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**The Rise of the Secondary Trading of
Private Company Shares in the United
States, Europe, and the United Kingdom:
New Opportunities and Unique Challenges**

Diana Milanese

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Abstract

Despite a large number of venture-backed companies going public in the United States, Europe and the United Kingdom in the first half of 2019, companies of various sizes and valuations continue to see the value in remaining private. As the number of private companies grows, so does the amount of investment capital looking to enter the private market. With record-high amounts of capital contributing to an increased number of high-valued private companies, the demand for liquidity solutions has been building up. Moreover, as the length of time that companies take to go public has increased, many companies are going through their main growth period while remaining private, thus increasing the demand for secondary investment opportunities. As a result of these trends, secondary transactions involving shares of private companies have grown significantly in the United States, Europe and the United Kingdom in recent years.

Secondary sales of private company shares introduce a unique set of challenges, including identifying the right investors, understanding the potential risks, and properly handling the transactions from a legal, accounting and tax perspective on both a personal and a company level. Yet, many of these challenges can be alleviated by the company carefully structuring the terms and conditions of the offering. With the right level of preparation, a well-crafted, company-facilitated secondary offering can help private companies satisfy the liquidity needs of a number of shareholders, while minimizing the risks involved in the transactions. Hence, more and more private companies now recognize the long-term benefits of structuring, managing and prioritizing liquidity strategies for their founders, early-stage investors and employees. As the volume, value and frequency of secondary transactions have increased, the secondary market activity has gradually progressed to a more mature phase. Until a few years ago, private tender offers were generally conducted as a precursor to an initial public offering (“IPO”) to achieve a reference price in the market or as a one-off transaction in which founders, early-stage investors and/or employees would cash out before the company exits. These secondary transactions would also allow a company to pave the way for a successful IPO, giving shareholders an opportunity to sell (part of) their shares without impacting the share price by selling on the public market after expiration of the lockout period. Although these techniques are still commonly used in preparation of an IPO or a direct listing, private companies have progressively broadened their use of private tender offers and have increasingly launched liquidity programs for strategic purposes. For instance, many private companies now consider recurring secondary transactions as an integral component of their incentive compensation programs and provide recurrent liquidity as means to recruit, retain and better incentivize employees. In addition, more and more private companies utilize private tender offers and liquidity programs to accomplish several other goals, including to consolidate or “clean-up” their cap-table, to optimize their governance structure, to locate and to add new strategic investors.

As secondary transactions have evolved, so too have the market participants that support them. For example, an increasing number of U.S., European and UK venture capital firms have raised liquidity (or secondary) funds over the last few years, which focus on providing tailored liquidity solutions to early shareholders - be they current and former founders or employees, angel investors or early stage venture firms - in

high-growth private companies. Notable examples include Founders Circle Capital, 137 Ventures, Saints Capital, Delta-V Capital, Akkadian Ventures, Industry Ventures, Oceanic Partners, Balderton Capital, Vitruvian Partners and Hambro Perks.

More recently new private markets have also emerged in the United States, Europe and the United Kingdom to facilitate controlled, liquid and transparent secondary transactions in private company shares. Various players have established different platforms and continue to innovate to meet growing demand and diversified customer needs. Examples include Nasdaq Private Market, Forge Global, EquityZen, SharesPost and Carta.

Liquidity funds and secondary markets for private company shares are positioned to experience significant growth in the United States, Europe and the United Kingdom over the coming years. They have created new models for how investors and other shareholders can unlock their value in private companies. In so doing, they have been changing the landscape of private companies financing and liquidity and have been redefining business ownership in private companies as we know it. Distinctions between public and private markets have been gradually diminishing and liquidity has been progressively shifting towards private capital. Moreover, while robust, transparent and liquid private secondary markets have benefits of their own, they also promote the health of the primary offering markets, which directly benefits emerging and growing private companies. For these reasons, encouraging continued innovation and supporting further development of liquidity funds and secondary markets for private company shares have become incredibly important for secondary buyers and sellers, as well as private companies in which shares are being sold through secondary transactions.

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PREFACE

Emerging and growing private companies play a vital role in driving progress, fostering innovation and facilitating job creation. Their ability to raise capital, expand their business activities, attract and retain skillful employees is therefore of crucial importance for the growth of the economy.

The last few years have seen a remarkable increase in the secondary trading of private company shares in the United States and a nascent use of secondary transactions in Europe and the United Kingdom. These developments have been largely driven by a raising pressure on U.S., European and UK private companies to provide liquidity to former and current employees, founders, early-stage investors and other shareholders. The increase in frequency and volume of secondary trading has highlighted the important role that an active and liquid secondary market for private company shares may play to facilitate the growth of private companies. However, the recent development of a red-hot trading in the shares of some of the world leading technology private companies has also sparked a large debate on the risks and complexities associated with the secondary trading of private company shares and has attracted the scrutiny of financial authorities and regulators.

This paper analyses recent developments in the secondary trading of private company shares in the United States, Europe and the United Kingdom. Chapter 1 reviews major drivers that have contributed to increase secondary sales and purchases of private company shares. Chapter 2 examines key players and new approaches to secondary market liquidity. Chapter 3 discusses a number of benefits associated with a controlled, transparent and liquid secondary trading of private company shares. Chapter 4 outlines certain challenges and potential risks that should be carefully considered by secondary buyers and sellers, as well as private companies in which shares are being sold through secondary transactions. Chapter 5 discusses measures to promote further development and enhance the growth of the secondary trading of private company shares in the United States, Europe and the United Kingdom.

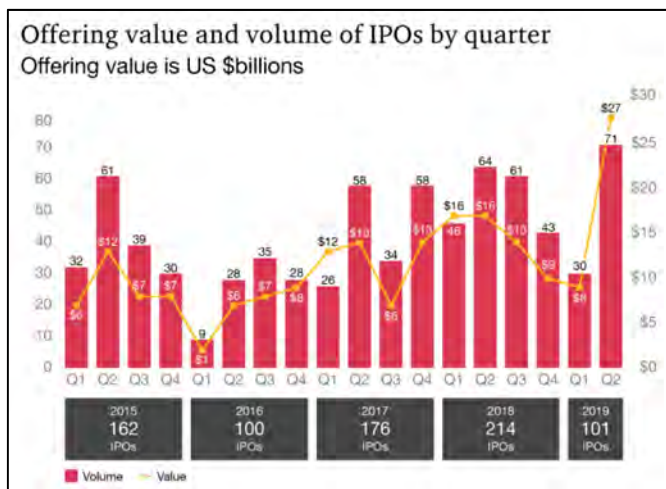
CHAPTER 1

DRIVING FORCES BEHIND THE RISE OF THE SECONDARY TRADING OF PRIVATE COMPANY SHARES

1.1. IPO ACTIVITY

1.1.1. THE U.S. IPO MARKET

The U.S. public markets made headlines in the first half of 2019, with a number of well-known and highly anticipated venture-backed companies becoming public, with varying degrees of initial trading success. 30 initial public offerings (“IPOs”) raising c. \$8 billion were priced in the first quarter, and 71 IPOs raising c. \$27.4 billion in the second quarter of 2019.¹ At the time of this publication, the pipeline for upcoming IPOs in the second half of 2019 remains reasonably strong.



*Values in US \$bn

Source: PwC, Q2 2019 Capital Markets Watch (PricewaterhouseCoopers, 2019)

Venture-backed tech IPOs drove technology, media and telecom (“TMT”) to be the most active sector and accounted for a third of all IPOs in the second quarter of 2019. 24 TMT companies raised c. \$16.3 billion in aggregate, mostly driven by market and e-commerce platforms including Lyft, Zoom, Pinterest and Uber. Additionally, following Spotify’s 2018 direct public offering (“DPO”) success, the TMT experienced another direct listing in the second quarter of 2019 with Slack becoming the second notable technology giant to opt for an alternative path to the public market bypassing a traditional IPO.²

¹ See, PwC, Q2 2019 Capital Markets Watch (PricewaterhouseCoopers, 2019), p. 1, retrieved from <https://www.pwc.com/us/en/services/deals/capital-markets-watch-quarterly.html>.

² Id., p. 2.

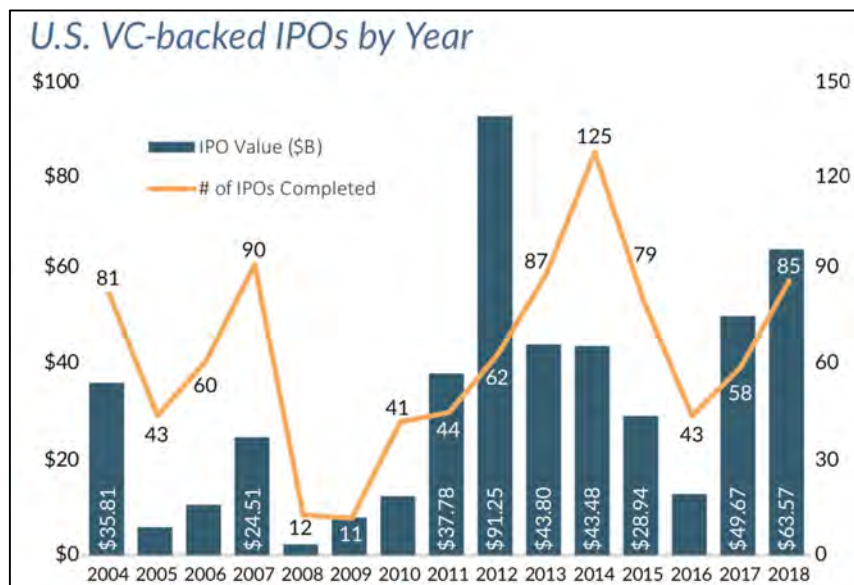
Value and volume of US IPOs by industry

	Q2'19		Q2'18	
	Volume	Value (bn)	Volume	Value (bn)
Consumer Markets	3	\$1.2	4	\$1.1
Energy, Utilities & Mining	1	\$0.7	-	-
Financial Services	5	\$0.3	9	\$4.1
Health Services	2	\$0.4	-	-
Industrial Products	3	\$3.5	2	\$0.7
Pharma & Life Sciences	20	\$2.1	22	\$2.3
SPAC	13	\$2.9	11	\$3.0
TMT	24	\$16.3	16	\$4.6
Total	71	\$27.4	64	\$15.8

Source: PwC, Q2 2019 Capital Markets Watch (PricewaterhouseCoopers, 2019)

U.S. venture-backed IPO market activity in 2019 continues an increasing trend in IPOs since the prior year³: 85 venture-backed companies went public accounting for 40% of all U.S. IPOs in 2018, a 15-year high. These companies raised a collective \$64 billion at IPO, the highest aggregate annual total for capital raised since the dot-com boom except for 2012 when Facebook went public. Together, these 85 IPOs had a post-money valuation of \$75 billion, created from \$16 billion invested prior to IPO.

The median size of IPOs in 2018 reached \$348 million and median IPO post-money valuation reached \$443 million, both 15-year highs.⁴



Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

³ See, Mary Schapiro, U.S. Securities and Exchange Commission Chairman, Statement at the Future of Capital Formation: Hearing Before the House Committee on Government and Oversight Reform, 112th Congress (May 10, 2011), available at http://oversight.house.gov/images/stories/Testimony/5-10-11_Schapiro_Capital_Formation_Testimony.pdf; SEC, Letter from Mary Schapiro, U.S. Securities and Exchange Commission Chairman, to The Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform (Washington, April 6, 2011), pp. 12-13, retrieved from <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf>. See, also, Jay R. Ritter, Initial Public Offerings: VC-backed IPO Statistics Through 2011 (December 31, 2011), retrieved from <http://bear.warrington.ufl.edu/ritter/IPOs2011VC-backed%20IPOs1912.pdf>.

⁴ See, National Venture Capital Association, NVCA Yearbook 2019, p. 33 retrieved from <https://nvca.org/wp-content/uploads/delightful-downloads/2019/03/NVCA-2019-Yearbook.pdf>

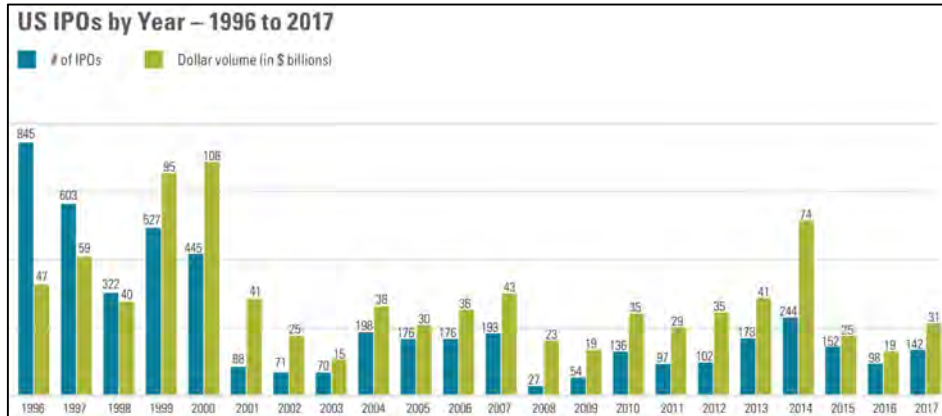
Interestingly, companies that went public in 2018 were younger than IPOs in prior years – the median time from first venture capital investment to IPO was c. 4.8 years.⁵

U.S. VC Backed IPO Value and Age Characteristics

	# of IPOs	Deal Value (\$M)	Median Deal Value (\$M)	Average Deal Value (\$M)	Post Value (\$M)	Median Post Value (\$M)	Average Post Value (\$M)	Median Time from 1st VC to Exit	Average Time from 1st VC to Exit
2007	90	24,510.3	248.8	310.3	33,169.3	330.2	409.5	5.18	5.60
2008	12	2,254.1	143.6	281.8	2,849.3	212.2	356.2	7.05	5.71
2009	11	7,838.8	317.1	783.9	9,624.2	387.1	962.4	7.32	7.50
2010	41	12,263.1	199.3	299.1	15,680.9	280.3	382.5	6.61	7.24
2011	44	37,779.4	331.2	944.5	43,322.7	423.6	1,083.1	5.81	6.73
2012	62	91,249.3	303.3	1,862.2	112,576.6	356.6	2,084.8	7.06	7.46
2013	87	43,804.5	240.0	554.5	52,707.3	320.7	635.0	6.68	7.21
2014	125	43,481.0	185.8	362.3	53,929.3	249.9	449.4	6.91	7.07
2015	79	28,941.1	222.0	402.0	39,122.3	302.5	535.9	6.96	6.42
2016	43	12,703.8	180.6	325.7	16,131.8	249.3	393.5	8.15	7.29
2017	58	49,667.6	336.6	955.1	58,877.4	434.0	1,132.3	7.08	6.84
2018	85	63,568.2	348.4	784.8	74,779.4	443.1	934.7	4.77	6.65

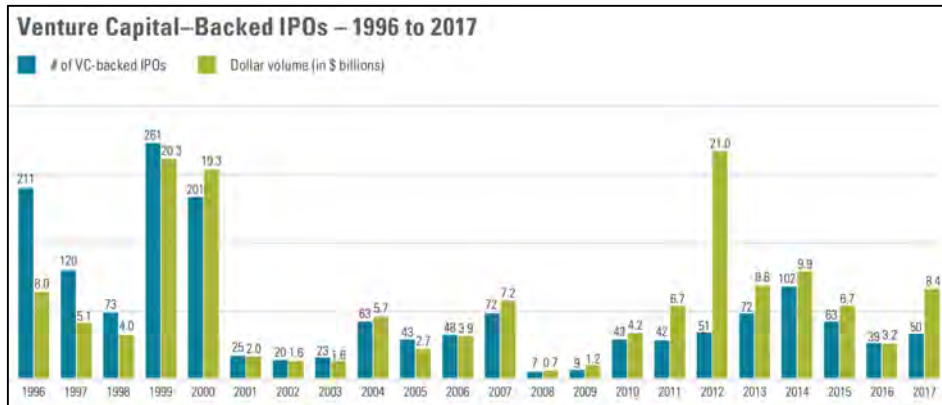
Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

Despite a relatively solid 2018 and first half of 2019, larger structural issues remain a challenge for the health of the U.S. public markets with what’s been a longer-term decline in the overall number of listed companies and venture-backed IPOs since the late 1990s.



Source: SEC filings

⁵ Id., p. 34.



Source: Dow Jones VentureSource and SEC filings. Based on US IPOs by VC-backed US issuers

Various factors have contributed to the described trend, including the following. First, structural and technological developments coupled with increased regulation governing execution of customer orders have made the IPO process more difficult for, and less attractive to, small-cap companies: narrow bid/ask spreads have reduced the incentives for broker-dealers for making markets for small-cap companies' stocks thus contributing in decreasing liquidity; the incentives for financial firms to provide research for smaller stocks have also significantly reduced thus limiting the information available to investors; and the economics of investment banking have been progressively shifted away from long-term investment in small-cap companies toward high-frequency trading of large-cap stocks.⁶

Second, legislative and regulatory reforms adopted in the wave of corporate and financial scandals (e.g., Sarbanes Oxley⁷ and, most recently, the Dodd–Frank Wall Street Reform and Consumer Protection Act⁸ (the 'Dodd-Frank Act') and the regulation promulgated thereunder) have further increased the complexity and raised both short- and long-term costs of an IPO and for remaining a public company.⁹

Third, the listing requirements of major stock exchanges - including Nasdaq and NYSE - have increased and those relating to corporate governance (e.g., audit committee standards, board and board committee composition and independence requirements, and stockholder approval of certain corporate actions) have been significantly strengthened.¹⁰

⁶ See, Grant Thornton LLP, Concept Release on Equity Market Structure, Letter to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (April 22, 2010), pp. 2-5, available at <https://www.sec.gov/comments/s7-02-10/s70210-151.pdf>; IPO Task Force Report, Rebuilding the IPO On-Ramp Putting Emerging Companies and the Job Market Back on the Road to Growth, Presented to The U.S. Department of the Treasury, retrieved from http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

⁷ Pub.L. 107-204, 116 Stat. 745, enacted July 29, 2002.

⁸ Pub.L. 111-203, H.R. 4173, enacted July 21, 2010.

⁹ See, e.g., SEC, Letter from Mary Schapiro, SEC Chairman, to the Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit., pp. 12-16; Steven E. Bochner, Esq., Jon C. Avina, Esq., IPO Guide, (Merrill Corporation, 7th Edition, 2010), pp. 5-7, retrieved from <http://www.wsgr.com/publications/PDFSearch/ipoguide2010.pdf>; Bartlett, Robert P. III, Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-private Decisions (The University of Chicago Law Review, Vol. 76, No. 1, Winter, 2009), pp. 7-44, retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1088830.

¹⁰ See, Steven E. Bochner, Esq., Jon C. Avina, Esq., IPO Guide, cit., pp. 60-64.

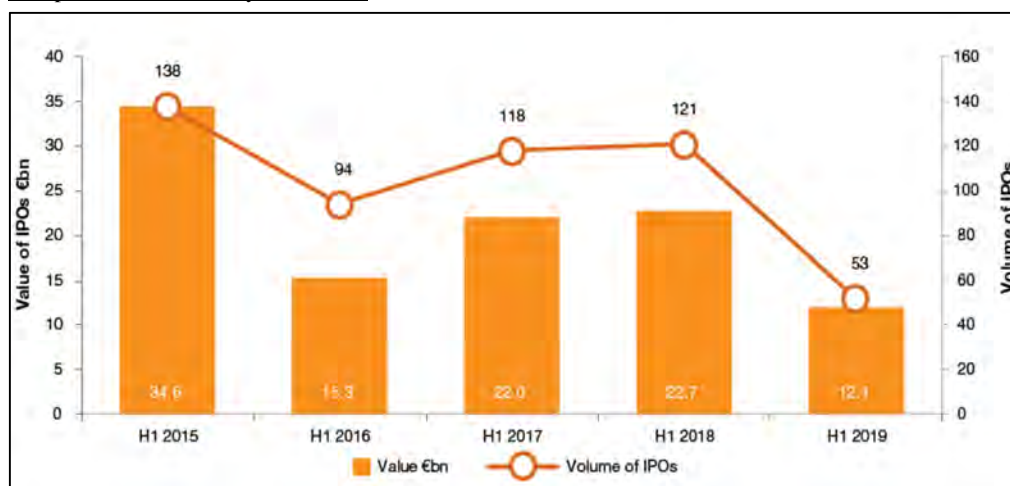
Fourth, intangible costs associated to an IPO (e.g., reduced control and flexibility,¹¹ loss of confidentiality,¹² and market pressure on short-term performance¹³) have also contributed in decreasing the incentives for private companies to go public.

Finally, equity market conditions have substantially impacted companies' valuation, as well as the timing and success of many companies' IPOs.¹⁴ Volatility reduces investors' confidence and causes market windows to repeatedly open and close very quickly; in addition, continuous volatility in equity markets can force certain companies planning IPOs to reduce target offering prices, face valuations at or below their last round of private financing, as well as postpone or even withdraw their issuance¹⁵.

1.1.2. THE EUROPEAN IPO MARKET

Following a particularly quiet first quarter, the European IPO market showed signs of recovery in the second quarter of 2019 with total proceeds of Euro 11.4 billion raised from 41 IPOs.¹⁶

European H1 IPO activity since 2015



Source: PwC, IPO Watch Europe - Q2 2019

¹¹ Cfr., Deloitte, Mid-market perspectives: 2011 report on America's economic engine (Deloitte LLP, 2011), retrieved from http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_dges_Midmarketperspectives_042111.pdf; Steven E. Bochner, Esq., Jon C. Avina, Esq., IPO Guide, cit., p. 5; James C. Brau and Stanley E. Fawcett, Evidence on What CFOs Think About the IPO Process: Practice, Theory and Managerial Implications (Brigham Young University, Journal of Applied Corporate Finance, Volume 18 Number 3, 2006), p. 107, retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=934935.

¹² See, e.g., SEC, Letter from Mary Schapiro, SEC Chairman, to the Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit., p. 13; Steven E. Bochner, Esq., Jon C. Avina, Esq., IPO Guide, cit., p. 6; Joan Farre-Mensa, Why Are Most Firms Privately Held? (Harvard University, Working Paper, March, 2011), p. 4, 38, retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1719204.

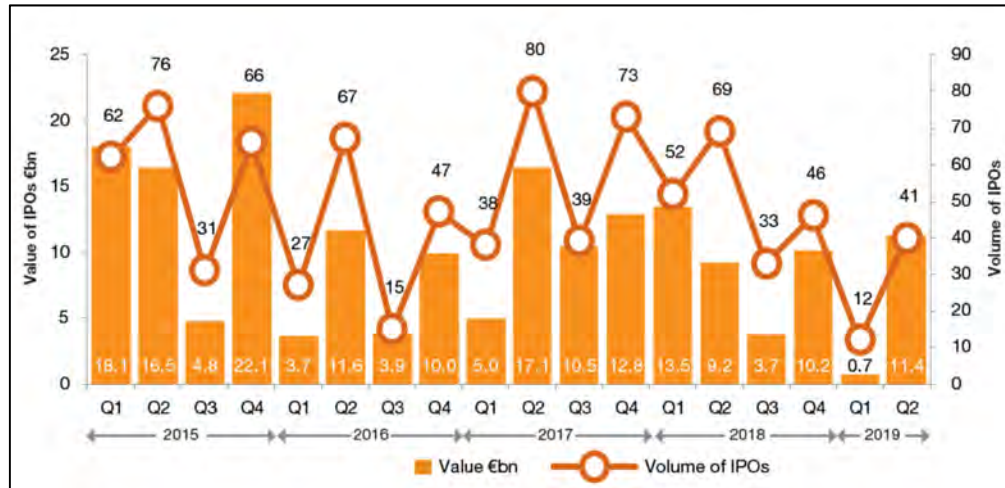
¹³ See, e.g., Barbara Ortutay, Groupon restatement sparks more worries (Bloomberg Businessweek, April 2, 2012), retrieved from <http://www.businessweek.com/ap/2012-04/D9TT1NDO0.htm>; Shayndi Raice and John Letzing, Groupon Forced to Revise Results (The Wall Street Journal, April 2, 2012) retrieved from <http://online.wsj.com/article/SB10001424052702303816504577313983768173826.html>.

¹⁴ See, James C. Brau and Stanley E. Fawcett, Initial Public Offerings: An Analysis of Theory and Practice (Journal of Finance 61, 2004), pp. 399-436, retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=530924.

¹⁵ See, PitchBook, PitchBook 2019 Venture Capital Outlook (Pitchbook, December 19, 2018), p. 2, retrieved from https://1790media.files.wordpress.com/2019/02/pitchbook_2019_venture_capital_outlook.pdf; EY, Global IPO trends: Q2 2019 - Should you wait for the perfect window of opportunity? (EY, 2019), retrieved from [https://www.ey.com/Publication/vwLUAssets/ey-global-ipo-trends-q2-2019/\\$FILE/ey-global-ipo-trends-q2-2019.pdf](https://www.ey.com/Publication/vwLUAssets/ey-global-ipo-trends-q2-2019/$FILE/ey-global-ipo-trends-q2-2019.pdf).

¹⁶ See, PwC, IPO Watch Europe - Q2 2019 (PricewaterhouseCoopers, July 2019), pp. 9-10, retrieved from <https://www.pwc.co.uk/audit-assurance/assets/pdf/ipo-watch-europe-q2-2019.pdf>.

Quarterly European IPO activity since 2015



Source: PwC, IPO Watch Europe - Q2 2019

The increase in the second quarter over the first quarter of 2019 was largely driven by several mega-IPOs, including Nexi SpA, Network International Holdings, Trainline plc, Traton SE and Stadler Rail AG, which raised a combined Euro 7.4 billion.¹⁷

Top Five European IPOs in H1 2019

	Nexi SpA	Network International Holdings plc	Stadler Rail AG	Traton SE	Trainline plc
Exchange	Borsa Italiana	London	SIX Swiss Exchange	Deutsche Börse; Nasdaq Stockholm	London
Pricing date	12-Apr	10-Apr	12-Apr	27-Jun	21-Jun
Money raised (€m)	2,056	1,414	1,351	1,350	1,227
Price range	€8.50 – €10.35	£3.95 – £4.65	CHF33 – CHF41	€27.00 – €33.00	£3.40 – £3.55
Offer price	€9.00	£4.35	CHF38	€27.00	£3.50

Source: PwC, IPO Watch Europe - Q2 2019

Driven by the mega-IPOs of payments companies Nexi and Network International Holdings, financials continued to be the most active sector, accounting for 43% of all IPOs priced in the first half of 2019 by value. In the UK, 7 of the 13 listings were from the financial sector, raising a total of £2 billion.¹⁸

¹⁷ Id, p. 12.

¹⁸ Id, p. 13.

European IPO Values by Sector

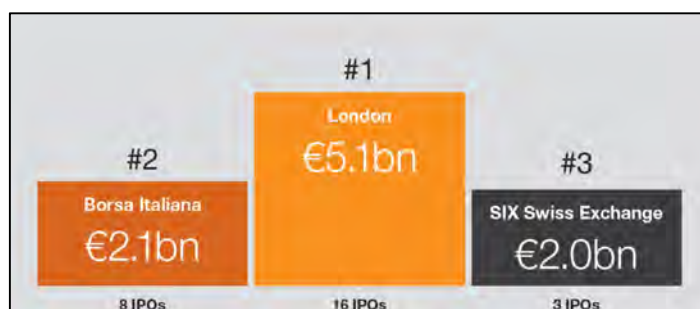
By offering value (€m)	Q1 2019	Q2 2019	H1 2019	H1 2018	Variance vs H1 2018
Financials	451	4,733	5,184	7,711	(2,527)
Industrials	33	2,958	2,991	3,326	(335)
Consumer Services	111	2,151	2,262	1,987	275
Health Care	94	635	729	5,184	(4,455)
Telecommunications	-	604	604	70	534
Consumer Goods	-	287	287	1,037	(750)
Technology	6	44	50	1,640	(1,590)
Oil & Gas	-	27	27	453	(426)
Basic Materials	-	-	-	921	(921)
Utilities	-	-	-	419	(419)
Total	695	11,439	12,134	22,748	(10,614)

Source: PwC, IPO Watch Europe - Q2 2019



Source: PwC, IPO Watch Europe - Q2 2019

London remained Europe's listing venue of choice, raising its highest amount in a second quarter since 2014, despite seeing 38% fewer IPOs than the same period last year. In contrast to other European markets, London increased IPO proceeds in the first half of 2019 compared to the first half of 2018 and retained its position as European's top exchange for overall raising capital, accounting for 42% of total proceeds raised in Europe.¹⁹ London also enhanced its international credential with the introduction of the Shanghai- London Stock Connect program.²⁰



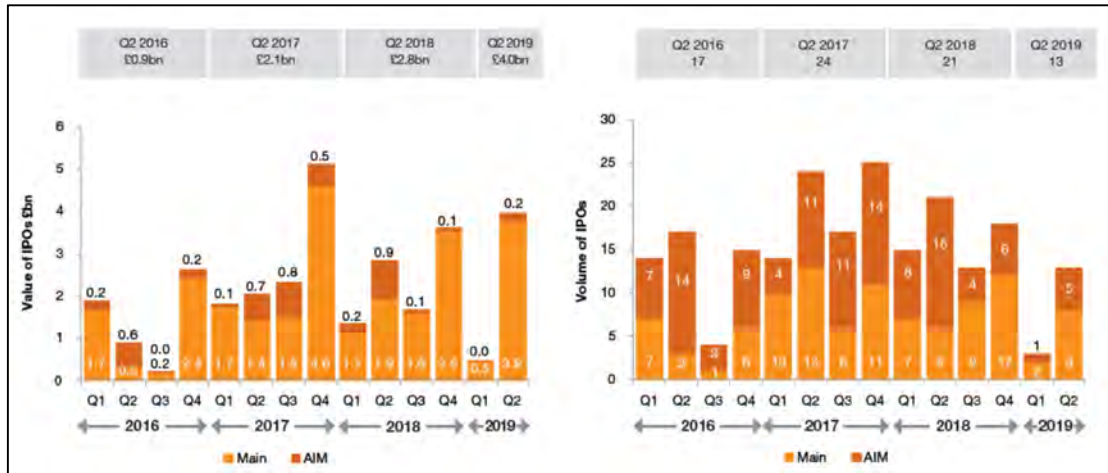
Source: PwC, IPO Watch Europe - Q2 2019

¹⁹ See, PwC, IPO Watch Europe - Q2 2019 (PricewaterhouseCoopers, July 2019), cit., pp. 6-7.

²⁰ See, The Shanghai-London Stock Connect - A Joint Announcement by the China Securities Regulatory Commission and the UK Financial Conduct Authority (June 17, 2019), available at <https://www.fca.org.uk/publication/mou/joint-announcement-fca-csrc.pdf>.

UK IPO trends (by offering value)

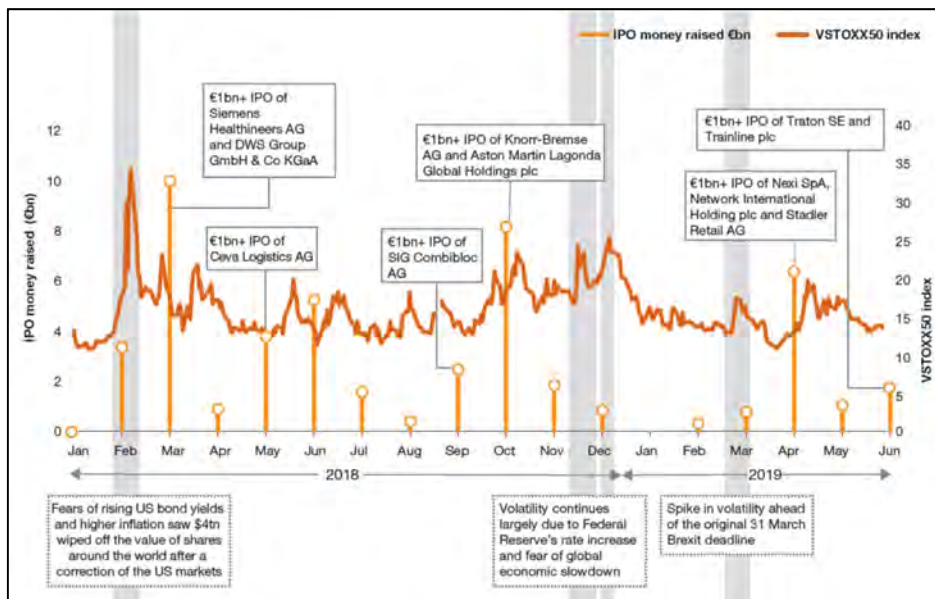
UK IPO trends (by volume)



Source: PwC, IPO Watch Europe - Q2 2019

Geopolitical tensions and upcoming Brexit deadlines caused companies and markets to exercise caution earlier in the year.²¹ In the UK, markets seem to have gradually adjusted to the Brexit uncertainty: both domestic and cross-border activity gained steam in the second quarter of 2019 as 11 companies went public, representing US\$4.5 billion.²² However, fears of a hard Brexit have begun to quickly replace Brexit uncertainty as the most significant negative for the UK and European capital markets.

Volatility tracked against European IPO values



Source: PwC, IPO Watch Europe - Q2 2019

Notwithstanding the healthy rebound of IPO activities in Europe and the positive performance by the UK IPO market in the second quarter of 2019, taken as a whole aggregate 2019 first half values fell by 44% by deal number and 47% by proceeds compared to the first half of 2018.²³

²¹ See, PwC, IPO Watch Europe - Q2 2019 (PricewaterhouseCoopers, July 2019), cit., 11.

²² See, EY, Global IPO trends: Q2 2019 - Should you wait for the perfect window of opportunity? cit., p. 22.

²³ See, PwC, IPO Watch Europe - Q2 2019 (PricewaterhouseCoopers, July 2019), cit., p. 10.

In the first half of 2019, the IPO volume in Europe shrunk to levels last seen in the financial crisis and by deal value it was the lowest since 2013.²⁴

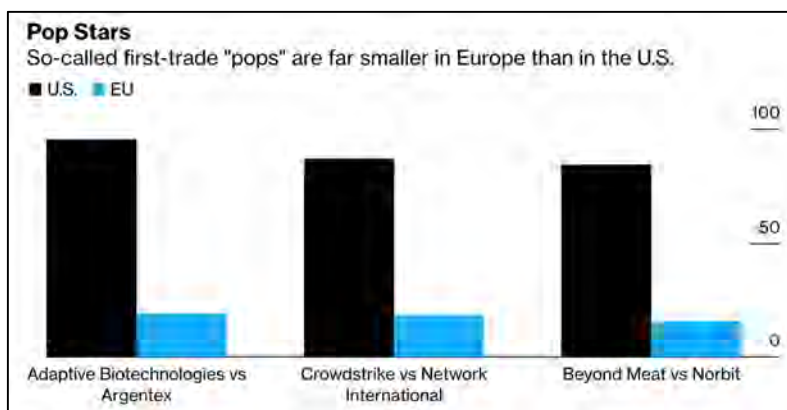


Source: Bloomberg. Data for all years is as of August 16

A number of factors may have contributed to the described decline of the European IPO markets, including structural changes and abundance of late stage private capital investments.

Moreover, contrasting sharply with the U.S. IPO market which has recently boomed on the back of the technology sector, IPOs in Europe have shown a more troubling vicious cycle as technology remains a relatively nascent market in the region. The relative scarcity of mature and high performing tech stocks has contributed to the chronic underperformance and fund outflows, which in turn weaken demand for new listings.²⁵

Because European issuers generally float a larger portion of their equity, partly due to different listing requirements, European IPOs are also less likely to deliver 'pop starts' upon public trading, making them relatively less attractive to an already shrinking pool of active investors.²⁶



Source: Bloomberg. Data for all years is as of August 16

²⁴ See, Justina Lee and Swetha Gopinath, Europe IPOs at Lowest Since Crisis Fuel Shrinking Market Fears (Bloomberg, August 19, 2019), retrieved from <https://www.bloomberg.com/news/articles/2019-08-19/stock-market-shrinkage-exacerbated-by-europe-ipos-at-decade-low>.

²⁵ Ibidem.

²⁶ Ibidem.

Moreover, high valuations of European companies going public have led to a gap between sellers' expectations and buy-side's comfort zone, as institutional investors would generally require some IPO discount to participate in listings, in order to protect some upside.²⁷

Lastly and as further discussed below, European private equity and venture capital funds have deployed abundance of capital through growth and late-stage investments thus allowing European companies to stay private for longer.

1.2. VENTURE CAPITAL ACTIVITIES

1.2.1. THE U.S. VENTURE CAPITAL INDUSTRY

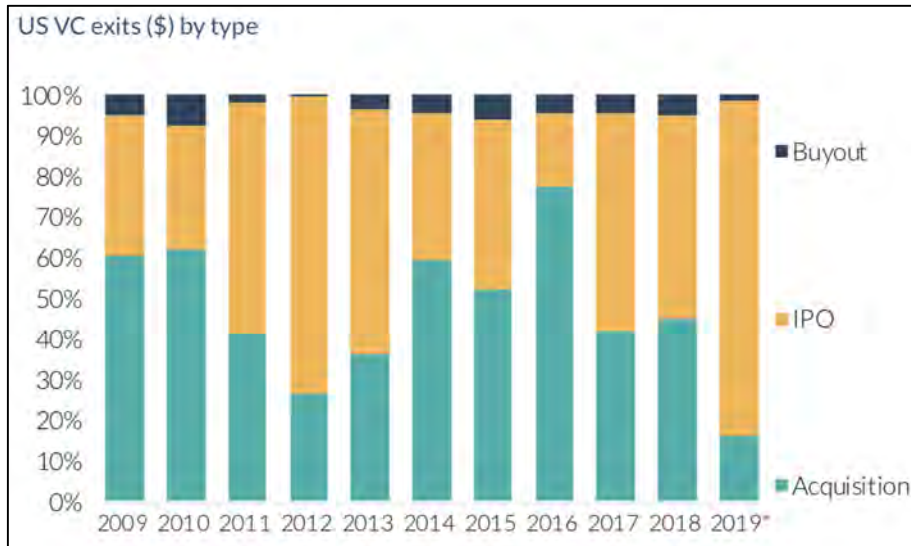
An important aspect of the flood of venture-backed IPOs that started in 2018 and continued in the first half of 2019 is the liquidity they bring to venture funds and their limited partners ("LPs"). Robust exit activity in 2019 has boosted returns to venture firms and produced strong distributions for LPs, who can now reinvest that capital to raise new funds for future investment in the next generation of companies. Accel is a prime example, achieving exits on huge stakes in PagerDuty, CrowdStrike and Slack in the second quarter of 2019 alone.



Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)
*As of June 30, 2019

With a relative scarcity of large acquisitions, IPOs' proportion of total exit value moved to new highs through the first half of 2019: IPOs comprised 82.9% of total exit value in 2019, thus sitting at higher levels than they were in 2012, when the Facebook IPO dominated the year's exit storyline.

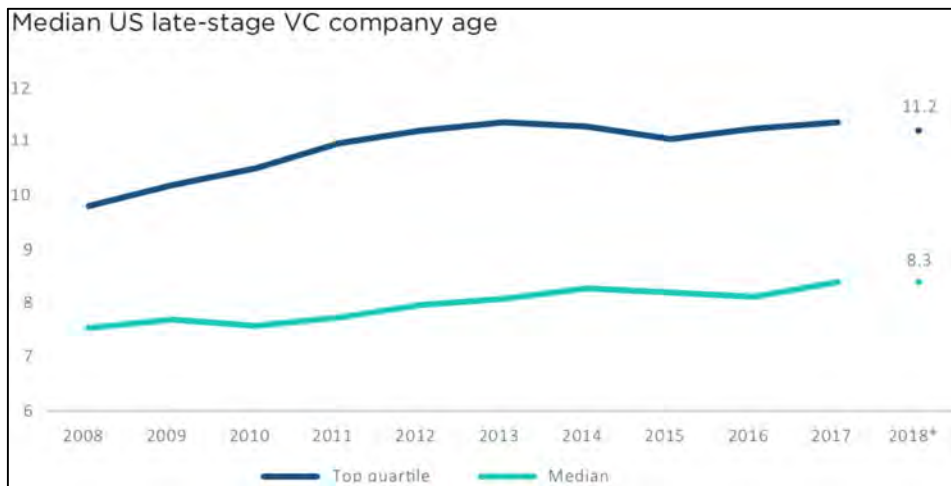
²⁷ Ibidem. See, also, Daniel Strauss, Goldman Sachs analyzed 4,481 IPOs over 25 years and concluded that these 5 attributes can make or break a newly public company (Markets Insider, September 8, 2019), retrieved from <https://markets.businessinsider.com/news/stocks/5-most-important-factors-for-successful-ipo-performance-goldman-sachs-2019-9-1028507003#sector-and-industry1>.



Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)
 *As of June 30, 2019

However, as previously discussed, despite a flurry of IPO activity in 2018 and again in the first half of 2019, the venture-backed IPO market has performed far below the IPO levels seen in 1999 and early 2000s.

Empirical data shows that over the last decade the number of venture-backed IPOs has reduced significantly, and the average time venture-backed companies remain private has considerably increased. During the period 1996-2000, the average company completing an initial public offering (IPO) was 6 years old at the time of the offering. In the early 2000s, the average age rose to 8 years. Following the financial crisis, it increased to 10 years and further up to 11 years in 2017.²⁸



Source: PitchBook, PitchBook 2019 Venture Capital Outlook (Pitchbook, December 19, 2018)
 *As of November 30, 2018

²⁸ See, Jay R. Ritter, Initial Public Offerings: Median Age of IPOs Through 2017 (University of Florida, (June 13, 2018)), available at <https://site.warrington.ufl.edu/ritter/files/2018/07/IPOs2017Age.pdf>.

The global shares of capital invested and exited attributed to U.S. companies have also decreased over the past 15 years. The U.S. accounted for 40% of total capital exited in 2018, dropping below 50% for the first time.²⁹

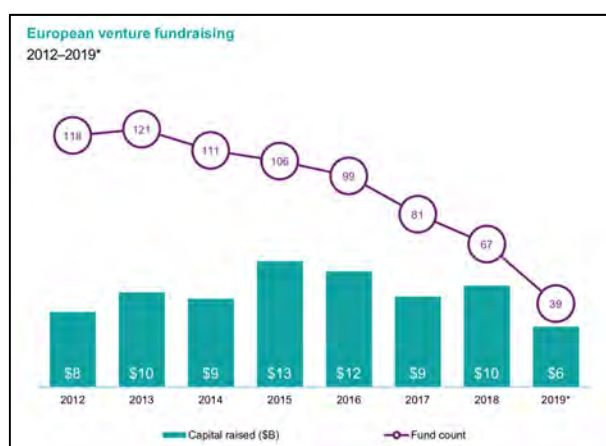
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Global Exit Value (\$B)	48.03	85.57	25.84	31.84	64.03	94.14	135.11	104.61	229.95	117.33	106.59	145.66	308.63
US Exit Value (\$B)	31.89	57.97	18.00	22.26	39.74	67.05	125.37	72.75	116.79	72.19	70.98	91.96	122.01
Global Exit Value (#)	873	1,065	820	784	1,187	1,238	1,409	1,528	1,919	1,895	1,697	1,694	1,444
US Exit Value (#)	533	623	487	480	704	738	875	900	1,078	1,020	888	885	864
US as % of Global (\$)	66%	68%	70%	70%	62%	71%	93%	70%	51%	62%	67%	63%	40%
US as % of Global (#)	61%	58%	59%	61%	59%	60%	62%	59%	56%	54%	52%	52%	60%

Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

The moderate IPO activity and the longer average time to IPO over the past decade have posed significant challenges to the venture capital industry: distributions to venture capital funds and returned capital to their LPs have remained substantially low, duration risk has increased, investment diversification problems have amplified, and in many cases human capital provided by venture capital firms has remained immobilized for long time onto the same portfolio companies, thus preventing search and development of new investments.³⁰

1.2.2. THE EUROPEAN VENTURE CAPITAL INDUSTRY

Although the European venture fundraising remained low in volume compared to the previous year, approximately \$5 billion in fundraising closed in Europe in the first half of 2019. The activities were driven in large part by well-established firms like Accel, which closed on a \$575 million vehicle in May 2019.³¹



Source: KPMG, Venture Pulse Q2 2019.

*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

²⁹ See, National Venture Capital Association, NVCA Yearbook 2019, cit., p. 33

³⁰ See, e.g., Steven Bochner, Keynote – How the Secondary Markets are Affecting the Capital Markets (SecondMarket - Capitalize 2011 Conference, San Francisco, May 11, 2011), video available at <https://www.secondmarket.com/discover/capitalize>.

