs of recovery. In 2010, there were 75 venture capital backed offerings, with an additional 52 offerings in 2011.
 3. Investors in private companies can also obtain liquidity through a merger or acquisition of their companies. In 2000 and 2001 there were 316 and 350 merger and acquisition deals for venture capital-backed companies. In comparison, 2010 saw a record 436 deals, with another 429 during 2011. However, even with the increase in M&A activity in 2010 and 2011, the combined exits from IPOs and M&A deals were still less than 2000 levels.
 4. For venture capital investors, the median holding time of investments in start-up companies has increased forty percent (40%) over the last

⁹ Note that these relaxed resale requirements do not apply to holders of restricted securities of reporting companies.

¹⁰ *Today's Marketplace for Securities of Pre-Public Companies How We Got Here*, THE CORPORATE COUNSEL, March-April 2011.

¹¹ Pandora Media, in an effort to provide liquidity to employee holders (some of whom had received stock options as their only compensation) and to reduce the pressure to permit sales on secondary markets, offered employees the opportunity to sell shares to several major shareholders. Pandora also reincorporated in Delaware to permit it to impose stronger restrictions on share transfers. Allison Bisbey Colter, *Managing the Risks of Secondary Trading*, IDD MAGAZINE, May 6, 2011.

decade. During the tech bubble, venture capital investors held investments for a median of three to five years. Currently, the median holding period for venture-backed companies is more than seven years.¹²

5. The reduction in available exits from private company investments has limited the options of venture capital firms and other investors desiring liquidity. As a result, there is increased attention to the private market of for resale of restricted securities.
6. The start-up company model also drives the private market for restricted securities. Traditionally, below-market cash compensation for employees of private companies is supplemented by equity in the company in the form of restricted stock units, stock options, stock purchase rights or similar plans. As private companies stay private for longer and longer times, strains can emerge among employees who have been consistently living on lower than market wages and who may want to liquidate some, or all, of their current holdings in the issuer.
7. Finally, the extremely high valuations placed on private companies such as Facebook and Twitter have created tremendous investor demand for the shares of companies that are not yet publicly traded, as investors try to invest in these private companies before their shares appreciate further. All of these forces have given rise to a rapid proliferation of internet-based trading platforms for restricted securities.

III. Growth of the private market for restricted securities.

- A. The SEC staff had approved certain types of electronic trading platforms as long ago as 1996 (*IPONET* (July 26, 1996), but recently a number of trading platforms have emerged, such as SecondMarket and SharesPost, and reported trading on the platforms has increased rapidly with SecondMarket facilitating over \$558 million in secondary-market transactions during 2011, a 55% increase from 2010.¹³ Some of these platforms charge transaction fees, while others purport to be no more than a fee-based “passive bulletin board” that fit within a line of SEC Staff no-action letters (e.g., *Real Goods Trading Corporation* (June 24, 1996)).¹⁴
- B. Unlike public companies, private companies are not legally required to provide public information about their operations and finances, and purchasers of restricted securities of private companies have no such entitlement to disclosure

¹² Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 Vand L. Rev. (forthcoming 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1688982.

¹³ SecondMarket, *SecondMarket's 2011 Year End Private Company Report*, <https://www.secondmarket.com/discover/reports/secondmarkets-2011-year-end-private-company-report>

¹⁴ *Today's Marketplace for Securities of Pre-Public Companies How We Got Here*, THE CORPORATE COUNSEL, March-April 2011.

by the issuer of the securities.¹⁵ Buyers and sellers of restricted securities of private companies therefore are far more likely to have limited and unequal access to information about the issuer (particularly where, for example, a buyer or seller is an employee of the issuer who has access to material nonpublic information), and there are enormous opportunities for abuse by sellers or buyers with access to material information about a private company.

- C. The fact that trades may occur between buyers and sellers with limited and unequal information might be manageable if the traders were sophisticated institutional investors, such as funds dedicated to making secondary purchases, capable of making their own investigations and evaluating the risks of the transaction. For the most part, however, the new internet-based secondary markets permit the purchase of restricted securities by any person that is an “accredited investor” (see below) for purposes of the SEC’s Regulation D. Many of these potential investors do not have the necessary information or sophistication to be able to make an informed investment decision in the absence of periodic, required reporting by the issuer.
- D. **Investments in restricted securities by accredited investors.** The emerging secondary-market of restricted securities increases the likelihood that less sophisticated investors will not have the necessary company information to make informed investment decisions:
1. An accredited investor is (a) a natural person who has individual net worth, or joint net worth with the person’s spouse, that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person; or (b) a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year.¹⁶
 2. The definition of an accredited investor is troublesome in the context of the secondary market for private securities. Many people that earn \$200,000 are not “savvy” investors akin to venture capital firms. Without adequate disclosure, the rationales for these investment decisions might be merely publicity and hype, increasing the propensity for rampant speculation or even fraud.
- E. **Broker-dealer registration.** It remains an open question whether the websites that facilitate the secondary-market transactions of restricted securities must register as a broker-dealer under Section 15 of the 1934 Act. Some secondary-market websites have registered with the SEC as a broker-dealer, yet others

¹⁵ SecondMarket reportedly recently began providing some information about issuers. Jean Eaglesham, *Guidance Is Sought on Private Trading of Closely Held Companies*, WALL ST. J. (May 9, 2011), <http://online.wsj.com/article/SB10001424052748704810504576310262093052504.html>.

¹⁶ Rule 501(a).

have relied on no-Action guidance that permits websites to operate as passive bulletin boards so long as the fees associated with the bulletin are not transaction based.¹⁷ For the most part, these secondary-market websites for trading in restricted securities have developed absent SEC guidance. SecondMarket, the largest website for restricted securities, sought guidance from the SEC in 2011 concerning its secondary-market website.¹⁸ It remains unclear, however, what approach the SEC will take.

¹⁷ See, e.g., Lamp Technologies, SEC No-Action Letter, No. 97-243-CC (May 29, 1997).

¹⁸ Jean Eaglesham, *Guidance Is Sought on Private Trading of Closely Held Companies*, WALL ST. J. (May 9, 2011), <http://online.wsj.com/article/SB10001424052748704810504576310262093052504.html>.