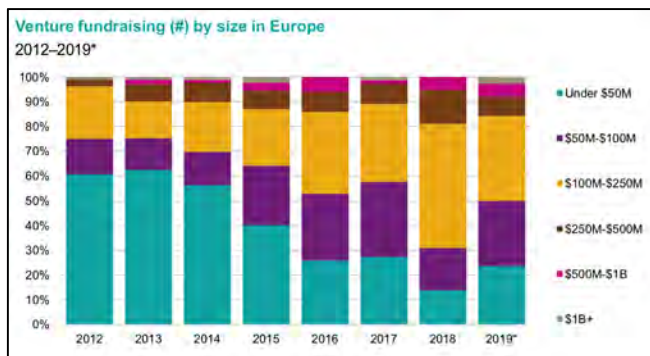
³¹ See, KPMG, Venture Pulse Q2 2019, Global Analysis of Venture Funding (KPMG, 11 July 2019), p. 68, retrieved from <https://assets.kpmg/content/dam/kpmg/xx/pdf/2019/07/venture-pulse-q2-2019-global.pdf>.

One third of the European venture capital funds announced in the second quarter of 2019 were funds larger than \$100 million and more concentrated in the UK, France, Germany and Nordics.

Investor	Location	Fund size	Date	Focus
Accel Accel partners	London / Palo Alto	€ 500M	May 2019	Series A
CATHAY Cathay Innovation	Paris	€ 320M	Jun 2019	Series B
CREANDUM Creandum	Stockholm	€ 265M	Jun 2019	Series A
Cherry Ventures	Berlin	€ 175M	Jun 2019	Seed
Latitude (by LocalGlobe)	London	€ 180M	Jun 2019	Series B
Vesalius Biocapital	Luxembourg	€ 120M	Jun 2019	Series A
Dawn Capital	London	€ 113M	Jun 2019	Series A
GP Bullhound	London	€ 113M	Jun 2019	Early VC
Velocity Capital Velocity Capital Fintech Ventures	Driebergen- Rijssenburg	€ 105M	Jun 2019	Series A
LocalGlobe	London	€ 115M	Jun 2019	Seed
ByFounders	Copenhagen	€ 100M	Apr 2019	Seed

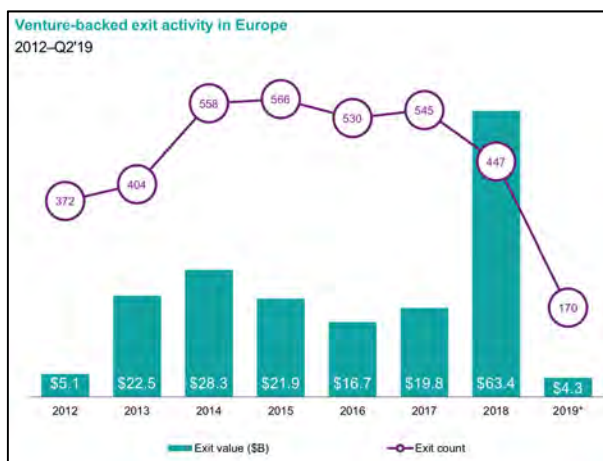
Source: Dealroom.co

Among the funds raised in 2019, smaller funds made somewhat of a comeback relative to the prior year.³²



Source: KPMG, Venture Pulse Q2 2019.

Taking away the Europe's two most high-profile listings in 2018 - those of Spotify and Adyen, which were worth a combined Euro 30.3 billion - venture-backed companies exit volume and value have remained quite sluggish in Europe though the first half of 2019.³³



Source: KPMG, Venture Pulse Q2 2019.

*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

³² See, KPMG, Venture Pulse Q2 2019, Global Analysis of Venture Funding, cit., p. 69.

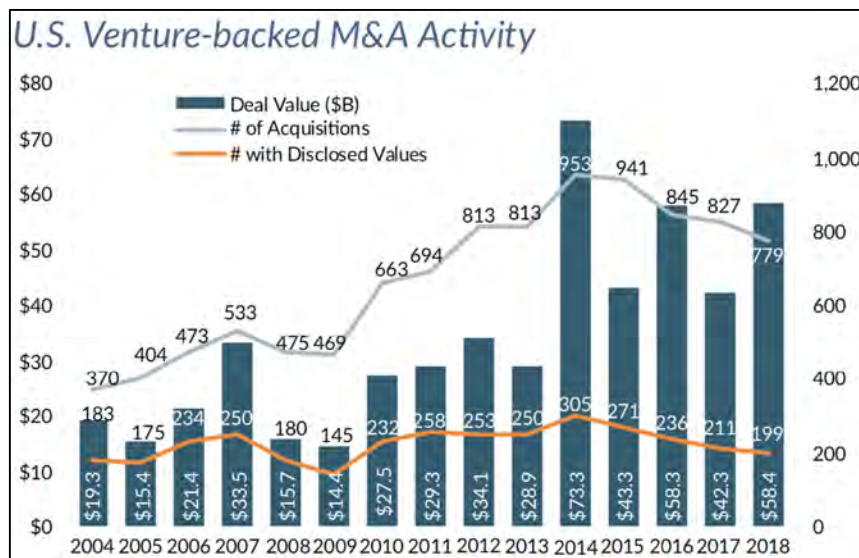
³³ Id., p. 66.

1.3. M&A ACTIVITIES

1.3.1. THE U.S. M&A MARKET

The shortage of IPOs and the increased length of time between the initial funding and the IPO have created a large pent-up demand for exits from private company investments over the past decade. Many companies have shifted their exit strategies and turned to mergers and acquisitions (M&As), which have gradually become the primary vehicle for private companies for providing liquidity to early stage investors, employees and other shareholders.

M&As accounted for the majority of venture-backed exits in 2018. In particular, 2018 recorded 779 M&As, and 199 M&As with disclosed values represented a total of \$58.4 billion in disclosed exit value. The median M&A deal value reached a 15-year high of \$105 million in 2018. In terms of age, companies that were acquired or merged last year were older than in prior years, with a median age from first venture funding to exit of 5.35 years. Software companies accounted for the majority (51%) of disclosed M&As by value, followed by pharmaceuticals and biotechnology (21%).³⁴



Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

³⁴ See, National Venture Capital Association, NVCA Yearbook 2019, cit., p. 35.

	# of Acquisitions	# with Disclosed Values	Deal Value (\$M)	Mean Deal Value (\$M)	Median Deal Value (\$M)	Median Time from 1st VC to Exit	Average Time from 1st VC to Exit
2006	473	234	21,425.5	91.6	42.3	4.78	4.72
2007	533	250	33,460.6	133.8	50.0	4.74	4.92
2008	475	180	15,746.0	87.5	34.4	4.75	4.97
2009	469	145	14,425.9	99.5	25.0	4.40	4.90
2010	663	232	27,477.8	118.4	37.3	4.35	5.00
2011	694	258	29,266.1	113.4	47.0	4.23	4.93
2012	813	253	34,122.5	134.9	45.0	4.53	5.06
2013	813	250	28,949.4	115.8	37.2	3.85	4.98
2014	953	305	73,309.2	240.4	50.2	4.44	5.31
2015	941	271	43,250.1	159.6	46.0	4.27	5.44
2016	845	236	58,271.7	246.9	76.5	4.58	5.73
2017	827	211	42,292.0	200.4	81.0	5.28	6.19
2018	779	199	58,441.8	293.7	105.0	5.35	6.34

Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

Microsoft’s \$7.5 billion acquisition of software development platform GitHub was the largest M&A of 2018. Three healthcare companies rounded out the top ten largest M&As, and all but one company in the top ten acquisitions was headquartered in California, Massachusetts or New York.

Company Name	Deal Size (\$M)	Industry Sector	State
GitHub	7,500.00	Information Technology	California
Impact Biomedicines	7,000.00	Healthcare	California
Duo Security	2,350.00	Information Technology	Michigan
AppNexus	2,000.00	Information Technology	New York
Flatiron	1,900.00	Healthcare	New York
Adaptive Insights	1,600.00	Information Technology	California
AlienVault	1,600.00	Information Technology	California
Ring	1,200.00	Consumer Products and Services (B2C)	California
Glassdoor	1,200.00	Consumer Products and Services (B2C)	California
Syntimmune	1,200.00	Healthcare	Massachusetts

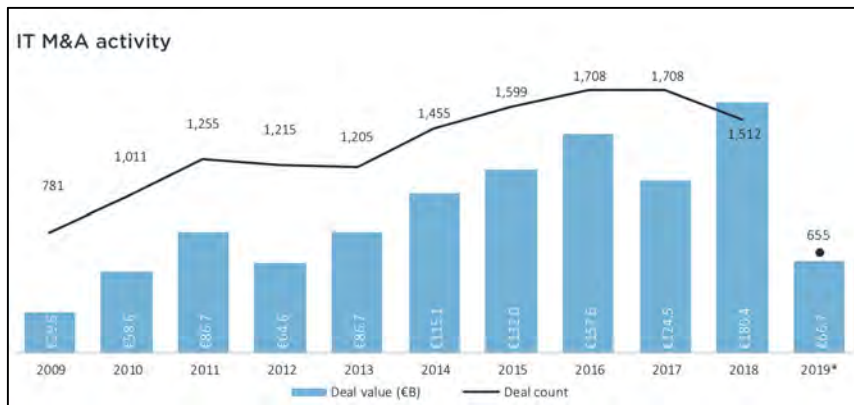
Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

As noted above, the trend has shifted in the first half of 2019, with recent IPOs from notable venture-backed companies – including Uber, Lyft, Pinterest, Slack and Zoom – making up a greater percentage

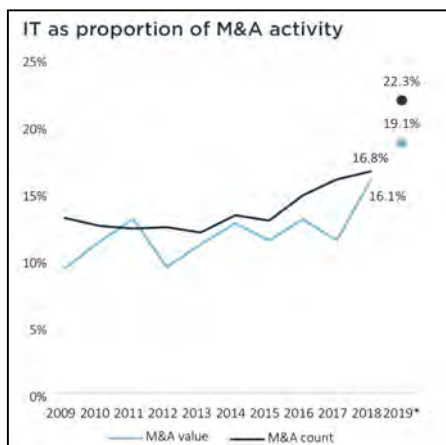
of exits. While several huge acquisitions could reverse back the trend by year end, at the date of writing this seems unlikely given the outlook for a moderate flow of additional IPOs.³⁵

1.3.1. THE EUROPEAN M&A MARKET

After a relatively modest opening to the year, European M&A activity continued to decline in the second quarter of 2019. Despite the reduction of the overall M&A activity, information technology (IT) as a proportion of European M&A market has been on pace for a record year: IT accounted for 22.3% of overall European M&A volume, with 4 of the top 10 deals closed in the second quarter occurring in the sector. Of the described 22.3% share, corporate M&A accounted for 14.2% and sponsor-backed M&A accounted for 8.1%, both at record-high mid-year proportions.³⁶



Source: PitchBook | Geography: UK
*As of June 30, 2019



Source: PitchBook | Geography: UK
*As of June 30, 2019

The largest IT M&A deal of the second quarter of 2019 was the Euro 4.8 billion acquisition of Gemalto by Thales Group.

³⁵ See, PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019), p. 28, retrieved from <https://pitchbook.com/news/reports/2q-2019-pitchbook-nvca-venture-monitor>.

³⁶ See, PitchBook, European M&A Report – 2Q 2019 (PitchBook, 2019), pp. 10-12, retrieved from <https://pitchbook.com/news/reports/2q-2019-european-ma-report>.

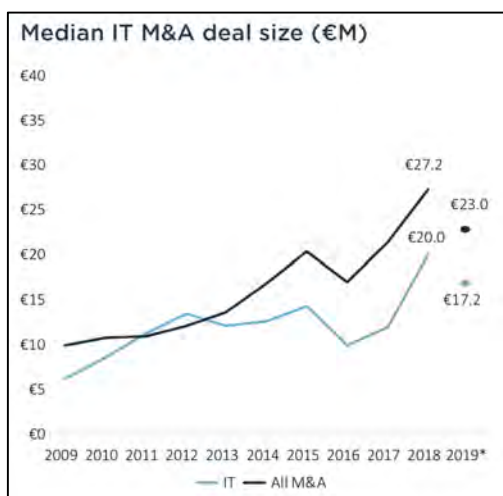
Top European software M&A deals (1H 2019)				
Acquired company	Acquirer	Valuation	Deal size (€M)	Industry
Lower middle market (€100M-250M)				
Cinnober Financial Technology	NASDAQ (NASDAQ: NDAQ)	EV/revenue 5.4x	€185.4	Fintech (SaaS)
Core middle market (€250M-\$500M)				
The Foundry Visionmongers	Roper Technologies (NYSE: ROP)	EV/EBITDA 25.9x	€458.8	Multimedia & design software
Mr. Green & Co.	William Hill (LON: WMH)	EV/EBITDA 12.7x	€269.8	Online casino games
Upper middle market (€500M-1B)				
Small Giant	Zynga (NASDAQ: ZNGA)	EV/revenue 6.8x	€600.8	Multiplayer mobile games
Bulge bracket (€1B-€5B)				
Gemalto (AMS: GTO)	Thales Group (EPA: HO)	EV/EBITDA 13.0x	€4,800.0	Digital security software

Source: PitchBook | Geography: Europe

*As of June 30, 2019

Although IT continues to gain increasing share of European M&A volume, deal count through the first half of 2019 decreased 18.2% year over year, in line with broader European M&A trends. Similarly, IT M&A deal value decreased through the first half of 2019, accounting for Euro 66.7 billion in deal value, a 39.0% year over year decrease largely attributable to the lack of IT M&A mega-deals (Euro 5 billion+).

Notwithstanding the lack of IT M&A mega deal in the first half of 2019, the IT M&A median deal size has been on pace for one of its highest years on record.³⁷



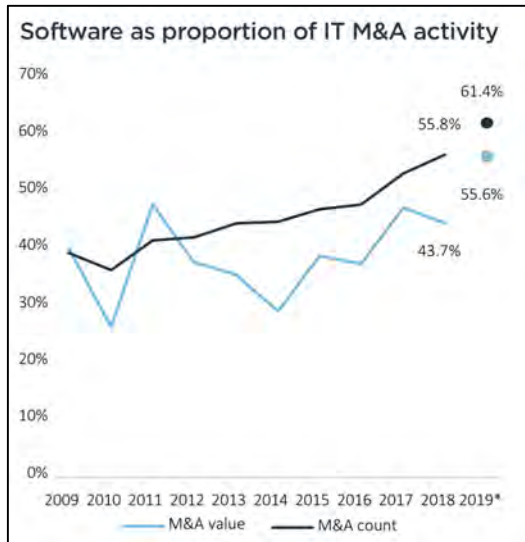
Source: PitchBook | Geography: Europe

*As of June 30, 2019

The European IT M&A industry was largely driven by software M&A activity. Through the first half of 2019, software recorded 402 completed M&A transactions for an aggregate Euro 37.1 billion and accounted for a record first half proportion of M&A deal value and volume at 10.6% and 13.7%, respectively.³⁸

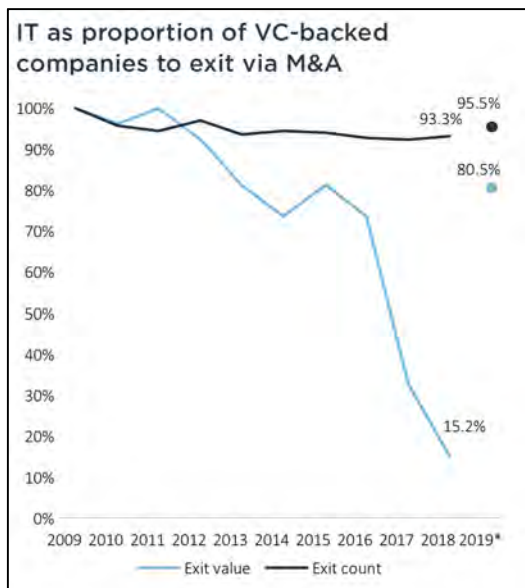
³⁷ Id, p. 11.

³⁸ Ibidem.



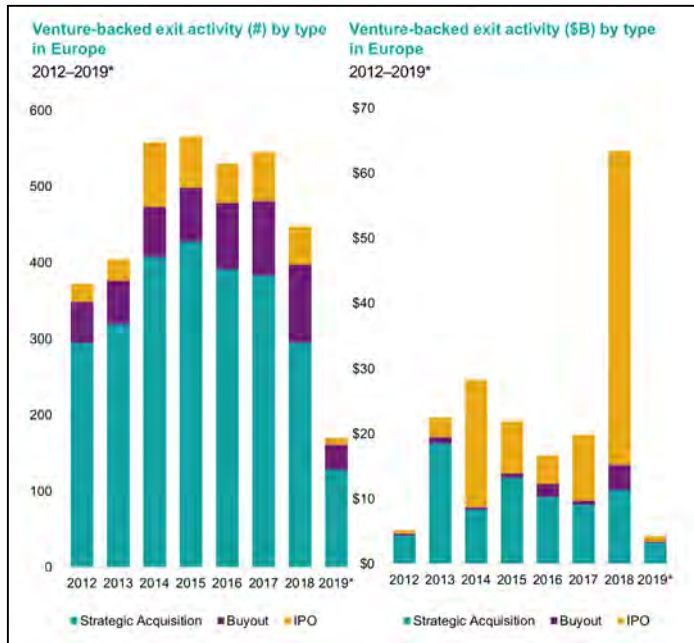
Source: PitchBook | Geography: Europe
 *As of June 30, 2019

As technology companies mature and scale in size, greater opportunities arise for strategic acquisitions in the sector which further drive M&A activity and integration synergies between companies. Aggregate value of venture capital-backed companies in the IT sector that have exited via M&A spiked 65.3% through the first half of 2019. Venture capital-backed IT M&A exit flow accounted for 106 completed exits, totaling Euro 2.1 billion, doubling in exit value year over year.³⁹



Source: PitchBook | Geography: Europe
 *As of June 30, 2019

³⁹ Id., p. 12.



Source: KPMG, Venture Pulse Q2 2019.

*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

1.4. THE INCREASE IN GROWTH AND LATE-STAGE INVESTMENTS: “MEGA DEALS” AND UNICORNS

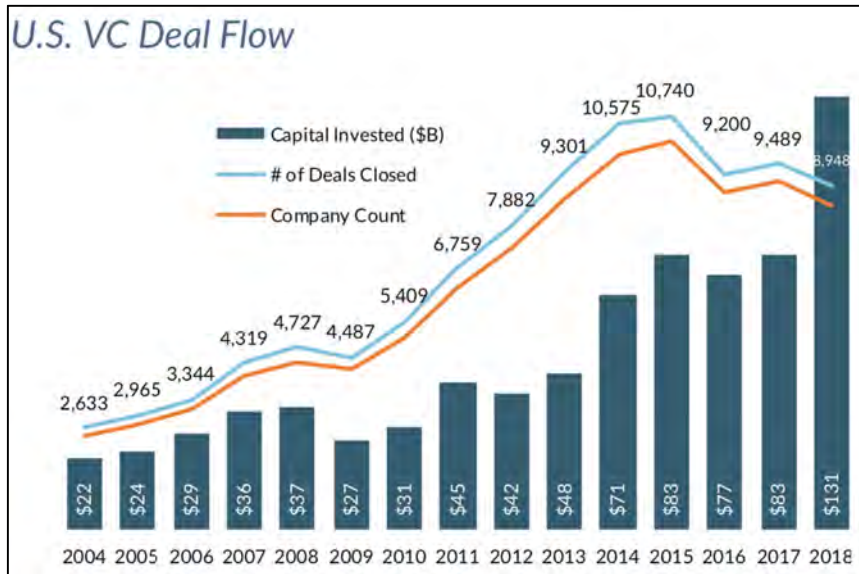
With new-found control and less pressure to go public, companies have been able to significantly mature in size and valuation while remaining private.⁴⁰ During the last decade, an increased amount of venture capital financing has become to flow into growth and late stage companies. This trend continued during 2018 and the first half of 2019.

1.4.1. U.S. GROWTH AND LATE-STAGE INVESTMENTS

In 2018, the U.S. venture industry achieved a record high amount of capital invested into companies: more than 8,380 venture-backed companies received aggregate \$131 billion in funding, far above the \$100 billion watermark set at the height of the dot-com boom in 2000.⁴¹

⁴⁰ See, McKinsey & Company, Grow fast or die slow: Why unicorns are staying private, McKinsey & Company Report (May 2016), available at <https://www.mckinsey.com/industries/high-tech/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private>.

⁴¹ See, National Venture Capital Association, NVCA Yearbook 2019, cit., pp. 23-24.

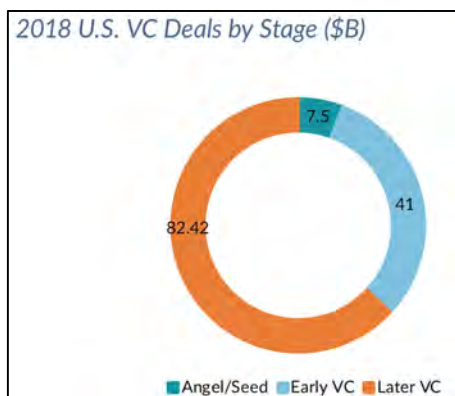


Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

U.S. VC Deal Flow by Stage (#)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Angel/Seed	458	787	918	1226	1723	2600	3532	4639	5472	5716	4585	4521	3760
Early VC	1750	2117	2260	1830	2101	2426	2584	2780	3067	3061	2849	3119	3156
Later VC	1136	1415	1549	1431	1585	1733	1766	1882	2034	1963	1766	1849	2032

Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook



Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

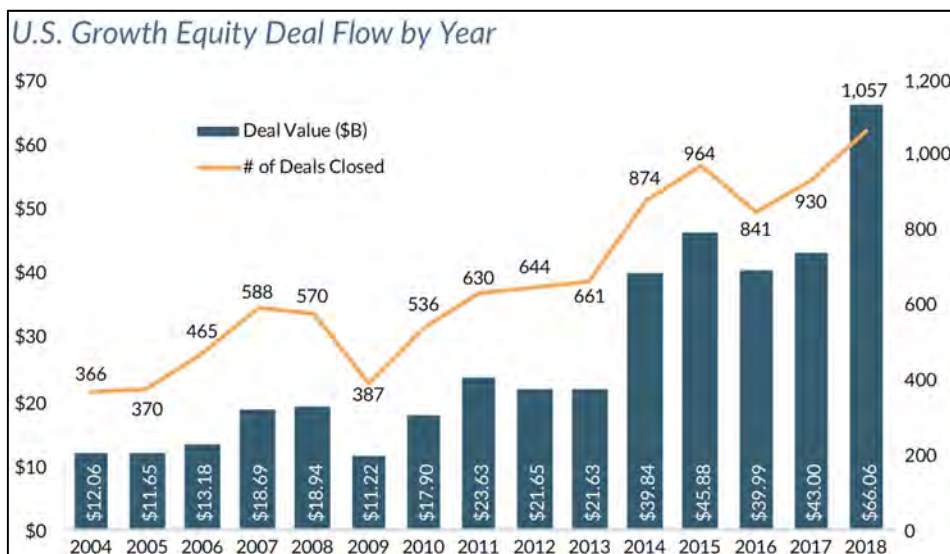
The ability of companies to close mega deals (i.e., investment rounds of \$100 million or more) in the private markets is consolidating, with the number of mega deals increasing from 36 in 2013 to 208 in 2018. In 2018, mega deals drove much of the capital influx, accounting for nearly half (47%) of the total capital invested through the year.⁴²

⁴² Ibidem.

Growth equity investments in 2018 increased after strong years from 2014 to 2017, with \$66 billion across 1,057 growth equity investments in 2018.⁴³ Software companies comprised the largest share of growth equity activity: they recorded the biggest rise with \$28 billion raised across 422 investments, representing year-over-year increases of 96% and 32% respectively. In line with venture activity, California-based companies accounted for the majority of growth equity investments, with 38% of deal count and 56% of capital invested.⁴⁴



Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook



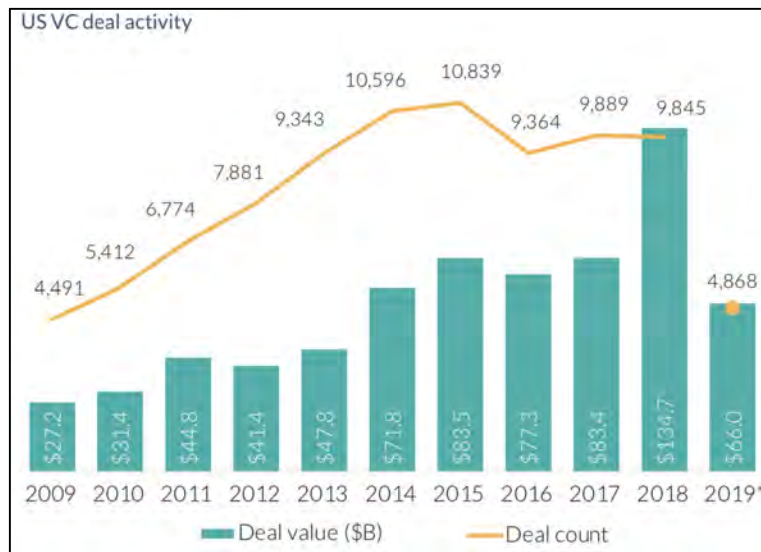
Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

During the first half of 2019, total venture capital deal value reached \$66.0 billion and at the date of this paper is nearly on pace to match 2018’s record highs. If this pace holds, 2019 would be the second

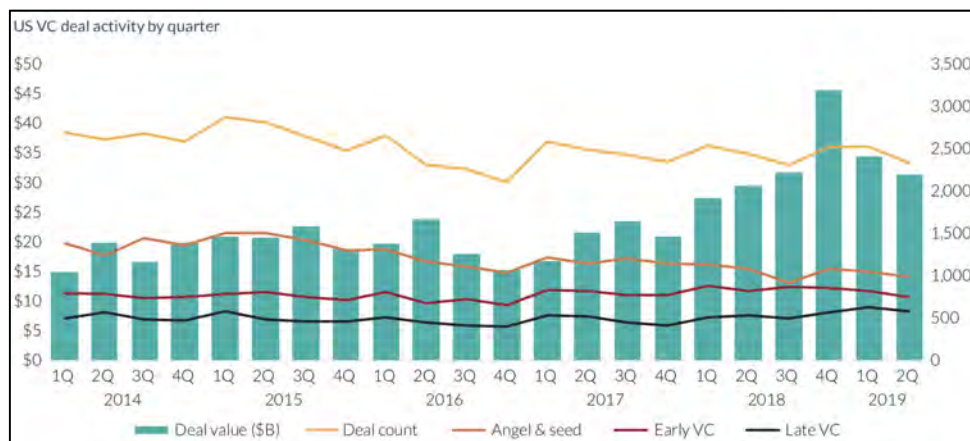
⁴³ Id., p. 32 (defining ‘growth equity investments’ as having the following characteristics: ‘1) company has a proven business model (established product and/or technology and existing customers); 2) company’s revenues are growing rapidly; 3) company is often cash flow positive, profitable or approaching profitability; 4) company is often founder- owned and / or managed; 5) investor is agnostic about control and purchases minority ownership positions more often than not; 6) industry investment mix is similar to that of earlier stage venture capital investors; 7) capital is used for company needs or shareholder liquidity; 8) additional financing rounds are not usually expected until exit; 9) investments are often unlevered or use light leverage at purchase; and 10) investment returns are primarily a function of growth, not leverage, with a lower expected loss ratio than venture capital portfolios.’).

⁴⁴ Ibidem.

consecutive year in which venture capital invested has topped \$100 billion, substantiating how the strategy has matured over the last decade.⁴⁵



Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)
*As of June 30, 2019

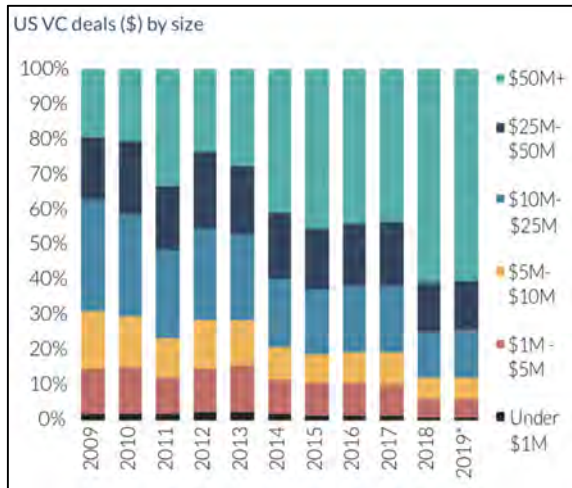


Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)

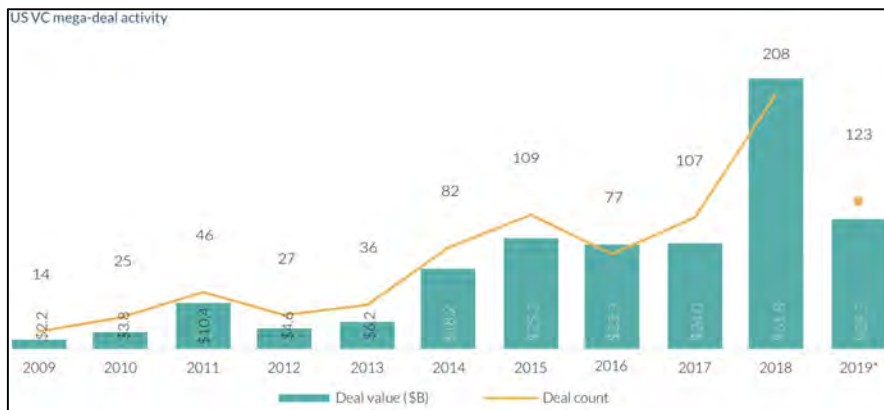
Mega-deals have continued to thrive in 2019: 123 closed in the first half of 2019, accounting for 44.6% of total venture-capital investments, up from 13.1% in 2013. However, deal sizes and valuations in aggregate plateaued in the first half of 2019, signaling a stabilization following prolonged run-up.⁴⁶

⁴⁵ See, PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019), cit., p. 4.

⁴⁶ Id., pp. 4-5.



Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)
*As of June 30, 2019



Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)
*As of June 30, 2019

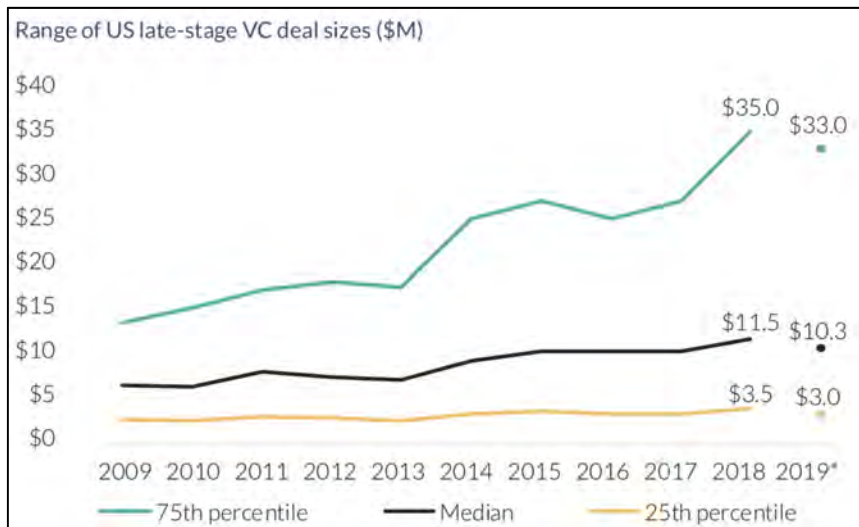
In the second quarter of 2019, the late-stage deal activity maintained a strong momentum, with \$20.9 billion invested in 583 deals, marking the first time late-stage investment has surpassed \$20 billion in four consecutive quarters. The persistence of such high levels over a full year demonstrates abundant capital availability to more mature private companies.⁴⁷



Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)

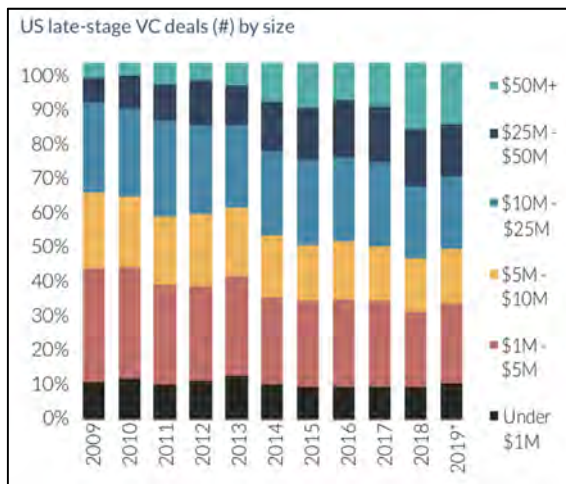
⁴⁷ Id., p. 10.

The volume of closed late stage deals has risen steadily over the past few years and the trend has continued in the first half of 2019. Contrary, deal size growth has cooled through the first half of 2019, even at the upper end of the range.⁴⁸



Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)
*As of June 30, 2019

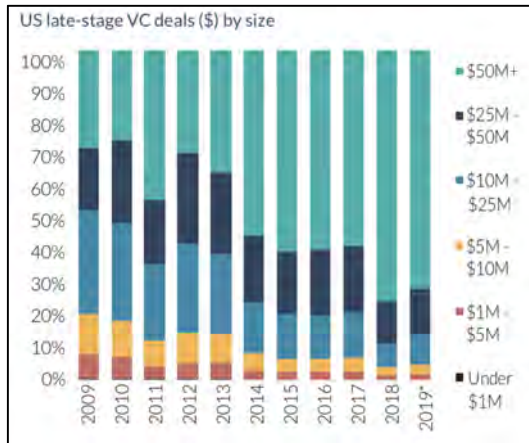
Looking at the distribution of late-stage deal sizes, the 75th percentile came in at \$33.0 million. Although a remarkable figure, this's also evidence that the large financings over \$50 million are a relatively small percentage of transactions, representing only 17.1% of closed late-stage deals in 2019. However, the outsized effect of these deals has persisted in 2019, accounting for more than 70% of late-stage deal value.⁴⁹



Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)
*As of June 30, 2019

⁴⁸ Ibidem.

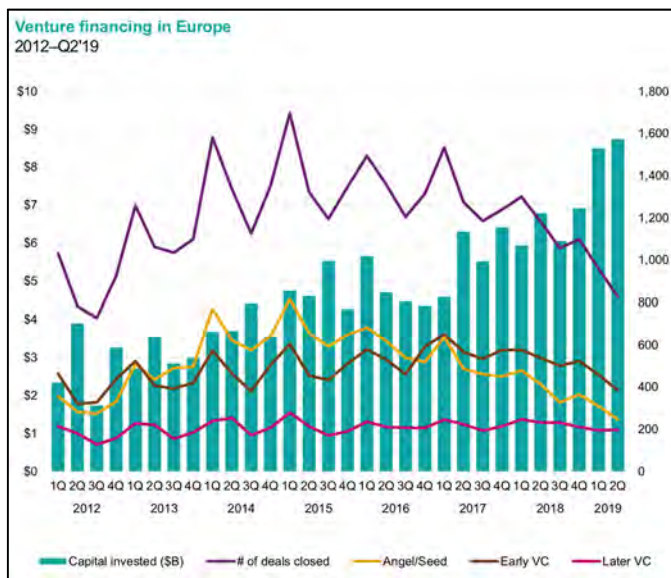
⁴⁹ Id., pp. 10-11.



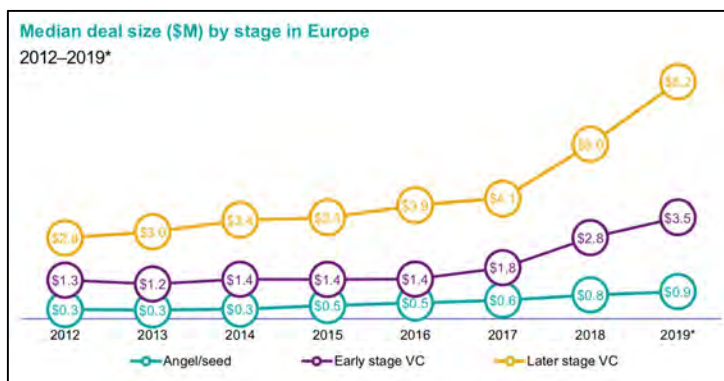
Source: PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019)
*As of June 30, 2019

1.4.2. EUROPEAN GROWTH AND LATE-STAGE INVESTMENTS

European venture capital activities have already broken records in the first half of 2019.⁵⁰













Source: KPMG, Venture Pulse Q2 2019.
*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.



Source: KPMG, Venture Pulse Q2 2019.
*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

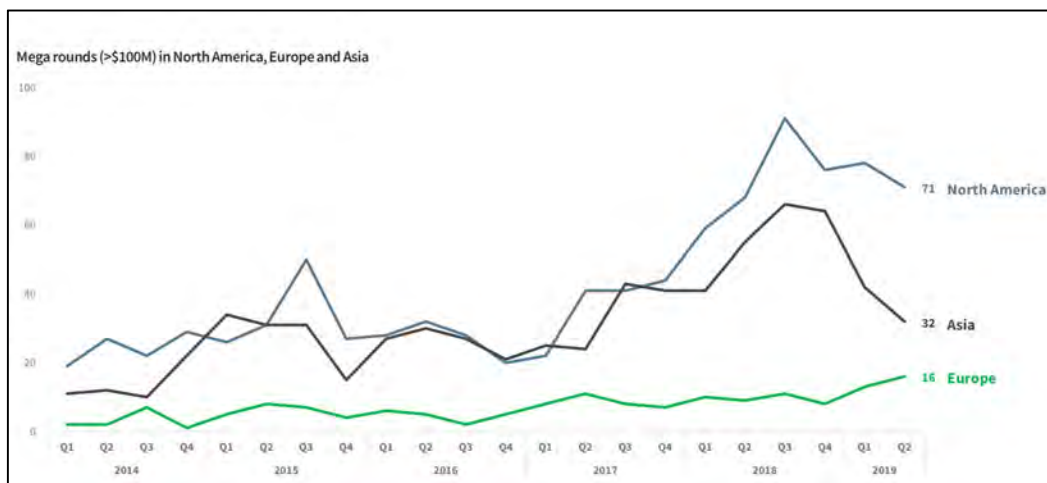
⁵⁰ See, KPMG, Venture Pulse Q2 2019, Global Analysis of Venture Funding (KPMG, 11 July 2019), cit., p. 59.

Venture capital investments continued to pour into Europe in record flows in 2019, mainly driven by mega-deals. The 10 largest rounds in Q2 accounted for Euro 4 billion or 43% of total investment.⁵¹

	NAME	INVESTORS	LOCATION	ROUND
	Northvolt Lithium-ion batteries	Goldman Sachs, Volkswagen Group	Sweden	\$1.0B GROWTH EQUITY
	Greensill Supply chain finance	SoftBank	UK	\$800M GROWTH EQUITY
	Deliveroo Delivering premium restaurant meals	Amazon, Greenvoaks, Fidelity, ...	UK	\$575M SERIES G
	UiPath Robotic process automation software	Accel, Sequoia, Wellington Management, ...	Romania / US	\$568M @ \$7B SERIES D
	GetYourGuide Booking platform for attractions	Lakestar, Heartcore Capital, Temasek, ...	Germany	\$484M @ \$1B SERIES E
	Checkout.com International online payment solutions for SMB growing businesses	Insight VP, DST Global, GIC, Endeavor Catalyst, ...	UK	\$230M @ \$2B SERIES A
	Meero AI for image processing	Aiven, Global Founders Capital, White Star Capital, ...	France	\$230M @ \$1B SERIES C
	Adjust Mobile marketing attribution	Sofina, Highland Europe, Eurazeo, ...	Germany	\$227M GROWTH EQUITY
	WorldRemit Cross-border money transfer	Accel Partners, Technology Crossover Ventures, LeapFrog Investments	UK	\$175M SERIES D
	Glovo Food and grocery delivery	Lakestar, Idinvest Partners, Drake Star, ...	Spain	\$170M SERIES D

Source: Dealroom.co

The numbers were significantly boosted by deals such as the Euro 900 million investment into Northvolt led by Volkswagen Group and Goldman Sachs, and the Euro 703 million investment in Greensill by Japan's Softbank. Large funding rounds raised by Deliveroo, UiPath, and GetYourGuide also contributed to the record breaking second quarter of 2019.



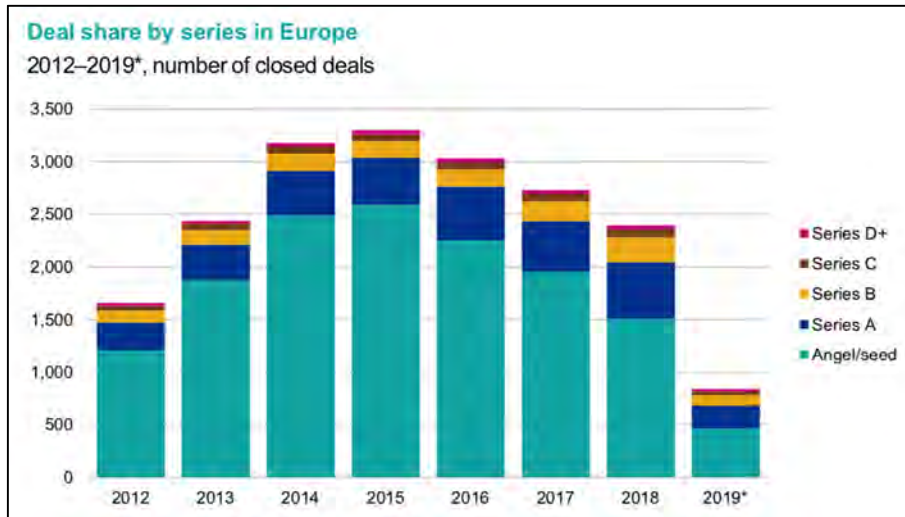
Source: Dealroom.co

As innovation hubs in Europe continue to mature, an increasing number of fast-growing companies seek larger size growth and late-stage funding rounds. Hence, latest stage funding rounds recorded a remarkable increase over 2018 figures,⁵² representing 63.6% of the total capital invested in European businesses through the first half of 2019.⁵³

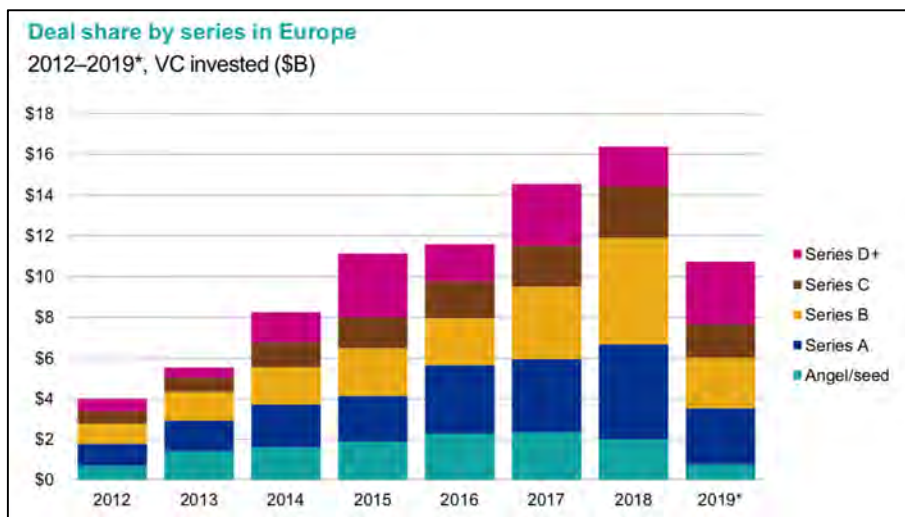
⁵¹ Id, pp. 59-60.

⁵² Id, p. 62.

⁵³ See, Leah Hodgson, Bigger is better: The most active investors in European late-stage rounds, PitchBook (September 20, 2019), retrieved from <https://pitchbook.com/news/articles/bigger-is-better-the-most-active-investors-in-european-late-stage-rounds>.



Source: KPMG, Venture Pulse Q2 2019.
 *As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

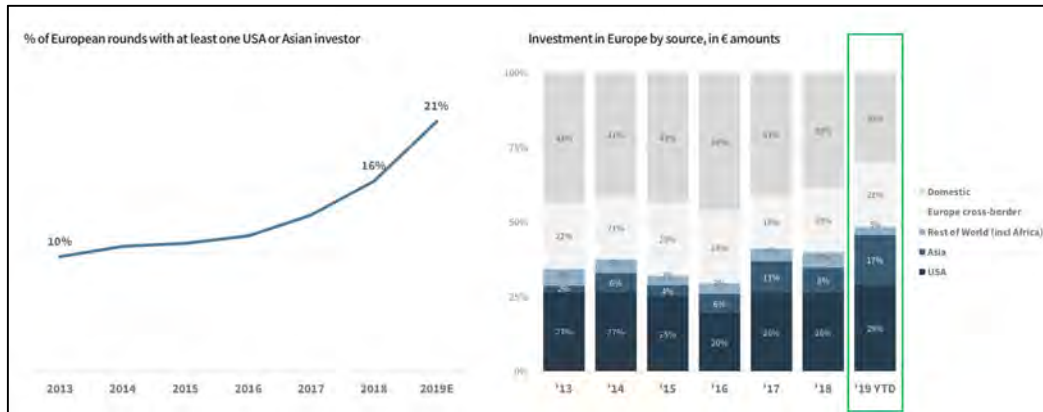


Source: KPMG, Venture Pulse Q2 2019.
 *As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

Among the most active venture capital investors investing in European late-stage rounds in the first half of 2019 were Mercia Asset Management, Almi Invest, Finnvera, Octopus Ventures and Balderton Capital.⁵⁴ At the same time, investments from the U.S. and Asia into Europe increased quite significantly in 2019, with US and Asian investor participation reaching more than 40% of total investment.⁵⁵

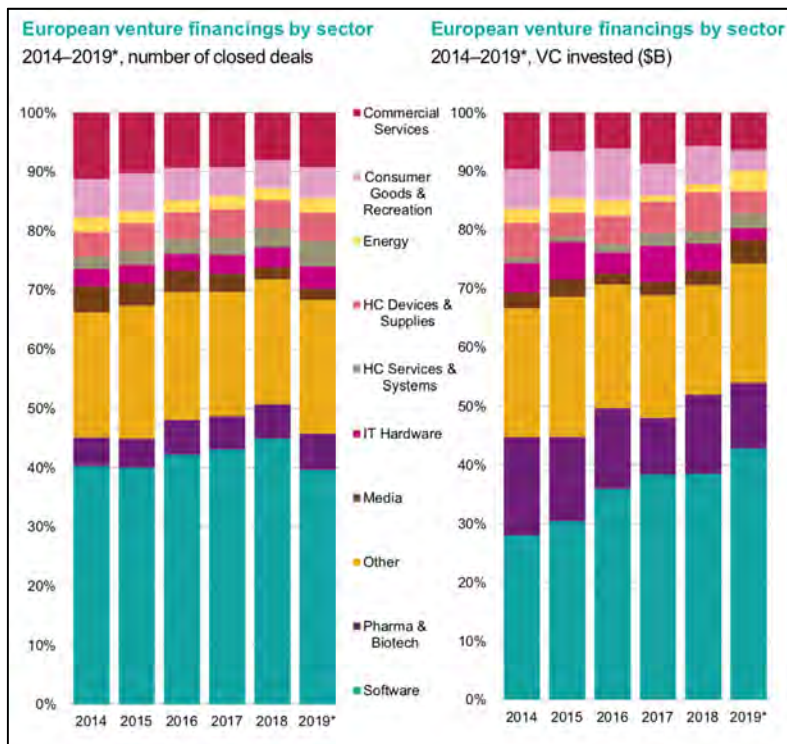
⁵⁴ Ibidem.

⁵⁵ See, Dealroom.co, Quarterly European Venture Capital Report - Q2 2019 (Dealroom.co, July 2019), p. 7, retrieved from <https://blog.dealroom.co/wp-content/uploads/2019/07/Dealroom-Q2-2019-Report-Final.pdf>.



Source: Dealroom.co

The software segment dominated the headlines and continued to drive a significant portion of the venture-capital investment in Europe, retaining top spot through the first half of 2019.⁵⁶



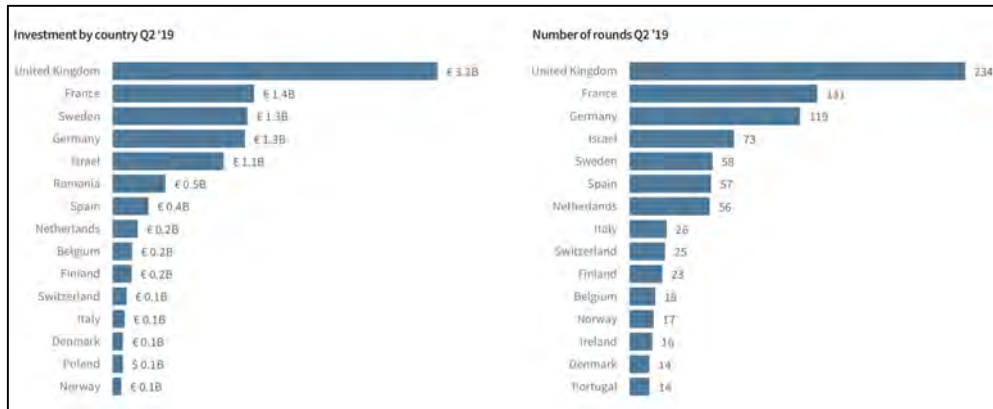
Source: KPMG, Venture Pulse Q2 2019.

*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

The UK, Germany, France and Sweden received more than 70% of total venture capital investment in the second quarter of 2019. The UK took once again the lion's share of investment, followed by France, Sweden and Germany more or less tied in second place.⁵⁷

⁵⁶ See, KPMG, Venture Pulse Q2 2019, Global Analysis of Venture Funding, cit., p. 63.

⁵⁷ See, Dealroom.co, Quarterly European Venture Capital Report - Q2 2019, cit., p. 9.

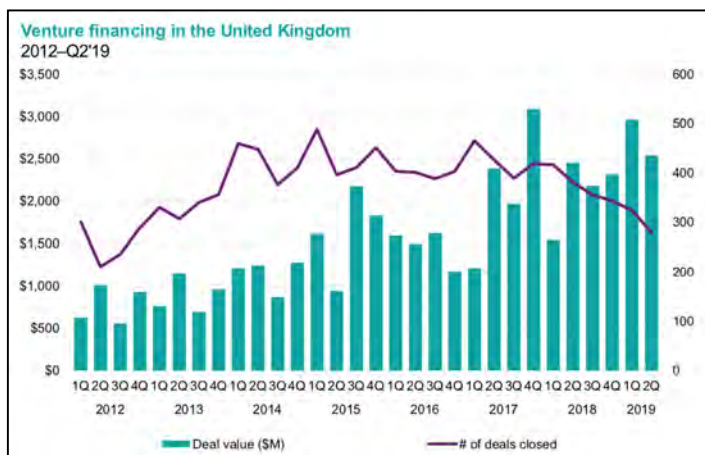


Source: Dealroom.co



Source: Dealroom.co

Amid the uncertainties of the UK political landscape, the technology sector showed more resilience than other areas of the economy. During the second quarter of 2019, the UK recorded several large venture capital financings, including funding rounds closed by fintech companies Checkout.com (\$230 million), and Monzo (\$144 million).⁵⁸

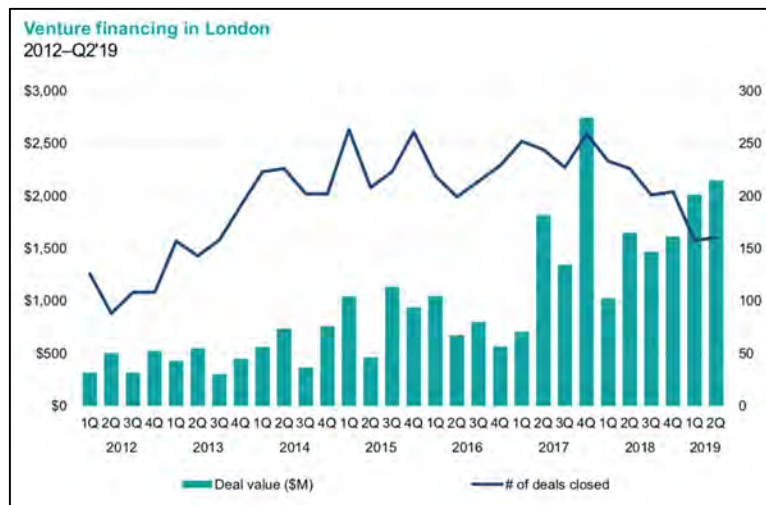


Source: KPMG, Venture Pulse Q2 2019.

*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

⁵⁸ See, KPMG, Venture Pulse Q2 2019, Global Analysis of Venture Funding, cit., p. 70.

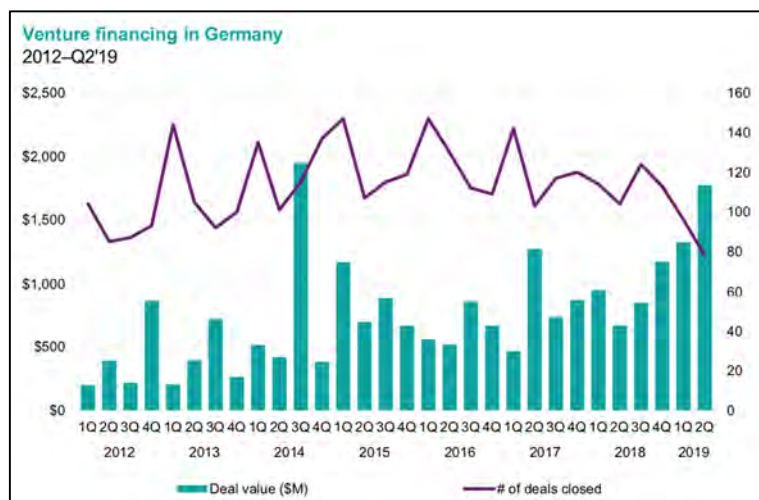
While London has long been established as a thriving, well-connected financial ecosystem, the first half of 2019 has seen record levels of venture capital investment in London-based companies.



Source: KPMG, Venture Pulse Q2 2019.

*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

Germany attracted a robust amount of venture capital investment in the second quarter of 2019, pointing to a healthy and mature ecosystem. This was driven in part by a \$484 million raise by online tour marketplace GetYourGuide Deutschland and an increased interest in fintech, as evidenced by Softbank's \$1 billion investment in Wirecard.⁵⁹

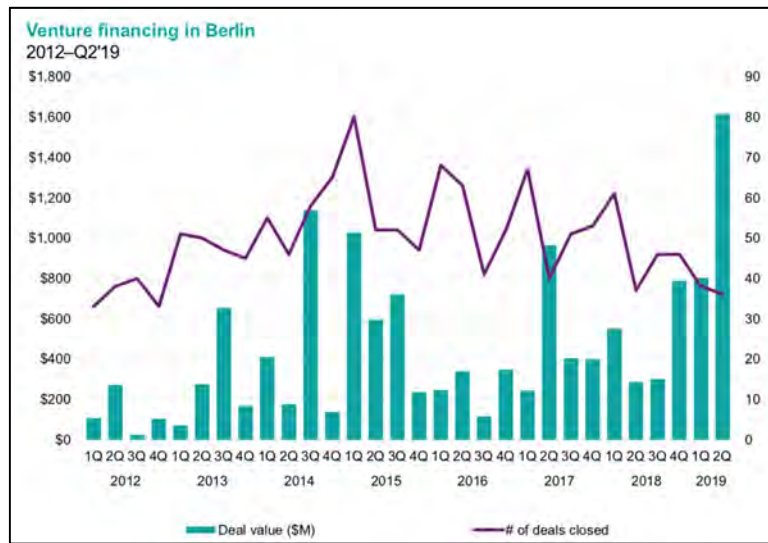


Source: KPMG, Venture Pulse Q2 2019.

*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

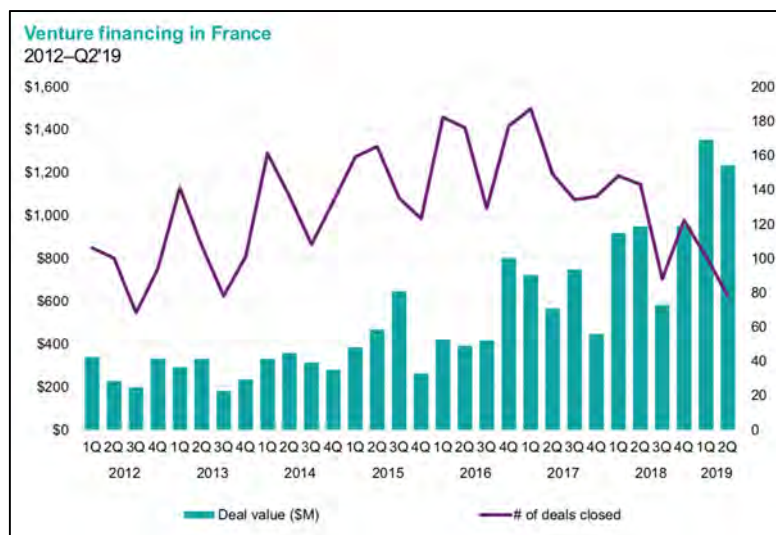
⁵⁹ Id, pp. 73-74.

Of the venture capital flowing to Germany in the first half of 2019, most was concentrated in Berlin.



Source: KPMG, Venture Pulse Q2 2019.
*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

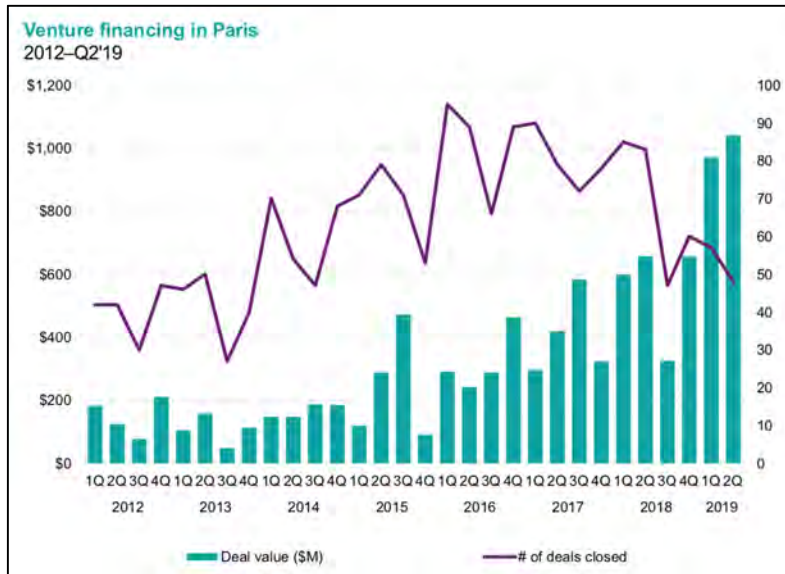
Venture capital investment in France recorded a strong second quarter in 2019, primarily driven by a \$230 million raise by photo editing company Meero, which earned the company unicorn status. Fast-growing online gardening marketplace ManoMano and digital wallet app company Dashlane also raised \$100 million+ funding rounds in the second quarter of 2019. Increased interest in the fintech sector led to a particularly robust second quarter: in addition to Dashlane, payroll company Payfit raised \$80 million and money management app Bankin’ raised \$23 million financing.⁶⁰



Source: KPMG, Venture Pulse Q2 2019.
*As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

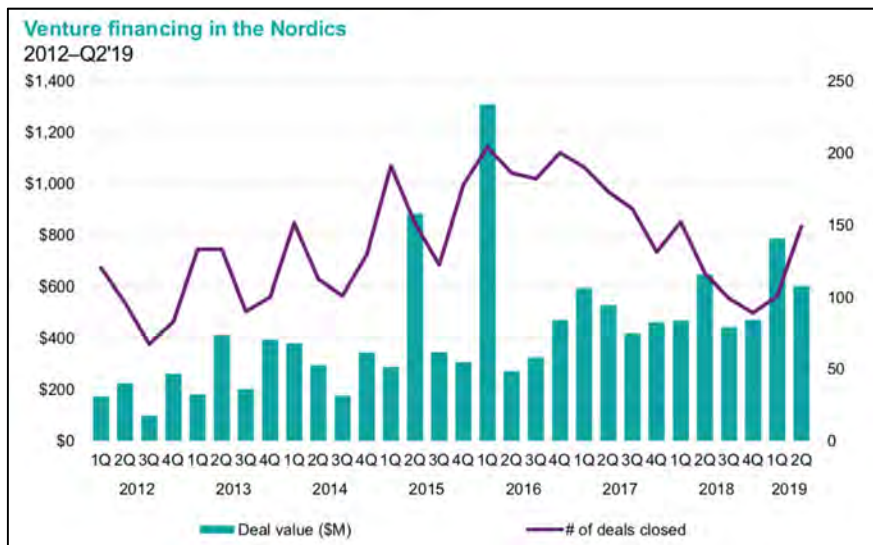
Most of the venture capital investment in France went into Paris-based businesses. Of the totals recorded in Q2, Paris saw an outsized proportion, as well as a majority of volume.⁶¹

⁶⁰ Id, p. 76.
⁶¹ Id, p. 77.



Source: KPMG, Venture Pulse Q2 2019.
 *As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

Similar to the UK and France, venture capital investment in the Nordic countries was very strong in the first half of 2019.⁶²



Source: KPMG, Venture Pulse Q2 2019.
 *As of June 30, 2019. Data provided by PitchBook, July 11, 2019.

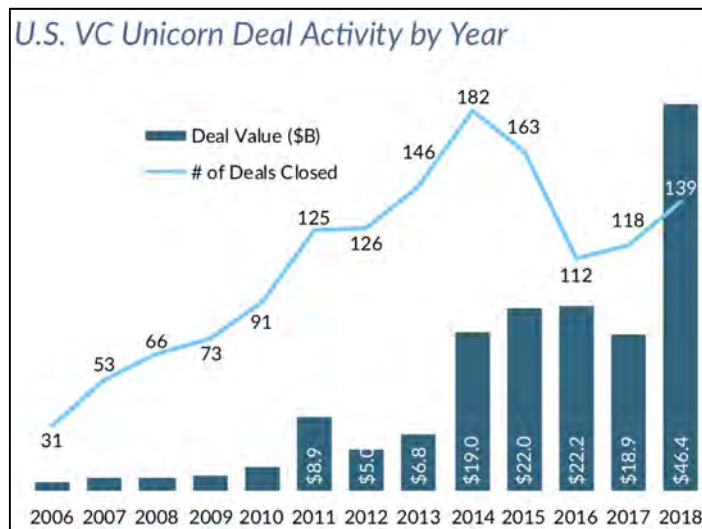
1.4.3. U.S. AND EUROPEAN UNICORNS

As previously discussed, the robust exit activity in 2018 and the first half of 2019 has boosted returns and produced strong distributions for LPs, who can now re-invest that capital into new venture capital funds and further strengthen investment activity including in growth and late stage companies. Growth and late stage private companies can also rely on increasing non-venture capital sources of financing such as corporates and private equity firms, which continue to seek out high-growth venture capital opportunities and the associated returns.

⁶² Id, p. 78.

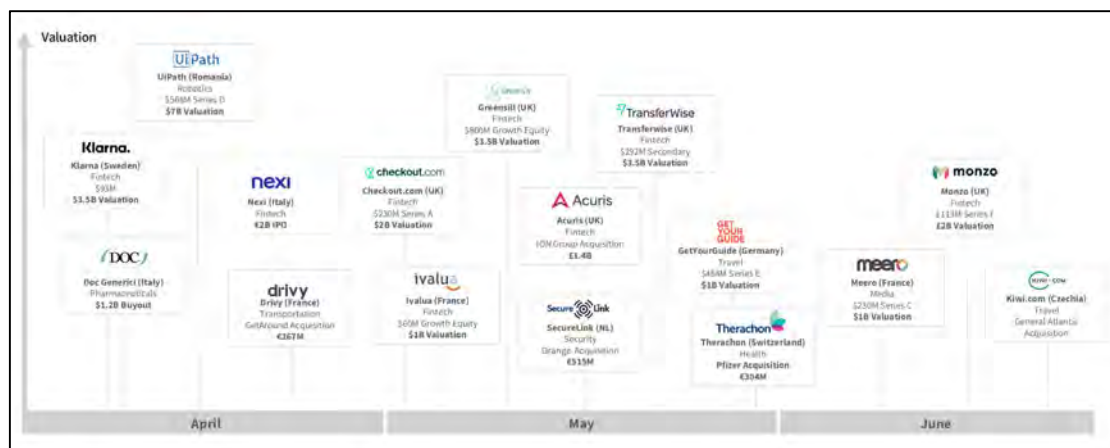
Huge amounts of financing raised from venture-capital investors have allowed many companies to remain private much longer and have contributed to boost their valuation.⁶³ As a result, the group of venture-backed private companies valued at \$1 billion or more (so-called “unicorns”) has rapidly expanded, with now more than 370 unicorns worldwide.⁶⁴

Among them, U.S. unicorns have attracted \$46 billion, or 35% of total capital invested, but less than 2% of the total deals completed in 2018.



Source: National Venture Capital Association, NVCA Yearbook 2019. Data provided by PitchBook

Similarly, in Europe 4 new companies acquired ‘unicorn’ status and others existing unicorns further elevated their position through large funding rounds in the second quarter of 2019.⁶⁵



Source: Dealroom.co

⁶³ See, Dan Primack, Big sale: Groupon discloses \$500 million investment, Fortune (December 30, 2010), retrieved from <http://fortune.com/2010/12/30/big-sale-groupon-discloses-500-million-investment/>; Brian Womack, Facebook Gets \$1.5 Billion Investment Led by Goldman, BloombergBusiness (January 11, 2011), retrieved from <http://www.bloomberg.com/news/articles/2011-01-21/facebook-raises-1-5-billion-valuating-social-network-site-at-50-billion>.

⁶⁴ See, CB Insights, The Global Unicorn Club - The Complete List of Unicorn Companies, CB Insights (July 2019), available at www.cbinsights.com/research-unicorn-companies.

⁶⁵ See, Dealroom.co, Quarterly European Venture Capital Report - Q2 2019, cit., p. 14.

A byproduct of the trend of companies staying private longer has been the slowing pace of liquidity events, which in turn has caused a backlog of unicorns.⁶⁶ The number of unicorns continues to swell, as does their age, driving a need for liquidity. A few of these companies have recently accessed the public markets with an IPO: 10% of unicorn value was unlocked in the US in 2018 and 2019 is shaping up to be an even better year driven by high-profile exits of notable unicorns like Uber, Slack, Lyft, Pinterest and Zoom.

1.5. REGULATORY DEVELOPMENTS

Recent regulatory developments have also created strong incentives for companies to remain private and have resulted in a far wider range of companies needing to find liquidity in the private markets. An example of these regulation would be the recent European rules relating to crowdfunding and those facilitating venture-capital investment across Europe.

Similarly, a further example is the U.S. Jumpstart Our Business Startups Act signed into law on April 5, 2012 (the “JOBS Act”).⁶⁷ The stated purpose of the JOBS Act is “to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”⁶⁸ Certain provisions of the JOBS Act have encouraged U.S. companies to stay private longer.⁶⁹ These include the provisions that increase the number of shareholders that a company can have before it must register under the Securities Exchange Act of 1934 as amended (the “Exchange Act”), those relating to crowdfunding, Regulation A, as well as the elimination under certain circumstances of the prohibition against general solicitation or advertising in Rule 506 of Regulation D and Rule 144A. These provisions have facilitated access to capital markets by private companies, promoted a wider distribution of their securities and given private companies the flexibility to decide how and when it’s best to go public.⁷⁰

⁶⁶ See, McKinsey & Company, *Grow fast or die slow: Why unicorns are staying private*, cit; PitchBook, *Unicorn Report 2019* (PitchBook, August 12, 2019), retrieved from https://files.pitchbook.com/website/files/pdf/PitchBook_2019_Unicorn_Report.pdf

⁶⁷ Pub. L. No. 112-106, 126 Stat. 325 (April 5, 2012).

⁶⁸ *Ibidem*. See, also, SEC, *Jumpstart Our Business Startups (JOBS) Act, JOBS Act Frequently Asked Questions*, available at <https://www.sec.gov/spotlight/jobs-act.shtml>.

⁶⁹ See, e.g., Davis Polk & Wardwell LLP, *The JOBS Act: Implications for Capital Markets Professionals, Pre-IPO Companies and Private Offerings*, Memorandum (March 26, 2012), p. 4, available at <http://www.davispolk.com/jobs-act/capital-markets/>.

⁷⁰ For an overview of the JOBS Act, see, e.g., Skadden, Arps, Slate, Meagher & Flom LLP, *Jumpstart Our Business Startups Act’ Signed Into Law, Corporate Finance Alert, Memorandum* (April, 2012), available at http://www.skadden.com/newsletters/Corporate_Finance_Alert_Jumpstart_Our_Business_Startups_Act.pdf; Sullivan & Cromwell LLP, *Congress Passes the “Jumpstart Our Business Startups Act”: The JOBS Act Eases Marketing Restrictions for Unregistered Offerings and Lowers Hurdles for IPOs of Smaller Issuers*, Sullivan and Cromwell Publication (March 27, 2012), available at <http://www.sullcrom.com/Congress-Passes-the-Jumpstart-Our-Business-Startups-Act-03-27-2012>; Simpson Thacher & Bartlett LLP, *Congress Adopts Capital Access Reform, Memorandum* (March 27, 2012), available at <http://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub1390.pdf?sfvrsn=2>; Davis Polk & Wardwell LLP, *JOBS Act Becomes Law, Memorandum* (April 5, 2012), available at <http://www.davispolk.com/jobs-act/>.

CHAPTER 2

SECONDARY TRADING ACTIVITY

Chapter 1 has analyzed recent developments that have contributed in re-shaping the private markets and have resulted in many U.S., European and UK companies stay private for some extended period of time.

With companies staying private longer and exits often many years away, the desire for early-stage investors, founders and employees of such companies to achieve liquidity has increasingly built up. The resulting pressure for liquidity on private companies has created an urgent need for a more active and transparent secondary trading of private company shares.⁷¹

Several are the considerations that private companies and market participants should take into account when deciding whether and how to engage in secondary transactions (or liquidity transactions).⁷² In addition, long before a private company is at the point when such transactions are feasible, there are a number of steps that should be considered in order to enable the company to have some degree of control over secondary transactions in its shares. The following paragraphs will discuss them in more detail.⁷³

2.1. PRIVATE COMPANIES PROFILE

Over the past decade, the number of private companies engaging in secondary transactions has rapidly increased. Age and size are two key variables that help determine when a company could consider engaging in such transactions. In general, when a company is around four to five-year old, or has issued the 100th equity grant, or has a valuation between \$500 million and \$1 billion is usually when founders, employees and early-stage investors would start considering selling their shares.

2.2. BUYERS AND SELLERS

The secondary market includes a broad range of potential sellers and buyers. On the supply side, as private companies delay their liquidity events, founders and employees look at private secondary markets to “cash-out”, whether for financial diversification, personal milestones (e.g., home purchase) or changes in role at the company. Similarly, early-stage investors increasingly seek liquidity, whether because of their fund structure (which typically require a liquidity event within 10 years or less), a change in firm investment strategy, the need to drive proceeds back to LPs before raising a new fund or their interest in re-investing some or all of their capital in new earlier-stage companies that promise bigger gains.

⁷¹ See, e.g., Chris Kelly, Jeff Kuhn, Dave McClure, Kate Mitchell and Yokum Taku (Speakers), Liz Gannes (Moderator), Panel – Private Company Stock Market – Friend or Foe? (SecondMarket - Capitalize 2011 Conference, San Francisco, May 11, 2011), video available at <https://www.secondmarket.com/discover/capitalize>; Jeremy Smith, Presentation – A Deep Dive into Secondary Market Mechanics (SecondMarket - Capitalize 2011 Conference, San Francisco, May 11, 2011), video available at <https://www.secondmarket.com/discover/capitalize>; Daniel L. Burstein, Paul Deninger, Dixon Doll, Chip Lion, Kushal Saha (Speakers), Dan Primack (Moderator), Panel – The Secondary Market vs. Going Public (SecondMarket - Capitalize 2011 Conference, San Francisco, May 11, 2011), video available at <https://www.secondmarket.com/discover/capitalize>; Paul Deninger, Panel – The Secondary Market vs. Going Public, SecondMarket (SecondMarket - Capitalize 2011 Conference, San Francisco, May 11, 2011), video available at <https://www.secondmarket.com/discover/capitalize>.

⁷² Note, a ‘secondary’ sale is a sale by an existing shareholder to a third-party purchaser, the proceeds of which benefit the selling shareholder. This is in contrast to a ‘primary’ issue, in which the company is issuing its share to an investor and using the proceeds for corporate purposes.

⁷³ There are alternative means for facilitating trading in private company shares, including venture exchanges and emerging company marketplaces (e.g., Nasdaq BX Venture Market), as well as derivatives contracts on private company shares. The analysis of alternative approaches is beyond the scope of this paper.

On the demand side, the network of secondary buyers has grown remarkably over the past few years highlighting the increasing demand for secondary investment opportunities. These include existing investors in a private company seeking to increase their stake in high-potential investment, as well as dedicated secondary funds or venture capital investors with a specific mandate to buy shares from founders, employees and executives. Notable examples are Founders Circle Capital, 137 Ventures, Saints Capital, Delta-V Capital, Akkadian Ventures and ESO.

Furthermore, non-venture capital investors increasingly seek to engage in robust private secondary offerings to gain exposure to high-growth private companies pre-IPO in the hopes of large returns on their investment ahead of an exit. These include private investors, family offices, sovereign wealth funds, hedge funds and special purpose vehicles willing to buy shares in private companies, or LLC interest in a SPV that owns shares in a fast-growing private company or an LP out of the fund. In cases where fees can be meaningful or there is a strong interest in building a relationship with the sellers or the relevant private company, investment bankers or other intermediaries also become interested in secondaries. Some investment banks are better at helping negotiate the sale process, others may be better at finding buyers among their spectrum of clients.⁷⁴

Lastly, private companies themselves may be willing to buy shares back from founders and employees with the aim to clean up their cap-table, realign investor interests, reduce dilution and/or retain and motivate employees through assisting in liquidity.

Among the potential buyers outlined above, existing investors and dedicated funds bring key benefits to the table that are not always present with other participants. For example, a dedicated fund or venture fund is likely to be well known in the market, and its reputation would provide a significant level of comfort to the company, its existing shareholders, as well as its board and management team. In addition, having depth in the industry of the company in which shares have being transferred, as well as good appreciation for the nuances of the investment process, would enable a fund to close the secondary transaction in an efficient manner. Similarly, structuring expertise of a dedicated fund or venture fund would create more flexibility for the sellers. Having existing funding in place also fosters larger transaction capability and certainty of a close, as well as the ability to execute multiple purchases over

⁷⁴ Over the last three years, technology has become one of the hottest and most hyped industry sectors, attracting more and more investors with growing appetite for shares in advance of an envisaged IPO. Various asset managers and investment banks have begun creating special purpose vehicles for their clients to make investment in the stocks of tech private companies. The use of pre-IPO pooled investment vehicles has contributed in broadening the spectrum of investors in private company shares and facilitating secondary trading of private company shares. However, as further discussed later in this paper, the use of pre-IPO pooled investment vehicles has also raised serious concerns for compliance with applicable securities laws. See, Steven Bochner, Keynote – How the Secondary Markets are Affecting the Capital Markets, cit.; Randall Smith and Sha Yndi Raice, Hot Item: Pre-IPO Facebook Shares (The Wall Street Journal, February 28, 2012), available at <http://online.wsj.com/article/SB10001424052970203833004577249512827646658.html>; Peter Lattman, Why Facebook Is Such a Crucial Friend for Goldman (DealBook, January 3, 2011), retrieved from <http://dealbook.nytimes.com/2011/01/03/why-facebook-is-such-an-important-friend-for-goldman-sachs/>; Joshua Gallu, Goldman Sachs Investment in Facebook May Draw SEC Scrutiny (BloombergBusiness, January 4, 2011), retrieved from <http://www.bloomberg.com/news/articles/2011-01-03/goldman-sachs-investment-in-facebook-may-draw-sec-scrutiny-on-disclosure>; Kerry A. Dolan, Frenzy For Facebook Shares Heats Up With A New Auction (Forbes, December 13, 2010), available at <http://www.forbes.com/sites/kerryadolan/2010/12/13/frenzy-for-facebook-shares-heats-up-with-a-new-auction/>.

time. Lastly, dedicated secondary buyers may have established processes to ensure confidentiality, which is often a critical factor for private companies exploring secondary transactions.⁷⁵

2.3. ELIGIBILITY CRITERIA

Founders secondary sales have become increasingly acceptable as a way for founders to relieve financial pressures while continuing to focus on the long-term goals of their companies. Active founders are often allowed to sell up to 10% of their equity holdings in the company (or up to \$5 to \$10 million whichever is lower) in secondary transactions. Enforcing these limitations on founders can help create the right incentives for active founders, while also sending a positive signal to non-executive employees. Such transactions typically occur around the time the company reaches a multi-hundred-million-dollar valuation.

Company-wide secondary sales have also increased in popularity. When facilitating employee tender offers, private companies are able to establish and control the program participants, sale terms, share price and limits to place on the secondary sales.⁷⁶ This can ensure that secondary transactions align with the company goals. For example, it is not uncommon to limit a liquidity transaction to current employees of the company (executives and non-executive employees), as a mean to reward them for their years of effort and value creation. Alternatively, companies may grant participation both to current and former employees (thus, wresting back control of former employees' shares). Where the tender offer is undersubscribed, current employees typically receive preference over former employees.

Some companies allow employees to sell up to a set percentage of their total holdings – e.g., up to 10% to 20% of each individual's holdings. The percentage is typically calculated so that the employees continue to have meaningful equity incentives and are, therefore, incentivized to focus on the long-term value of the company.⁷⁷

Alternatively, other companies allow employees to sell up to a certain dollar amount. This means that all employees could cash out an equal amount irrespective of the overall net worth of the employee due to the company stock.⁷⁸ Similar to the above approach, a dollar value limit would provide employees with meaningful liquidity without skewing the incentive structure of equity grants.

Recently, more and more companies have adopted a hybrid approach whereby employees can sell up to a set percentage of their holdings (e.g., 10% or 20% of their holdings) or a set dollar amount (e.g., \$1 million in stock) whichever comes first over the course of their secondary sales. Thus, for example, if an employee holds \$20 million in stock, the employee can sell up to \$1 million, even though that does not

⁷⁵ See, PwC, *Private Company Liquidity: CEO and CFO Considerations A Guide to Secondary Transactions* (PricewaterhouseCoopers, July 2017), p. 7, retrieved from <https://www.pwc.com/us/en/services/deals/library/private-company-liquidity.html>.

⁷⁶ Note that for a private company, if a tender offer is triggered, the sale of shares would require additional procedures to comply with securities laws, including having the offer be made open for at least 20 business days.

⁷⁷ See, Elad Gil, *High Growth Handbook* (Stripe Press, 2018), pp. 282-283 (noting that 'For companies that have truly broken out and are worth many billions, or for very early employees, these amounts many add in to the tens of millions of dollars. Sales of this magnitude create a potential disincentive for employees to continue to work. Moreover, they can lead to a two-class system within the company before a true liquidity event occurs (an IPO or a large sale). This two-class system can be culturally jarring.').

⁷⁸ *Ibidem* (noting that '[i]n some cases a dollar limit many cause some early employees to leave the company if doing so unlocks their ability to sell larger amount of stock. In reality, people who leave solely to sell many not have stuck around much longer to begin with').

trigger their 20%. Alternatively, if an employee holds \$1 million in stock, they can only sell 20% or \$200,000. This approach ensures that employees continue to hold the majority of their equity in the company and remain focused to build long-term value of the company.⁷⁹

Whichever model they adopt, private companies typically place additional limits on secondary sales by employees. First, employees need to be with the company for a minimum period of time, which typically ranges from one year (and so the employees must hit their cliff) to two or three years. Second, the amount of secondary sold is limited to, at most, what the employee has vested or a proportion of what the employee has vested (e.g., ‘no more than 20% of vested equity’).⁸⁰

Other selling limitations may be placed on secondary sales by former employees. For example, many companies have enforced an all-or-nothing requirement on these group of shareholders, allowing them to participate in the secondary sales only if they sell all of their vested equity holdings. When companies do not impose the all-or-nothing sale limitation, the restrictions for former employees range from being ineligible to participate to being limited to sell up to a set % of vested holdings.⁸¹

2.4. STRUCTURING A LIQUIDITY TRANSACTION

Acknowledging that there are a number of permutations of secondary transactions, the following sections will outline secondary structures that are prevalent in the market and their relative pros and cons. As discussed in more detail below, when thoughtfully designed and effectively implemented, liquidity transactions can orient all stakeholders toward longer-term company building.

2.4.1 COMPANY BUYBACKS AND THIRD-PARTY PRIVATE TENDER OFFERS

As companies remain private much longer and their valuations progressively grow, an increasing pressure become building on them for some form of early stock sale. To respond to this pressure, a private company may decide to use existing cash and purchase shares directly from its shareholders. In so doing, the company will be able to maintain full control of all aspects of the transaction.⁸²

However, most venture-backed companies and other private companies typically do not have consistent cash flows and/or enough cash availability to repurchase their shares. Therefore, to provide their shareholders with some liquidity, most private companies need to rely on outside capital. To this end, companies may decide to execute a primary offering and use the resulting proceeds (or part of them) to

⁷⁹ Ibidem.

⁸⁰ Ibidem (noting that ‘[i]n general refresher grants that occur later in the lifetime of a company are a fraction of the grants employees receive upon joining (with rare exceptions for true outlier performers or people who, for example, advance from an individual contributor to a VP and get a large refresher grant to reflect this heightened position and impact). This means that most of the value employees get in stock tends to derive from the earliest grant that will be their primary financial incentive to contribute to the long-term success of the company.’).

⁸¹ See, Founders Circle, A Guide to Employee Liquidity Programs: Why and How Companies Align the Interests of All Parties (Founders Circle, 2019), retrieved from <http://www.founderscircle.com/secondary-employee-aligned-liquidity-guide/>.

⁸² The back-back could be targeted to certain employees or be broadly open to all employees and/or early shareholders. The offer would be for shares and/or options to purchase shares. The repurchase would likely require board consent and shareholder approval. Existing contractual arrangements (e.g., company loan facilities) would need to be reviewed to ensure that there are no applicable restrictions requiring a consent or waiver. Sellers would execute a repurchase agreement with the company. Employees holding options would need to exercise their options prior to or in connection with the repurchase or have their options cancelled in exchange for cash. The company would run the process and typically prepare an information statement containing information on the proposed transaction, the process for tendering shares, financial information of the company and the risks related to the company. The overall process could be a one-time transaction or it could be repeated periodically (for instance, every six months).

buyback their shares. Alternatively, companies may decide to have a buyer(s) (either an existing shareholder(s) or a third-party investor, or a combination of the two) acquire shares directly from existing shareholders, any such acquisition being either paired with a primary equity financing of the company or as a standalone transaction.⁸³

The choice between the approaches outlined above is typically driven by the company's specific goals, as well as, preference and dilution considerations. In particular:

- Company repurchases are common ways to give liquidity to employees and early investors and their implementation is relatively straightforward. The company has full control over the process and minimal input is required from third parties. A company repurchase also helps reduce the number of shares outstanding and is therefore anti-dilutive. Because the company buybacks the shares, no new shareholders are added on the company's cap-table who may influence future votes or investor dynamics. However, as mentioned above, company repurchases consume company cash and private companies typically do not have consistent cash flows and/or enough cash availability to complete any such repurchase.

- Contrary, a company's buyback using primary offering proceedings has the benefit of preserving the company's available cash, but it also involves potential drawbacks including dilution of existing shareholders' equity ownership and the grant of preferred terms that the new investors will most likely demand. In addition, investors participating in the financing may resist the use of proceeds for large repurchases.

- A third-party tender offer allows a company to preserve its funds and does not require issuance of dilutive new equity with preferred terms. When the third-party buyer is a favored existing investor, the tender offer can allow such investor to increase its position in the company.⁸⁴ Instead, when the process involves, and requires cooperation by, a third party which is not an existing investor, then the company may have less flexibility on price, timing and other terms. However, if the company is involved with selecting the third-party purchaser, it can have oversight of favored new entrants onto its cap-table and can help structured the transaction to best optimize the overall process. Companies would typically restrict their investing partners for secondary sales to a single fund or a syndicate of two to three funds, which would help the company retain control and visibility on the aggregate number of shareholders. In all cases, the relevant investor added to their "approved-buyer list" would need to be known, trusted (by management, the board of directors and existing investors) and aligned with the long-term value creation goals of the company.

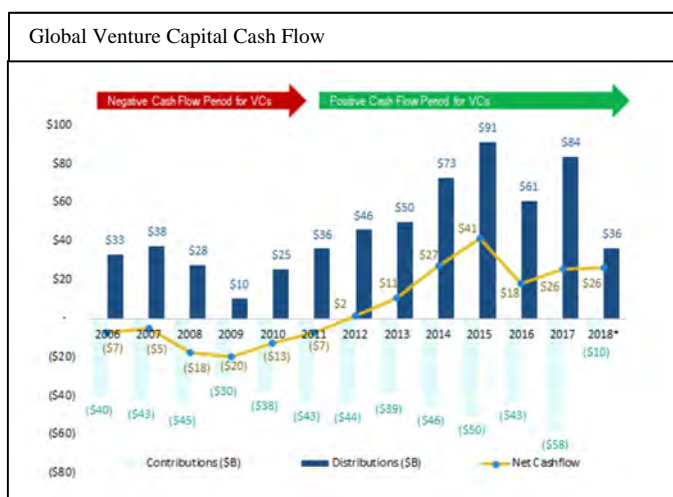
⁸³ The purchaser could be an existing investor or a new investor. The third-party purchase could be targeted to certain employees or be broadly open to all employees and/or early shareholders. It would apply to shares only and employees holding options would need to exercise their options immediately prior to the sale. Sellers would execute a transfer agreement with the third party. The price at which shares are repurchased would be determined by the buyer. The purchase would likely require board consent and shareholder approval and board and major shareholders must typically waive applicable rights of first refusal and co-sale. The company would run the process and typically prepare an information statement containing information on the proposed transaction, the process for tendering shares, financial information of the company and the risks related to the company.

⁸⁴ PwC, Private Company Liquidity: CEO and CFO Considerations A Guide to Secondary Transactions (PricewaterhouseCoopers, July 2017), cit., pp. 8-9.

The last ten years have seen an increasing number of private companies coordinating private tender offers that they could tightly control.⁸⁵ Until 2009, these transactions were still very limited and highly customized. The watershed event that started the trend is the Digital Sky Technologies (DST)'s investment in Facebook in 2009: by combining a primary offering component (a \$200 million investment by DST in Facebook in exchange for preferred stock, representing a 1.96% equity stake at a \$10 billion valuation) and a secondary offering component (the agreement by DST to buy an additional \$100 million of common stock from current and former employees and existing common stock investors), this investment allowed Facebook to raise capital and provide liquidity to early investors and employees.⁸⁶ Although acknowledging the unique features of the DST investment in Facebook, this transaction has certainly paved the way for similar investments (commonly referred to as "DST deals") in the following years. In fact, after the completion by Facebook of its tender offer with DST, the volume of these transactions has rapidly grown particularly in respect to venture-backed technology companies.⁸⁷ The scale and frequency of combined capital-raising and liquidity events have also significantly increased, thus reflecting a growing need for liquidity among early-stage investors and employees of private companies.⁸⁸ The following section will discuss this in more detail.

2.4.2 SECONDARY FUNDS

The capital provided to venture capital firms by LPs has significantly increased over time. Since 2012, the global venture capital industry has received positive net capital inflow by LPs of c.\$151billion. In particular, since 2012 the venture capital industry has reportedly received c.\$441billion of new capital and distributed c.290 billion to LPs.



Source: Pitchbook

⁸⁵ See, Brad Stone, Silicon Valley Cashes Out Selling Private Shares (Bloomberg Businessweek, April 21, 2011), retrieved from http://www.businessweek.com/magazine/content/11_18/b4226070179043.htm; Fred Wilson, The Tug of War Between M&A and VC (Business Insider, January 19, 2010), retrieved from http://articles.businessinsider.com/2010-01-19/tech/30027815_1_deals-big-companies-zynga.

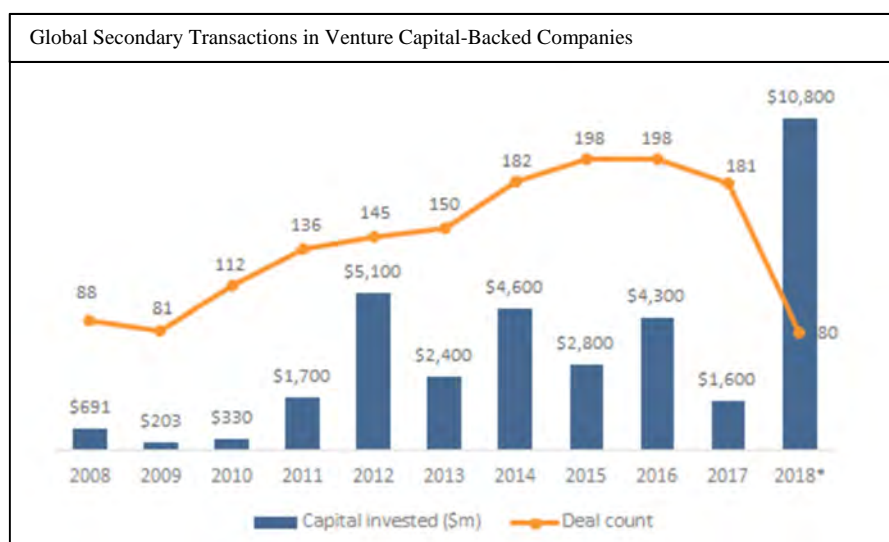
⁸⁶ Ibidem.

⁸⁷ See, Jeremy Drean, The Secondary Private Markets – New Players in the Venture Capital Ecosystem, cit. p. 11.

⁸⁸ Ibidem.

The large amount of capital raised has since then been deployed across a number of companies, reaching record peaks between 2017 and 2019. Due to the increased availability of excess capital to venture capital and the rate of capital deployment, venture capital-backed companies have been able to raise large growth and late-stage funding rounds and so stay private longer than in previous cycles. This, in turn, has led to a reduction in exit activity over time relative to venture capital investments. In addition, as companies stay private longer, venture capital investment holding period has increased significantly from 6.3 (4.2) years for exit via IPO (acquisition/buyout) in 2010 to 8.3 (4.9) years for exit via IPO (acquisition/buyout) in 2016.

Exits have been predominantly achieved via IPOs or acquisitions with the composition changing over time. However, given the current status of the capital markets, IPO and M&A activity are expected to slow down in the short to medium term. An alternative route has emerged more recently as potential exit option which would involve achieving liquidity through secondary sales.⁸⁹



Source: Chirag Modi, Venture Capital Funding Trends & The Emergence of Secondary Funds (Medium, January 13, 2019).

Since the closing of the DST-Facebook deal discussed in the prior section, venture-capital firms have demonstrated increased appetite for secondary sales. While deal count has varied annually, the size of the publicly disclosed secondary deals completed over the past eight years has significantly increased, with 2018 recording some sizable examples: 80 deals have involved a total \$10.8 billion in capital invested in 2018, compared to the 181 deals and \$1.6 billion in 2017.⁹⁰

The 2018 year kicked off with the closing of the SoftBank-led \$8 billion backing in Uber, valuing the company at c. \$48 billion. This transaction reportedly helped the company provide liquidity to early investors and employees.⁹¹ Other notable large secondary deals in 2018 include: Francisco Partners and

⁸⁹ See, Chirag Modi, Venture Capital Funding Trends & The Emergence of Secondary Funds (Medium, January 13, 2019), retrieved from <https://medium.com/@cmodi/venture-capital-funding-trends-the-emergence-of-secondary-funds-1b615e92372d>.

⁹⁰ See, Sean Lightbown, Alternative Exits: The Rise of Secondary Deals in Venture Capital (PitchBook, October 26, 2018), retrieved from <https://pitchbook.com/news/articles/alternative-exits-the-rise-of-secondary-deals-in-venture-capital>.

⁹¹ See, Jason D. Rowley, Uber Finally Seals \$9 Billion Deal With SoftBank And Others (Crunchbase, January 18, 2018) retrieved from <https://news.crunchbase.com/news/uber-finally-seals-9-billion-deal-softbank-others/>; Leslie Hook, SoftBank-led group to acquire \$9bn stake in Uber (Financial Times, December 28, 2017), retrieved from <https://www.ft.com/content/33ca6fbc-ec00-11e7-8713-513b1d7ca85a>.

GPI Capital-led \$500 million in legal services specialist LegalZoom, valuing it at c. \$2 billion;⁹² Silver Lake's \$500 million in Credit Karma, giving it a \$4 billion valuation;⁹³ and another \$600 million for Uber. These secondary transactions surpassed the biggest secondary deal of 2017, a \$250 million investment by Brightfolk in Swedish fintech Klarna.⁹⁴

More recently, in May 2019 Transferwise announced the closing of a \$292 million secondary funding round which doubles its valuation to \$3.5 billion. The round allowed the company to provide liquidity to early stage investors and employees and to add investors more in line with its stage of growth. The round was led by growth capital investors Lead Edge Capital, Lone Pine Capital and Vitruvian Partners. Existing investors including Baillie Gifford and Andreessen Horowitz also expanded their holdings in the company and some of the investment came from funds managed by BlackRock Inc.⁹⁵

To date, a large number of publicly disclosed secondary transactions have occurred on the back of a primary investment led by growth and late stage investors seeking pre-IPO exposure and willing to pour massive \$100-million plus primary rounds. In the context of these transactions, private companies have been able to accomplish two things at once: raise the capital they need from growth and late stage investors; and also use part of it to go directly to their earlier investors and employees so to give them the opportunity to take something off the table and reduce some of the pressure for a future exit.⁹⁶

Driven by demand for liquidity by early investors and employees, secondary transactions are becoming more global in nature and are increasing in frequency and size. In response to these developments, vehicles utilized for these transactions are becoming more structured and niche-focused to get in on these deals. Hence, the past couple of years have seen a rapid emergence of liquidity, or secondary funds. Some of these funds are discussed in more detail below.

2.4.2.A U.S. SECONDARY FUNDS

Secondary, or liquidity funds have been used in Silicon Valley for more than a decade by investors who want to gain exposure to later-stage fast growing companies. These funds are seen as an important element in the technology industry because they enable early-stage shareholders to exit private companies and reduce pressure on founders to sell their businesses or list on public markets. Among the most prominent US-based firms that have raised secondary funds are the following:

⁹² See, Gerrit De Vynck, LegalZoom Gains \$2 Billion Valuation in Funding Round (Bloomberg, July 31, 2018), retrieved from <https://www.bloomberg.com/news/articles/2018-07-31/legalzoom-gains-2-billion-valuation-in-latest-funding-round>.

⁹³ See, Matthew Lynley, Silver Lake is buying a \$500M stake in Credit Karma in a massive secondary round (TechCrunch, March 28, 2018), retrieved from <https://techcrunch.com/2018/03/28/silver-lake-is-buying-a-500m-stake-in-credit-karma-in-a-massive-secondary-round/>.

⁹⁴ See, Katie Roof, Fashion magnate takes \$225M+ stake in Swedish payment unicorn Klarna (TechCrunch, June 7, 2017) retrieved from <https://techcrunch.com/2017/06/07/fashion-magnate-takes-225m-stake-in-swedish-payment-unicorn-klarna/>.

⁹⁵ See, e.g., Alex Wilhelm, TransferWise Snags \$292M In Pre-IPO Secondary Liquidity (CruchBase News, May 22, 2019) retrieved from <https://news.crunchbase.com/news/transferwise-snags-292m-in-pre-ipo-secondary-liquidity/>; Anna Irrera, TransferWise closes \$292 million secondary funding round at \$3.5 billion valuation (Reuters, May 22, 2019), retrieved from <https://www.reuters.com/article/us-transferwise-funding/transferwise-closes-292-million-secondary-funding-round-at-3-5-billion-valuation-idUSKCN1SS09K>; MarketWatch, TransferWise valued at US\$3.5b after US\$292m funding round (MarketWatch, May 22, 2019) retrieved from <https://www.marketwatch.com/press-release/singapore-transferwise-valued-at-us35b-after-us292m-funding-round-2019-05-22>.

⁹⁶ See, PitchBook, Q&A: What VC Professionals Think About Alternative Exits And Liquidity (PitchBook Blog, November 13, 2018), retrieved from: <https://pitchbook.com/blog/qa-what-vc-professionals-think-about-alternative-exits-and-liquidity>; Garrett James Black, The evolution of liquidity: Shifting exit strategies for private market investors (PitchBook June 19, 2018), retrieved from <https://pitchbook.com/news/articles/the-evolution-of-liquidity-shifting-exit-strategies-for-private-market-investors>.

- 137 Ventures: San Francisco-based 137 Ventures was founded in 2010 and since then has emerged as a leading growth-stage venture firm that provides customized liquidity solutions to founders, investors, and early employees of high-growth private companies. In March 2019, the firm announced its fourth fund with \$210 million in committed capital.⁹⁷ The firm's portfolio includes investments in Wish, Flexport, Gusto, Palantir, Airbnb and DiDi among others, as well as a significant stake in SpaceX.⁹⁸
- Industry Ventures: Founded in 2000, Industry Ventures is the largest dedicated liquidity provider for private companies and limited partnership interests in venture funds. As of the date of this publication, Industry Ventures manages over \$3.4 billion and provides comprehensive exit alternatives to employees, founders, angel investors, corporate venture capital programs, hedge funds, mutual funds and other non-traditional venture investors. The firm has acquired stakes in ventures funds such as Battery Ventures, DFJ Venture Capital, Draper Esprit, Foundation Capital, Lightspeed Venture Partners, as well as high profile private companies including Alert Logic and Cambridge Display.⁹⁹
- Founders Circle Capital: Founders Circle Capital is a U.S. based growth capital firm specializing in providing liquidity to founders and employees of growth and late-stage private companies through the purchase of their vested employee stock options. Founders Circle Capital works by invitation only of management and their boards where they're asked to structure programs that operate under the company's control and are thoughtfully managed throughout the process. To date, Founders Circle Capital has invested in a number of high-profile companies including DoorDash, Intercom, Turo and Udemy.
- Oceanic Partners: Leading firm Oceanic Partners focuses on principal investments in secondary private market opportunities. In addition, the firm offers bespoke liquidity options for individual and institutional holders of private equity. Transactional types include direct brokerage, managed funds, single-name syndications, synthetic interest products, as well as structured employee equity compensation liquidity plans.¹⁰⁰
- Saints Capital: With nearly 20 years of experience and a track record of investing in over 200 companies, Saints Capital is the oldest and one of the largest direct secondary investors. The firm raised its first fund in 2000, pioneering as a direct secondary fund. Since then, Saints Capital has provided liquidity to a large number of GPs and their LPs in venture capital and private equity funds, to founders and early employees of venture capital backed companies, and to financial institutions (banks, hedge funds and corporations) who have portfolios of private investments that they wanted to sell.¹⁰¹
- Akkadian Ventures: Founded in 2010, San Francisco-based Akkadian Ventures is a direct secondary investment firm focused on providing liquidity to early employees and investors of

⁹⁷ See, Kate Clark, 137 Ventures raises \$210M to give liquidity to startup employees (TechCrunch, March 12, 2019), retrieved from <https://techcrunch.com/2019/03/12/137-ventures-raises-210m-to-give-liquidity-to-startup-employees/>.

⁹⁸ Information about 137 Ventures in this section is retrieved from 137 Ventures website at <https://137ventures.com>.

⁹⁹ Information about Industry Ventures in this section is retrieved from Industry Ventures website at <http://www.industryventures.com>.

¹⁰⁰ Information about Oceanic Partners in this section is retrieved from Oceanic Partners website at <https://www.oceanic.us>.

¹⁰¹ Information about Saints Capital in this section is retrieved from Saints Capital website at <http://www.saintscapital.com>.

venture-backed businesses. The firm has created a broad offering of products and services to help entrepreneurs and investors generate liquidity and diversify their risk by monetizing a portion of their private stock.¹⁰² Liquidity solutions include loans, profit sharing and stock purchases, with transactions ranging from \$75,000 to over \$10 million. Notable investments include stakes in Gusto, Lime and MasterClass.¹⁰³

- Delta-v Capital. Founded in 2009, Delta-v Capital is a leading provider of liquidity solutions and growth equity to private technology companies and their shareholders, including founders, management and early investors. Initially established with a focus on providing secondary liquidity to minority investors, the firm has since expanded its scope to include growth equity to support growth-stage technology companies. The firm typically invests in companies with a minimum of 20% growth and its secondary approach allows it to buy in at a 20%-30% discount. Since 2009, Delta-v Capital has invested in over 20 market leading companies, including LogRhythm, Expensify, ExteNet Systems, NSS Labs, Chegg, Borderfree and Zayo.¹⁰⁴

2.4.2.B EUROPEAN AND UK SECONDARY FUNDS

While secondary funds buying equity stakes from early stage investors, employees and founders in high-growth companies is a common practice in the United States, it has only started to become prevalent in the European venture capital ecosystem over the past few years, as a raft of technology unicorns have emerged across Europe.

In fact, high-growth private companies in Europe have not generally had easy access to liquidity due to the absence of a structured route to liquidity for any early shareholder, be they founders, early employees or investors. With increased valuations and the typical time between initial funding rounds and exit getting longer and longer, a growing number of these early stakeholders have been increasingly looking to cash in some of their shares. In response to these developments, leading European venture capital firms have begun to raise secondary funds.¹⁰⁵ Notable example includes the following:

- Balderton Capital - Balderton Capital was the first investment firm to close a multimillion-dollar fund for buying equity from existing shareholders of European high growth, scale-up technology companies in October 2018. The \$145 million secondary fund - Balderton Liquidity I - was backed by family offices and institutional investors and currently focuses on buying equity in start-ups which have been founded over the past decade and have raised at least \$20 million in equity financing. Balderton Capital reportedly decided to launch the fund after identifying a critical mass of interesting European companies in the growth stage that fit the described profile. The fund invests in these companies through the mechanism of purchasing

¹⁰² See, Anthony Ha, Akkadian Ventures Raises \$22M For Secondary Stock Purchases (TechCrunch, June 14, 2012) retrieved from <https://techcrunch.com/2012/06/14/akkadian-ventures-second-fund/>; Chelsea Stevenson, Akkadian: eyes on early VC liquidity (Secondaries Investor, December 1, 2014) retrieved from <https://www.secondariesinvestor.com/akkadian-eyes-early-vc-liquidity/>.

¹⁰³ Information about Akkadian Ventures in this section is retrieved from Akkadian Ventures website at <https://www.akkadianventures.com>.

¹⁰⁴ Information about Delta-v Capital in this section is retrieved from Delta-v Capital website at <https://www.deltavcapital.com/>.

¹⁰⁵ See, Scott Carey, The rise of European VC liquidity funds (Techworld, July 5, 2019), retrieved from <https://www.techworld.com/startups/rise-of-european-liquidity-funds-3699143/>.

shares from existing, early shareholders who want to liquidate pre-exit some or all of their shares.¹⁰⁶

- **Draper Esprit** - Draper Esprit, a publicly-listed venture capital firm based in London, acquired two opening funds of early-stage investor Seedcamp - Seedcamp Funds I & II - for approximately Euro 20 million in 2017.¹⁰⁷ The original Fund 1 size was Euro 2.5 million and was raised in 2007, while the Fund II size was Euro 5.2 million and was raised in 2010. The acquisition delivered a 4x return to the LPs that invested in those two funds, and also allowed Draper Esprit to gain stakes in high profile growing technology companies including European fintech unicorn TransferWise.¹⁰⁸
- **Vitruvian Partners** - A very active secondary tech investor in Europe, Vitruvian Partners counts among its portfolio companies leading European high growth companies like Transferwise, Accountor and Darktrace.¹⁰⁹
- **Hambro Perks** - London-based venture firm Hambro Perks raised its liquidity fund - Access Fund I - in 2018. With this fund, the firm aims to invest in between funding series in secondary positions (from angel investors, founders, employees or management) in technology-enabled businesses across Europe, Middle East and Africa region.¹¹⁰

2.4.3 U.S., EUROPEAN AND UK SECONDARY MARKETS FOR PRIVATE COMPANY SHARES

The following paragraphs discuss secondary markets for private company shares as viable means for promoting an active, liquid and transparent trading of private company shares.¹¹¹ Although characterized by different market structures and business models, all the secondary markets discussed below use the benefits of online and electronic platforms to efficiently connect participants in secondary transactions and to increase safeguards, transparency and control of trading.

2.4.3.A NASDAQ PRIVATE MARKET

The Marketplace, San Francisco-based Nasdaq Private Market (NPM) was announced on March 6, 2013 as a partnership between SharesPost and NASDAQ OMX Group and since then it has established itself

¹⁰⁶ Information about Balderton Capital in this section is retrieved from Balderton Capital website at <https://www.balderton.com>. See, also, Aliya Ram, Balderton pioneers fund for buying stakes in European start-ups (Financial Times, October 3, 2018), retrieved from <https://www.ft.com/content/54af8462-c664-11e8-ba8f-ee390057b8c9>; Steve O'Hear, Balderton's \$145M 'secondary' fund will give shareholders in European scale-ups the chance to exit early (TechCrunch, October 3, 2018), retrieved from <https://techcrunch.com/2018/10/02/secondary-vc-fumes/>.

¹⁰⁷ Information about Draper Esprit in this section is retrieved from Draper Esprit website at <https://draperesprit.com/>.

¹⁰⁸ See, Mike Butcher, Publicly-listed UK VC Draper Esprit acquires Seedcamp's Fund I & II for \$23.6M (TechCrunch, October 25, 2017), retrieved from <https://techcrunch.com/2017/10/25/publicly-listed-uk-vc-draper-esprit-acquires-seedcamps-fund-i-ii-for-23-6m/>; Jonathan Keane, Draper Esprit acquires Seedcamp Funds I and II for €20 million (Business Insider, October 25, 2017) retrieved from <https://www.businessinsider.com/draper-esprit-acquires-seedcamp-funds-i-and-ii-for-20-million-2017-10?r=UK>.

¹⁰⁹ Information about Vitruvian Partners in this section is retrieved from Vitruvian Partners website at <https://www.vitruvianpartners.com>.

¹¹⁰ Information about Hambro Perks in this section is retrieved from Hambro Perks website at <https://www.hambroperks.com>.

¹¹¹ See, e.g., Steven Bochner, Keynote – How the Secondary Markets are Affecting the Capital Markets, cit.; Adam Oliveri, Panel - The Secondary Market Big Picture (SecondMarket - Capitalize 2012 Conference, New York, February 15, 2012), video available at <https://www.secondmarket.com/discover/event-replay-capitalize-east>; Russ Garland, Secondary Marketplaces Showing Signs Of Finding Their Niche (The Wall Street Journal, March 12, 2010), available at <https://www.secondmarket.com/discover/news/secondary-marketplaces-showing-signs-of-finding-their-niche>.

as a leading player in the private secondary market.¹¹² NPM offers purpose-built platforms for structured liquidity programs with a standardized workflow to make secondary transactions an efficient process for private companies.¹¹³ SharesPost acts as a broker with NPM.¹¹⁴

Since 2013, the demand for NPM's expertise in private market liquidity has grown significantly, most notably regarding the number of tender offers and repurchase programs. As of the date of this paper, NPM has facilitated over 230 liquidity events for private companies, involving more than 24,000 participants, for a total transaction value of over \$19 billion.¹¹⁵

In October 2015, Nasdaq agreed to buy SecondMarket Solutions to combine forces with NPM.¹¹⁶ At that time, SecondMarket operated as a registered broker dealer and member of the Financial Industry Regulatory Authority (FINRA), the Municipal Securities Rulemaking Board (MSRB) and the Securities Investors Protection Corporation (SIPC), as well as a U.S. Securities and Exchange Commission ("SEC") - registered alternative trading system for private company stocks. Initially founded to provide a liquidity solution for restricted securities in public companies, starting from 2008 SecondMarket had expanded its trading activity to include a number of additional assets (e.g., auction-rate securities, bankruptcy claims, private company stock, and fixed income products) and launched its private company marketplace in mid-2009. Since then, the volume and size of the transactions had grown significantly with SecondMarket completing more than \$558 million in private company transactions in 2011 (a 55% increase from the previous year) and over \$1 billion since 2008.¹¹⁷ In 2011, SecondMarket pivoted its private company secondary business to provide liquidity solely in the context of company-sponsored or supported liquidity programs, working closely with private companies to facilitate orderly sales of stock

¹¹² See, Nasdaq, Nasdaq OMX and SharesPost to form Private Market, Nasdaq Press Release (March 6, 2013), retrieved from <http://ir.nasdaq.com/news-releases/news-release-details/nasdaq-omx-and-sharespost-form-private-market>.

¹¹³ Note, the Nasdaq Private Market, LLC is not: (a) a registered exchange under the securities exchange act of 1934; (b) a registered investment advisor under the investment advisors act of 1940; or (c) a financial or tax planner, and does not offer legal, financial, investment or tax advice to any user of the Nasdaq Private Market website. Technology services may be offered by the Nasdaq Private Market, LLC's wholly-owned subsidiary, SecondMarket Solutions, Inc. securities-related services offered through NPM Securities, LLC, a registered broker-dealer and alternative trading system and SMTX, LLC, a registered broker-dealer, each of which is a member FINRA/SIPC and wholly-owned subsidiary of the Nasdaq Private Market, LLC. Transactions in securities conducted through NPM Securities, LLC and SMTX, LLC are not listed or traded on the Nasdaq Stock Market LLC, nor are the securities subject to the same listing or qualification standards applicable to securities listed or traded on the Nasdaq Stock Market LLC.

¹¹⁴ SharesPost and Nasdaq OMX Group teamed up to form NPM in 2013. In 2015, SharesPost sold its interest in the NPM to Nasdaq. Though SharesPost remains a member broker dealer of the NPM, SharesPost is no longer an equity holder.

¹¹⁵ See, Nasdaq Private Market, A Review of the Private Company Secondary Market and Structures (Nasdaq Private Market Report (April 2019)), p. 2, retrieved from <https://www.nasdaqprivatemarket.com/a-review-of-the-private-company-secondary-market-and-structures/>; Nasdaq Private Market, 2019 Mid-Year Private Company Report (Nasdaq Private Market Report (July 2019)), p. 1, retrieved from http://img.n.nasdaq.com/Web/GIS/%7Bed9ff2df-ea0c-40c7-b31d-d899ab740177%7D_1686-Q19_Nasdaq_Private_Market_Mid-Year_Report_CS-v6.pdf.

¹¹⁶ See, e.g., Katie Roof, NASDAQ Acquires SecondMarket To Help Startups Sell Shares (Techcrunch, October 2015), retrieved from <https://techcrunch.com/2015/10/22/nasdaq-acquires-secondmarket-to-help-startups-sell-shares/>; Leslie Hook and Philip Stafford, Nasdaq acquires SecondMarket (Financial Times, October 22, 2015), retrieved <https://www.ft.com/content/3ab8a3de-78cb-11e5-a95a-27d368e1ddf7>; Tess Stynes and Bradley Hope, Nasdaq Acquires SecondMarket, Profit Rises 12% (The Wall Street Journal, October 22, 2015), retrieved from <https://www.wsj.com/articles/nasdaq-acquires-secondmarket-profit-rises-12-1445511644>.

¹¹⁷ SecondMarket, SecondMarket's 2011 Year End Private Company Report (January 19, 2012), available at <https://www.secondmarket.com/discover/reports/secondmarkets-2011-year-end-private-company-report>.

by their existing shareholders.¹¹⁸ Following this pivot, SecondMarket grew from around \$30 million in transactions in 2008, to \$1.4 billion in 2014.¹¹⁹

In 2017, NPM expanded its liquidity solutions to support funds structures in the form of partnership interests or registered '40 Act vehicles. Through NPM's technology and regulatory infrastructure, fund managers can now provide centralized liquidity to investors through NPM market-driven auction process.¹²⁰

Private Companies and Liquidity Programs Insights. Latest data from NPM highlight an increasing number of successful growth stage private companies engaging in secondary transactions and provide useful insights on recent trends in this regard.¹²¹ First, a shift in market share by location. From 2013 to 2017, about 64% of NPM clients were based in California as well as 80% of clients with unicorn-level valuations. However, as venture capital activities booms in other hubs (including Atlanta, Boston, Denver and New York), the share of non-west coast NPM clients conducting liquidity programs has increased from less than 10% in 2013 to an almost equal split between west coast and east coast in 2018. The number of California NPM clients increased to 44, up from the previous record of 27 in 2017, yet their market share as a percent has decreased annually, with the exception of 2018. This suggests that the market is actually growing at a faster pace in other regions of the U.S., and the startup culture of liquidity as an employer and employee benefit is spreading.¹²²

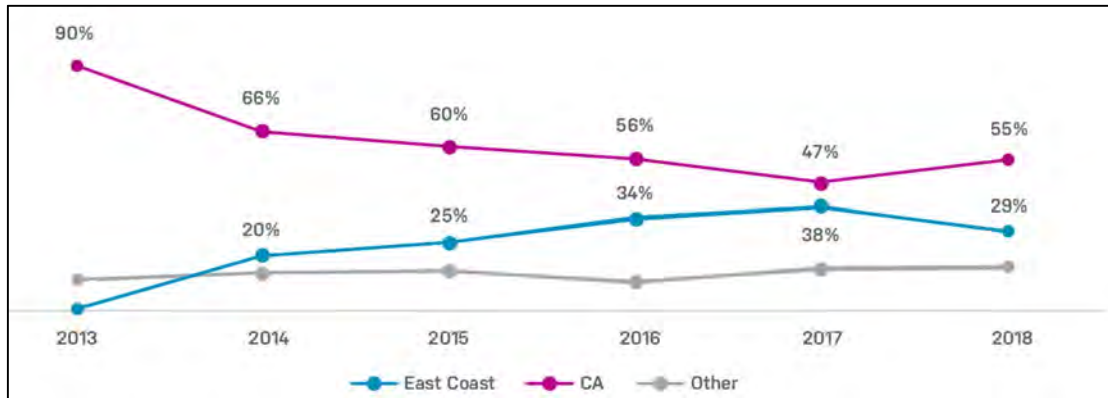
¹¹⁸ Initially, SecondMarket performed one-off transactions: buyer and sellers reached the market and indicated the number of shares they were willing to buy or sell and the proposed price, and then SecondMarket played the role of broker and facilitated the transaction between the parties. All of this was typically done without requiring the consent of the issuer. In 2011 SecondMarket changed its business model by adopting a "company-based" strategy. Since then, SecondMarket started designing "customized liquidity programs" for private companies. Typically, SecondMarket entered into an agreement with a private company wishing to establish a liquidity program for its securities on SecondMarket's platforms. Pursuant to the terms and conditions of such agreement, SecondMarket agreed to allow transactions in the private company's shares only by buyers and sellers approved by the sponsoring private company. Private companies sponsoring a liquidity program were allowed to determine how the market for their shares would be structured and operate. For instance, they could decide the sellers and select the prospective buyers, establish the number of shares being sold, the frequency of the transactions and the pricing mechanism (e.g., fixed-price tender, multi-lateral negotiation, or sealed-bid dutch auction). At the same time, private companies sponsoring liquidity programs on SecondMarket were audited and required to provide financial information to eligible buyers and sellers to use in considering a transaction, which was made available to them through a secure data room. Once established the selection requirements, a "road show" was conducted and the price for the transaction was determined. Separately, SecondMarket entered into intermediary services agreements with buyers and sellers and provided them with stock purchase agreements and escrow agreements for their use in connection with the secondary transactions. Liquidity programs could be repeated and subsequently modified as requested by the private companies sponsoring the plans. See, e.g., Jeremy Smith, Presentation – A Deep Dive into Secondary Market Mechanics, cit.; 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>; Barry Silbert, CEO, SecondMarket statement at the Future of Capital Formation: Hearing Before the House Committee on Government and Oversight Reform, 112th Congress (May 10, 2011), available at http://oversight.house.gov/wp-content/uploads/2012/01/5-10-11_Barry_Silbert_Capital_Formation_Testimony.pdf; and Mary Schapiro, SEC Chairman, Statement at the Future of Capital Formation: Hearing Before the House Committee on Government and Oversight Reform, cit.; Chris Kelly, Jeff Kuhn, Dave McClure, Kate Mitchell and Yokum Taku (Speakers), Liz Gannes (Moderator), Panel – Private Company Stock Market – Friend or Foe?, cit.; Daniel L. Burstein, Paul Deninger, Dixon Doll, Chip Lion, Kushal Saha (Speakers), Dan Primack (Moderator), Panel – The Secondary Market vs. Going Public, cit.

¹¹⁹ For an overview of SecondMarket's activities see Diana Milanese, Secondary Trading of Private Company Shares: New Opportunities and Challenges (May 31, 2012), pp. 6-8 (and accompanying notes), retrieved from <https://ssrn.com/abstract=2630899> or <http://dx.doi.org/10.2139/ssrn.2630899>.

¹²⁰ See, Kevin Feather, Nasdaq Private Market: Meeting the Challenges of Liquidity in Alternative Investments (Nasdaq, March 8, 2017), retrieved from <https://business.nasdaq.com/marketinsite/2017/Nasdaq-Private-Market-Meeting-the-Challenges-of-Liquidity-in-Alternative-Investments.html>.

¹²¹ See, Nasdaq Private Market, A Review of the Private Company Secondary Market and Structures, cit., pp. 2-3 (Activity since 2013 with data aggregated from NPM and SecondMarket platforms. Data collected from the SecondMarket platform may include transactions conducted through current and former affiliates of SecondMarket), retrieved from <https://www.nasdaqprivatemarket.com/a-review-of-the-private-company-secondary-market-and-structures/>.

¹²² Ibidem.



Source: Nasdaq Private Market, A Review of the Private Company Secondary Market and Structures (NPM Report (April 2019))

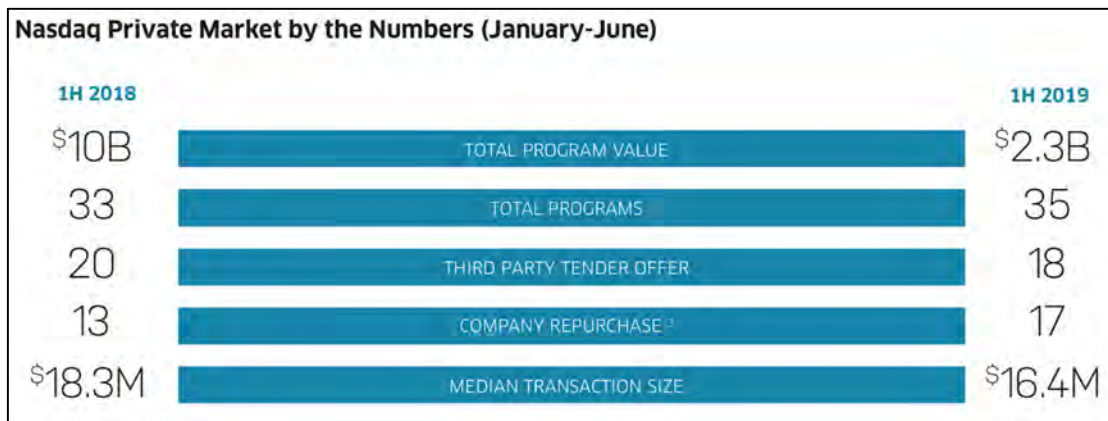
Along with a shift in market share by location, latest data from NPM illustrate important developments in the characteristics of venture-backed private companies engaging in secondary transactions. The number of new clients for NPM as well as eligible participants annually has increased since 2016. New clients in 2018 accounted for 49 of the 71 individual companies NPM worked with, which is greater than the number of repeat and new clients in 2017 combined (46). In the first half of 2019, programs by new clients accounted for 21 of the 35 programs, with the remaining 14 by repeat clients. The increase in interest and activity in private secondary transactions fueled the large growth in total transaction value facilitated by NPM. From 2013 to 2017, NPM facilitated a total of \$7.8 billion in transactional value, and in 2018 alone, that number increased up to \$12 billion.¹²³ While the number of NPM liquidity programs has increased in 2019, total program value has declined, as NPM clients that represented a substantial portion of the transaction volume from the prior year period went public.¹²⁴



Source: Nasdaq Private Market, A Review of the Private Company Secondary Market and Structures (NPM Report (April 2019))

¹²³ See, Nasdaq Private Market, A Review of the Private Company Secondary Market and Structures, cit., pp. 2-3.

¹²⁴ See, Nasdaq Private Market, 2019 Mid-Year Private Company Report, cit., p. 2.



Source: Nasdaq Private Market, 2019 Mid-Year Private Company Report (NPM Report (July 2019))

In addition, in terms of age and valuation, the majority of NPM clients are venture-backed companies with a valuation between \$500 million and \$1 billion. However, over the past three years, NPM has also worked with several companies both over 20-year old or valued below \$60 million, demonstrating a trend of non-late-stage venture-backed companies increasingly embracing private tender offers as a recurring feature of employee compensation.¹²⁵

Significantly, in 2018, 50% of NPM's clients completed a program within four months of closing their most recent primary offering.¹²⁶ The number has further increased in 2019, with about 65% of private companies completing a secondary offering within four months of their primary round, an increase from 55% over the same period in 2018.¹²⁷ This exemplifies a significant number of NPM clients have taken a proactive approach to plan a liquidity event following a financing round that provides an increase in capital and shareholders.

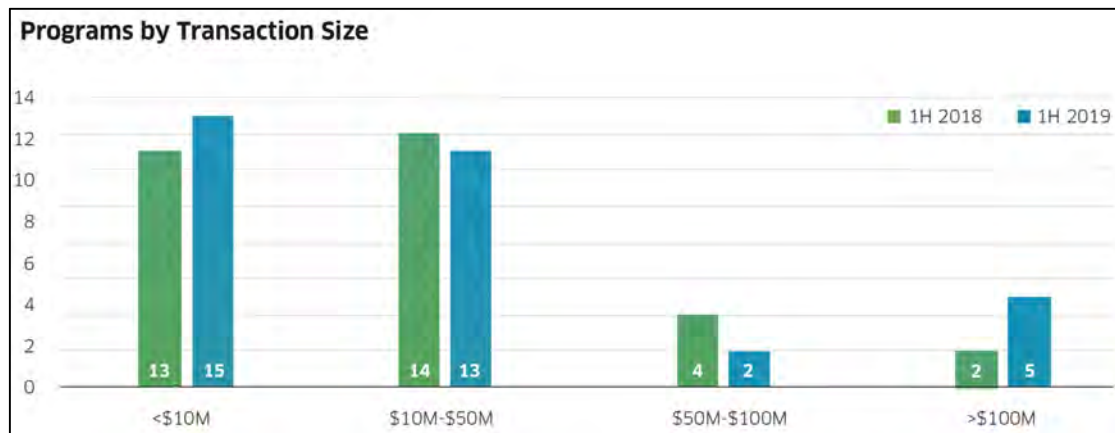
Finally, data illustrate an increase in the number of returning clients looking to conduct a larger transaction than their initial stock sale. That said, private tender offers are not only for large block transactions. In fact, one of the smallest programs that NPM facilitated was approximately \$5 million, thus implying that it is likely not the size of the program, but the message and recurrence of liquidity that matters to shareholders.¹²⁸

¹²⁵ Id., p. 4.

¹²⁶ Ibidem.

¹²⁷ See, Nasdaq Private Market, 2019 Mid-Year Private Company Report, cit., p. 2.

¹²⁸ Ibidem.



Source: Nasdaq Private Market, 2019 Mid-Year Private Company Report (NPM Report (July 2019))

Private Companies Liquidity Solutions. As discussed in the previous chapter, throughout the company lifecycle, liquidity pressures for shareholders and early-stage investors grows. Nasdaq aligns its liquidity solutions across the life of a company, from private to public and provides a model that evolves as the company grows.¹²⁹



Source: Nasdaq Private Market

With regard to private company secondaries, NPM’s offerings covers: (a) tender offers and company buybacks, whereby NPM provides an automated, streamlined liquidity process for shareholders and investors; (b) secondary capital introductions, whereby NPM helps locate the capital and strategic investors to propel the company forward by leveraging its extensive relationships with a wide-variety of buyers; and (c) private company auctions, whereby NPM provides a flexible auction mechanism that fits the company’s timing, price range and sell limits.

The main appeal of the NPM private company liquidity offering is control. NPM provides companies with control over the participants and the terms of the liquidity transactions. The company can create a private, branded environment, with a secure and monitored data room and can control who can access its private company portal to view company information and participate in the program. Further, the company can control who can buy (which can help ensure that new shareholders will be aligned with the company’s goals) or sell shares, set the limits for participating selling security holders which can be

¹²⁹ See, Founders Circle, Navigating the Employee Liquidity Path: Private vs. IPO - A Conversation with Jeff Thomas at Nasdaq, (Founders Circle Publications, September 21, 2017), available at <https://medium.com/kitchen-table-series/navigating-the-employee-liquidity-path-private-vs-ipo-778cbd22af5>.

customized by participant or participant type (e.g., requiring all or nothing participation, or allowing employees to sell a fixed percentage of their vested holdings) and establish cutback rules and priority rules (e.g., in the event of oversubscription, sellers can prioritize sellable shares by holding type; or in the event of undersubscription, sellers can be prioritized based on type). Moreover, the company retains control on how many shares can be offered, the purchase price and the offering period (for example, the portal can be used for a single program or can be kept active for sales over a longer period).

Transaction Process. By using modern technology and hosting an ecosystem of institutional buyers within a comprehensive regulatory framework, NPM delivers a seamless transaction process from setup and onboarding through cash settlement. During the pre-launch phase, NPM team of specialists work with the private company's management team to define transaction requirements, program goals and create a customized solution reflecting industry best practices. Once the program is live, the NPM platform guides company-approved shareholders through the sell order process, collecting necessary documents and signatures. NPM user-friendly platform and end-to-end technology helps streamline manual workflows like allowing sellers to select which stock holdings to sell from, document signature collection, settlement and processing payments, while dedicated specialists provide ongoing shareholder support. NPM platform automatically closes at the end of the offer period and sell orders lock. Once the offer period expires, NPM facilitates closing activities, coordinates funds flow and provides comprehensive settlement reporting to the company.

Private Company Auctions and Price discovery. NPM offers several methods for price discovery, including dutch, call, buy-side and customer auctions. The company has access to NPM institutional buyers (see below) and can extend participation to any additional buyers with existing relationships to the company.

NPM can facilitate investor-driven price through a competitive bidding process to establish the offering price for the tender offer within share sellable limits, price range (floor and ceiling price) and price bands determined by the company.

NPM Institutional Buyer Network. Through NPM, companies have access to a growing pool of vetted institutional buyers focused on direct secondaries with private companies. These include secondary funds, growth equity funds, family office, hedge funds, asset managers, mutual funds and sovereign wealth fund.

Latest data from NPM illustrate a growth in the NPM buyer network of 25% over the past year, highlighting the high demand for secondary investment opportunities. Contributing to this growth are the factors discussed in the prior chapter, including increased length of time that companies take to go public and higher company valuations in the private markets. Historically, many companies experienced the majority of their growth during their early years as a public company. Now, however, more companies are going through their growth period while remaining private.¹³⁰

¹³⁰ See, Nasdaq Private Market, 2019 Mid-Year Private Company Report, cit., p. 1.

Prospective buyers on NPM must be “accredited investors” as the term is defined in Rule 501 of Regulation D of the U.S. Securities Act of 1933, as amended (the “Securities Act”),¹³¹ or “qualified institutional buyers” (“QIBs”) as the term is defined in Rule 144A under U.S. federal securities laws.¹³²

Disclosure Requirements. NPM imposes some disclosure requirements on member companies and buyers before allowing them to sign up. Member companies are required to provide a minimum set of financial and informational disclosures to investors considering a possible purchase in company securities. Depending on the circumstances, these may include audited annual and unaudited quarterly financial statements, capitalization information, business developments, and risk factors. Information provided through NPM is stored in online data rooms.

Fees Structure. The price for companies to use NPM is also customized based on client requirements and takes into account a number of factors, including whether the company is seeking to connect with Nasdaq’s broker-dealer network, the complexity and scope of the company’s liquidity program, and the level of service the company is seeking.

2.4.3.B FORGE GLOBAL

The Marketplace. Forge Global (“Forge”), which was founded in 2014 under the name of Equidate, is an online trading platform that facilitates and brokers investments in shares of fast growing mid- to late-private companies. Currently, Forge marketplace for private equity gives private and institutional investors access to nearly 300 private technology companies, at ticket sizes ranging from \$50,000 to \$100 million, especially in the largest growth-stage companies.¹³³

In July 2018, Forge announced it had secured \$50 million in a Series B fundraising round led by Financial Technology Partners and Panorama Point Partners.¹³⁴ The company had earlier raised seed and Series A rounds from renowned investors Scott Banister, Tim Draper and Peter Thiel. Most recently, in February 2019, Forge announced a Series B extension round for an additional \$35 million, which was led by German reinsurance company Munich Re, a Forge business partner. With its influx of new capital, Forge plans to increase its headcount, boost marketing activities and further expand product development efforts.¹³⁵

¹³¹ See, §230.501. See, also, SEC, Investor Bulletin: Accredited Investors, available at <http://www.investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors>.

¹³² See, §230.144A.

¹³³ Information on Forge in this section is retrieved from Forge website at <https://forgeglobal.com>.

¹³⁴ See, PR Newswire, Equidate, the Private Company Stock Market, Raises \$50 Million in Series B Funding (PR Newswire, July 25, 2018), retrieved from <https://www.prnewswire.com/news-releases/equidate-the-private-company-stock-market-raises-50-million-in-series-b-funding-300685962.html>; Connie Loizos, In hot market for secondary shares, one player, Equidate, just locked down \$50 million in new funding (TechCrunch, July 25, 2018), retrieved from <https://techcrunch.com/2018/07/25/in-hot-market-for-secondary-shares-one-player-equidate-just-locked-down-50-million-in-new-funding/>.

¹³⁵ See, Cameron Albert-Deitch, This Peter Thiel-Backed Startup's New \$1 Billion Fund Will Let Your Employees Cash Out Before an IPO (Inc., April 4, 2019), retrieved from <https://www.inc.com/cameron-albert-deitch/peter-thiel-forge-global-bnp-paribas-employee-pre-ipo-stock-sales.html>; Dawn Kawamoto, Platform for pre-IPO trading plans to double workforce in Salesforce Tower with \$85 million in its pocket (San Francisco Business Times, January 29, 2019), retrieved from <https://www.bizjournals.com/sanfrancisco/news/2019/01/29/equidate-raises-85-million-series-b-round-plans.html>; Bernadette Tansey, Equidate re-named Forge Global, boosts Series B to \$85m (Xconomy, January 29, 2019), retrieved from <https://xconomy.com/san-francisco/2019/01/29/equidate-re-named-forge-global-boosts-series-b-to-85m/>; JD Alois, Pre-IPO Securities Marketplace Equidate Rebrands as Forge Global, Tops \$1 Billion in Trading (Crowdfund Insider, January 30, 2019), retrieved from <https://www.crowdfundinsider.com/2019/01/143849-pre-ipo-securities-marketplace-equidate-rebrands-as-forge-global-tops-1-billion-in-trading/>.

Transaction Process. Forge collects asks from shareholders, who are expressing good faith interest in liquidity. These are non-binding, private offers to sell shares. This helps Forge get an accurate picture of price and volume in each company. When a shareholder has placed an ask along with the documents, this information is processed in the system, and investors are able to express interest in shares of the company. Forge gathers appropriate investor interest and help put together a transaction. The goal at every stage is to do this in a company – and shareholder – friendly manner.

Forge reviews each shareholder’s individual documentation to determine the best path forward – whether a direct sale, a forward contract, some other transaction structure, or in some cases, a decision that a transaction is not feasible (for example, because transfer restrictions in the company documentation are too onerous and/or prevent any of the above approaches).

With a direct sale, Forge would follow on the company’s established processes for transferring ownership from an existing shareholder to the buyer (usually Forge holding company¹³⁶). This process is generally known as the right of first refusal (ROFR) process for common stock, or transfer process for preferred stock. Before contacting the company, beginning this process, or disclosing any of the shareholder’s information or indications of interest, Forge would first get the shareholder’s explicit permission.

With a forward contract, Forge’s holding company would sign a forward purchase agreement with the shareholder, where the contract, terms and liquidity occur immediately but the delivery of shares occurs in the future, after the shares become freely transferable, which would happen in an IPO (after a lockup period, typically 6 months), certain forms of acquisition, or any instance of liquidity for the shares. The company’s cap-table is not directly affected, any voting and information rights stay with the shareholder as shareholder of record, and the process is normally greatly expedited (1-2 weeks from confirming terms, rather than 6-10 weeks for the ROFR/transfer process). The forward contracts are typically executed for a 10-year term, which is designed to be sufficiently long for a typical venture-backed company. The agreements renew one year at a time after that, if the shares are not yet transferrable.

There are other more particular scenarios, where for example the seller owns an interest in a fund, or a holding company, that owns company shares. Depending on circumstances, or the existing relationship with the company, Forge may be able to tailor a special liquidity solution.

For mature late-stage private tech companies, Forge typically hold a closing a few times a month. However, the frequency of closings for any given company depends on investor demand. Forge

¹³⁶ Once investors express interest in a given asset, Forge investment entity or Forge partner affiliated broker-dealer, secures the investment. New investors don’t typically acquire private shares directly from a company’s employees and early investors. Instead, new investors become limited partners in the fund that Forge establishes, advises, and manages, to secure a secondary market investment on behalf of the buyer/investors. Investors can participate in funds that are either: (a) dedicated to individual companies, organized by Forge; (b) a pre-selected set of companies, which are not actively managed but provide diversified exposure to a number of growth stage private tech companies. This suite of products is designed to provides access for investments of \$50,000 up to \$5 million. Larger investments can also be placed and customized on a one-to-one basis. Forge funds are set up to operate for 10 years. The securities are held by the Forge funds for the benefit of the investors until the shares are freely transferable, whether due to a liquidity event such as a company acquisition or IPO (after any lockup or holdback periods), or any other reason the shares become transferable. In the event that there is no event leading to company share transferability (and subsequent distribution of shares) in the said time, there is a provision for a liquidation trust similar to the provision in other private equity or venture capital funds, through which Forge would take commercially reasonable efforts to ensure that investors’ interests in the fund are redeemable as expected.

assembles the participants for each closing on the basis of asking price, date of the ask, and the volume expected to execute.

Early steps in the process are just indicators of interest and aren't binding. Generally, by the point the transaction documents or ROFR notice are triggered, the interest becomes a good faith commitment, even if the shareholder hasn't signed it yet. During the ROFR/transfer process there may also be relevant clauses within the company's agreements to consider. If a shareholder backs out of their good faith commitments, there are generally no legal obligations to Forge, but Forge may decide it is not prudent to work with them in the future and may restrict access to the platform altogether. Similarly, on the buyer side, submission of an 'invest' interest is a non-binding action, a good-faith expression of the investor intent to complete the investment. However, consistent failure to close may result in a restriction of access to Forge platform.

The shareholder and investor commitments are binding after signing of the relevant transaction documents (e.g., stock transfer agreement, forward agreement, etc.) and the funds transfer process is completed. The transaction is considered complete at this point and cannot be reversed, except in a short list of extraordinary circumstances.

Private Companies Profile. Forge marketplace includes a variety of companies, but in particular late stage venture-backed technology companies (typically Series E or later, \$2 billion valuation or higher), or rapidly growing mid-stage companies (typically Series B through Series D, \$200 million – \$1 billion valuation) with proven unit economics. These companies are typically U.S. incorporated companies, or one of a handful of international companies that are proactive in facilitating secondary transactions.

Buyer. Accredited investors who meet suitability and compliance standards are eligible to invest on Forge platform. Forge frequently also works with family offices, institutions, and funds. Investors include U.S. based and international investors.

Type of Equity. Equity being sold includes common stock acquired through a stock grant, stock acquired through exercise of vested options, advisor shares, or preferred shares purchased in an equity financing round.

Pricing. Forge relies on market pricing established by investors and shareholders. The end prices vary from company to company based on a number of factors, including funding stage, time since last raise, performance and growth potential. Forge provides the estimated closing price where known, based on recent transactions, demand and supply, market events such as financing rounds, but ultimately, demand and supply set the price. Often, for late-stage companies that recently raised a financing round, shares are seen transacting at a slight discount to the known valuation.

Fees Structure. In terms of fees charged by Forge, the baseline fee is 5% to the buyer, and 5% to the seller. On certain transactions, Forge may need to charge a higher amount to one side (and charge proportionally less to the other) for structural or operational reasons. Forge is transparent in quoting the net price after fees to all parties, so that the parties are aware of the economics from the get-go. Reduced fees may also be applied on larger transactions, typically beginning at \$5 million.

Information Disclosure. Forge provides publicly available data such as capitalization information, financing history, valuation information from venture financing rounds, and discovery tools for private and public technology companies. The estimated capitalization of companies is a summary of each company's financing history. Since those valuations were established by venture capital firms on the basis of extensive due diligence, investors on Forge platform tend to use them as a good anchor point to begin. In addition, where available, Forge directs investors to other information regarding the company's performance – third-party reports, press articles, and other publicly available information. Investors are encouraged to conduct independent research to build comfort and understanding of the potential investment thesis, opportunities and risks of a potential investment, and also ensure that they have enough information to make an informed decision.

In certain cases, particularly for large institutional transactions (\$10 million or more, usually), the seller or company are able to make an online data room, management conversations and other diligence information available. This is typically handled on a case-by-case basis.

Legal and Compliance. Forge conducts all transactions through a licensed broker-dealer, executed by General Securities Principals and Representatives, licensed by the SEC and registered by FINRA to engage in broker-dealer activities, as required by securities regulation.

Forge runs identity verification and background checks to ensure the shareholders are legitimate. It acquires credit information, and place caps on how much each shareholder can liquidate to limit risk. In addition, before confirmation or execution, Forge conducts a thorough legal review of every shareholder's document set, with internal and external legal advisers, assessing whether they own the shares, and the compliance with transfer restrictions imposed by the relevant companies.

Further, Forge's put in place various backup enforcement provisions - with multiple recourses and protections for the investor in the unlikely case of a default (e.g., power of attorney to enforce the contracts). It also diversifies investors' exposure across the whole pool of a number of shareholders.

Lastly, Forge's investment funds are insured through a strategic partnership with Munich Re. If the shareholder's default, fraud, bankruptcy or similar event causes the fund to fall below the investment amount, Munich Re will pay a claim to make the fund whole. Even after this, Forge, Munich Re and other relevant affiliates will pursue enforcement of the contract through the legal process.¹³⁷

2.4.3.C EQUITYZEN

The Marketplace. With over 6,500 private placements completed in more than 125 private companies, EquityZen is building a rapidly-growing marketplace that provides liquidity to private company shareholders and gives accredited investors access to private markets.¹³⁸ Investors in EquityZen include Draper Associates and WorldQuant Ventures.

¹³⁷ See, Forge Global, Inc. and Munich Re, Overview of Insurance Solution between Forge Global, Inc. and Munich Re, retrieved from <https://forgeglobal.com/static/doc/insurance.pdf>

¹³⁸ Information on EquityZen in this section is retrieved from Forge website at <https://equityzen.com>.

Transaction Process. When investors make an investment on EquityZen, they will purchase ownership in an EquityZen fund (organized as an LLC) as limited partners. The fund will then purchase and own a specific company's shares. EquityZen will act as the managing member of the LLC fund, and the fund will be a single new entrant on the company's cap table.

On the investor side, EquityZen collects commitments to the proposed investment opportunities based on signed term sheets. EquityZen Term Sheets are by nature non-binding, but EquityZen views them as formal commitments to the fund so they can reserve allocations based on supply. EquityZen keeps track of all investors who request and sign term sheets. If an investor signs a term sheet for an investment, EquityZen will then provide a final date for which the investor can submit a completed investment subscription to finalize their commitment. Investors are subject to a \$500 termination fee if they cancel their investment after completing the investment process.¹³⁹

Once EquityZen's received full commitments from investors, it stops accepting allocation and approaches the company with the proposed deal terms. The company typically has a ROFR which generally gives the company a 30-day period to purchase the shares on the same terms as the EquityZen offer. The company can either decide to waive the ROFR, let it expire, or purchase the shares directly from the selling shareholder on the same terms. Transaction normally close 4-6 weeks from the time EquityZen closes its fund and stop accepting investor commitments.

If a company in which EquityZen has invested goes public, after the completion of the IPO, the shares purchased by the EquityZen fund will be held with the company's transfer agent. Once the lock-up period expires, or one year has passed since purchase, EquityZen will either (i) transfer the shares from the account of the fund to a brokerage account designated by the investor or (ii) sell the shares in the open market and deliver to the investors their portion of the proceeds. Similarly, if a company in which EquityZen has invested is acquired, the proceeds (stock and/or cash) would be transferred to the LLC, after which EquityZen (the managing member) would distribute these proceeds to the investors.

Sellers. Sellers on EquityZen are current and former employees, early-stage investors and advisors of private companies. They are typically selling only a portion of their holdings in order to cover costs associated with exercising and paying taxes on the remainder of their shares, whether for life events (such as purchasing a home or preparing for a child) or to diversify their holdings.

EquityZen minimum transaction size is \$175,000. A seller's shares can be pooled with another shareholder of the same company should the individual holdings not meet the minimum required.

In order to determine whether the selling shareholder has a legitimate interest in the share being sold and whether the equity is transferrable and can be sold, EquityZen conducts due diligence on prospective sellers and requires them to provide a number of documents, including their stock certificate (if the company issues one), a signed option exercise notice, and/or a signed shareholders agreement.

¹³⁹ If an exercise of the ROFR by the issuer of the equity interests that are the subject of the fund's investment occurs or if EquityZen fails to complete the investment due to other company restrictions, the investors will not be charged a termination fee. While the investment is subject to the termination fee, an indication of interest or term sheet is not binding.

Buyers. EquityZen conducts private placement transactions in compliance with Rule 506(b) of the SEC's Regulation D. For investors, the minimum investment size is \$20,000.

The private offerings are open to accredited investors only. Investors must be under NDA with EquityZen. To verify an accredited status, investors are required to fill in (a) EquityZen's accredited investor questionnaire, (b) EquityZen's investment suitability questionnaire, and (c) a binding representation from the investor regarding their own status.

Private Companies Profile. The majority of investment opportunities on EquityZen platform are companies who have received institutional financing from late-stage or growth funds, who have a typical investment horizon of 2-5 years.

EquityZen software allows relevant private companies to nominate shareholders for liquidity. Private companies can control who sells, how much, and when. For example, they can control the total dollar amount, as well as the individual percentage of a shareholder stock and they can choose the start and end dates between which an employee can sell shares.

Equity. EquityZen only provides liquidity for vested shares. All equity holdings must be converted to common or preferred shares and fully vested and owned by the seller in order to transact on the EquityZen platform. However, the liquidity can be provided in conjunction with the exercise of vested options.

Pricing. Typically, EquityZen works with the seller to determine price per share for each investment opportunity. The price of the last financing round of the company is often used as a benchmark for the share price. Other factors that determine the price are publicly available information, investor demand, pricing history from past secondary transactions, among others. Any information that is provided regarding an investment opportunity is publicly available or is derived from publicly available information.

Fees Structure. Investors are charged a one-time sales fee through EquityZen Securities LLC, a SEC-registered broker-dealer and member of FINRA. This fee generally scales based on the size of the investment: investments up to \$500,000 are charged a 5% fee; investments of \$500,000 up to \$1 million are charged a 4% fee; and investments of \$1 million and up are charged a 3% fee. Currently, EquityZen does not charge carried interest nor a recurring management fee on non-actively managed funds. The sales fee is subject to partial or complete waiver by EquityZen Securities LLC and/or its affiliates.

Selling shareholders are charged a placement fee in connection with the sale of their shares. The placement fee is paid to EquityZen Securities LLC. Where possible, the placement fee is netted from the purchase price for the shares, which is held in an escrow account. This means that at closing, the selling shareholders will receive the purchase price for their shares less any placement fee that is due. The placement fee will be held in the escrow account, pending closing and satisfaction of other applicable contingencies. The placement fee will then be released from escrow to EquityZen Securities. Where netting of the placement fee is not practically feasible, the placement fee is required to be paid immediately upon closing of the sale of the shares.

2.4.3.D SHARESPOST

The Marketplace. Founded in early 2009, SharesPost conducts its securities activities through its wholly-owned subsidiary SharesPost Financial Corporation, which is registered as a broker-dealer with the SEC and is a member of FINRA and the SIPC.¹⁴⁰ SharesPost's Registered Investment Advisor, SP Investments Management, LLC, which manages the SharesPost100 Fund and other investment entities, is registered with the SEC. SharesPost private client specialists are FINRA-registered brokers. Additionally, the SharesPost platform is registered as an alternative trading system under Regulation ATS of the Securities Act.¹⁴¹

Type of Assets Traded. SharesPost's mission is to provide insight and access to the private tech group asset class, with particular focus on growth and late stage private equity. SharesPost offers a wide variety of products: it enables private brokerage accounts for employees and investors, has an asset management part, and is increasingly investing in digital assets enabling accredited investors to buy, sell, and custody security tokens.¹⁴²

Breakdown of Completed Transactions. As of July 2019, SharesPost's completed transactions for more than 280 private companies and more than \$4.5b transacted on SharesPost marketplace. Transaction information is provided by SharesPost via its website and through its "SharesPost Index" and research reports.¹⁴³

Insights and Research Activities. SharesPost provides regular research insights via its website and platform to educate investors on trends and activities in the private equity space. In addition, SharesPost provides a "SharesPost Private Growth Index", which is designed to be a proxy of the performance and valuation of a selected group of c. 106 venture capital-backed private growth firms.¹⁴⁴ Since its launch in January 2017, the SharesPost Index has increased 83.78% through March 31, 2019. By comparison, the S&P 500 increased 26.6% and the Dow Jones U.S. Technology Index increased 58.48% during the same period. On a cumulative basis from January 1, 2015 to May 31, 2019, the SharesPost Index increased approximately 244%, the S&P 500 rose 33.7% and the Dow Jones Index increased 76.3%.

Fees Structure. SharesPost's baseline fee is 5% to the buyer, and 5% to the seller for transactions greater than \$100,000. On certain transactions, SharesPost charges a higher amount to one side (and charge proportionally less to the other), for structural or operational reasons. For transactions less than \$100,000,

¹⁴⁰ Information on Sharespost contained in this section is retrieved from SharesPost website at <https://sharespost.com>. In March 2012, the SEC charged SharesPost with engaging in securities transactions without registering as a broker-dealer. As a result of these charges, SharesPost and its CEO consented to an SEC order finding that SharesPost committed and the CEO caused a violation of Section 15(a) of the Exchange Act and agreed to pay penalties of \$80,000 and \$20,000 respectively. Subsequently, SharesPost acquired SharesPost Financial Corporation (a registered broker-dealer and member of FINRA and the Securities Investor Protection Corporation (SIPC)) and SharesPost Financial Corporation's registration with the SEC as an Alternative Trading System and its membership agreement was approved by FINRA.

¹⁴¹ See, SharesPost, A SharesPost Primer on Secondary Market Securities Law (SharesPost Inc., 2012), retrieved from <https://welcome.sharespost.com/resources-and-insights/insights>. See, David Weir, Interview - Weir Sees 'Explosive' Growth in Secondary Markets (Bloomberg, November 9, 2011), video available at http://www.washingtonpost.com/business/weir-sees-explosive-growth-in-secondary-markets/2011/11/09/gIQAjDnt6M_video.html.

¹⁴² See, SharesPost, The Role of Secondary Marketplaces in Silicon Valley (SharesPost Webinar, December 5, 2018), available at <https://sharespost.com/insights/webinars/the-role-of-secondary-marketplaces-in-silicon-valley/>.

¹⁴³ See, SharesPost insights available at <https://sharespost.com/insights/>.

¹⁴⁴ See, SharesPost, SharesPost Private Growth Index – Q1 2019 Update, available at <https://sharespost.com/insights/sharespost-private-growth-index/>.

SharesPost's fee is a flat \$5,000. Where a special purpose vehicle is being employed, SharesPost charges a management fee to the investors in the vehicle.

Participation Requirements. A person that registered on SharesPost platform and is interested in buying securities in a transaction using SharesPost's trading platform must qualify as an accredited investor under Regulation D.¹⁴⁵ Additionally, registered members who are interested in purchase securities must certify that they are "sophisticated" as the term is defined under the Securities Act.

A visitor to SharesPost may only become a member and access the trading platform, private investor portals and other services by completing an initial form indicating interest, providing contact information (which is then verified), creating an account and establishing a password. The initial form does not reference any transactions posted or to be posted, and new members may only transact on posts made after they have been contacted and accredited. While SharesPost is available to answer press inquiries, no member posts are discussed on the portion of SharesPost's website accessible to the general public. Moreover, SharesPost does not provide information regarding the advisability of buying or selling stock to the general public, does not receive, transfer or hold funds or securities, and does not refer any participant to a third party to clear or settle the purchase or sale of common stock other than to a reputable bank that functions as an escrow agent for transactions. These safeguards are designed to facilitate a substantial, preexisting relationship between SharesPost and its members and among the members in order to help prevent sellers from being deemed to have conducted a general solicitation by posting an indication of interest to sell.¹⁴⁶

Any members proposing to act as a buyer in a transaction must reconfirm their accredited investor status by updating and certifying the financial information that they have submitted to SharesPost, as well as updating their representations to SharesPost regarding their status as an accredited investor. Each member participating in a transaction must also provide additional financial information sufficient for SharesPost's broker-dealer to satisfy suitability and other FINRA "know your customer" requirements, certify that it is aware of the need for an exemption from registration under the Securities Act and that such an exemption exists, and agree to indemnify the issuer for any breach of this certification.

SharesPost requires that prospective buyers of shares execute non-disclosure agreements prior to engaging in detailed conversation regarding an investment opportunity. Any financial information provided to SharesPost by an issuer is also shared only with the consent of the issuer and on a need-to-know basis.

In addition, the form purchase agreements provided by SharesPost include representations and warranties by the buyer and seller that a valid securities law exemption is available, as well as specific representations and warranties as to the facts and circumstances necessary to support such an exemption; issuers are named third-party beneficiaries with respect to these representations and warranties.

¹⁴⁵ See, SharesPost, A SharesPost Primer On Secondary Market Securities Law, cit.

¹⁴⁶ Ibidem. SharesPost complies with the guidance provided by the SEC in a series of no-action letters; see, e.g., SEC Staff no-action letters, IPOnet (available July 26, 1996); SEC Staff no-action letters, Lamp Technologies, Inc. (available May 29, 1997); SEC Staff no-action letters, International Capital Corp. (available 1997).

SharesPost provides a form of escrow agreement that is entered into by the buyer and seller with the third-party escrow agent following execution of the purchase agreement for the transaction. Pursuant to the terms of the escrow agreement, the seller shall demonstrate ownership of the shares for the buyer to be required to wire funds into the escrow.¹⁴⁷

Transaction Process. An interested seller typically posts desired terms for the sale of its private company shares on SharesPost and identifies any transfer restrictions. SharesPost private securities specialist help the sellers navigate the relationship with their companies and compliance with their preferred transaction process. In doing so, SharesPost also helps issuers efficiently manage and control secondary transactions and works closely with issuers to understand their investor preferences and secondary policies and processes. SharesPost's issuer solutions range from informal shareholder-by-shareholder referral relationships to the structuring and management of large, formal liquidity programs.

If a buyer agrees to the terms, then the buyer can use the SharesPost system to create a form of agreement for the transaction. Upon digital signature by each of the buyer and seller, the agreement is binding. The binding agreement is then submitted to U.S. Bank to initiate opening of the escrow account into which the seller will deposit evidence of ownership of its shares, and the buyer will deposit the purchase price plus any additional required fees.

2.4.3.E CARTA

The Marketplace. Founded in 2012, Carta (formerly known as eShares)¹⁴⁸ started by helping private companies manage their cap-tables. Since then, Carta has significantly grown its offering to provide equity management, 409A valuations, fund administration and liquidity support services. In so doing, Carta has helped transform private markets and business ownership and has created an extensive network of LPs, venture capital investors and growing startups – more than 11,000 companies, their investors, and their employees now utilize Carta's software on a daily basis.

In 2018, Carta raised \$80 million and closed their Series D funding round, led by Meritech and Tribe Capital, with participation from existing investors. With the new capital, investors valued Carta at \$800 million.¹⁴⁹ Thereafter, in May 2019, Carta announced completion of their \$300 million Series E funding round at a \$1.7 billion post-money valuation.¹⁵⁰ The round was led by Andreessen Horowitz, and also included Lightspeed Venture Partners and Goldman Sachs Principal Strategic Investments. Previous investors including Tribe Capital, Menlo Ventures, and Meritech, as well as new investors Tiger Global Management and Thrive Capital, also participated in the round.

Carta plans to use the new funding to enable liquidity across its network of companies and investors, with the aim of becoming a private stock market for companies.¹⁵¹ In this regard, Carta is building

¹⁴⁷ See, SharesPost, A SharesPost Primer on Secondary Market Securities Law, cit.

¹⁴⁸ See, Carta, Carta – Ownership Management, Carta Blog (November 6, 2017), available at <https://carta.com/blog/eshares-is-now-carta/>.

¹⁴⁹ See, Carta, Announcing our Series D, Carta Blog (December 27, 2018), available at <https://carta.com/blog/series-d/>.

¹⁵⁰ See, Carta, Our Series E and the future of Carta, Carta Blog (May 6, 2019), available at <https://carta.com/blog/seriee/>.

¹⁵¹ See, Connie Loizos, Carta was just valued at \$1.7 billion by Andreessen Horowitz, in a deal some see as rich, TechCrunch (May 6, 2019), available at <https://techcrunch.com/2019/05/06/carta-was-just-valued-at-1-7-billion-by-andreessen-horowitz-in-a-deal-some-see-as-rich/>.

CartaX, an issuer centric electronic trading platform offering tailored liquidity programs for privately held companies, funds, and other fractional assets.

Transaction Process. Among its offering, Carta helps companies run stock buybacks and secondaries to provide liquidity for employees and shareholders. When a company's cap-table is on Carta, setting up a Carta tender offer is relatively simple. Carta pulls data from the company's cap-table, so the company just need to add details of the transaction. In addition to a simple set up, Carta provides automatic cap-table updates. When a company runs a liquidity event on Carta, its cap-table automatically updates as soon as the transaction settles. Contrary, with other providers, manual entry is often required to update a company's cap-table and process paper certificates.

Carta has designed the participant experience to make it easy for shareholders to understand the details of the transaction. Everything from reviewing the FAQ details, filling out desired indications of interest, and settling the transaction is completed on Carta, without paper or complicated forms. Furthermore, Carta's experienced team facilitates the transaction for the company and its shareholders by collecting participants' orders on Carta platform, settle the transaction, and automatically update the cap-table when it's done. The combination of the described features increases efficiency and transparency of process, gives companies control over secondary transactions and helps them reduce their administrative costs.

Insights and Research Activities. Carta provides regular reports and updates on trends and activities in the private equity space via its website. In addition, to help the industry track performance, Carta has built the "Carta 100 Index."¹⁵² Launched in 2018, Carta 100 Index tracks the performance of the most valuable private companies on the Carta platform over time and provides valuable insights on the funding environment for private companies.¹⁵³

2.4.3.F ASSET MATCH

The Marketplace. Asset Match is an electronic platform for trading shares in private companies based in the UK. Founded in 2012, Asset Match is authorized and regulated by the UK Financial Conduct Authority (FCA).¹⁵⁴

Sellers and Buyers. The individuals using the Asset Match platform mainly consist of shareholders of the companies on the platform who want to increase their stake in the company or cash out their initial investment along with high-net-worth individual and sophisticated investors looking to invest in the private sector space. To buy and sell shares on Asset Match, individuals need to use a stockbroker.

Private Companies Profile. More than 30 companies across 10 different sectors are currently on the Asset Match platform. These are private companies that are at the pre-IPO stage or companies using the platform to give periodic liquidity to their shareholders. They typically have over 50 shareholders, a turnover in excess of £10 million and a well-experienced management team and board of directors.

¹⁵² See, Carta 100 Index at <https://index.carta.com>.

¹⁵³ See, Carta, The Carta 100 Index, Carta Blog (August 20, 2018), available at <https://carta.com/blog/carta-100-index/>.

¹⁵⁴ Information on Asset Match Limited ('Asset Match') contained in this section is retrieved from Asset Match website at <https://www.assetmatch.com>.

Information Available and Due Diligence. All companies on the Asset Match platform are subject to due diligence checks by Asset Match, and company documentation and the full range of historical company information is available for prospective investors. Each company on the Asset Match platform has a profile dedicated to providing information. Below each real-time order book there is a devoted section providing information on key people, price history, news, financials, contacts and auction instructions.

Pricing. All Asset Match auctions use a matching engine to determine a single price for both buyers and sellers. During the auction period an ‘indicative price’ will be displayed, which shows the price the shares would trade at if the auction were to close at that point in time. More often than not this indicative price is calculated where supply meets demand within the auction. The pricing mechanism is designed to provide a fair way of establishing market derived prices where there are differences in the level of user sophistication.¹⁵⁵

Transaction and Fees. There is no minimum value that can be invested through an Asset Match auction. However, there is a minimum commission of £20 payable to the recommended stock broker, The Share Centre, regardless of the size of the order. There is no maximum to how much an individual can invest in a company via an Asset Match auction, although one can only buy shares when they become available. Shareholders can buy and sell shares freely through the open Asset Match auctions. Asset Match also operates closed auctions and the purchase of these shares are monitored by the companies themselves.

Asset Match costs a company approximately £6,000 per year, plus a £1,500 application fee. Buyers and sellers pick up a trading levy of 3%, excluding stockbroker fees and buyers' stamp duty.

2.4.4 EUROPEAN AND UK CROWDFUNDING PLATFORMS AND SECONDARY TRANSACTIONS

Crowdfunding providers are progressively expanding into facilitating secondary transactions. The following sections will focus on three crowdfunding platforms – Seedrs, Crowdcube and Funderbeam – which have started creating a secondary market to let their users buy or sell shares in private companies.

2.4.4.A SEEDRS

UK-based equity crowdfunding platform Seedrs launched its Secondary Market in May 2017. Seedrs Secondary Markets gives eligible investors the chance to sell shares in private companies that have raised investment on Seedrs at earlier stages than would otherwise be possible, and allows other investors to buy shares in Seedrs portfolio companies where they might have missed the initial fundraising rounds.¹⁵⁶

Since its launch in 2017, the Seedrs Secondary Market has seen increasing levels of trading, demonstrating a strong demand for a fully functioning secondary market. To date nearly 4,323 exits have closed on the Seedrs Secondary Market for an aggregate consideration of approximately £3.5 million with shares traded from more than 383 businesses.

¹⁵⁵ See, Asset Match, Order Book Help Guide, retrieved from https://www.assetmatch.com/media/34156/20170104_Help_Guide___Order_Book_FINAL.pdf.

¹⁵⁶ Information on Seedrs contained in this section is retrieved from Seedrs website at <https://www.seedrs.com/secondary-market>.

The Secondary Market. The Seedrs Secondary Market operates as a bulletin board that enables participants to express an interest to sell or buy shares held under the Seedrs Nominee Structure during a set trading cycle.¹⁵⁷ All trades take place under the Seedrs nominee structure. Each trade requires the execution of a transfer agreement directly between the buyer and the seller, after which the payment is processed and Seedrs registers the new ownership of the shares within the Seedrs Nominee Structure.¹⁵⁸ This means that upon completion of the transfer, Seedrs nominee company continues to be the legal shareholder of the shares but, instead of holding them on behalf of the seller, the nominee holds them on behalf of the buyer.

Valuation and Fees. There's no bidding element on Seedrs Secondary Market. All shares trade at "fair value", which is the price Seedrs sets in accordance with their valuation policy.¹⁵⁹

There is no fee for buyers to purchase shares on the Seedrs Secondary Market. The seller will be charged a nominee administration fee on any profit that they make in the event that their share lot is sold. The fee charged is set in accordance with the terms of the investment agreement entered into when the seller made the investment.

Restrictions. The Seedrs Secondary Market was launched with several key restrictions. Originally, only existing shareholders of a specific private company could participate in the secondary trade buying or selling their shares and the total value of each trade was capped at no more than £1,000. These initial limitations were put in place to help the Seedrs team better understand the needs of buyers and sellers. After eight months of operations, Seedrs lifted one of these restrictions by opening up its secondary market to anyone who's authorized to invest on Seedrs – whether they were previous shareholders or not. This significantly increased the overall volume of trading on the Seedrs Secondary Market.¹⁶⁰

In terms of caps, the value of a share lot cannot currently exceed 1,000 if the business is located in the UK or Ireland or 10,000 elsewhere.

Evolving the secondary market further, Seedrs is now looking into auction pricing and incorporating new technologies to improve the efficiency, transparency and speed of execution of trades.

Due Diligence. Seedrs does not perform due diligence in respect of trades on its Secondary Market. The only information provided by Seedrs to buyers on the Secondary Market is on the relevant Secondary

¹⁵⁷ The market is open for one week, starting on the first Tuesday of every month at 11:00am and ending on the following Tuesday at 11:00am. Investors can only request to buy shares while the market is open. Investors can request to sell shares at any time.

¹⁵⁸ An expression of interest to sell or buy shares on the Seedrs Secondary Market does not create a legally binding right or obligation. Investors are solely responsible for making a decision to sell or buy shares on the Secondary Market and Seedrs does not execute a trade automatically, or otherwise on behalf of the relevant investor, following an expression of interest. The Seedrs Secondary Market does not constitute a "multilateral system" as defined in the Markets in Financial Instruments Directive II.

¹⁵⁹ See, Seedrs, Understanding Portfolio Value and IRR, Seedrs Blog available at <https://help.seedrs.com/en/articles/1790270-understanding-portfolio-value-and-irr>.

¹⁶⁰ See, e.g., Oscar Williams-Grut, Crowdfunding platform Seedrs will let people trade shares in private companies they invest in (Business Insider, May 8, 2017) retrieved from <https://www.businessinsider.com.au/crowdfunding-platform-seedrs-launches-secondary-market-for-private-shares-2017-5>; Samantha Hurst, Seedrs Secondary Market is Now Open to All Investors (Crowdfund Insider, February 5, 2018), retrieved from <https://www.crowdfundinsider.com/2018/02/127980-seedrs-secondary-market-now-open-investors/>; Jeff Lynn, Seedrs: The Most Active UK Funder Of Private Companies (Forbes, March 2, 2018) available at <https://www.forbes.com/sites/lawrencewintermeyer/2018/03/02/seedrs-the-most-active-uk-funder-of-private-companies/#15c38ffe1ca7>; JD Alois, Seedrs Provides Update on Secondary Market, Some Companies Driving 19X Returns (Crowdfund Insider, June 25, 2018), retrieved from <https://www.crowdfundinsider.com/2018/06/135432-seedrs-provides-update-on-secondary-market-some-companies-driving-19x-returns/>.

Market share lot, and investors are encouraged to obtain sufficient other information to make their own investment decisions.

Private Companies. All companies listed on Seedrs use a nominee structure – making shareholder management far simpler. Only investors who use the Seedrs nominee structure are eligible to sell their shares on the market. Seedrs takes care of all the administration of the secondary transfer and the private company in which shares are being traded does not need to issue new share certificates or sign any documents and does not need to update its corporate register.

Legal Documentation. Before shares are listed on the Seedrs Secondary Market, a seller is required to confirm that they agree to a seller agreement and a transfer agreement. Once the transfer agreement is countersigned by the buyer, the seller will be required to release the transfer agreement in order to complete the transfer of shares.

Funds Flow. Buyers must pay for any shares they wish to purchase during the trading cycle. These funds are held in a separate client money account by Seedrs. After the trading cycle, once the transfer paperwork is complete, Seedrs releases the funds directly into the seller's investment account, at the same time they register the transfer of shares on the Seedrs platform.

2.4.4.B CROWDCUBE

UK investment crowdfunding platform, Crowdcube announced its plan to pioneer secondary liquidity on its platform in 2016.¹⁶¹

Mettrr Technologies (formerly Sole Trader) was the first company to provide financial returns for its crowd investors through a secondary share sale on Crowdcube in April 2017. Investors, who backed the tech startup in 2012 on Crowdcube, received a 9x return on their original investment.¹⁶² The secondary transaction was boosted by interest by outside investors as angels acquired an ownership stake in Mettrr. While the secondary trade was relatively small in size, its successful completion highlighted the interest in secondary transactions from crowd investors and foreshadowed additional secondary transactions in the near future.¹⁶³

Since then, UK fintech company Revolut offered their Crowdcube investors two opportunities, in 2016 and 2018, to realize returns on their investments through secondary offerings. In 2018, investors were able to realize a 19x return on their original investment. The total financial return for investors from both of Revolut's secondary offerings was c. £1.76 million.¹⁶⁴

Following completion of these secondary transactions, Crowdcube has continued to testing ways of creating a secondary market for shares of fast-growing private businesses as well as working with more

¹⁶¹ Information on Crowdcube and its secondary activities contained in this section is retrieved from Crowdcube website at <https://www.crowdcube.com>.

¹⁶² See, Crowdcube, Crowdcube completes first on-platform secondary share trade (Crowdcube Blog April 13, 2017), retrieved from <https://www.crowdcube.com/explore/blog/crowdcube/crowdcube-completes-first-on-platform-secondary-share-trade-as-angel-investors-snap-up-crowd-shares-in-mettrr-technologies>.

¹⁶³ Crowdcube reported that 10 investors collectively realized £50,000 in Mettrr shares and two other investors realized £250,000 in an off-platform transaction. Exact details as to the technology utilized and any fees accrued to Crowdcube were not shared.

¹⁶⁴ See, Crowdcube, Crowd investors make 19x returns on Revolut investments (Crowdcube Blog August 2, 2018), retrieved from <https://www.crowdcube.com/explore/blog/crowdcube/crowd-investors-make-19x-returns-on-revolut-investments>.

established and venture backed companies. This is expected to open the private industry up to a wider investor base and help a greater number of dynamic private companies raise the capital they need for growth.

2.4.4.C FUNDERBEAM

Funded in Estonia in 2013, Funderbeam provides a trading platform to buy and sell equity in private companies. Funderbeam marketplace is operated by Funderbeam Markets OÜ and allows participants to buy stakes in previously funded companies, at a free market price. If participants are current investors, their priority rights will give them the first chance to adjust their portfolio.¹⁶⁵

In order to begin trading, participants need to verify their account to obtain “investor status.” Investors can start trading only in case the investment has been admitted to trading on the Funderbeam marketplace.

To buy shares, participants can either match one of the current sell order on the marketplace or place their own buy order with the amount and price that they are interested to trade. Once an order is matched, participants will receive a payment notice with details for a bank transfer. As soon as funds are in the wallet, the transaction will be completed, and the investment will be transferred. To sell shares, participants can either sell to one of the buy offers on the marketplace or place their own sell order with the amount and price that they would like to trade. Once an order is matched, the buyer will receive a payment notice with around 7-day deadline to transfer the funds.

Initial selling fee applies when offering transferred shares for sale via the Funderbeam marketplace. This fee will be debited from the sale price of the shares and will only apply to the initial shareholders.

As of the date of this publication, Funderbeam has around 45 high-growth portfolio companies on its marketplace, with over 12,000 verified investors across 122 countries exchanging over \$3 million worth of investment shares.

In September 2019, the company obtained new financial licenses from the Monetary Authority of Singapore: one for Capital Market Services and the other as a Recognised Market Operator. These licenses aim to facilitate Funderbeam’s next stage of growth: the creation of a global secondary market for private businesses across Europe and Asia.

¹⁶⁵ Information on Funderbeam and its secondary activities contained in this section is retrieved from Funderbeam website at <https://www.funderbeam.com>.

CHAPTER 3

THE BENEFITS OF THE SECONDARY TRADING OF PRIVATE COMPANY SHARES

Secondary trading of private company shares can offer many advantages and provide great opportunities for various participants to the trading. The benefits associated with a transparent, liquid and efficient secondary trading of private company shares are analyzed in detail in the following paragraphs.

3.1. BENEFITS FOR PRIVATE COMPANIES

3.1.1. A CURE FOR THE IPO BLOCKAGE AND LIMITED M&A ACTIVITY

Although the U.S. and European IPO and M&A markets have begun to show signs of improvement in 2018 and most recently during the first half of 2019, their activities remain far from a full recovery. The development of a transparent and liquid secondary trading of private company shares can provide a cure for the IPO and M&A deadly affliction by enabling private companies to satisfy the liquidity needs of early investors and employees before an exit.¹⁶⁶

3.1.2. BENEFITS OF AN IPO WHILE STAYING PRIVATE

Without losing the benefits of being a private company, a private company may achieve certain advantages typically associated with an IPO by allowing its shares to be traded on a secondary market. These include increased liquidity, as well as improved visibility and perception of quality of business and brand with customers, suppliers and employees.¹⁶⁷

3.1.3. A CUSTOMIZED AND WELL-ORDERED MARKET FOR PRIVATE COMPANIES

A key feature of secondary markets for private company shares is the control over the parameters of the transaction that is given to private companies sponsoring liquidity programs. For example, in structuring a liquidity program a private company can determine eligibility rules (e.g., identity and number of shareholders entitled to sell, qualifications and number of potential purchasers), establish share transfer limitations and sale restrictions, set the frequency of trading and choose applicable pricing mechanisms (e.g., a negotiated sale, fixed price or an auction format).

This level of involvement by a private company significantly contributes in aligning the interest of the parties to the trading with the company's specific goals and objectives, enables the company to create and maintain valuable relationships with key investors and helps the company control the aggregate number of its shareholders.

¹⁶⁶ See, Brad Stone, Silicon Valley Cashes Out Selling Private Shares, *cit.*; Jay Gould and Bill Auslander, Why The Secondary Market For Private Company Stock Is Great For The Startup Community (Business Insider, December 2, 2010), retrieved from http://articles.businessinsider.com/2010-12-02/strategy/30053197_1_secondary-market-market-secondary-sale.

¹⁶⁷ See, e.g., Michael Pitts, Panel - The Secondary Market – The Value Proposition (SecondMarket - Capitalize 2012 Conference, New York, February 15, 2012), video available at <https://www.secondmarket.com/discover/event-replay-capitalize-east>; 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>.

3.1.4. DECOUPLING EXIT STRATEGIES FROM THE DESIRE FOR LIQUIDITY

A liquid, transparent and efficient secondary trading of private company shares may help decoupling company's exit strategies from the desire for liquidity.¹⁶⁸ Traditionally, investors' expectations to have some liquidity in their private company stock have been satisfied by either taking a company public or selling the company.¹⁶⁹ However, using exit strategies solely to address liquidity needs may have unintended consequences¹⁷⁰: liquidity needs of founders and employees may be misaligned with the company's needs for growth and expansion and may force the company to sell prematurely or to go public too early.¹⁷¹

Structured secondary trading of private company shares may help alleviate this problem by providing an alternative liquidity source for former and current employees, early-investors and other shareholders of private companies, thus reducing internal pressure to exit. By delaying an exit, a company can retain control and privacy over its affairs, continue to grow its business away from the scrutiny of public markets and use exit strategies more efficiently.¹⁷²

3.1.5. INCREASED FLEXIBILITY AND ABILITY TO ATTRACT NEW INVESTORS

Interim liquidity provided by secondary trading of private company shares gives private companies the opportunity to build more flexible structure and clean up a disorderly cap-table.

As the valuation rises, early investors may want to sell all or part of their initial investment in the company, whether to diversify their holdings if angel investors or to return money to LPs if venture capital firms, especially if the latter are planning to raise their next fund and want to ensure the participation of those same LPs. In this context, secondary sales create an opportunity for the company to renegotiate prior terms with early investors, claw back rights and clean up governance in a manner that is positive and mutually beneficial for all parties involved. For example, as the investor's ownership stake diminishes, the company could agree to limit or eliminate certain information rights previously owned by the investor.

In addition, a private company could use secondary sales to clean up its cap-table by offering small, early angels and leavers an 'all or nothing' sale, where they can sell their entire stake (or none of it) to a single investor.¹⁷³

¹⁶⁸ See, e.g., Barry Silbert, A New Vision for Capital Markets, Lecture at Stanford University (Stanford University Entrepreneurial Thought Leaders Lecture Series, April 13, 2011), video available at <http://ecorner.stanford.edu/author/MaterialInfo.html?mid=2698>; Phil Libin, Decoupling Exits from Liquidity, Lecture at Stanford University (Stanford University Entrepreneurial Thought Leaders Lecture Series, October 12, 2011), video available at <http://ecorner.stanford.edu/author/MaterialInfo.html?mid=2805>.

¹⁶⁹ See, Constance E. Bagley, Craig E. Dauchy, *The Entrepreneur's Guide to Business Law* (South-Western College/West, 4th Edition, 2011), p. 705.

¹⁷⁰ See, John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials* (Foundation Press, 11th Edition, 2009), p. 26 (explaining that “start-up companies that have not yet successfully marketed a product or earned significant revenues rarely attempt to enter the public equity market with an initial public offering (IPO). This is less because of legal restrictions, than because of the difficulties in valuing such an infant company that is still at the “concept” stage. At this stage its product line will have uncertain value and its management is untested”).

¹⁷¹ See, e.g., Tony Hsieh, Why I sold Zappos (Inc.com, June 1, 2010), retrieved from <http://www.inc.com/magazine/20100601/why-i-sold-zappos.html>.

¹⁷² See, Phil Libin, Decoupling Exits from Liquidity, cit. See, also, Ken Sawyer, Zack Scott and Balazs Veress, *A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies* (Saints Capital Services, LLC with contributions from Wilson Sonsini Goodrich & Rosati, 2010), retrieved from <http://www.saintsvc.com/>.

¹⁷³ See, Elad Gil, *High Growth Handbook*, cit., pp. 284.

Lastly, private companies that wish to remain private longer may find it easier to attract new investors by offering them the promise of interim liquidity: with the prospect of secondary sales available, more investors are likely to want to invest in private companies.¹⁷⁴

3.1.6. IMPROVING THE USE OF EQUITY COMPENSATION

The trend of staying private longer has important implications for equity compensation, which is a significant component of pre-IPO pay packages. Equity compensation is used to attract employees and to align their interests to those of the company by tying compensation to the company's long-term profitability and performance. In addition, equity awards serve as a retention tool in that employees generally must remain with the company for a minimum period of time in order to convert the awards to cash upon a liquidity or other relevant event.

However, with companies staying private longer, employees holding equity in these companies are restricted from realizing value from vested equity awards sometimes even 7 or 10 years after the company started. As the value of the company rises, they are also exposed to a concentrated investment portfolio with a significant portion of their net worth invested in a single company and no readily accessible public markets through which to diversify. As a result, as companies remain private longer, the effectiveness of their equity compensation programs reduces.

Secondary sales may help mitigate this problem and strength the incentive value of equity compensation, thus helping private companies attract, retain and motivate skillful workforce.¹⁷⁵ This is because interim liquidity provided by secondary trading gives employees the opportunity to be rewarded and to monetize (at least partially) their equity holdings prior to the company's IPO or acquisition, while remaining committed to the company's long-term goals and continued success.

Private secondary sales have also the benefit of an almost immediate boost to employee morale, which can lead to a spike in the company's reputation and goodwill, for fairly compensating and acknowledging the work of its employees.¹⁷⁶

Related to the above, private secondary sales often instill a heightened sense of ownership and confidence in employees with respect to the company and its business model. When well respected accredited investors purchase private shares from employees on the secondary market, it is generally a testament to the company's leadership and long-term viability. The resulting increase in confidence is a welcomed benefit to the company and can help the company attract and retain top talent.¹⁷⁷

¹⁷⁴ Ibidem; See, also, Michael Pitts, Panel - The Secondary Market – The Value Proposition, cit.

¹⁷⁵ Equity-based compensation (either in the form of common stocks or stock options), generally subject to time- or performance-base vesting, is a vital component of founders' and employees' compensation scheme in private company. Equity compensation aims at attracting key employees and founders and maintaining them long-term committed to the company's projects: because the rewards from equity ownership come over times and/or as a result of the achievement by the company of business and strategic goals, entrepreneurs and employees have the strong incentive to maximize the value of the company. See, e.g., Carta, Why do private companies run liquidity events?, Carta Blog (August 27, 2019), available at <https://carta.com/blog/liquidity-event-tender-offer/>; Carta, Work @ Carta, get liquidity, Carta Blog (June 8, 2018), available at <https://carta.com/blog/work-at-carta-get-liquidity/>.

¹⁷⁶ See, Founders Circle, Cultural Benefits of Employee Liquidity (Founders Circle Publications, November 17, 2017), available at <https://www.founderscircle.com/building-culture-through-tender-offers-of-employee-stock-options>.

¹⁷⁷ Ibidem (noting that “[t]here’s a difference in philosophies of compensation as [a company] become[s] more mature and stable. You have to be thinking about yourselves in the context of your competitive peer group and start looking into ways to motivate current and future employees. For existing team members, they have a greater sense of where their companies are at and that they

Moreover, private companies who offer liquidity to their employees can better compete with public companies for talent. If competing for talent with other private companies, regular company-sponsored liquidity events can make a company more appealing to applicants.

Lastly, by strengthening the value of equity incentive compensation, secondary trading of private company shares allows companies to conserve capital and use it to scale their business and support their growth.¹⁷⁸

3.1.7. SOLID BASIS FOR MANAGEMENT VALUATION AND PRICING VALIDATION

Given the increased scrutiny by regulators on the pricing of equity awards by private companies,¹⁷⁹ a liquid and structured secondary trading of private company shares may further benefit private companies by serving as a sophisticated “reference market” capable of providing a reliable basis for private company valuations and option pricing.¹⁸⁰

3.1.8. MORE EFFICIENT ALLOCATION OF BOARD CONTROL

By allowing a private company to bring in new investors who are focused on the continued growth and the long-term success of the company and remove old unhappy shareholders, the secondary trading for private company shares has the potential for creating better board dynamics and more efficient board control and governance.¹⁸¹

For example, as part of a secondary sale by an early-stage investor, the company could ask that their board member step down or convert their board seat into an independent seat (from a preferred one) or an observer seat. This change would help return control to the company and remove people from the board who are no longer helpful.

3.1.9. MANAGING DILUTION DURING FUNDRAISINGS

Current investors, founders and employees of private companies have a common concern when it comes to raising a new round of financing — dilution. In the context of a fundraising there’s typically a balance between issuing new shares and diluting current shareholders.

Assuming a private company has enough available cash, a tender offer can be a helpful anti-dilution tool. Private companies can leverage tender offers as a way to bring on new investors or allow current

won’t be getting a big pop in the value of current options or the granting of new options. They become more focused on the value of their vested shares and when and how they’ll get liquidity. For prospective hires, If you are competing for talent, you need to consider their perspective. Those you’re hiring would otherwise go to public companies in your space. They’re not of the same mindset as those who would join an early stage company with the idea that their options are going to appreciate 10x, even 100x. For a later-stage company, new hires tend to be looking at the actual liquidity of the stock they will be granted upon hire.”)

¹⁷⁸ Ibidem. See, also, Jay Gould and Bill Auslander, Why The Secondary Market For Private Company Stock Is Great For The Startup Community, cit.

¹⁷⁹ See, Wilson Sonsini Goodrich & Rosati, Equity Compensation Overview, Memorandum (2009).

¹⁸⁰ See, e.g., Steven Bochner, Keynote – How the Secondary Markets are Affecting the Capital Markets, cit.; Yokum Taku, Panel – Private Company Stock Market – Friend or Foe? (SecondMarket - Capitalize 2011 Conference, San Francisco, May 11, 2011), cit.

¹⁸¹ See, Ken Sawyer, Zack Scott and Balazs Veress, A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies, cit.

investors to increase their holdings without diluting other existing shareholders. All this while giving existing investors and employees an opportunity to turn some of their shares into cash.

3.1.10. TURNING “BASEBALL CARDS” INTO ATTRACTIVE CURRENCY

Shares of private companies have been traditionally seen as very illiquid assets. Secondary sales may change this by allowing private companies to gain greater liquidity in their stocks and, thus, use their own stocks as liquid and attractive currency for strategically assets and target acquisitions.¹⁸²

3.1.11. PAVING THE WAY FOR A SUCCESSFUL IPO

A well-structured and liquid secondary trading of private company shares may contribute to a more favorable environment for private companies willing to go public and may operate as a ‘dry-run’ to a successful IPO in a number of ways.

First, by helping private companies provide liquidity opportunities to current and former employees and investors, secondary trading would free the companies from the pressure to exit earlier and, thus, would give them the time they need to grow their business activities.¹⁸³

Second, secondary trading may benefit private companies that eventually go public by simplifying their cap-table prior to the IPO¹⁸⁴ and by helping them replace early-stage investors with institutional investors, which are typically long-term shareholders and are less likely to sell company shares shortly following an IPO.¹⁸⁵

Third, a liquid and efficient secondary trading may help mitigate volatility when a company is first publicly listed because shareholders who need liquidity get the opportunity to sell beforehand and this, in turn, limits an early trading frenzy. Furthermore, secondary transactions can help gauge investor sentiment and provide a reliable benchmark for a more accurate listing pricing. A useful example in this sense were the secondary transactions completed by Spotify prior to its direct listing. These transactions helped Spotify with price discovery for later investors and eliminated “pent-up” liquidity needs, thus smoothing the company’s transition to the public market.¹⁸⁶

Finally, an active secondary trading may allow private companies to plan sufficiently their IPO, get familiar with the due diligence process (e.g., the gathering of financial information, and the review of corporate and other contractual arrangements typically conducted in the context of an IPO), consolidate

¹⁸² See, e.g., Barry Silbert, A New Vision for Capital Markets, cit.; Keith Paul Bishop, Trading in Private Shares: El Dorado or Fools Gold? (The Daily Journal, April 23, 2010), retrieved from <http://www.allenmatkins.com/~media/088E2EB581C14C5F91DD82329820C504.ashx>.

¹⁸³ See, paragraph 3.1.4 above.

¹⁸⁴ See, Dan Burstein and Sam Schwerin, Inside the Growing Secondary Market for Venture Capital Assets (Millennium Technology Value Partners, L.P., 2008), retrieved from <http://mtvlp.com/files/resources/InsidetheGrowingSecondary.pdf>.

¹⁸⁵ See, Exhibit 10, Part II.

¹⁸⁶ See, e.g., PitchBook, Why more and more VCs are turning to the secondary market (PitchBook, June 27, 2018), retrieved from <https://pitchbook.com/blog/why-more-and-more-vcs-are-turning-to-the-secondary-market>; Dan Burstein and Sam Schwerin, Inside the Growing Secondary Market for Venture Capital Assets, cit.; Joseph Menn, Insight: Pre-IPO stock trading boom could be scary for investors (Reuters, March 15, 2012), retrieved from <http://www.reuters.com/article/2012/03/15/us-secondary-trading-idUSBRE82E0CD20120315>; Alexei Oreskovic and Sarah McBride, Facebook halts secondary market trading, plans for May IPO (Reuters, March 28, 2012), retrieved from <http://www.reuters.com/article/2012/03/28/net-us-facebook-secondary-idUSBRE82R18920120328>.

their corporate structures, organize accounting, financial and internal control functions, and thus eventually look at the IPO process with increased confidence.¹⁸⁷

3.1.12. ADDRESSING EMPLOYMENT LITIGATION AND SEVERANCE SITUATIONS

The secondary trading may also provide liquidity to help solve a wide range of employment-related litigations and severance situations.¹⁸⁸

3.2. BENEFIT FOR EXISTING AND PROSPECTIVE INVESTORS

3.2.1. NEW EXIT

Traditionally, investors in private companies needed to wait until the occurrence of an IPO or an M&A event to receive a return on their investment.¹⁸⁹ As previously discussed, starting in the early 2000s, an increasing number of private companies have decided to stay private longer; in addition, for those companies willing to go public, a combination of technical, regulatory, economic and systemic changes in the public markets has made it increasingly difficult and costly to successfully complete an IPO and remain public.

As the number of private companies that have either intentionally delayed or have been forced to postpone their IPOs has grown, existing investors in such companies have incurred severe liquidity and 'lock-in' problems.¹⁹⁰

The longer a company delays going public, the more early-stage investors demand liquidity. Most venture capital funds are structured to require a liquidity event within 10 years or less and early stage investors may be motivated to sell stock early by a need to return money to their LPs (particularly if they are in the process of raising another fund and want to show result) or they may be eager to reinvest some or all of their capital in new earlier-stage companies that promise bigger gains.

Current market conditions have further increased the liquidity pressure by making cashing-out for early investors more appealing now rather than later. More than 370 private companies are now valued at \$1 billion or more, compared to just 13 in 2012 and 35 at the height of the dot-com bubble in 2000. The number of companies valued at \$10 billion or more has also increased in the past year, up to 19

¹⁸⁷ See, e.g., Jeff Kuhn, FLG Partners, Panel – Private Company Stock Market – Friend or Foe? (SecondMarket - Capitalize 2011 Conference, San Francisco, May 11, 2011), cit.

¹⁸⁸ See, Dan Burstein and Sam Schwerin, Inside the Growing Secondary Market for Venture Capital Assets, cit.

¹⁸⁹ Cfr. Margaret M. Blair, Reforming Corporate Governance: What History Can Teach Us, (1 Berkeley Bus. L.J., 2004), p. 43, retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=485663; Margaret M. Blair, Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century (51 UCLA L. REV., 2003), pp. 387, 389, retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=495984.

¹⁹⁰ See, e.g., Darian M. Ibrahim, The New Exit in Venture Capital (Vanderbilt Law Review, Volume 65, Number 1, January 2012), retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1688982; Tomio Geron, As SecondMarket Passes \$1 Billion In Deals, Who's Next After Facebook? (Forbes, January 19, 2012), retrieved from <http://www.forbes.com/sites/tomiogeron/2012/01/19/as-secondmarket-passes-1-billion-in-deals-whos-next-after-facebook/>; Ken Sawyer, Zack Scott and Balazs Veress, A Guide to Secondary Transactions: Alternative Paths to Liquidity in Private Companies, cit.; 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), retrieved from http://www.industryventures.com/pdf/Venture_Capital_Secondaries_White_Paper.pdf; Duncan Davidson, Panel - The Secondary Market Big Picture (SecondMarket - Capitalize 2012 Conference, New York, February 15, 2012), video available at <http://new.livestream.com/secondmarket/capitalize/archives>.

companies, and at the upper end of the valuation range private companies like Didi Chuxing (\$56 billion) and Airbnb (\$33 billion) are valued more in the private market than comparable public companies.¹⁹¹

Organized secondary transactions can help solve these ‘lock-in’ problems and take advantage of existing market conditions by offering liquidity and a viable exit strategy at any stage of a company’s life cycle. Secondary transactions would allow funds that have reached the end of their lifecycles without exiting all of their private portfolio investments to liquidate their positions, give general partners of funds the opportunity to liquidate investments in portfolio companies in connection with changes in partnership structures, and provide venture funds with liquidity to support other portfolio investments and free up capital to grow their portfolio.

3.2.2. RETAINING VALUE BEFORE IT IS TOO LATE

Initial investments in private companies are typically designed to provide sufficient funds for the company to achieve certain selected milestones. Once the relevant milestones have been achieved, the company typically applies for additional financing from its current and/or new investors. If all goes well, the final goal for early-stage and venture investors, as well as founding entrepreneurs is to have the company either go public or be acquired. Both exit strategies can lead to big rewards. However, if the company fails to achieve the target milestones, or otherwise underperforms, the “washout decision” may come into play. When it becomes difficult for private companies to raise money, contractual terms of new financing rounds tend to be more favorable to new investors and may cause the issuance of shares that significantly dilute the ownership of previous investors. In such circumstances, existing investors may be forced to either backstop their initial investments or sit by and watch their investments lose value.¹⁹² In addition, under certain circumstances, anti-dilution provisions although properly drafted and enforced may not be enough to prevent financing events that could potentially diminish initial investors’ return.¹⁹³

Against this scenario, secondary transactions in private company shares may offer investors a way to recover some value. Existing investors can sell to secondary market buyers before it gets too late, and the buyer can sometimes ascribe a higher price to the asset given the ability of the buyer to “play” the shares in the next financing.¹⁹⁴

3.2.3. STRENGTHENING INVESTORS’ DECISION-MAKING POWER

¹⁹¹ See, CB Insights, The Global Unicorn Club - The Complete List of Unicorn Companies, cit.

¹⁹² See, Yokum Taku, Navigating Down-Round and Dilutive Financings in The Entrepreneurs Report: Private Company Financing Trends (Wilson Sonsini Goodrich & Rosati, 2008), retrieved from <http://www.wsgr.com/publications/PDFSearch/entreport/fall2008/private-company-financing-trends.htm#5>.

¹⁹³ See, e.g., John R. LeClaire, Michael J. Kendall and Kingsley L. Taft, WatchMark Ruling Clarifies Pay-To-Play (Venture Capital Journal, 2005), retrieved from http://www.goodwinprocter.com/~media/Files/Publications/Attorney%20Articles/2005/WatchMark_Ruling_Clarifies_Pay_To_Play.pdf; Michael Kendall and John LeClaire, The Benchmark Case and the Limits of Preferred Stock Protections (Venture Capital Journal, 2002), retrieved from http://www.goodwinprocter.com/~media/Files/Publications/Attorney%20Articles/2002/The_Benchmark_Case_and_the_Limits_of_PREFERRED_Stock_Protections.pdf.

¹⁹⁴ See, Dan Burstein and Sam Schwerin, Inside the Growing Secondary Market for Venture Capital Assets, cit., p. 7.

Secondary trading of private company shares can strengthen the power of investors within the corporate governance structure of a company as investors can threaten exit when managers significantly underperform.¹⁹⁵

3.2.4. EXPENSES AND ADMINISTRATIVE BURDEN REDUCTION

In an environment characterized by weak economic growth, enhanced systemic and counterparty risks, and funding constraints, many investors have decided to restructure and resize their portfolios to focus on core investment objectives.¹⁹⁶ An active, liquid and transparent secondary trading of private company shares may benefit these investors by allowing them to efficiently dismiss non-core assets and rebalance private equity exposures.¹⁹⁷

3.2.5. INVESTMENT DIVERSIFICATION STRATEGIES

Over the past few years, value creation has clearly shifted from the public to the private markets: in past many companies experienced the majority of their growth during their early years as a public company; now, however, more and more companies are going through their main growth period while remaining private. The increased length of time that companies take to go public and higher company valuations in the private markets have been key factors in driving this change.

Because private companies increasingly rely on late-stage capital and mature away from the public market, institutional investors find that it is often too late to capture a significant return if they wait for companies to go public before acquiring a stake. As investors look for greater returns, venture capital is at its highest level since 2001.¹⁹⁸ Faced with this competition, larger assets managers, hedge funds, sovereign wealth fund, family offices and mutual funds have begun to steer away from the familiar investments in mature public companies, and come to make investments in high-growth private companies in the hopes of participating in their growth and realizing large financial gains in the next headline IPO.¹⁹⁹ The development of secondary trading of private company shares has helped broaden the spectrum of participants in private companies²⁰⁰ and secondary marketplaces have quickly become a hot spot offering new and profitable diversification investment opportunities to these new investors.²⁰¹

3.2.6. PRE-IPO SHARES FRENZY

As previously discussed, a renewed interest has become sparking in the technology sector, which has maintained a very high pre-IPO profile across the last few years. Additional investors now recognize the potential of a liquid secondary trading as vehicle to realize enormous gains: secondary trading of private

¹⁹⁵ Ibidem.

¹⁹⁶ Ivi, p. 5.

¹⁹⁷ Ivi, p. 3; See, also, Jeremy Drean, The Secondary Private Markets – New Players in the Venture Capital Ecosystem, cit., pp. 44-45.

¹⁹⁸ See, National Venture Capital Association, NVCA Yearbook 2019, cit., pp. 23-24, 32; PitchBook and National Venture Capital Association, 2Q 2019 Pitchbook-NVCA Venture Monitor (2019), cit., pp. 4, 10-11.

¹⁹⁹ See, e.g., Paul-Noël Guély, The Expansion Of Private Markets Is Irreversible (Forbes, July 22, 2019), retrieved from <https://www.forbes.com/sites/paulnoelguely/2019/07/22/the-expansion-of-private-markets-is-irreversible/#6a2cb4fb1780>; Garrett James Black, The evolution of liquidity: Shifting exit strategies for private market investors, cit.

²⁰⁰ See, Jay Gould and Bill Auslander, Why The Secondary Market For Private Company Stock Is Great For The Startup Community, cit.; Adam Oliveri, Panel - The Secondary Market Big Picture, cit.

²⁰¹ See, also, Jeremy Drean, The Secondary Private Markets – New Players in the Venture Capital Ecosystem, cit., pp. 44-45.

company shares allows institutional and financial investors to cash in their bet on a number of technology private companies with the expectation that they ultimately go public at a higher offering price, thus, generating large profits.²⁰²

3.3. BENEFIT FOR FORMER AND CURRENT EMPLOYEES

3.3.1 MONETIZING EQUITY COMPENSATION

As a private company valuation grows, so does the demand for secondary market activity from employees who may look to the private secondary market to sell part of their stock in the company.

For current and former employees, the desire of selling stock may be driven by personal reasons or milestones in life, such as buying a home for themselves or their family, paying a child's tuition or caring for a parent. Early employees who dedicated themselves to the company vision in the seed and angel-backed stages may also be looking to monetize their efforts and diversifying what may be most of their net worth.

In addition, when employees need to (or are asked to) depart from a company, they generally have 90 days to exercise their vested stock options and may be in need of liquidity to finance their option exercise. If they don't exercise that right within the 90-day window, the options typically expire and are absorbed back into the company pool. This policy is generally applied by the company on a case-by-case basis, and the company may extend this expiration timeline for certain exiting employees (for example, by granting an option extension to employees after 3 years of employment with the company, which gives them the opportunity to exercise their option for the life of the option (i.e., 10 years from the date of grant if no liquidity event occurs), rather than the standard 90 day post-termination window).

Furthermore, founders may want to sell part of their shares to diversify their net worth. Changes in management with the early departure of a founder or other senior executives may also contribute to the desire by individuals to achieve liquidity.

The development of a liquid, transparent and efficient secondary trading of private company shares can address these needs and benefit employees and founders by allowing them to monetize (at least in part) their equity compensation and address personal financial needs.²⁰³ The opportunity given to former and current employees to cash out a portion of their shares, in turn, enables them to realize the value of their equity holdings while maintaining their commitment to the company's long-term goals.²⁰⁴ For that reason, employees' and founders' sales, if done correctly, tend to incentive employees and founders to focus on the long-term building and success of the company.

²⁰²See, e.g., Brad Stone, *Silicon Valley Cashes Out Selling Private Shares*, cit.

²⁰³Recent years have also seen the establishment of certain funds (e.g. ESO Fund) that provide funding to former and current employees of selected private companies to finance the exercise of their options. The analysis of the activities of these funds is beyond the scope of this paper.

²⁰⁴See, Panel – The Secondary Market vs. Going Public, SecondMarket Capitalize 2011 Conference, San Francisco. (May 11, 2011), video available at: <https://www.secondmarket.com/discover/capitalize>.

3.4. BENEFITS FOR THE EQUITY MARKET

3.4.1 BREAKING THE “HOTEL CALIFORNIA” SYNDROME

Private companies are often said to be subject to a “Hotel California” syndrome because investors in private companies can “check in but they can never leave.”²⁰⁵ A liquid secondary trading of private company shares can help alleviate this problem and benefit the capital market for private companies as a whole. This is because interim liquidity may raise the incentive and economics associate with an investment in private companies with the ultimate effect of increasing the depth of the markets.²⁰⁶

3.4.2 MOVING OUT OF THE DARK

An active and more structured secondary trading of private company shares can help take transactions in private company stocks out of the dark, thus increasing transaction transparency and efficiency.²⁰⁷

3.4.3 LIQUIDITY AND INNOVATION IN PRIVATE CAPITAL MARKETS

Secondary trading of private company shares is rapidly transforming private company stocks in more liquid assets. In so doing, secondary trading is changing the dynamics of wealth creation and promoting innovation in private capital markets.²⁰⁸

3.5. BENEFITS FOR THE GENERAL PUBLIC AND THE REAL ECONOMY

3.5.1 ADVANCING INNOVATION AND PROGRESS

Early-stage and emerging companies often need quickly available funding to grow their business activities, but end up facing hard time raising capital. Accessing debt financing and other sources of funding (including strategic funding or private funding) may be extremely challenging: lenders and investors may be reluctant to provide debt financing or capital to early-stage and emerging companies because these companies have little or no historic credit, they are generally characterized by high unpredictability of return and performance, and the investment in such companies would involve a high level of risk. As a result, more traditional capital raising and financing channels may leave worthy projects unfunded and unexplored.²⁰⁹ A vital secondary trading of private company shares may help private companies increase their ability to attract investors and focus on the development of their innovative projects by providing interim liquidity to employees and investors.²¹⁰

3.5.2 SUPPORTING WEALTH CREATION AND JOB GROWTH

Emerging and growing company play a significant role in driving economy activity and facilitating job creation. Thus, by helping foster and sustain a more dynamic environment where emerging and growing

²⁰⁵ See, Dan Burstein and Sam Schwerin, Inside the Growing Secondary Market for Venture Capital Assets, cit., p. 8.

²⁰⁶ Ibidem.

²⁰⁷ See, Brad Stone, Silicon Valley Cashes Out Selling Private Shares, cit.

²⁰⁸ See, Barry Silbert, A New Vision for Capital Markets, cit.

²⁰⁹ See, Constance E. Bagley, Craig E. Dauchy, The Entrepreneur's Guide to Business Law, cit., p. 152.

²¹⁰ See, Evelyn M. Rusli, As S.E.C. Watches, Secondary Market Seeks Transparency (DealB%k, March 18, 2011), retrieved from <http://dealbook.nytimes.com/2011/03/18/as-s-e-c-watches-secondary-market-seeks-transparency/>.

companies can flourish and grow their business activities, an active secondary trading of private company shares can significantly contribute to wealth creation and job growth.²¹¹

²¹¹ See, Paul Kedrosky, Right-sizing the U.S. Venture Capital Industry (Ewing Marion Kauffman Foundation, June 2009) retrieved from <http://www.kauffman.org/uploadedFiles/USVentCap061009r1.pdf> (noting that “venture backed companies have accounted for the creation of 10 million jobs from 1970 to 1995, represented \$2.1 trillion in revenues or 17% of the American gross GDP in 2005”); Barry Silbert, Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation (Written Testimony to the Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises U.S. House of Representatives, September 21, 2011), retrieved from <https://www.secondmarket.com/discover/wp-content/uploads/2012/01/Barry-Silbert-Testimony-before-House-Financial-Services-Comm-September-21-2011.pdf> (noting that “[t]he growth market is a significant and vital part of the capital formation process, and the systemic failure of the US capital markets to support healthy IPOs inhibits our economy’s ability to create jobs, innovate and grow. Clearly, a new growth market must emerge”); Tim Kane, The Importance of Startups in Job Creation and Job Destruction (Kauffman Foundation Research Series: Firm Formation and Economic Growth, July 2010) retrieved from http://www.kauffman.org/uploadedFiles/firm_formation_importance_of_startups.pdf; Richard Teitelbaum, Facebook Drives SecondMarket Broking \$1 Billion Private Shares (Bloomberg Markets Magazine, April 26, 2011), retrieved from <http://www.bloomberg.com/news/2011-04-27/facebook-drives-secondmarket-broking-1-billion-private-shares.html> (quoting Barry Silbert, founder and chief executive officer of SecondMarket stating that “[t]he money that we are freeing up is being reinvested in other venture-backed startups -- and creating jobs (...). This market we’re building is critical to the whole capital-formation process”).

CHAPTER 4

SELECTED RISKS AND CHALLENGES AFFECTING THE SECONDARY TRADING OF PRIVATE COMPANY SHARES

Notwithstanding the wide range of advantages previously discussed, the secondary trading of private company shares is not always an unmitigated good for private companies and the potential risks associated with such trading should be carefully considered. Without proper management at the company level, trading of private company shares can have a severe impact on issues like preserving confidential information or valuing options and can become a major distraction for the organization itself. In addition, since shares of private companies are unregistered, their trading is highly scrutinized by regulators, which means that their sales by employees or early investors may run afoul of applicable regulation if such sales are not carefully arranged to fit within an available exemption.

The remaining part of this chapter will proceed as follows: Sections 4.1 to 4.3 will discuss certain considerations relating to the secondary trading of private company shares under U.S., UK and European financial and securities laws and regulation; and Sections 4.4 to 4.15 will examine a number of risks and challenges associated with the secondary trading of private company shares (whether in the U.S., UK and Europe) and techniques for mitigating them.

4.1. U.S. FEDERAL SECURITIES LAWS RELATED CONSIDERATIONS

Section 4.1 examines certain federal securities law issues that may be faced by various participants to a liquidity program sponsored by a private company on a secondary market platform.²¹²

4.1.1. POTENTIAL LIABILITY OF THE LIQUIDITY PROGRAM SPONSOR

4.1.1.A BROKER DEALER REGISTRATION

Secondary markets provide great flexibility to private companies in structuring liquidity programs for their securities. For example, an issuer can select the shareholders who will be entitled to sell the company shares, the qualifications, identity and number of potential purchasers, the number of shares that can be sold, the frequency of sales and the pricing mechanism. The resulting level of involvement may benefit the sponsoring private company in that it allows the company to maintain control on, and visibility of, the trading activities. However, a significant level of involvement may also create the concern that the activities performed by the private company sponsoring a liquidity program could be deemed “broker-dealer activities” carried out in violation of the registration requirements under Section 15 of the Exchange Act.²¹³

²¹² In addition to federal securities laws, secondary transactions of private company shares must also satisfy the blue sky laws of the state of residence of the potential buyers. A comprehensive analysis of applicable blue sky laws is beyond the scope of this paper.

²¹³ See, e.g., Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, (Memorandum addressed to Annemarie Tierney, General Counsel SecondMarket Holdings, Inc., August 11, 2011), pp. 3-4, retrieved from <https://www.secondmarket.com/wp-content/uploads/2014/12/Memo-on-Company-Sponsored-Liquidity-Programs-Gibson-Dunn.pdf>; Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues (Memorandum addressed to Annemarie Tierney, General Counsel SecondMarket Holdings, Inc., October 19, 2011), pp. 1-3, retrieved from <https://www.secondmarket.com/discover/wp-content/uploads/2012/01/Memo-on-Company-Sponsored-Liquidity-Programs-Morgan-Lewis.pdf>.

The Exchange Act governs the way in which brokers and dealers operate. Section 15(a) of the Exchange Act prohibits any person from acting as a broker or a dealer unless registered with the SEC or expressly exempted.²¹⁴ Section 3(a)(4) of the Exchange Act defines “broker” as “any person engaged in the business of effecting transactions in securities for the account of others” and Section 3(a)(5) of the Exchange Act defines “dealer” as “any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise.”²¹⁵ Given the expansive definition of these terms, in certain scenarios determining whether an individual or entity qualifies as a “broker” or a “dealer” may be unclear.²¹⁶ In addition, the phrase “in the business” in both definitions is intended to distinguish between the professional market maker and an “active investor” who trades frequently. In certain circumstances, however, the line between the two can be very close.²¹⁷ In general, the more open, public and regular are the activities, the more likely is that the requirement of “acting in the business” would be deemed satisfied.²¹⁸

The SEC has provided some guidance with respect to the definitions of “broker” and “dealer.” The Division of Trading and Markets of the SEC (former SEC Division of Market Regulation) has identified certain factors that should be considered to determine whether an individual or an entity is acting as “broker,” including: whether the individual or entity participates in important parts of a securities transaction (e.g., solicitation, negotiation, or execution of the transaction); whether the compensation for participating in the transaction is dependent upon, or is related to, the outcome or size of the transaction or deal; whether the individual or entity receives trailing commissions, or any other transaction-related compensation; whether they are otherwise engaged in the business of effecting or facilitating securities transactions; or whether they handle the securities or funds of others in connection with securities transactions.²¹⁹ Moreover, with respect to the definition of “dealer,” the SEC Division of Trading and Markets has indicated that if any of the following are satisfied an individual or entity may need to register as a dealer: the individual or entity advertises or otherwise let others know that they are in the business of buying and selling securities; the individual or entity does business with the public (either retail or institutional); they make a market in, or quote prices for both purchases and sales of, one or more securities; they participate in a “selling group” or otherwise underwrite securities; they provide services to investors (e.g., handling money and securities, extending credit, or giving investment advice); or they write derivatives contracts that are securities.²²⁰ The Division of Trading and Markets of the SEC has also noted that, although issuers generally do not qualify as “brokers” (because they sell securities for their own accounts) nor as “dealer” (because they do not buy and sell their securities for their own accounts as part of a regular business), it may be the case that an issuer needs to consider register as broker-dealer because its activities go beyond selling its own securities, including, among others, the case where an issuer effectively operates markets in its own securities.²²¹

²¹⁴ Section 15(a)(1) of the Exchange Act.

²¹⁵ Section 3(a)(4) and Section 3(a)(5) of the Exchange Act.

²¹⁶ See, SEC - Division of Trading and Markets, Guide to Broker-Dealer Registration, April 2008 (Modified December 12, 2016), available at <http://www.sec.gov/divisions/marketreg/bdguide.htm#1>

²¹⁷ See, John C. Coffee, Jr. and Hillary A. Sale, Securities Regulation – Cases and Materials, cit., pp. 644.

²¹⁸ *Ibidem*.

²¹⁹ See, SEC - Division of Trading and Markets, Guide to Broker-Dealer Registration, cit.

²²⁰ *Ibidem*.

²²¹ *Ibidem*.

Based on the regulatory framework outlined above, concerns of violation of the registration requirement under Section 15(a) of the Exchange Act might arise when an issuer sponsoring a liquidity program on a secondary market is significantly involved in the structuring and operating of such a program.

Although the SEC has not yet addressed this concern in detail, it has provided guidance on the activities that could trigger the broker-dealer registration requirement in the context of issuer-sponsored direct participation plans. Such guidance might be useful in the case at issue. In particular, in the context of issuer-sponsored direct participation plans, the SEC has stated that the obligation to register as broker-dealer under Section 15(a) of the Exchange Act may be triggered if the issuer “induces or attempts to induce the purchase or sale of its securities, receives compensation based on securities transactions, or holds or maintains the funds, securities and accounts of [investors].”²²² Based on this guidance, practitioners, who have examined secondary trading activities conducted on SecondMarket’s platforms²²³, have concluded that an issuer sponsoring a liquidity program on SecondMarket may not be required to register as a broker-dealer if it does not receive any compensation in connection with purchases or sales of its securities, it limits its involvement to mere ministerial matters, and the solicitation activities and the transfer of funds and securities are handled by a registered broker-dealer.²²⁴ Other practitioners have also expressed the view that the risk that activities carried out by an issuer establishing a liquidity program on SecondMarket be deemed in violation of the registration requirement is not significant.²²⁵ First, they have noted that both the definition of “broker” and the definition of “dealer” should not apply to private companies sponsoring liquidity programs on SecondMarket because in the context of such programs sponsoring private companies: don’t execute transactions for the accounts of others; don’t bring together buyers and sellers; don’t operate or control SecondMarket; don’t receive any compensation for the trading; and don’t conduct any other activities typical of a broker-dealer.²²⁶ In addition, the same practitioners have noted that the SEC Division of Trading and Markets issued no-action letters in the context of electronic bulletin boards operated and maintained by an issuer in which the SEC indicated that it would not recommend enforcement action if the issuers did not register as broker-dealers under Section 15 of the Exchange Act.²²⁷ Therefore, practitioners have concluded that the risk of registration would not be significant in respect to an issuer sponsoring a liquidity program on SecondMarket because its involvement would be substantially limited when compared to issuers operating and maintaining a bulletin boards referred to in the said SEC no-action letters.²²⁸

²²² SEC, Release No 33-7114, Exemption from Rule 10b-6 for Certain Dividend Reinvestment and Stock Purchase Plans, (December 1, 1994).

²²³ Nasdaq acquired SecondMarket in 2015.

²²⁴ See, Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, cit., p. 2. (noting that “the SEC staff has issued no-action letters permitting issuers to sponsor internal markets without registering under Section 15(a), as long as the securities and cash transfers are handled by a registered broker-dealer (Science Applications, Inc., avail. December 5, 1973, reaffirmed, July 11, 1977)” and that “[t]he SEC staff has not required that an issuer register as a broker-dealer when establishing a matching service to bring buyers and sellers of its securities together, as long as the issuer does not handle funds or securities, make a recommendation to buy or sell the security, participate in price negotiations, or receive any compensation in connection with purchases and sales through the matching service (Flamemaster Corporation, avail. October 29, 1996; PerfectData Corporation, avail August 5, 1996; Real Goods Trading Corp., avail. June 24, 1996; Spring Street Brewing Company, avail. March 22, 1996)”).

²²⁵ See, Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, cit., pp. 3-4.

²²⁶ Ivi, p. 4.

²²⁷ Real Goods Trading Corp., SEC No-action Letter (June 24, 1996); Portland Brewing Co., SEC No-action letter (December 14, 1999).

²²⁸ See, Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, cit., p.4.

A more significant risk of liability under Section 15(a) of the Exchange Act may arise when a private company sponsoring a liquidity program is involved in setting the price at which its securities will be exchanged on a secondary market platform, or otherwise interposes itself between secondary trading buyers and sellers.²²⁹ Although the SEC has not specifically addressed this issue, the position taken by the SEC in similar contexts could provide useful guidance.²³⁰ In particular, SEC no-action letters issued in scenarios where the issuer interposed itself between buyers and sellers seem to have favored the use of a fixed price system with the price set through an independent valuation process. However, practitioners, who have studied the secondary trading of private securities in the context of liquidity programs run on SecondMarket's platforms, have noted that in no case the adoption of a fixed price system has been imposed as a condition by the SEC to granting no-action relief, that in no SEC letters the negotiation of a price by the issuer has been deemed a determinative factor, and that the SEC has never raised a broker-dealer registration issue when an issuer negotiated the purchase price in the context of a friendly third-party tender offer.²³¹ In addition, the same practitioners have noted that the involvement of a registered broker-dealer like SecondMarket may contribute in further mitigating the concern of liability under Section 15(a) of the Exchange Act.²³²

An additional question may arise as per whether a private company sponsoring a liquidity program may inform its employees and investors about the existence and terms of the program. Practitioners have answered positively this question arguing that it would be consistent with SEC no-action letters for an issuer to make its employees and shareholders aware of the establishment of a liquidity program.²³³

A final question is whether the employees of a sponsoring private company that directly interact with potential buyers on behalf of the private company should also be required to register as broker-dealer and be subject to regulation as such. The risk is that employees of a sponsoring private company may be deemed "brokers" if they seek to induce purchase of the company's shares or otherwise assist in selling its securities. In this regard, Rule 3a4-1 under the Exchange Act provides a safe harbor from broker registration to an employee and other person associated with the issuer, provided that the employee (1) is not subject to a "statutory disqualification," as defined in Section 3(a)(39) of the Exchange Act, (2) is not compensated by payment of commissions or other remuneration based directly or indirectly on securities transactions, (3) is not an associated person of a broker or dealer, and (4) limits his/her sales activities as set forth in the rule.²³⁴ If these conditions are satisfied the employee or other person associated with the issuer who participates in the sale of securities of the issuer will not be considered acting as a "broker" as the term is defined under the Exchange Act solely by reason of their participation

²²⁹ For instance, SecondMarket allows the use of different pricing mechanisms, including, fixed-price tender with the price established through an independent valuation process, multi-lateral negotiations by the issuer with one or more buyers, sealed-bid Dutch auction or other competitive pricing process with the issuer setting the number of shares available and the reserve price. In addition, on SecondMarket platforms buyers and sellers can exchange securities only during designated trading windows, and all secondary purchases and sales of a given security that occur within a certain session are at the same price per share.

²³⁰ Professional Project Services, SEC No-action letter (June 22, 2006); TEOCO Corporation, SEC No-action letter (October 20, 2005); Marshalls Finance LTD, SEC No-action letter (June 15, 1993).

²³¹ See, Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, cit., pp.2-3.

²³² Ivi, p. 3.

²³³ Ivi, p. 2.

²³⁴ Rule 3a4-1.

in the sale, and thus they will not be required to register pursuant to Section 15. Failure to meet the conditions of the safe harbor does not give rise to a presumption that the employee is acting as broker.

Practitioners, who have analyzed the issue above in the context of liquidity programs run by private companies on SecondMarket, have noted that the concern may become more relevant if a private company wishes to sponsor liquidity programs on a regular basis.²³⁵ Therefore, they have recommended that, if a private company intends to allow secondary trading in its securities more often than once every 12 months, the company should consider either limiting direct contact between its employees and potential buyers or using the secondary market platform as an intermediary in negotiations with potential buyers.²³⁶

4.1.1.B “UNDERWRITER” STATUS

An additional concern that may be faced by a private company sponsoring a liquidity program on a secondary market platform is that of being deemed an “underwriter” as the term is defined under the Securities Act, with the resulting risk of being exposed to potential liability for conducting unregistered sales of securities without an exception from the registration requirements under the Securities Act.

Section 2(a)(11) of the Securities Act defines “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 participation in the direct or indirect underwriting of any such undertaking.”²³⁷ The term “underwriter” is defined broadly enough to encompass not only the ordinary underwriter, but also a person who purchases securities outright with the idea of then selling the securities to the public, a person that for a commission agrees to take over pro rata the underwriting risk assumed by the first underwriter, and a person that, regardless of whether is a formal party to the underwriting contract or not, is given a certain share or interest therein.²³⁸

Practitioners, who have analyzed this point in the context of liquidity programs organized by private companies on SecondMarket’s platforms, have concluded that in such a context no distribution of securities occurs and no participants to the liquidity programs (including the private company sponsoring the program) should be deemed an “underwriter” in connection with the secondary transactions undertaken thereunder.²³⁹ In particular, practitioners have noted that the secondary transactions conducted through liquidity programs on SecondMarket’s platforms are not made pursuant to public offerings, rather they are executed only pursuant to an exemption from the Securities Act registration requirements (e.g., Section 4(a)(1) (formerly Section 4(1) redesigned Section 4(a)(1) by the JOBS Act), the so-called Section 4(a)(1½), or Rule 144), and only to purchasers who must qualify as accredited investors or as qualified institutional buyers under federal securities laws and must be approved by the private company sponsoring the liquidity program.²⁴⁰

²³⁵ See, Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, cit., pp.2-3.

²³⁶ Ivi, p. 3.

²³⁷ Section 2(a)(11) of the Securities Act.

²³⁸ See, John C. Coffee, Jr. and Hillary A. Sale, Securities Regulation – Cases and Materials, cit., p. 479.

²³⁹ Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, cit., p.2.

²⁴⁰ Ibidem.

4.1.1.C SECURITIES ACT REGISTRATION AND EXEMPTIONS

In addition to the foregoing, a private company sponsoring a liquidity program may face the risk that its activities conducted in connection with the liquidity program could be deemed to constitute offers to sell or solicitations of offers to buy its securities, which would be subject to registration requirements under the Securities Act, unless an exception to the registration requirements applies.

Section 5(c) of the Securities Act governs activities during the pre-filing period making it unlawful to any person, directly or indirectly, to make use of interstate facilities or the mails to offer to sell or offer to buy any security, unless a registration statement has been filed with the SEC in respect to such security.²⁴¹ Section 2(a)(3) of the Securities Act defines the terms “offer to sell”, “offer for sale”, or “offer” to include “every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.”²⁴² Thus, if the activities conducted by an issuer in connection with a sponsored liquidity program were deemed to constitute an offer to dispose of, or a solicitation of an offer to buy, its securities, then the issuer would need to establish an exception from the requirements under Section 5 of the Securities Act.²⁴³

Practitioners, who have investigated this issue in the context of liquidity programs run on SecondMarket’s platforms, have found somehow instructive the guidance provided by the SEC regarding the level of issuer activity that triggers Section 5(c) in the context of employee benefit and other stock purchase plans funded by open market purchases.²⁴⁴ In particular, practitioners have observed that in such a context the SEC has generally allowed issuers to engage in ministerial activities, including conducting payroll deductions or including notice of the plan availability in communications addressed to shareholders.²⁴⁵ In addition, they have noted that the sole fact that a private company makes the plan available to employee and shareholder would not per se cause a violation of the Securities Act Section 5(c) requirements.²⁴⁶

Other practitioners, who have also investigated this issue in the context of liquidity programs run on SecondMarket’s platforms, have considered the risk of sponsoring private companies being deemed to act in violation of Section 5(c) of the Securities Act to be not significant²⁴⁷. This is because the activities conducted by sponsoring private companies on SecondMarket are typically limited to the review and approval of lists of eligible buyers and sellers, the disclosure of information about the private company’s securities that can be sold, and the delivery to liquidity program participants of relevant documents for

²⁴¹ Section 5(c) of the Securities Act.

²⁴² Section 2(a)(3) of the Securities Act. See, e.g., Charles J. Johnson (Jr.), Joseph McLaughlin, Eric S. Haueter, *Corporate Finance and the Securities Laws* (Wolters Kluwer Law & Business, 4th Edition, 2006-to date), §1.06[C] (noting that “[offer] means any communication written or oral or activity that in effect conditions the market for the securities to be registered”) and §1.06[D]; John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., pp. 95-114 (analyzing the definition of “offer” under the Securities Act, and discussing exceptions to, and exclusions from, the restrictions set forth in Section 5(c) of the Securities Act).

²⁴³ See, Morgan, Lewis & Bockius LLP, *Summary Analysis of Certain Securities Law Issues*, cit., p.4 (noting that “if the issuer were deemed to be soliciting offers to buy, buyers would be subject to a new one-year holding period under Rule 144; this would also be the case if affiliates were sellers.”). See below for further discussion on this point.

²⁴⁴ See, Morgan, Lewis & Bockius LLP, *Summary Analysis of Certain Securities Law Issues*, cit., p. 3.

²⁴⁵ *Ibidem*.

²⁴⁶ *Ibidem*.

²⁴⁷ See, Gibson, Dunn & Crutcher LLP, *Potential Risks Facing Companies Participating in SecondMarket*, cit., p.3 (primary liability) and p 5 (secondary liability for conspiracy to evade Section 5 of the Securities Act).

them to be use in making investment decisions.²⁴⁸ In particular, practitioners have noted that the described level of involvement appears significantly limited when compared to the activities conducted by certain issuers establishing and operating bulletin boards, which the SEC Division of Corporation Finance reviewed and deemed not to constitute offers or sales of securities requiring registration under the Securities Act.²⁴⁹ Because of this, practitioners have concluded that it would be unlikely for a private company sponsoring a liquidity program on SecondMarket’s platforms to be deemed offering to sell, or soliciting offers to buy, its securities which would require registration under the Securities Act.²⁵⁰

The risk of violation of Section 5 of the Securities Act by a private company sponsoring a liquidity program on a secondary marketplace might become more relevant when the private company takes a more active role through the process, for instance by selecting potential buyers or negotiating the purchase price. Practitioners, who have addressed this issue with specific reference to liquidity programs sponsored by private companies on SecondMarket’s platforms, have recommended that private companies take steps to ensure compliance with the requirements of the registration exemption under Section 4(a)(2) of the Securities Act (formerly Section 4(2) but redesigned Section 4(a)(2) by the JOBS Act).²⁵¹ Section 4(a)(2) of the Securities Act sets forth the basis for the so-called “private offering” or “private placement” exemption by excluding from registration “transactions by an issuer not involving any public offering.”²⁵² In particular, practitioners have reasoned that because Section 4(a)(2) exemption would be available to the issuer if the issuer were the direct seller, then the exemption should also be available to protect the issuer from liability for soliciting offers to buy in the resale context.²⁵³ On that basis, they have explained that to rely on this exemption: (i) the issuer sponsoring a liquidity program on a marketplace for private company shares should avoid general solicitation; (ii) the issuer should ensure that all buyers are QIBs and/or accredited investors;²⁵⁴ (iii) the number of prospective buyers should be limited; (iv) buyers should sign an acknowledgement that resale is restricted under the securities laws; (v) certificated shares should be legended; and (vi) the issuer should provide buyers with all information that it considers material to a decision to purchase its securities.²⁵⁵

4.1.1.D ANTI-FRAUD PROVISIONS

A private company sponsoring a liquidity program on a secondary market platform may incur liability under the anti-fraud provisions of the federal securities laws for: (i) making material misstatements, or material omissions, of information made available to buyers or sellers; or (ii) failing to maintain adequate

²⁴⁸ *Ibidem*.

²⁴⁹ Real Goods Trading Corp., SEC No-Action Letter (June 24, 1996); Portland Brewing Co., SEC No-Action Letter (Dec. 14, 1999).

²⁵⁰ See, Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, *cit.*, p.3.

²⁵¹ Section 4(a)(2) of the Securities Act.

²⁵² See, Charles J. Johnson (Jr.), Joseph McLaughlin, Eric S. Haueter, *Corporate Finance and the Securities Laws*, *cit.*, §7.02.

²⁵³ See, e.g., John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, *cit.*, Chapter 5; Charles J. Johnson (Jr.), Joseph McLaughlin, Eric S. Haueter, *Corporate Finance and the Securities Laws*, *cit.*, §7.

²⁵⁴ Section 4(a)(2) of the Securities Act exempts from registration offers and sales by the issuer that do not involve a public offering or distribution. SEC rulings and case law have set out Section 4(a)(2) sales by an issuer do not involve a public offering or distribution when the offers are only made to “sophisticated investors.” Although this term is not defined by Section 4(a)(2), it generally is understood to include both QIBs and the much larger pool of “accredited investors,” which includes individuals who have an income that exceeds \$200,000 (or \$300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or who have a net worth over \$1 million, either alone or together with a spouse (excluding the value of their primary residence).

²⁵⁵ See, Morgan, Lewis & Bockius LLP, *Summary Analysis of Certain Securities Law Issues*, *cit.*, p. 4.

controls on insider trading activities by employees and other insiders; or (iii) aiding or abetting insider trading.

(i) PRIMARY LIABILITY

Section 10(b) of the Exchange Act makes it unlawful “[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”²⁵⁶ Pursuant to this Section, the SEC promulgated Rule 10b-5, which makes it unlawful “for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”²⁵⁷

Rule 10b-5 has been promulgated with the purpose to protect buyers and sellers against fraudulent actions or omissions in the transfer of securities, whether securities of a public company or a private company. Thus, a private company sponsoring a liquidity program on a secondary market for private company shares might be found liable under the anti-fraud provisions of the federal securities law if: (i) it makes a materially false or misleading statement or omits to state a material fact necessary to make a statement not misleading; (ii) recklessly or with intent to defraud, deceive, or manipulate a purchaser or a seller of securities; (iii) the purchaser or seller relies upon the misstatement; and (iv) they are injured as a result.²⁵⁸

(ii) SECONDARY LIABILITY

- SECTION 20(a) OF THE EXCHANGE ACT (CONTROLLING PERSON LIABILITY)

Section 20(a) of the Exchange Act extends joint and several liability to those that “directly or indirectly, control”²⁵⁹ the primary actor. To avoid liability the controlling person can establish that he “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of

²⁵⁶ Section 10(b) of the Exchange Act.

²⁵⁷ Section 10(b) of the Exchange Act and Rule 10b-5 adopted by the SEC under Section 10(b) of the Exchange Act make it unlawful to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading in connection with the purchase or sale of any security. Accordingly, to establish a claim under Rule 10b-5, plaintiffs (including the SEC) must prove manipulation or deception, materiality, connection with the purchase or sale of securities, and scienter. In addition to these elements, private plaintiffs must also establish standing, reliance, loss causation; and damages.

See, e.g., Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, cit., pp. 4-5; Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, cit., pp. 4-5; Goodwin Procter LLP, Disclosure Requirements and Best Practices in Secondary Transactions of Private Company Stock (Memorandum addressed to Annemarie Tierney, General Counsel SecondMarket Holdings, Inc., March 16, 2012), pp. 1-3, retrieved from <https://www.secondmarket.com/discover/wp-content/uploads/2012/01/Memo-on-Secondary-Sale-Disclosure-Requirements-Goodwin-Proctor.pdf>.

²⁵⁸ See, Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, cit., p.4; Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, cit., p. 4 (noting that “[i]ssuer liability for disclosures is possible even if the issuer is not selling securities, as long as the information is provided “in connection with” or “touches” a securities transaction.”).

²⁵⁹ 15 U.S.C. Section 78t(a).

action.”²⁶⁰ Thus, to establish secondary liability of a “controlling person,” at minimum, a plaintiff shall prove an underlying violation of the securities laws by a primary violator that was under the control of the defendant, and that the defendant directly or indirectly “controlled” the primary violator.²⁶¹

Employers may incur liability under Section 20(a) of the Exchange Act for any conduct that could directly or indirectly “induce” a violation by an employee.²⁶² For instance, an issuer might incur controlling person liability if it is found that it caused employee violation through failure to establish, maintain and enforce effective written insider trading policies and procedures reasonably designated to prevent the misuse of material non-public information by its employees.

- SECTION 20(e) OF THE EXCHANGE ACT (AIDING AND ABETTING LIABILITY)

Section 20(e) of the Exchange Act authorizes the SEC to bring actions against “any person that knowingly or recklessly provides substantial assistance” to a primary violator of the securities laws. Under this section, aiders and abettors of securities fraud shall be deemed to be in violation of such securities laws to the same extent as the person to whom they provided assistance.²⁶³

Thus, for instance, if a company learns of unlawful insider trading by one of its directors, officers, employees, or consultants and nevertheless fails to take appropriate actions to interrupt and address that behavior, the company could itself be held liable for aiding and abetting in the violation.²⁶⁴

Practitioners have investigated this risk in the context of liquidity programs sponsored by private companies on SecondMarket. They have noted the use of certain contractual provisions in the SecondMarket agreements designed to mitigate the risk of a participant trading on the basis of material non-public information about the securities or the relevant private company, and the risk of aiding and abetting liability by the private company sponsoring the liquidity program. Among them are: the provisions that require sellers to represent to SecondMarket that they do not possess or have knowledge of material non-public information about the private company in which shares are being traded or its affiliates and that they are not selling their shares on the basis of any such information; and other provisions that give the sponsoring private company the right to review the list of proposed sellers and exclude from selected candidates anyone that is likely to have material non-public information, as well as the right to set specific trading windows.²⁶⁵

²⁶⁰ *Ibidem*.

²⁶¹ See, John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., pp. 1097 et seq.

²⁶² See, *In re Morgan Stanley & Co. Inc.*, SEC Release No. 34-54047 (June 27, 2006) available at <https://www.sec.gov/news/press/2006/2006-103.htm> (In 2006 the SEC brought administrative proceedings against Morgan Stanley & Co. Inc. and Morgan Stanley DW Inc. (collectively, “Morgan Stanley”) for causing employee violation through failure to establish, maintain and enforce effective written insider trading policies and procedures reasonably designated to prevent the misuse of material non-public information. The order issued by the SEC ordered Morgan Stanley to cease and desist from committing or causing any violations and any future violations of Section 15(f) of the Exchange Act and Section 204A of the Advisers Act, ordered Morgan Stanley to pay a \$10 million penalty, and to retain an independent consultant to review Morgan Stanley’s policies and procedures. Morgan Stanley consented to the issuance of the Order without admitting or denying any of the Commission’s findings.)

²⁶³ 15 U.S.C. Section 78t(e). See, e.g., John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., pp. 1106 et seq.

²⁶⁴ See, Ari B. Lanin, *Building a Better Insider Trading Compliance Program* (The Corporate & Securities Law Advisor, Aspen Publisher (Volume 25 Number 3, March 2011), p. 2, available at <http://www.gibsondunn.com/publications/Documents/Lanin-Stolman-BuildingaBetterInsiderTradingComplianceProgram.pdf> (noting that “[t]o be successful, the SEC would have to prove that the Participating Company substantially assisted in the trading of securities on the basis of material non-public information with the requisite knowledge that its conduct was improper.”)

²⁶⁵ Gibson, Dunn & Crutcher LLP, *Potential Risks Facing Companies Participating in SecondMarket*, cit., p.5.

4.1.1.E SECTION 12(G) OF THE EXCHANGE ACT

Special purpose vehicles (SPVs) created for the purpose of investing in shares of private companies have raised a number of policy and regulatory issues.²⁶⁶ Among others, it is unclear whether the holders of the SPV should count in determining compliance with the shareholder-count rule under Section 12(g) of the Exchange Act, or whether this should be the case only when the issuer is involved in forming the SPV (and in such case which level of involvement by the issuer should be relevant).²⁶⁷ The risk could be significant: if the SEC were to find a case of investor-count rule gaming through the use of SPV or otherwise reach the conclusion that holders of the SPV should count against the relevant shareholder threshold under Section 12(g) of the Exchange Act, then the private company in which shares are being traded would be required to register its securities and would become subject to costly reporting requirements under the Exchange Act.²⁶⁸

As previously discussed, recent amendments to Section 12(g) of the Exchange Act have had a significant (positive) impact on the secondary trading of private company shares. In particular, prior to the JOBS Act, Section 12(g) of the Exchange Act required issuers to register a class of equity securities with the SEC if, at the end of the issuer's fiscal year, such class of equity securities was held of record by 500 or more record holders and the issuer had total assets exceeding \$10 million.²⁶⁹ The JOBS Act amended Section 12(g) providing that an issuer would become subject to Exchange Act requirements within 120 days after the last day of its first fiscal year ended on which the issuer has total assets in excess of \$10 million and a class of equity securities held of record by either 2,000 persons or 500 persons who are not accredited investors.²⁷⁰

In addition to raising the shareholder-threshold, the JOBS Act also amended Section 12(g) to exclude from the definition of "record holder" persons who receive the securities pursuant to an employee compensation plan in transactions exempt from the registration requirements under Section 5 of the Securities Act,²⁷¹ as well as those who acquire securities in exempt crowdfunding offerings under Title

²⁶⁶ See, SEC, Letter from Mary Schapiro, SEC Chairman, to the Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit., pp. 20-21.

²⁶⁷ Ivi, p. 21.

²⁶⁸ See, Google Inc., Registration Statement (Form S-1), at 36 (Apr. 29, 2004), available at <http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm>; SEC, Response of the Office of Chief Counsel Division of Corporation Finance, Re: Facebook, Inc. Incoming letter dated October 13, 2008 (October 14, 2008), retrieved from <http://www.sec.gov/divisions/corpfin/cf-noaction/2008/facebook101408-12gh.htm>.

²⁶⁹ 15 U.S.C. 781(g).

²⁷⁰ See, Titles V of the JOBS Act. In case of issuers that are banks or bank holding companies as the term is defined in Section 2 of the Bank Holding Company Act of 1956, as amended, Title VI of the JOBS Act amends Section 12(g) to require registration if the issuer has total assets exceeding \$10 million and a class of equity securities (other than exempted securities) held of record by 2,000 or more persons, regardless of accredited investor status. Title VI of the Jobs Act also raised the threshold for banks and bank holding companies for exiting the reporting system from 300 holders of record to 1,200 holders of record. See, also, SEC, Jumpstart Our Business Startups Act Frequently Asked Questions, Changes to the Requirements for Exchange Act Registration and Deregistration (April 11, 2012), available at <https://www.sec.gov/divisions/corpfin/guidance/cfjobsactfaq-12g.htm>.

²⁷¹ Equity incentive compensation used to attract, retain, and motivate employees constitute a class of equity security relevant for purpose of calculation of the shareholder threshold under Section 12(g) of the Exchange Act. Over the years, the SEC has granted exemptive relief on a case-by-case basis to various issuers who would have otherwise been required to register and become subject to reporting requirements under the Exchange Act due to the grant of compensatory stock options. In 2006, the Advisory Committee on Smaller Public Companies recommended that the SEC provide Section 12(g) registration relief for compensatory stock options. See, SEC Advisory Committee on Smaller Public Companies, Final Report of the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission, Apr. 23, 2006, p. 87, available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>. Thereafter in 2007, the SEC adopted two exemptions from the registration requirements of Section 12(g) of the Exchange Act for compensatory stock options. See, SEC, Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Exchange Act of 1934, Release No. 34-56887 (December 3, 2007), available at <http://www.sec.gov/rules/final/2007/34-56887.pdf>. Following the release of December 2007, the SEC extended the exemptive relief to restricted stock units in response to specific requests. See, e.g., SEC, Response of

III of the JOBS Act.²⁷² These changes have allowed private companies to remain public and continue to grow much larger without being forced to start publicly reporting their financial results. This, in turn, has contributed in creating a fertile environment for secondary trading in private company shares.

4.1.2. POTENTIAL LIABILITY OF BUYERS AND SELLERS

4.1.2.A. SECURITIES ACT SECTIONS 4(a)(1) AND SO-CALLED SECTION 4(a)(1½) EXEMPTION

Under Section 5 of the Securities Act all offers and sales of securities, including the resale of securities acquired in unregistered sales, must be registered with the SEC or qualify for an exemption from the registration requirements. Section 4(a)(1) of the Securities Act specifically exempts from registration those transactions conducted “by any person other than an issuer, underwriter, or dealer.”²⁷³ Assuming that the seller is not a dealer, and by definition the seller is not an issuer, the critical question in assessing the availability of Section 4(a)(1) exemption is whether the resale transaction involves an “underwriter.” If a resale transaction involves an “underwriter,” then no party to the transaction will be able to rely on Section 4(a)(1) exemption.²⁷⁴

While it is fairly easy to spot an issuer or a dealer, the definition of an underwriter is sufficiently broad to prevent most affiliates of an issuer from relying upon this exemption.²⁷⁵ Section 2(a)(11) of the Securities Act defines “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 participation in the direct or indirect underwriting of any such undertaking.”²⁷⁶ The statutory term “underwriter” is broad both in the way it is drafted and in the way is interpreted by courts. In particular, interpretation of Section 4(a)(1) has traditionally focused on the words “with a view to distribution.”²⁷⁷ Because determination of the mental state of the purchaser at the time of his acquisition is difficult, the question of whether a transaction involves an “underwriter” has generally required a very careful analysis of all facts and circumstances of the case, as well as consideration of key factors including the amount of shares involved, the time the selling holder has held such shares, the circumstances under which the selling holder has received such securities, and the relationship to the issuer.²⁷⁸ In addition, the term “distribution,” which is crucial to the analysis of “underwriter” status, has been traditionally interpreted as to refer to “the entire process in a public offering through which a block of securities is dispersed and ultimately comes to rest in the hands of the investing public,”²⁷⁹ and is generally understood by courts

the Office of Chief Counsel Division of Corporation Finance, Re: Facebook, Inc. Incoming letter dated October 13, 2008 (October 14, 2008), retrieved from <http://sec.gov/divisions/corpfin/cf-noaction/2012/fenwickwest021312-12g.htm>. Most recently, on February 13, 2012, the SEC issued a No-Action Letter to Fenwick & West LLP law firm granting a much broader exemptive relief from Section 12(g) registration for compensatory restricted stock units. See, SEC, Response of the Office of Chief Counsel Division of Corporation Finance Re: Fenwick & West LLP, Incoming letter dated February 7, 2012 (February 13, 2012), available at <http://www.sec.gov/divisions/corpfin/cf-noaction/2012/fenwickwest021312-12g.htm>.

²⁷² See, Titles V of the JOBS Act.

²⁷³ Section 4(a)(1) of the Securities Act. See, paragraph 4.1.1.B. for analysis of Section 4(a)(1).

²⁷⁴ See, e.g., In the Matter of Rodney R. Schoemann, Release No. 33-9076 (Oct. 23, 2009).

²⁷⁵ See, paragraph 4.1.1.B above.

²⁷⁶ Section 2(a)(11) of the Securities Act. See, paragraph 4.1.1.B. for analysis of Section 2(1)(11).

²⁷⁷ See, Preliminary Note to Rule 144 under the Securities Act.

²⁷⁸ For a recent enforcement action that applied a facts and circumstances analysis in determining the availability of Section 4(a)(1) to a resale transaction, see *Zacharias v. SEC*, 569 F.3d 458, C.A.D.C. (June 23, 2009).

²⁷⁹ In the Matter of Jacob Wonsover, Release No. 34-41123 (March 1, 1999).

and by the SEC as being “synonymous with a public offering [...] in which the shares flow into the trading markets in a manner such that members of the investing public might come to hold the shares.”²⁸⁰ As a result, individual investors who are not professionals in the securities business may still be deemed “underwriters” if it appears that under all the circumstances and specific facts of the case they act as links in a chain of transactions through which securities move from an issuer to the public.²⁸¹

In light of the foregoing, the purchase of restricted securities²⁸² accompanied by a subsequent resale of such securities has traditionally raised the concern that the resale could be deemed involving an “underwriter” in a chain of activities which amount to a “distribution” under the Securities Act, thus, precluding reliance on Securities Act Section 4(a)(1) registration exemption. Because of this concern, generally resales of restricted securities are either registered, or conducted in compliance with Rule 144 under the Securities Act or executed in reliance on an exemption from the registration requirement other than Section 4(a)(1) of the Securities Act.

Rule 144²⁸³ provides a non-exclusive safe harbor for the resale of control securities²⁸⁴ and resales of restricted securities if a number of conditions are met. A person selling control securities or restricted securities that satisfies all applicable conditions of Rule 144 safe harbor is deemed not to be engaged in a distribution of the securities, and therefore not an underwriter of the securities for purposes of Section 2(a)(11) of the Securities Act. As a result, such person may rely on Section 4(a)(1) exemption for the resale of securities. The Rule 144’s conditions are briefly summarized below:²⁸⁵

- Holding Period. The seller must have held the securities being sold for a period of at least six months when the issuer is a reporting company, or at least one year when the issuer isn’t a reporting company. In all cases, the holding period begins when the securities are bought and fully paid for.²⁸⁶
- Current Information. Adequate current information about the issuer must be publicly available.²⁸⁷ When the issuer is a reporting company, this requirement is generally satisfied if the reporting company has complied with the periodic reporting requirements under the Exchange Act.

²⁸⁰ In the Matter of GFL Ultra Fund Ltd., Respondent, Release No. 33-7423 (June 18, 1997). The Supreme Court addressed the meaning of “public offering in SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

²⁸¹ See, Preliminary Note to Rule 144 under the Securities Act.

²⁸² Rule 144(a)(3) under the Securities Act. The Rule identifies the following categories of “restricted securities”: specifically include (i) securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering; (ii) securities acquired from the issuer that are subject to the resale limitations of Rule 502(d) under Regulation D or Rule 701(c); (iii) securities acquired in a transaction or chain of transactions meeting the requirements of Rule 144A; (iv) securities acquired from the issuer in a transaction subject to the conditions of Regulation CE; (v) equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of Rule 901 or Rule 903 under Regulation S; (vi) securities acquired in a transaction made under Rule 801; (vii) securities acquired in a transaction made under Rule 802; and (viii) securities acquired from the issuer in a transaction subject to an exemption under section 4(5) of the Securities Act.

²⁸³ Rule 144 under the Securities Act.

²⁸⁴ Control securities are securities held by an affiliate of the issuing company. Rule 144(a)(1) defines “affiliate” of an issuer as “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.”). The term “control” means the power to direct the management and policies of the company in question, whether through the ownership of voting securities, by contract, or otherwise. Securities acquired from an affiliate are restricted securities, even if such securities were not restricted in the affiliate’s hands.

²⁸⁵ See, SEC, Rule 144: Selling Restricted and Control Securities, Investor Publications, available at <http://www.sec.gov/investor/pubs/rule144.htm>; John C. Coffee, Jr. and Hillary A. Sale, Securities Regulation – Cases and Materials, cit., pp. 512-520.

²⁸⁶ Rule 144(d).

²⁸⁷ Rule 144(c).

When the issuer is a non-reporting company, this requirement is satisfied when certain information about the company is made publicly available (e.g., information regarding its financial statements, its business, the identity of its officers and directors). The SEC has clarified that in case of a non-reporting issuer, information about the issuer will be deemed “publicly available” for purposes of Rule 144 if the company distributes reports containing the 15c2-11 information to its shareholders, brokers, market makers and any other interested person and information about the company is published in a recognized financial reporting services.²⁸⁸ If the seller is a non-affiliate that has held the securities for at least one year, the seller may sell the securities without compliance with the additional requirements under Rule 144. If the issuer is a reporting company and the seller is a non-affiliate that has held the securities for a period of at least six months but less than one year, the seller may sell the securities as long as the seller satisfies the current public information condition.

- Restrictions on Amount of Securities Sold. In case the seller is an affiliate, the number of equity securities the seller may sell during any three-month period cannot exceed the greater of 1% of the outstanding shares of the same class being sold, or if the class is listed on a stock exchange, the greater of 1% or the average reported weekly trading volume during the four weeks preceding the filing of a notice of sale on Form 144.²⁸⁹

- Manner of Sale. In case the seller is an affiliate, the sale must be made in either brokerage transactions (as defined in Section 4(4) of the Securities Act), or directly with a market maker (as the term is defined in section 3(a)(38) of the Exchange Act) or as a riskless principal transaction.²⁹⁰

- Notice. If the seller is an affiliate, a notice must be filed with the SEC on Form 144 if the amount of securities to be sold in reliance upon Rule 144 during any period of three months exceeds 5,000 shares or other units or has an aggregate sale price in excess of \$50,000.²⁹¹

In certain circumstances the holder of securities cannot rely on Section 4(a)(1) of the Securities Act and cannot meet Rule 144’s conditions.

A common example is the case of an employee (either an affiliate or a non-affiliate) of a private company that holds stock options and wants to resell the option shares immediately upon exercise of his/her stock options in order to pay the exercise price and other costs of acquiring the underlying shares. In this case, the employee cannot satisfy the holding period requirement under Rule 144 because the holding period for restricted securities acquired upon exercise of an employee stock option always begins on the date of exercise of the option and full payment to the issuer of the exercise price.²⁹² The date of the option grant cannot be used for this purpose, even if the exercise involves no payment of cash or other consideration

²⁸⁸ Securities Act Release No. 6099 (august 2, 1979), at Question 20.

²⁸⁹ Rule 144(e).

²⁹⁰ Rule 144(f).

²⁹¹ Rule 144(h).

²⁹² See, SEC, Rule 144 — Persons Deemed Not to be Engaged in a Distribution and Therefore Not Underwriters, Section 110. Rule 144(d)(1). Question 110.01, available at <https://www.sec.gov/divisions/corpfin/guidance/rule144interp.htm>; SEC, Securities Act Rules, Compliance and Disclosure Interpretations (“C&Dis”), Question 132.11, available at <https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

to the issuer. Because the option is issued to the employee without any payment for the grant, the employee holds no investment risk in the issuer before the exercise.²⁹³

In the case outlined above reliance on Section 4(a)(1) registration exemption may also be prohibited. Practitioners, who have analyzed the case of employees (affiliates or non-affiliates) of private companies entering into an agreement with SecondMarket to sell their option shares immediately upon exercise of their options, have noted that the SEC and the courts almost certainly would take the view that the option shares have not come to rest in the hands of the employees.²⁹⁴ As a result, the resale of option shares by employees would likely be deemed constitute a further step in a distributive process by the issuer, making the employees statutory underwriters, and thus prohibiting them from relying on the exemption under Section 4(a)(1) of the Securities Act. Furthermore, because the employees would not be able to rely on the exemption under Section 4(a)(1) for the resale of their option shares, such practitioners have noted that SecondMarket itself would be precluded from relying on the exemptions under Securities Act Sections 4(3)²⁹⁵ or Section 4(4),²⁹⁶ with resulting exposure by SecondMarket to strict liability under Securities Act Section 12(a)(1) for the offers and sales made in contravention of Section 5.²⁹⁷

Another example is the case of affiliates of a private company that hold shares and want to resell part of their shares. As discussed above, for these affiliates Rule 144 requires that certain current information about the issuer be made public. Although generally not as stringent as reporting requirements for public companies, private companies whose affiliates rely upon Rule 144 must still provide the general public with material information regarding the issuer's business, products, services offered and facilities, as well as balance sheets, profit and loss and retained earnings statements among others. Many private companies do not wish to provide this level of public disclosure, thus making Rule 144 safe harbor inapplicable for executive officers, directors and large early investors.

When a holder of restricted securities that have not come to rest seeks to resell such securities and cannot meet the conditions of Rule 144 resale safe harbor and the requirements of Securities Act Section 4(a)(1) exemption (as in the cases described above), then the holder of restricted securities may attempt to rely on Section 4(a)(1½) exemption. Section 4(a)(1½) is a hybrid exemption that has developed over time as a result of case law and legal analysis.²⁹⁸ It is not provided for in the Securities Act, nor it is formally established by any written SEC regulation, although the SEC has recognized this exemption to be clearly

²⁹³ Ibidem.

²⁹⁴ See, Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, Private Resales Under Securities Act Sections 4(1) and 4(a)(1½) (Memorandum addressed to Annemarie Tierney, General Counsel SecondMarket Holdings, Inc., November 8, 2011), p. 3, available at <https://www.secondmarket.com/discover/wp-content/uploads/2012/01/Memo-on-Availability-of-Rule-4-1-1-2-Exemption-Skadden-Arps1.pdf>.

²⁹⁵ Section 4(3) of the Securities Act. See, e.g., John C. Coffee, Jr. and Hillary A. Sale, Securities Regulation – Cases and Materials, cit., pp. 500-512.

²⁹⁶ Section 4(4) of the Securities Act. See, e.g., John C. Coffee, Jr. and Hillary A. Sale, Securities Regulation – Cases and Materials, cit., pp. 500-512.

²⁹⁷ See, Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, Private Resales Under Securities Act Sections 4(1) and 4(a)(1½), cit., p. 3.

²⁹⁸ See, e.g., The Study Group on Section “4(1½)” of the Subcommittee on 1933 Securities Act, The Section “4(1½)” Phenomenon: Private Resales of “Restricted” Securities, Report to the ABA Committee on Federal Regulation of Securities from the Study Group on Section “4(1½)” of the Subcommittee on the 1933 Act, The Business Lawyer, Vol. 34, No. 4 (July 1979), pp. 1961-1978; Carl W. Schneider, Section 4(1-1/2)-Private Resales of Restricted or Control Securities, Ohio State Law Journal, vol. 49, no. 2 (1988), 501-516, available at <http://kb.osu.edu/dspace/handle/1811/64421>; John C. Coffee, Jr. and Hillary A. Sale, Securities Regulation – Cases and Materials, cit., pp. 523-531.

within the intended purpose of the Securities Act.²⁹⁹ Section 4(a)(1½) allows affiliates and non-affiliates to make private resales of securities held by them so long as certain criteria set forth in Section 4(a)(1) and Section 4(a)(2) of the Securities Act are satisfied.³⁰⁰ The underlying rationale is that the holder of securities may establish that the resale of such securities does not involve a distribution, thus avoiding being deemed a statutory underwriter, if the securities are resold in a private transaction that generally reflects the criteria applicable to private offerings conducted by an issuer under Section 4(a)(2) of the Securities Act.³⁰¹ To this purposes, practitioners and commentators have recommended that holders of securities that plan to rely on Section 4(a)(1½) exemption take adequate measures, including the following:

- Placing a legend on the securities being sold notifying the buyer that the securities are restricted under Rule 144(a)(3);
- Providing adequate written disclosure to each buyer that the securities have not been registered with the SEC and cannot be resold in the US without registration or an applicable exemption from the registration requirements;
- Limiting the aggregate number of buyers and obtain a certification in writing from each of them in which the buyer represents and warrants his investor qualification (e.g., the buyer is a QIB or an accredited investor) and that is acquiring the securities for his own account or for others for whom the buyer exercises investment discretion without a view to distribution;
- Providing the issuer with a right to obtain a legal opinion confirming that the shares are being sold pursuant to a valid exemption;
- Compliance with the prohibition on general solicitation and general advertising;³⁰²
- Generally, providing buyers with information about the issuer and the securities similar to that information that the buyers would have received if they were acquiring private company shares from the issuer in a private placement (e.g., capitalization information, historical financial

²⁹⁹ Securities Act Release No. 6188 (February 1, 1980) at n.178 (noting that Section 4(a)(1½) is a “hybrid exemption not specifically provided for in the 1933 Act but clearly within its intended purpose ... so long as some of the established criteria for sales under both Section 4(1) and Section 4(2) ... are satisfied.”).

³⁰⁰ See, e.g., Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, *Private Resales Under Securities Act Sections 4(1) and 4(a)(1½)*, cit., p. 4 (noting that “[t]he principle or theory behind the exemption provides that transactions that would be exempt under Section 4(a)(2) if undertaken by the issuer probably do not involve a “distribution” if undertaken by an affiliate of the issuer or holder of restricted securities”); and Paul Hastings, *Navigating a Successful Private Secondary Offering through Murky Waters*, Paul Hastings publication (October 28, 2015), pp. 60-61, retrieved from [https://www.paulhastings.com/docs/default-source/PDFs/f-mack_nov15-\(2\).pdf](https://www.paulhastings.com/docs/default-source/PDFs/f-mack_nov15-(2).pdf); Fenwick & West, *Pre-IPO Liquidity for Late Stage Start-Ups*, Fenwick & West Publications (May 31, 2018), pp. 3-4, available at <https://www.fenwick.com/FenwickDocuments/Pre-IPO-Liquidity-for-Late-Stage-Start-Up.pdf>.

³⁰¹ *Ibidem*.

³⁰² See, Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, *Private Resales Under Securities Act Sections 4(1) and 4(a)(1½)*, cit., p. 6 (noting that “because the exemption under Section 4(a)(1½) imports from Section 4(a)(2), among other things, the prohibition on general solicitation and advertising, the SecondMarket website and related marketing materials must refrain from any communications that would threaten the private character of the transaction(s).”). The JOBS Act requires the SEC to eliminate the prohibition against general solicitation and general advertising under Rule 506 of Regulation D when all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors. In addition, the JOBS Act requires the SEC to amend Rule 144A under the Securities Act to provide that securities sold pursuant to Rule 144A may be offered to persons other than QIBs, including by means of general solicitation, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. However, the JOBS Act does not explicitly require the SEC to adopt rules to eliminate the prohibition on general solicitation and general advertising in connection with private placements conducted in reliance of Securities Act Section 4(a)(2) exemption nor those private placements conducted under Section 4(a)(1½) exemption.

statements, and terms and conditions of any agreements applicable to the purchased securities),³⁰³ and

- Notification to the buyers of any “stop transfer” procedures applicable to the unregistered securities being sold.

With respect to the disclosure requirement referred to above, practitioners, who have analyzed the applicability of Section 4(a)(1½) exemption in the context of secondary resales of private company shares on SecondMarket, have noted that buyers acquiring private company shares from insiders in reliance of Section 4(a)(1½) exemption tend to conduct a full diligence process similar to the one they would have conducted if they were purchasing securities from the issuer in a primary private placement.³⁰⁴ In addition, practitioners have noted that, in certain circumstances, secondary sales by company insiders are executed alongside a primary placement of securities by the issuer, which may somehow facilitates the disclosure process in respect to the secondary transaction. Finally, they have observed that, even in the absence of a primary placement, issuers may still permit great disclosure (for instance, when the secondary transactions involve friendly insiders such as key executives or early institutional investors with an ongoing relationship with the issuer).³⁰⁵

A question may arise as per whether the limited holding period existing between the exercise of the option by an employee (affiliate or non-affiliate) of the issuer and the resale of the restricted securities acquired thereunder by such employee may preclude reliance on Section 4(a)(1½) exemption. Practitioners, who have investigated this question in the context of secondary sales of private company shares on SecondMarket, have concluded that - although with no certainty because the SEC has not provided clarification on the question at issue - there may be a defensible argument that the employee can resell immediately so long as he adheres to the standards discussed above.³⁰⁶

4.1.2.B. ANTI-FRAUD PROVISIONS

Compliance with disclosure requirements of the registration exemption provisions discussed above does not relieve buyers and sellers in a secondary trading from potential liability under Section 10(b) of the Exchange Act and Rule 10b-5 adopted thereunder.³⁰⁷ As previously indicated, Rule 10b-5, promulgated under Section 10(b) of the Exchange Act, prohibits fraudulent devices and schemes, misstatements and

³⁰³ Although the SEC has acknowledged the validity of Section 4(a)(1½) exemption, it has declined to provide any guidance on the requirements necessary to satisfy the legal construct, as well as, the required disclosure. The position adopted by the SEC in no-action letters vary from indicating that the prospective purchasers should be limited to those who receive the same information about the issuer's stock that a registration statement would provide, to requiring that the seller indicate to the offerees where to obtain information regarding the issuer and the stocks being sold, to the requirement that the seller disclose to the buyer all information about the issuer and the stock known to him. The discussion in this paragraph focuses solely on disclosures that may be required under section 4(a)(1½) in order to avoid violating the registration provisions of the Securities Act. Additional disclosure obligations arise under the anti-fraud provisions of the securities laws. For further discussion on disclosures required under the anti-fraud provisions of the securities laws, see paragraph 4.1.2.B below.

³⁰⁴ See, Goodwin Procter LLP, Disclosure Requirements and Best Practices in Secondary Transactions of Private Company Stock, cit., pp. 2-3.

³⁰⁵ *Ibidem*.

³⁰⁶ See, Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, Private Resales Under Securities Act Sections 4(a)(1) and 4(1½), cit., pp. 5-6 (noting that “so long as the resale transaction heeds the guidance above, the Non-Affiliate Seller or Affiliate Seller (as the case may be) may be viewed to purchase the Options Shares not “with a view to distribution,” but rather with a view to a private resale, which should not cause the Non-Affiliate Seller or Affiliate Seller or SecondMarket to be deemed a statutory underwriter.”).

³⁰⁷ *Ibidem*.

omissions of material facts, and acts and practices that operate as a fraud or deceit in connection with securities transactions.³⁰⁸

In practice, Rule 10b-5 has been applied to three main categories of fraudulent behavior: misrepresentations or omissions in corporate statements (e.g., proxy statements and offering documents), insider trading, and manipulation.³⁰⁹ Among them, “insider trading” refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security.³¹⁰ There are two main theories of insider trading liability.³¹¹ First, the “traditional” theory of insider trading liability focuses on corporate insiders (such as an officer or a director), who owe fiduciary duties to their company and its shareholders. Under this theory, a corporate insider violates Section 10(b) and Rule 10b-5 by trading in the company’s securities on the basis of material non-public information about the company. Thus, a corporate insider in possession of such information has a duty either to abstain from trading or to disclose such information before trading.³¹² A second theory of insider trading liability is the so-called “misappropriation” theory, which focuses on non-insiders. Under the “misappropriation” theory, a non-insider violates Section 10(b) and Rule 10b-5 when he/she misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information.³¹³

In the context of secondary trading of private company securities, the risk of liability under Rule 10b-5 may arise when either the buyer or the seller is in possession of material, non-public information about the security being traded or the private company in which shares are being traded and the other party does not have this information.³¹⁴ This is particularly important when the sellers do not have board-level information about the company. In order to avoid liability, the party possessing such information must either disclose it to the other party (to the extent permitted and without breaching confidentiality obligations owed to the issuer), refrain from trading, or postpone the trading until the material non-public information has become public.³¹⁵

Whether the private company in which shares are being traded has any liability largely depends on the degree of the company involvement and the relevance of any undisclosed information. It is generally in the company’s best interest to provide a symmetry of information sharing to both the seller and the buyer. This helps the company establish a fact pattern of ensuring that all parties are making an informed decision based on the same information, and that no party was advantaged over the other. In this regard,

³⁰⁸ See, 17 C.F.R. § 240.10b-5.

³⁰⁹ See, e.g., John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., pp. 933 et seq.

³¹⁰ See, SEC, Frequently Asked Question / Insider Trading, (SEC) available at <http://www.sec.gov/answers/insider.htm>. For a detailed analysis of insider trading regulation under federal securities law, see, John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., pp. 1173 ss..

³¹¹ Under either theory, insider-trading violations may occur when a person (“tippee”) is provided with material non-public information by another person (“tipper”) acting in violation of a duty of trust and confidentiality. For a discussion of the elements to be met to establish liability of a tipper and liability of a tippee, see John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., pp. 1177 et seq.

³¹² See, e.g., John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., pp. 1173 et seq.

³¹³ Ivi, pp.1187 et seq.

³¹⁴ See, Goodwin Procter LLP, *Disclosure Requirements and Best Practices in Secondary Transactions of Private Company Stock*, cit., p. 3.

³¹⁵ Ivi, pp. 4-6. See, also, Cooley, *Secondary Sales of Private Company Stock*, Cooley Publications, retrieved from <https://www.cooleygo.com/secondary-sales-of-private-company-stock/>; Fenwick & West, *Pre-IPO Liquidity for Late Stage Start-Ups*, cit., p. 3.

best practices suggest that a company should consider providing (at minimum) disclosures similar to those required under Rule 701(e).³¹⁶

4.1.2.C. RULE 144(D) HOLDING PERIOD

Rule 144(d)(1)(ii) under the Securities Act provides that “[i]f the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, a minimum of one year must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities.”³¹⁷ Thus, Rule 144(d)(1)(ii) subjects restricted securities of an issuer that is not subject to reporting requirements under the Exchange Act to a 12-month holding period, which begins to run from the later of the date the securities were acquired from the issuer or from an affiliate of the issuer.³¹⁸

The 12-month holding period requirement can be satisfied by the purchaser by tacking the holding period of the prior non-affiliate seller to his or her own holding period. Thus, for example if an individual acquires restricted securities with a one year holding period from a non-affiliate who has held those securities for six months, then the individual needs only hold the securities for another six months in order to comply with the holding period requirement.

Only if the prior holder was a non-affiliate of the issuer is tacking permitted.³¹⁹ Contrary, tacking is not allowed when the prior holder is an affiliate of the issuer or the transaction is deemed an acquisition from the issuer; in such cases, the holding period will reset and the buyer will be subject to a new 12-month holding period under Rule 144.³²⁰

The above means that in case of secondary sales of private company securities executed in the context of a liquidity program sponsored by a private company, tacking will not be allowed where the seller is an affiliate of the private company sponsoring the program, or where the private company sponsoring the program is deemed “seller” or “underwriter” with respect to such secondary transactions.³²¹

4.2. UK FINANCIAL AND SECURITIES LAWS RELATED CONSIDERATIONS

The increasing use of secondary marketplaces by UK private companies and the growing activities of UK based liquidity funds have raised a number of interesting considerations from a UK financial and securities law point of view. The following sections will discuss a few of these considerations in detail.³²²

³¹⁶ See, 17 C.F.R. § 230.701. To the extent the company does wish to ensure that the parties to a secondary sale each have some fundamental information on which to base a decision to sell or buy company securities, the company should provide this information (e.g., financial information, performance metrics) under a non-disclosure agreement to protect the confidentiality of any such information and should require that the information shall not be shared with others or used for any purpose other than evaluating the potential transaction.

³¹⁷ See, Rule 144(d)(1)(ii) under the Securities Act.

³¹⁸ See, John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., pp. 515 et seq.

³¹⁹ See, SEC Release No. 33-6862 (April 23, 1990).

³²⁰ See, John C. Coffee, Jr. and Hillary A. Sale, *Securities Regulation – Cases and Materials*, cit., p. 516

³²¹ See, Gibson, Dunn & Crutcher LLP, *Potential Risks Facing Companies Participating in SecondMarket*, cit., p.6. See, above Paragraphs 4.1.1.B and 4.1.1.C.

³²² The information contained in this and the following sections is intended as a general overview of a few selected UK financial and securities laws related issues and is by no means exhaustive.

4.2.1. POTENTIAL LIABILITY OF THE PRIVATE COMPANY

4.2.1.A. PUBLIC OFFERS

Pursuant to section 755 of the Companies Act 2006 (“CA 2006”), a private limited company must not offer its securities (including shares and debentures) to the public. Under the CA 2006, an offer is not considered as an offer to the public if it can properly be regarded in all the circumstances as: (a) not being calculated to result, directly or indirectly, in the shares or other securities of the company becoming available to persons other than those receiving the offer; or (b) otherwise being a private matter between the company and the recipient of the offer (this is often the case when for example an offer is made to existing members and/or employees of the company)).

The involvement of the secondary platform as well as the private company in which shares are being traded can and shall be structured so as to reduce the risk of violation of these restrictions and them being constituted as offering securities to the public. For example, in order to avoid contravening them, care must be taken in establishing eligibility criteria for buyers/sellers and to ensure that the offer is expressed to be open to acceptance only by those eligible persons receiving it. Another safeguard would be to approach investors in a two-stage process.

4.2.1.B. PROSPECTUS INFORMATION

Pursuant to section 85 of the Financial Services and Markets Act 2000 (“FSMA”), it is unlawful for a company to offer transferable securities (including shares) to the public in the UK unless a prospectus, approved by the Financial Conduct Authority (“FCA”), has been prepared and made available to the public before the offer is made. A breach of section 85 constitutes a criminal offence.

Under FSMA, there is an offer of transferable securities to the public if there is a communication (in any form and by any means) to any person which presents sufficient information on the transferable securities to be offered and the terms on which they are to be offered to enable an investor to decide to buy or subscribe for the securities in question. There are a number of exemptions commonly used by private companies including the following: (a) the total consideration for the transferable securities being offered in the European Economic Area (“EEA”) states is less than Euro 8,000,000 (calculated over a period of 12 months); (b) the offer is made to or directed at qualified investors only (e.g. venture capitalists and business angels and other persons regulated by the FCA); (c) the offer is made to or directed at fewer than 150 natural or legal persons, other than qualified investors, in each EEA state; or (d) the minimum consideration payable by any person for transferable securities acquired by him pursuant to the offer is at least Euro 100,000.

Before any offer is made through a secondary marketplace, the scope and extent of the offering should be carefully assessed to ensure that these restrictions are not triggered. Companies which are then legally required to publish a prospectus must do so before admission to the secondary marketplace. Companies that seek admission and are not legally required to publish a prospectus would normally be asked to publish a statement before admission including, among other information: a brief summary of the current and proposed activities of the company; the assets and liabilities, financial position, profits and losses and prospects of the company; and the rights attaching to the company’s securities being traded.

4.2.1.C. FINANCIAL PROMOTION

Even if the shares in private companies can be offered without the need to issue a prospectus as discussed above, the offering and trading in these shares will still be subject to compliance with the financial promotion regime contained in FSMA.

Section 21 of FSMA provides that a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity or to engage in claims management activity unless the promotion has been made or approved by an authorized person or it is exempt. Private companies seeking investment may rely on the statutory exemptions set out in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (“FPO”). These exemptions include, for example, communications made to investment professionals or which may reasonably be regarded as directed to investment professionals; communications made to high net worth individuals; or communications made to a person whom the person making the communication believes on reasonable grounds to be a self-certified sophisticated investor.

The prohibition under 21 FSMA is intended to be media neutral and applies regardless of the amount of investment sought from investors. It is a criminal offence to make such a communication in violation of the described restriction and any agreement entered into in breach of this provision is unenforceable as against the other person entering into it.

Any private company (and its personnel) making a financial promotion should therefore ensure that such communication does fall within a particular exemption before it is relied upon and the communication made.

4.2.2. POTENTIAL LIABILITY OF PARTICIPANTS TO THE SECONDARY TRADE

4.2.2.A. ANTI-FRAUD PROVISIONS

In addition to the requirements set out in the previous sections, private companies as well as buyers and sellers involved in a secondary trading may incur liability for misleading statements. This can arise under English law in several ways.

First, under section 89 of the Financial Services Act 2012 (“FSA”) a criminal offence may be committed if false or misleading information is published which may induce another person to buy or refrain from buying the shares. This applies regardless of whether the prospectus requirements discussed above apply. The person must know that, or be reckless as to whether, the statement is false or misleading, or have dishonestly concealed the material facts.

Moreover, if an investor can demonstrate that he bought shares in reliance on a false or misleading pre-contractual representation for which the seller or the company in which shares are being sold is responsible he may be able to bring a claim against the seller or the company under the law of misrepresentation under certain circumstances.

Finally, a civil action for negligence may arise to recover damages for losses where a person relies on a misstatement of fact made by the seller or the company in which shares are being sold or any of its directors to buy shares and suffers a loss as a result of the misstatement, and such misstatement was

negligently made. Civil liabilities may also arise in respect of a fraudulent statement of fact or under the law of deceit under certain circumstances.

Thus, for example, to ensure compliance with the describe provisions, UK based secondary marketplace Asset Match requires UK companies seeking admission of their securities on the platform to provide, among other documents, copy of a board resolution of the company: (a) authorizing the company to seek admission of its securities to Asset Match platform and enter into the arrangements in connection therewith; (b) confirming that the accuracy and completeness of the contents of the relevant documents and any other information provided to Asset Match in connection with the admission of the company's securities has been properly verified; and (c) undertaking to meet the requirements of the Asset Match Code of Practice, comply with the UK Listing Authority's Model Code on directors' dealings and comply with the UK Market Abuse and Insider Dealing regimes (as detailed within the FSMA, Criminal Justice Act 1993 and the FCA Rules), as amended from time to time, and apply their terms to all relevant staff and the company's dealings in its own securities, in each case at least 10 business days prior to the date on which it is intended that the relevant document of the company is to be published. Once the company has been admitted to Asset Match platform, it must continue to comply with eligibility requirements and must provide Asset Match with updated, accurate and properly verified information.

4.3. FINANCIAL REGULATION RELATED CONSIDERATIONS ACROSS EUROPE

Different from the U.S. and the UK, secondaries trading in private company shares is a nascent phenomenon in Europe and liquidity programs run by private companies on an on-going basis are quite rare across Europe. The opportunity in European country specific secondary exchanges or liquidity funds, as well as a purely pan-European secondary marketplace for private company shares is still largely unexplored.

However, the increased maturity of the European technology sector is expected to be a driving factor for new liquidity funds and secondary marketplaces to emerge across Europe in the coming years. The activities of any such fund and secondary marketplace will require compliance with applicable laws and regulations both at European and local levels. Various European countries have established anti-fraud provisions, disclosure requirements, restrictions to the offering of securities and financial promotion rules equivalent to the ones adopted in the UK briefly discussed in the prior sections.

4.4. LACK OF INFORMATION

Particularly when private companies have little or no oversight over secondary trading in their shares, problems may arise due to a lack of information about the securities being traded and/or the company in which shares are being traded.³²³

³²³ See, SEC, Letter from Mary Schapiro, SEC Chairman, to The Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit., p. 21; David Weir, Interview - The Market for pre-IPO shares (Forbes Video Network), available at <http://video.forbes.com/fvn/business/the-market-for-pre-ipo-shares>; Richard Teitelbaum, Facebook Drives SecondMarket Broking \$1 Billion Private Shares, cit. (quoting Stephen Grant, a private-equity banker at Internet Securities Inc. in Oakland, California stating that "investors using SecondMarket and SharesPost to load up on venture-backed private-company shares are taking a leap of faith").

Lack of information constitutes a primary concern for secondary trading as it may negatively affect the entire decision process at the basis of the investment. Investors may face the risk to find themselves making investment decisions without the benefit of important information, including financial statements and risk disclosures.³²⁴

Furthermore, lack of information affecting uncontrolled secondary trading may undermine the transparency of the transactions causing the mechanics of trading to remain largely unknown to investors.³²⁵ In this respect, the risk is that the transaction may be carried out by persons or entities not formally licensed as broker and, thus, not subject to regulation and regulatory supervision as such, or that no accurate due diligence may be performed in connection with the purposed transaction.³²⁶

Lack of information may also dampen the liquidity and depth of the secondary trading itself. Secondary trading that occurs out of control and with no involvement by the private companies in which shares are being traded may become sporadic and erratic, may leave investors with no possibility to cash out, and may create thin and ample territories for speculation and fraud.³²⁷

Moreover, lack of information affecting uncontrolled secondary trading of private company shares may create “inequality” among private companies.³²⁸ Tech and social-media companies often disclose on their website useful information to evaluate their performance (e.g. number of users, time spent on their site, or number of links), some large and well-recognized research companies have also specialized in providing reports and metrics analysis on tech and social-media companies, and generally investors can easily familiarize with the services provided by these companies.³²⁹ However, these unique features set tech and social-media private companies apart from the large majority of private companies, which generally suffer greater information asymmetry problems.

Lastly, information constrain may cause the universe of interested investors to narrow by creating significant investment challenges for investors such as mutual funds, hedge funds, non-regional investors, as well as, international investors.³³⁰

³²⁴ SEC, Letter from Mary Schapiro, SEC Chairman, to The Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit., pp. 14, 21-22.

³²⁵ See, e.g., SEC Press Release 2012-43, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares, cit.; Inyoung Hwang, Private Trades of Facebook Spur Questions About Transparency (Bloomberg, December 29, 2010), available at <http://www.bloomberg.com/news/2010-12-29/private-trades-of-facebook-spur-questions-about-transparency.html>.

³²⁶ For further discussion on this point, see below.

³²⁷ See, Brad Stone, Silicon Valley Cashes Out Selling Private Shares, cit.

³²⁸ See, Jeremy Drean, The Secondary Private Markets – New Players in the Venture Capital Ecosystem, cit., p. 34-35.

³²⁹ Ibidem. See, also, e.g., Miguel Helft, Facebook Deal Offers Freedom From Scrutiny (DealBook, January 3, 2011), retrieved from <http://dealbook.nytimes.com/2011/01/03/facebook-deal-offers-freedom-from-scrutiny/>; Russell Garland, Secondary Markets Showing Signs Of Finding Their Niche, The Wall Street Journal (May 12, 2010), retrieved from <http://blogs.wsj.com/venturecapital/2010/05/12/secondary-marketplaces-showing-signs-of-finding-their-niche/>; Peter Lattman, Stock Trading in Private Companies Draws S.E.C. Scrutiny (DealBook – The New York Times, December 27, 2010), available at <http://dealbook.nytimes.com/2010/12/27/stock-trading-in-private-companies-draws-scrutiny/>.

³³⁰ David Weir, Interview - The Market for pre-IPO shares, cit. <http://video.forbes.com/fvn/business/the-market-for-pre-ipo-shares> (noting that “Silicon Valley’s venture capital investors sit in a pretty precious position compare to other investors, they have access to these companies, they can pick up the phone and discussing their interested in investing and often times they are able to buy stocks either directly form the company or existing founders or venture capitals on terms that other investors outside a very small club would have not have access to. So what we are trying to at SharesPost is to provide access to a much broader universe of investors on a fully disclosed basis”). See, also, John C. Coffee, Jr. and Hillary A. Sale, Securities Regulation – Cases and Materials, cit., pp. 217-218.

4.5 INSIDER TRADING

Insider trading is an additional concern that may arise when secondary trading of private company shares occurs with no control or involvement by the private companies in which shares are being traded. The potential for insider trading practices has gathered significant media attention when Facebook fired a corporate development manager that traded Facebook shares on a secondary market violating the company's insider trading policy.³³¹ Since then, the increased opportunities for insiders to trade their shares may have further intensified this concern.³³² Private companies are generally not required to publicly disclose information on a regular basis and on the scale required for public companies, and their employees, executives, and investors may often acquire or have access to information regarding the company and its activities, which qualifies as material non-public information for purposes of insider trading liability.

4.6 CONFLICTS OF INTEREST AND SELF-DEALING

Recent SEC's investigations have highlighted the negative impact of self-dealing practices on secondary trading of private company shares occurring outside of the control of the private companies in which shares are being traded.³³³ In particular, regulatory investigations have unveiled a scenario of uncontrolled secondary trading where pricing of securities was influenced by conflicted market participants who bought or sold for their own account or facilitated transactions for other buyers and sellers.³³⁴

4.7 PRE-IPO SPECULATION AND FRAUD

As previously discussed, during most recent years the industry sector for high-profile tech and social-media private companies has turned "hot" causing investor appetite for shares in such companies to surge. In response, a secondary market for pre-IPO securities of private companies has rapidly grown.³³⁵ However, the rapid escalation of uncontrolled secondary trading activities has made this market fertile territory for fraud and speculation.³³⁶

³³¹ See, Brad Stone, Silicon Valley Cashes Out Selling Private Shares, *cit.*; Michael Arrington, "Facebook Terminated Corporate Development Employee Over Insider Trading Scandal," TechCrunch, March 31, 2011, retrieved from <http://techcrunch.com/2011/03/31/facebook-terminated-corporate-development-employee-over-insider-trading-scandal/>; Stephen F. Diamond, The Facebook Effect: Secondary Markets and Insider Trading in Today's Startup Environment (Santa Clara University, Legal Studies Research Paper No. 2025494 (March 17, 2012)), available at SSRN: <https://ssrn.com/abstract=2025494> or <http://dx.doi.org/10.2139/ssrn.2025494>.

³³² See, e.g., Facebook, Inc., Form S-1 Registration Statement under the Securities Act of 1933 (filed with the SEC on February 1, 2012), p. 93, retrieved from <http://sec.gov/Archives/edgar/data/1326801/000119312512034517/d287954ds1.htm> (stating that "[t]he Enforcement Division of the Securities and Exchange Commission has been conducting an inquiry into secondary transactions involving the sale of private company securities as well as the number of our stockholders of record. In connection with this inquiry, we have received both formal and informal requests for information from the staff of the SEC and we have been fully cooperating with the staff. We have provided all information requested and there are no requests for documents or information that remain outstanding. We believe that we have been in compliance with the provisions of the federal securities laws relating to these matters").

³³³ See, Alison Frankel, SEC ventures into the murk in secondary market cases (Thomson Reuters, March 15, 2012), available at <http://newsandinsight.thomsonreuters.com/Legal/News/ViewNews.aspx?id=42239>.

³³⁴ *Ibidem*. See also SEC Press Release 2012-43, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares (Washington, D.C., March 14, 2012), retrieved from <http://www.sec.gov/news/press/2012/2012-43.html>.

³³⁵ See, Kerry A. Dolan, Frenzy For Facebook Shares Heats Up With A New Auction, *cit.*

³³⁶ See, FINRA, Pre-IPO Offerings — These Scammers Are Not Your Friends, (FINRA, Investors' Alerts, March 15, 2011) available at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P123316>; SEC, Investor Alert: Pre-IPO Investment Scams (SEC Investors' Alerts, April 24, 2012) available at http://www.sec.gov/investor/alerts/pre_ipo_scams.htm. See also, Tom Taulli, Dealing with Secondary Markets for Your Company's Stock (Forbes, July 26, 2011) available at

In addition, a growing number of special purpose vehicles investment funds has become to pool investors' money and purchase shares in pre-IPO companies.³³⁷ At the beginning were Wall Street institutions that rushed to purchase shares of the most desirable private companies,³³⁸ but soon thereafter the number of investment vehicles has rapidly increased.³³⁹ The SEC begun inquiry into the use of these pre-IPO pooled investment funds few years ago, conducted various investigation activities and eventually brought charges against certain fund managers, alleging that they mislead and overcharge investors in funds formed to buy shares of high-profile technology companies.³⁴⁰ SEC's investigations also unveiled the existence of various fraudulent schemes and highlighted a real concern for a murky market fraught with fraud, lack of transparency and lack of material information disclosure to investors.³⁴¹

4.8 VIOLATION OF SHARE TRANSFER RESTRICTIONS

The existence of valid and enforceable share transfer restrictions may significantly limit the secondary trading of private company shares by creating the risk of contractual liability for violation of conventional provisions and increasing uncertainty as per the validity and efficacy of the transfer. Sellers must carefully review the documents they signed or instruments by which they are bound (e.g., a company's bylaws or certificate of incorporation, or a company's insider trading policies if the selling stockholder is an employee) to determine if there are restrictions to transfer unique to the company.

To control secondary trading of private company shares, certain private companies are also increasing the use of their rights of first refusal (ROFR), which allow them to buy their stocks or steer the shares toward more desirable investors.³⁴² The ROFR is often contained in the company's bylaws, in which case it automatically applies to all shares issued after the bylaws are adopted. Alternatively, or in addition to this, a ROFR can be included in the company's option award agreements or other contracts.³⁴³ In some

<http://www.forbes.com/sites/tomtaulli/2011/07/26/dealing-with-secondary-markets-for-your-companys-stock/>; Joseph Menn, Insight: Pre-IPO stock trading boom could be scary for investors, cit..

³³⁷ See, SEC v. Mazzola, Et. Al., CV-12-1258 EDL (U.S. District Court for the Northern District of California, filed March 14, 2012) (Complaint), retrieved from <http://www.sec.gov/litigation/complaints/2012/comp-pr2012-43.pdf>; SEC, Litigation Release No. 22292 / March 14, 2012, Securities and Exchange Commission v. Frank Mazzola et al., CV-12-1258 EDL (U.S. District Court for the Northern District of California, filed March 14, 2012), available at <http://www.sec.gov/litigation/litreleases/2012/lr22292.htm>.

³³⁸ Among others, in January 2011, in one of the highest-profile deals, Goldman Sachs created a special purpose investment vehicle to through allow its high-net-worth clients to invest \$1.5 billion into Facebook, valuing the social network at an astounding \$50 billion. See, Susanne Craig and Andrew Ross Sorkin, Goldman Offering Clients a Chance to Invest in Facebook (New York Times, January 2, 2011), available at <http://dealbook.nytimes.com/2011/01/02/goldman-invests-in-facebook-at-50-billion-valuation/>.

³³⁹ See, Brad Stone, Silicon Valley Cashes Out Selling Private Shares, cit.

³⁴⁰ In late December 2010, shortly after the Securities and Exchange Commission settled a civil action, federal prosecutors brought criminal charges against a self-employed securities trader who allegedly bilked more than 50 U.S. and foreign investors out of more than \$9.6 million in a series of pre-IPO scams spanning an eight-year period. In this criminal case, the defendant falsely claimed that he had worked at Goldman Sachs, was a preferred client of the firm and had access to discounted, pre-IPO shares of such well-known companies as AOL, Google, Facebook and Rosetta Stone. See, Litigation Release No. 21654, SEC v. Randy M. Cho, Civil Action No. 09-CV-6261 (USDC) (N.D.Ill.), District Court Enters Judgment Order Setting Disgorgement, Prejudgment Interest and a Civil Penalty Against Randy M. Cho, available at <http://www.sec.gov/litigation/litreleases/2010/lr21654.htm>.

³⁴¹ See, SEC, Letter from Mary Schapiro, SEC Chairman, to the Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit., pp. 21-22.

³⁴² See, Constance E. Bagley, Craig E. Dauchy, The Entrepreneur's Guide to Business Law, cit., pp. 458-459.

³⁴³ A ROFR requires stockholders to offer their shares to the company to purchase before they can sell those shares to a third party. Because of this, once a shareholder has negotiated a deal with a prospective buyer, the shareholder must deliver a notice to the company regarding the proposed sale. The parameters of the notice and related procedural requirements are set forth in the stock issuance agreement and/or the bylaws and usually require that the notice include certain minimum information such as the number of shares, price per share, identity of the buyer, and other material terms of the proposed transaction. Upon receipt of the notice, the company generally has a period of time (often 30 days) to decide whether to exercise its ROFR or assign it to another party. If the company does not exercise or assign its ROFR, then the seller may proceed with selling the shares to the proposed buyer on the terms set forth in the notice. Typically, if the proposed sale is not completed within a specified period of time (often 30 days

instances, particularly where the shares to be transferred consist of preferred stock, investors in the company may also have ROFRs and co-sale rights entitling them to sell shares pro-rata along with the seller.³⁴⁴

If it exercises its ROFR, the company will pay the purchase price set forth in the ROFR notice delivered by the selling shareholder to the company and repurchase the shares, using a stock transfer agreement that contains the mechanics of the repurchase. The stock transfer agreement will generally include basic representations and warranties from the seller regarding title, enforceability, due authorization, non-contravention and securities law compliance among others. Typically, the company will not deliver any representations to the seller, but should consider whether any material information asymmetries exist that could create potential liability for the company – for example, if the company knew of material transaction which could significantly impact the price of the company’s share or that an exit of the company at a price higher than the repurchase price was imminent. Best practices suggest that a company should at minimum provide disclosures similar to those required under Rule 701³⁴⁵ for employees and contractors who receive company securities as part of a written compensation plan pursuant to Rule 701. These would include audited financial statements for the last two fiscal years, as well as any additional period needed to bring such financial statements within 180 days of the date of delivery. In addition, if the company knows that the shares are more valuable than the purchase price at the time of transaction, there is risk that the company may be found liable for trading based on material nonpublic information that is not shared with the stockholder counterparty. In that case, the company should either not purchase the shares or disclose the material information to the seller (under a non-disclosure agreement) before completing the sale.

A ROFR is a useful for controlling ownership of stock only to the extent that the company or its assignee is willing and able to spend the necessary funds to purchase the shares. Otherwise, the shares can be sold to the proposed buyer. As secondary transactions have increased in popularity and frequency, and valuations have grown, it has become more and more common for certificates of incorporation, bylaws and/or equity incentive plan and agreements to have a separate requirements and additional restrictions on transfer. For example, numerous private companies now impose blanket restrictions on all share transfers with limited exceptions that may include board approval for proposed transfers of shares, estate planning transactions or family transfers.³⁴⁶ The increasing use of share transfer restrictions reflects the concern by private companies of losing control over the identity of their shareholders and the allocation

from the company’s declining to exercise its ROFR or 60 days from the company’s receipt of the original notice), then the ROFR is once again revived and the shareholder would have to deliver a new notice to proceed with the same or different stock sale. Note that, if there is a serious risk for a buyer that the company (or another shareholder in the company) may want to exercise its ROFR, then the buyer may be less likely to make an offer and might ask for a breakup fee.

³⁴⁴ Share subject to co-sale rights create a risk to the seller that it may only be able to sell a portion of the amount that the buyer is willing to purchase.

³⁴⁵ See, 17 C.F.R. § 230.701.

³⁴⁶ Governing documents of private companies (e.g., corporate charter and bylaws) often contain provisions restricting the transfer of the company’s shares. In addition, shares transfer restrictions may be contained in shareholders’ agreements, for instance when the shareholders of a private company want to protect their status and strictly monitor the inclusion of new shareholders. A typical formulation of blanket restrictions would: (a) prohibit the sale, disposition, pledge, encumbrance, or other transfer of any shares of the company’s capital stock; (b) apply to the transfer of legal title, beneficial ownership, voting rights, and/or economic benefits; and (c) extend further to prohibit the use of derivative or synthetic transactions where the underlying asset is the company’s shares or interest to/rights in the shares. See, Cooley, *Secondary Sales of Private Company Stock*, cit.; DLA Piper, *Secondary Sales*, DLA Piper Publications (2017), available at <https://www.dlapiperaccelerate.com/knowledge/2017/secondary-sales.html>; Fenwick & West, *Pre-IPO Liquidity for Late Stage Start-Ups*, cit., pp. 2-3.

of their securities (which, in turn, may create the risk of adding a rival company or a competitor to the group of company's shareholders),³⁴⁷ as well as their concern of exceeding relevant "shareholder thresholds" such as the threshold set under Section 12(g) of the Exchange Act for U.S. private companies.

A number of U.S. based private companies have also been seen offering their founders Series FF shares, which have preference over the common but are subordinate to any other preferred shares. The purpose of the Series FF is to give founders the opportunity to obtain liquidity in connection with a venture financing and to sell part of their shares, with limited impact on the company's common stock valuation and without the need to wait for a traditional exit. Series FF is basically identical to common stock except that it converts at the option of the holder into the same series of preferred stock issued in a subsequent round of equity financing if the holder of the Series FF pays the same price as the shares of preferred stock sold in connection with such subsequent equity financing and the board approves the conversion. The Series FF converts into common stock at any time at the election of the Series FF holder, or at any time upon the consent of holders of the majority of Series FF, or automatically upon a qualified IPO.³⁴⁸

Moreover, to refrain secondary trading in private company shares, start-ups and growing private companies have begun granting restricted stock units (RSUs) to their employees, directors and consultants as a preferred form of equity incentive compensation, which are subject to a released schedule and they typically strictly limit the ability of an holder to transfer the shares.³⁴⁹

To deter secondary trading of their securities, certain private companies also charge high fees for each sale of their shares by current holders.

Finally, sometimes companies may decide not to exercise their ROFR and they may just stay silent and not cooperate. Doing a secondary transaction without any involvement by the company can be difficult and may add significant complexity to the process.

4.9 ALTERING THE TRADITIONAL RISK-REWARD RELATIONSHIP

As previously discussed, companies tend to stay private much longer and their valuations grow while they expand their business activities and raise additional private capital. These developments affect the use of equity-based compensation by creating a potential misalignment between the interests of founders and employees in search for liquidity, and the interest of the companies focused on growing their business activities. The rapid development of secondary trading of private company shares conducted with little

³⁴⁷ A private secondary offering, especially if it is conducted without oversight by the interested company, has the potential to attract undesirable investors into the company's shareholder base. New investors who purchase private shares from existing shareholders may not always have the company's best interests in mind and may, in some instances, be direct competitors. See, Tom Taulli, *Dealing with Secondary Markets for Your Company's Stock*, cit.

³⁴⁸ See, e.g., Matt Marshall, *The "FF class" of stock, for founders who want cash early*, Venturebeat.com (December 15, 2006), available at <http://venturebeat.com/2006/12/15/the-ff-class-of-stock-for-founders-who-want-cash-early/>; Michael Arrington, *Founders Fund Closes \$220 Million Second Fund*, Techcrunch.com (December 17, 2007), available at <http://techcrunch.com/2007/12/17/founders-fund-closes-220-million-second-fund/>; Michael F. Martin, *Series FF stock and the Friedman-Savage Model for Risk Profiles*, Weblog (August 7, 2007), available at http://brokensymmetry.typepad.com/broken_symmetry/2007/08/series-ff-stock.html.

³⁴⁹ On February 13, 2012, the SEC issued a global no-action letter that grants relief from registration requirement under the Securities and Exchange Act 1934 when a company reaches the 500-holder-of-record limit due to the issuance of RSUs. The SEC's position is limited to RSUs that meet the conditions specified in the no-action letter and does not apply to a company generally, nor does the Staff's position cover other securities that the company may issue. The Staff had previously provided no-action relief on the topic to individual companies, including Facebook, Zynga and Twitter. See, e.g., SEC, *Response of the Office of Chief Counsel Division of Corporation Finance, Re: Facebook, Inc. Incoming letter dated October 13, 2008* (October 14, 2008), retrieved from <http://sec.gov/divisions/corpfin/cf-noaction/2012/fenwickwest021312-12g.htm>.

or no involvement by the private companies in which shares are being traded may further exacerbate the tension between the parties by offering employees and founders viable means for cashing out their holdings.³⁵⁰

Against this scenario, private companies have responded by adopting severe transfer restrictive measures as noted in the previous paragraph, or in other cases by organizing sponsored liquidity events that they could tightly control. However, even in the latter case, private companies have appeared quite cautious about allowing existing employees to sell their shares and have generally limit sales only to a selected percentage of the employees' vested shares.³⁵¹

Furthermore, companies generally tend to limit secondary transactions to "mature" shares (i.e., vested shares held for more than six months). The repurchases of "mature" shares would not create risk of "tainting" other equity-classified share-based awards because the award is considered equity-settled as the holder held the risks and rewards of share ownership for a reasonable period of time before the repurchase. Contrary, private companies that establish a pattern of repurchasing unvested employee stock options, restricted stock or 'immature shares' (i.e., shares held for a period of less than six months after vesting and, if applicable, exercise) would be at risk of causing their entire employee share-based payment plan to be liability-classified. Moreover, as the frequency of repurchase transactions increases, so too can the founders' and employees' expectation that their interests will be cash settled by the company or an economic interest holder on an ongoing basis. As a result, outstanding share-based payment awards could become in-substance liabilities, and the company could be required to re-measure such awards at fair value on each reporting date until the award is settled, thereby introducing income volatility (and potentially more compensation expense).³⁵²

Even when limited to a percentage of the aggregate shareholding and only to "mature" shares, allowing the sale of vested equity awards has the potential to distort employee incentives. This is because in structuring their compensation programs, companies decide on the correct mix of cash and equity to attract, retain, and motivate employees to pursue company objectives. An employee who is allowed to sell vested equity awards is effectively being allowed to convert variable, performance-based pay to a fixed amount of cash, thus reducing (and potentially distorting) the future incentive value of the compensation program.³⁵³

4.10 COSTLY BUYBACKS AND INCREASED RIVALRY BETWEEN EXISTING SHAREHOLDERS

³⁵⁰ See, Brad Stone, Silicon Valley Cashes Out Selling Private Shares, cit. (quoting Gordon Davidson, chairman of Silicon Valley law firm Fenwick & West arguing that " it is just not orderly, (...) the secondary market has created a natural tension between employee who have worked hard in a startup for many years and want to balance their portfolios and the philosophy of companies that you really should not cash in until the job is done").

³⁵¹ See, Tom Sansone, Panel - The Secondary Market – The Value Proposition (SecondMarket - Capitalize 2012 Conference, New York, February 15, 2012), video available at <https://www.secondmarket.com/discover/event-replay-capitalize-east>; Annemarie Tierney, Panel - Secondary Transaction Mechanics and Primer (SecondMarket - Capitalize 2012 Conference, New York, February 15, 2012), video available at: <https://www.secondmarket.com/discover/event-replay-capitalize-east>.

³⁵² See, PwC, Private Company Liquidity: CEO and CFO Considerations A Guide to Secondary Transactions, cit., p. 19.

³⁵³ See, David F. Larcker, Brian Tayan, Edward Watts, Cashing It In, Private-Company Exchanges and Employee Stock Sales Prior to IPO (Stanford University Closer Look Series, September 12, 2018), pp. 2-4, available at <https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-73-private-company-exchanges.pdf>.

To control unwanted secondary trading of their stocks, private companies may be forced to buy back their shares. Although in certain circumstances a company buyback can be a viable solution, in most cases private companies do not have enough available cash resources to buyback their shares. As a result, private companies often decide to steer the shares to their current investors. In certain cases where companies have made this decision, the result has been the opening of a fiercely competitive acquisition process by existing shareholders who started undercut each other for deals and privately complained about each other's tactics.³⁵⁴

4.11 SOURCE OF DISTRACTION

Private companies may underestimate the complexities of secondary transactions. The result is often a costly, time-consuming and disorganized process, which may extend over a prolonged period of time.

A secondary offering not properly managed can be a major source of distraction to all levels of the organization with tangible impact on employee productivity. Management can easily be distracted from important operational matters; recently hired employees may complain about eligibility requirements which exclude them from participating in the offering with their shares; and early employees or executive officers may have time-consuming and complex questions about the tax consequences of participating in the offering. In addition, while companies often accommodate requests for support from key investors and service providers, such accommodations can set expectations among other stockholders regarding the level of support they can anticipate receiving should they propose a transaction. Even the most carefully considered offering is likely to leave some current or former employees frustrated due to the various legal and technical issues that are likely to arise before, during and after the offering.

If a private company allows secondary transactions, it may still want to impose blackout periods on the sales of employee shares during certain periods of time, such as fundraising, advance negotiation or execution of material transactions. Depending upon the maturity of the company, it may also be prudent for the company to black out trading around quarter or year end to prevent incentives from becoming misaligned between the company and its employees.³⁵⁵

4.12 DISCLOSURE CONSIDERATIONS FOR PRE-IPO COMPANIES

The issue of "cheap stocks" has long been an area of focus for financial regulators, which continues to request analyses reconciling the estimated fair value of the company's common stock as of each grant date leading up to an IPO with the estimated IPO price when reviewing IPO filings. As part of such disclosures, companies in which shares trade in secondary market transactions should be prepared to discuss how such secondary transactions were factored into their fair value measurements and the weighting ascribed to them. A company's failure to appropriately consider such indications of value in its fair value measurements could create the risk of challenges to its accounting conclusions and/or restatement, with the effect of delaying the company's IPO.³⁵⁶

³⁵⁴ A remarkable example of competitive fight between current investors of private company was the one involving one of the Internet's most promising company Twitter, see Brad Stone, *Silicon Valley Cashes Out Selling Private Shares*, cit.

³⁵⁵ See, PwC, *Private Company Liquidity: CEO and CFO Considerations A Guide to Secondary Transactions*, cit., p. 25.

³⁵⁶ See, PwC, *Private Company Liquidity: CEO and CFO Considerations A Guide to Secondary Transactions*, cit., p. 20.

In addition, if directors, officers and/or 5% shareholders participate in a secondary sale, the company may have to disclose the transactions in its IPO registration statement as related party transactions. Dependent upon materiality, a third-party purchase not involving the company will also need to be disclosed. When a secondary market transaction occurs during the registration period, underwriters will typically require that the buyers agree to certain restrictions on shares and the company will have to file an amendment disclosing relevant information about the secondary transactions.³⁵⁷

4.13 VALUATION PROBLEMS

Establishing a value for common shares is the cornerstone of any employee secondary sales or liquidity programs. Valuations for common stock sold in secondary transactions vary with the specifics of the company and transaction structure, but typically reflect a 20-30% discount from the price per share of the preferred shares in the latest funding round. Factors contributing to discounts may include minority interests, the illiquidity of the securities, the security terms and priority, as well as the liquidation preferences relative to the company other outstanding securities.³⁵⁸ However, if the company is fast growing and well performing or there is significant appetite on the buyer side, secondary investors may be willing to pay the same amount for common and preferred.

When secondary trading of private company shares occurs out of control of the private companies in which shares are being traded, investors may incur significant valuation problems.³⁵⁹ First, estimating the value of private company shares is inherently challenging, because private companies: (i) do not disclose information regularly or on the scale that public companies do and this limited disclosure generates information asymmetry; (ii) generally have smaller and more variable cash flows than mature, public companies; (iii) typically have a smaller asset base and larger percentage of intangible assets than do mature entities; and (iv) are inherently risky and require a long-term investment approach. Second, new ways for trading of private company shares have amplified and diversified the universe of prospective investors in private company shares and this, in turn, may have created additional valuation problems because new investors may lack technical skills and industry expertise of venture capitalists and more traditional early-stage and growing company investors. Finally, the lack of transparency and disclosure affecting uncontrolled secondary trading previously discussed may further exacerbate valuation problems by adding uncertainty regarding the value of the traded securities³⁶⁰ and the pricing

³⁵⁷ See, Cooley, *Secondary Sales of Private Company Stock*, cit.

³⁵⁸ Pricing depends on a number of factors, including the class of stock being sold, the stage of the company, and the company's financing. Generally, the discount declines as the valuation increases. In fact, as a company matures and proceeds towards an IPO, the common stock becomes more and more valuable, approaching the valuation of the preferred stock. Once the company goes public, preferred stock and common stock tend to have equal value. See, e.g., Carta, *SF CFO Summit: expert advice on secondaries*, Carta (June 20, 2017), available at <https://carta.com/blog/sf-cfo-summit-expert-advice-on-secondaries/>; Carta, *NYC CFO Summit: Secondary Markets Panel*, Carta (July 11, 2017), available at <https://carta.com/blog/sf-cfo-summit-expert-advice-on-secondaries/>; Founders Circle, *A Guide to Employee Liquidity Programs: Why and How Companies Align the Interests of All Parties*, cit.

³⁵⁹ See, Tom Taulli, *Dealing with Secondary Markets for Your Company's Stock*, cit.

³⁶⁰ See, SEC, *Letter from Mary Schapiro, SEC Chairman, to the Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform*, cit.

mechanism adopted,³⁶¹ and by causing significant discrepancies in pricing and extraordinary fluctuations in the value of the traded shares.³⁶²

Valuation problems connected with uncontrolled secondary trading of private company shares may also negatively impact the private companies in which shares are being traded. For instance, the cost of capital may increase³⁶³ and/or severe disputes may arise between a private company and its existing shareholders and employees when the company does a private placement at a lower price than expected.

Moreover, in certain circumstances, valuation problems and uncertainty regarding price variables and pricing mechanics surrounding uncontrolled secondary trading in private company shares may extend to negatively impact the IPO pricing³⁶⁴ and eventually the success of the IPO process itself.³⁶⁵ The share price in the private secondary offering may be used to set a practical base valuation for the company at its subsequent IPO. However, because it tends to be based on less fulsome disclosures, the price and derived valuation of a company based on the price obtained from a private secondary offering is somewhat speculative and may not adequately represent the true value of the company. If the implied company valuation during the private secondary offering is too high, it may be difficult to set a similar or higher price for the IPO.

Finally, secondary trading of private company shares itself may be severely impacted by valuation problems because of the absence of appropriate and fair pricing which makes it extremely difficult to develop and maintain depth and liquidity in the trading.³⁶⁶

4.14 EFFECT ON EQUITY-BASED COMPENSATION

A possible detriment to private secondary offerings is the impact that such offerings may have on the fair market value of the company shares.

For example, in the UK under a company share option plan (CSOP), a private company can grant tax favorable options to employees at an exercise price which cannot be lower than the market value of the

³⁶¹ See, Dan Burstein and Sam Schwerin, Inside the Growing Secondary Market for Venture Capital Assets, cit., p. 8.

³⁶² See, Jeremy Drean, The Secondary Private Markets – New Players in the Venture Capital Ecosystem, cit., p. 37 (noting that “shares of Facebook traded on SharesPost at \$27.6, \$40.0, \$51.0, \$60.0 and \$35.0, all on the same day”); Evelyn M. Rusli, As S.E.C. Watches, Secondary Market Seeks Transparency, cit.

³⁶³ See, Tom Taulli, Dealing with Secondary Markets for Your Company’s Stock, cit. (pointing out how this problem may be particularly relevant “for early-stage companies for which it is important to have low values on employee stock options, traditionally used as a great tool to motivate employees. However, this gets tougher if there is a valuation premium on the common stock”).

³⁶⁴ To understand the relevance of this problem, it may be useful to look at Form S-1 filed by LinkedIn with the SEC on January 27, 2011. See, Retrieved from <http://www.sec.gov/Archives/edgar/data/1271024/000119312511016022/0001193125-11-016022-index.htm> (reporting that “[w]hile, prior to this offering, our shares have not been listed on any stock exchange or other public trading market, there has been some trading of our securities, for instance, in private trades or trades on alternative online markets, such as SecondMarket and SharesPost, that exist for privately traded securities. These markets are speculative, and the trading price of our securities on these markets is privately negotiated. The future value of our Class A common stock will depend to a large degree on our business and financial performance, and we cannot assure you that the price of our Class A common stock will equal or exceed the price at which our securities have traded on these private secondary markets.”)

³⁶⁵ See, e.g., Brad Stone, Silicon Valley Cashes Out Selling Private Shares, cit.; ArabianBusiness.com, Abu Dhabi firm sues Zynga for right over \$12.87m shares deal (Bloomberg, March 1, 2011) available at <http://www.arabianbusiness.com/abu-dhabi-firm-sues-zynga-for-right-over-12-87m-shares-deal-383946.html>; Alpha Investment LLC vs. Zynga Inc. and Andrew Trader, Civil Action 11-04764, U.S. District Court for the Central District of California, filed June 3, 2011), (Complaint), available at <http://docs.justia.com/cases/federal/district-courts/california/cacdce/2:2011cv04764/503837/1/0.pdf?1307480290>; Alexei Oreskovic, Facebook halts secondary market trading, plans for May IPO, cit.; Sarah McBride, Facebook stops private shares trading ahead of May IPO (Reuters, March 29, 2012), available at <http://bottomline.msnbc.msn.com/news/2012/03/28/10908416-facebook-stops-private-shares-trading-ahead-of-may-ipo>.

³⁶⁶ See, Dan Burstein and Sam Schwerin, Inside the Growing Secondary Market for Venture Capital Assets, cit.

underlying shares on the grant date. If a private secondary offering is then conducted shortly after the issuance of CSOP options and the price per share in the secondary offering is substantially higher than the exercise price of the CSOP options, then the valuation of the CSOP options might be challenged and they might risk their beneficial tax treatment.

Similarly, under U.S. Section 409A of the Internal Revenue Code, stock options with an exercise price that is less than the fair market value of the underlying stock could result in significant adverse tax consequences to the option holder. Thus, for instance, if a private secondary offering is conducted shortly after the issuance of stock options and the price per share in the secondary offering is substantially higher than the exercise price of the options, then the Internal Revenue Service (IRS) may be inclined to use the private secondary offering as evidence of the fair market value of the stock as of the grant date.

Related to the above, as part of its regular process of generating valuation reports, a private company's appraiser will usually review the details of secondary sales, and factor those into its overall analysis of the fair market value of the company's common stock.³⁶⁷ This is due to the fact that arm's length transactions are generally viewed as the best indicator of fair market value. However, the specific facts and circumstances of any secondary sale will determine its precise impact on subsequent Section 409A valuations, and the corresponding impact on the exercise price of future stock options granted and/or the valuation of share-based payments to employees.

For example, a small number of arm's length sales involving a small percentage of the company's outstanding shares would generally be unlikely to have a significant impact on the fair market value, particularly if the sales are to unaffiliated purchasers. Contrary, a steady flow of sales with significant deal volume may be more indicative of sophistication, access to company data and material due diligence by a buyer and may indicate there is a free-flowing market for shares that can more strongly influence the fair market value. Similarly, a high number of trades by multiple independent third parties would likely provide greater support for fair value. If the company is highly involved in the secondary transaction, provides information, runs the process and/or sponsors the program, then the secondary sales are also likely to have a more significant impact on the fair market value. Lastly, if the company (or potentially an affiliate of the company) purchases shares from employees and takes the position that any premium paid to the Section 409A price is not compensatory, then an appraiser is likely to weight the purchase price more heavily in its analysis regarding the company's fair market value.³⁶⁸

4.15 TAXATION

There are significant tax issues that accompany secondary sales, and it is imperative that all parties involved in the transaction understand the tax effects that may result.

³⁶⁷ See, PwC, *Private Company Liquidity: CEO and CFO Considerations A Guide to Secondary Transactions*, cit., pp. 10-14 (noting 'Private company valuations are performed using the guidance of ASC 820, Fair Value Measurements and Disclosures, and the AICPA Practice Aid on Valuation of Privately Held Company Securities Issued as Compensation [...] ASC 820 established a fair value hierarchy of Level 1, Level 2 and Level 3 inputs, with objectively verifiable information carrying more weight for accounting purposes. Secondary market transactions are generally considered Level 1 or 2 inputs. Valuation techniques should maximize the use of relevant observable inputs (Level 1 and 2) and minimize use of unobservable inputs (Level 3), which would typically include discounted cash flows and relevant multiples.').

³⁶⁸ Id., pp. 13-14. See, Founders Circle, *A Guide to Employee Liquidity Programs: Why and How Companies Align the Interests of All Parties*, cit.

For example, under UK tax laws, once structured liquidity trading arrangements are in place for employees, their shares would likely be treated as readily convertible assets (RCAs). Since the underlying shares are RCAs, unapproved options and CSOP options (generally) exercised before the third anniversary of grant would be subject to employee and employer's national insurance contributions (NIC) on top of income tax. In addition to the increased charges, participants would be subject to an acceleration of income tax liability, which would be payable through pay-as-you-earn (PAYE) rather than through self-assessment.

Under U.S. tax laws, a key tax question is how a seller should treat the gains from a secondary sale of shares. The spread between the original purchase price paid by the seller and the fair market value of the shares at the time of sale is almost certain to be treated as capital gain. However, in many instances, the purchase price paid by the buyer in the secondary transaction is higher than the then-current fair market value as determined by the company's board of directors for Section 409A purposes (i.e., the minimum price used as the exercise price for contemporaneous stock option grants). If such a spread exists, the seller and the company must determine the character of the spread (either capital gain or ordinary income) in order to apply the appropriate tax treatment. This means that setting the purchase price in a secondary transaction above what the company's board of directors otherwise considers "fair market value" of the common stock creates the risk that current or former employees or service providers selling shares may receive a bifurcated tax treatment - capital gains up to the 409A price and ordinary income for proceeds above that price.³⁶⁹ If the spread is ordinary income, then the seller will be subject to a higher tax rate and employment-related taxes, and the company will be subject to withholding obligations and employer contributions.

The risk outlined above is particularly acute if the company is the purchaser,³⁷⁰ but can apply even if the purchaser is a third party (e.g., an affiliate of the company) depending on the specific circumstances of the case.³⁷¹

³⁶⁹ See, PwC, *Private Company Liquidity: CEO and CFO Considerations A Guide to Secondary Transactions*, cit., pp. 16-18, 20-23.

³⁷⁰ The spread between the then-current fair market value and the purchase price is almost certainly going to be characterized as compensation if the seller is an employee and the company is the purchaser. As a result, seller will have to pay taxes on the spread at the ordinary income rate, as well as applicable employment taxes. The company must withhold at the minimum withholding rate and pay the employer-side taxes as well.

³⁷¹ See, PwC, *Private Company Liquidity: CEO and CFO Considerations A Guide to Secondary Transactions*, cit., pp. 16-18 (noting '[i]t is [...] important to understand the relationship between the company and the buyer in the secondary market transaction. If the buyer holds a pre-existing economic interest in the company, then the buyer is presumed to be acting on behalf of the company with regard to amounts paid to employees. As a result, a purchase by an economic interest holder could be viewed similarly to a direct purchase by the company. If the transaction price exceeds fair value, then the excess amount is considered compensation for employee services, unless the payment is clearly for another purpose, and the company will recognize the compensation expense that was incurred on its behalf. This is the case even if the company is not responsible for directly funding that cost.').

CHAPTER 5

WHAT'S NEXT?

In the long run, the growth of a deep and liquid secondary trading of private company shares will be largely dependent on increased efficiency and transparency of trading, as well as a more active and strong cooperation among market participants, financial authorities and regulators.³⁷²

The following paragraphs highlight certain proposals for improvement and further development in the secondary trading of private company shares.

5.1. FINANCIAL AUTHORITIES

Financial authorities have been closely watching the conduct of private companies and emerging platforms that trade in private company shares. This is particularly true in the United States where secondary activities have been growing for over a decade driven by well-established liquidity funds and more recently by emerging secondary trading platforms.³⁷³ During the past few years, U.S. financial regulators have initiated administrative proceedings³⁷⁴, brought enforcement actions,³⁷⁵ and issued investors' alerts and guidelines.³⁷⁶ Three major issues seem to have attracted their attention: lack of information disclosure and illiquidity, the existence of conflicts of interest and self-dealing, and the need for regulatory reforms.

³⁷² See, e.g., Dan Primack, Post-Facebook: What do private secondary traders want? (CNN Money, April 3, 2012), available at <http://finance.fortune.cnn.com/2012/04/03/post-facebook-what-do-private-secondary-traders-want/>; Tomio Geron, As SecondMarket Passes \$1 Billion In Deals, Who's Next After Facebook?; Steven Russolillo, What's Next For Private Stock Markets After Big Web IPOs? (WSJ Blogs, October 27, 2011), available at <http://blogs.wsj.com/venturecapital/2011/10/27/whats-next-for-private-stock-markets-after-big-web-ipos>; April Dembosky, Facebook to be keenly missed by private markets (Financial Times, February 6, 2012), available at <http://www.ft.com/cms/s/0/493319b6-50ee-11e1-8cdb-00144feabdc0.html#axzz1o6xUPGj5>.

³⁷³ See, e.g., SEC, Letter from Mary Schapiro, SEC Chairman, to the Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit., p. 19; SEC, Press Release 2012-43, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares, cit. (quoting Marc Fagel, Director of the SEC's San Francisco Regional Office, and Robert Kaplan, Co-Chief of the SEC Enforcement Division's Asset Management Unit); Alison Frankel, SEC ventures into the murk in secondary market cases, cit.; Robert P. Bartlett III, Interview - Bartlett Discusses SEC Scrutiny of Secondary Market (The Washington Post with Bloomberg, March 28, 2011), video available at http://www.washingtonpost.com/business/bartlett-discusses-sec-scrutiny-of-secondary-markets/2011/03/28/AFpG2rqB_video.html (discussing about the Security and Exchange Commission's scrutiny of so-called secondary markets. The SEC has begun requesting data from the markets where buying and selling of private shares have surged in recent years); Fenwick & West, Securities Enforcement Alert: SEC Increases Scrutiny of "Unicorns" and Other Private Companies and Secondary Market Trading of Pre-IPO Shares, Fenwick & West Publications (April 4, 2016), available at https://www.fenwick.com/publications/Pages/SEC-Increases-Scrutiny-of-Unicorns-and-Other-Private-Companies-and-Secondary-Market-Trading-of-Pre-IPO-Shares.aspx?WT.mc_id=SEA_040416&WT.mc_id=SEA_040416.

³⁷⁴ See, e.g., Sarah N. Lynch, SEC seeks light for murky tech company trade (Reuters, March 1, 2011), available at <http://www.reuters.com/article/2011/03/01/us-finance-summit-sec-offerings-idUSTRE7204HF20110301>; SEC, Letter from Mary Schapiro, SEC Chairman, to the Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit.; Nadia Damouni, Analysis: SEC could focus on secondary market platforms (Thomson Reuters, December 31, 2010), available at <http://www.reuters.com/article/2010/12/31/us-secondarymarket-idUSTRE6BU1T020101231>.

³⁷⁵ See, Chapter 4 above. See, e.g., In the Matter of SharesPost Inc. and Greg Brogger, Adm. Proc. File No. 3-14800 (Filed March 14, 2012), retrieved from <http://www.sec.gov/litigation/admin/2012/34-66594.pdf>; In the Matter of Laurence Albuquerk, Adm. Proc. File No. 3-14801 (Filed March 14, 2012), retrieved from <http://www.sec.gov/litigation/admin/2012/33-9302.pdf>. See, also, SEC Press Release 2015-43, SEC Halts Ponzi-Like Scheme by Purported Venture Capital Fund Manager in Buffalo (February 27, 2015), available at <https://www.sec.gov/news/pressrelease/2015-43.html>; SEC Press Release 2014-92, SEC Charges California-Based Stock Promoter With Defrauding Investors Seeking Pre-IPO Facebook and Twitter Shares (December 23, 2014), available at <https://www.sec.gov/news/pressrelease/2014-292.html>; SEC Press Release 2013-44, SEC Charges Financier with Stealing Investor Funds in Purported Offerings of Pre-IPO Facebook Shares (March 19, 2013), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513392>; SEC Press Release 2012-43, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares (March 14, 2012), available at <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171487740>; SEC Press Release 2016-57, SEC Halts Fraud by Manager of Investments in Pre-IPO Companies (March 25, 2016), available at <https://www.sec.gov/news/pressrelease/2016-57.html>.

³⁷⁶ See, FINRA, Pre-IPO Offerings—These Scammers Are Not Your Friends, (FINRA, Investors' Alerts, March 15, 2011) available at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P123316>.

5.1.1. ADDRESSING INFORMATION DISCLOSURE FAILURE AND ILLIQUIDITY

The SEC's core mission is to protect investors, including employees of private companies or other shareholders who hold private company shares. Ensuring transparency and timely disclosure of all material information is of primary importance in order to protect investors and maintain the integrity and efficiency of the capital markets.³⁷⁷ The SEC may contribute in increasing transparency of secondary trading by analyzing the causes of the information asymmetry and lack of information disclosure, and then deploying regulatory instruments to properly address them. This would require the SEC to conduct a more focused analysis of the structure of secondary markets, the mechanics of secondary trading of private company shares, and the adopted pricing mechanisms. It would also command more focus by the SEC on investor education, which is necessary to ensure that participants to the secondary trading understand the risks involved in the transactions.³⁷⁸

More recently, the SEC has increased its scrutiny of a newly emerged segment of the secondary market, structured largely around derivative contracts and other novel ways to capture the economic interest in private companies without actually transacting in their shares. This segment has grown significantly over the last couple of years mostly driven by the fact that private companies have progressively restricted the transfer of their shares, leading to employees and other shareholders retaining the shares themselves but selling an economic interest in their shares or promising to deliver shares after a liquidity event. Depending on the structure of these derivative transactions, errors or misconceptions in valuation could be amplified – whether through leverage or simply contracts built on faulty valuations.³⁷⁹ In addition, depending on the structure of the deals, such transactions may be securities-based swaps which raise regulatory and compliance issues if sold to retail investors under SEC rules passed in the wake of the Dodd-Frank Act.³⁸⁰

Related to the above, secondary markets also raise liquidity concerns as per whether they have, or will have, sufficient liquidity to allow investors to trade out of their positions. Recognizing that many participants in the secondary market may be seeking exposure to late round pre-IPOs so they can profit from an eventual IPO or acquisition, the SEC has significantly increased its scrutiny of these emerging platforms to ensure they provide a functioning market that operates within the parameters disclosed to investors and that they are transparent as to what their liquidity actually is.

5.1.2. ADDRESSING CONFLICTS OF INTEREST AND SELF-DEALING

Secondary markets and fund managers should fully disclose their compensation and any material conflicts of interest in order to protect investors and avoid the occurrence of undisclosed self-dealing. As both the volume and the frequency of secondary trading in private company shares have grown, increased

³⁷⁷ Ivi, pp. 21-22.

³⁷⁸ The establishment and enforcement of appropriate eligibility standards (e.g., restricting the access to secondary trading to sophisticated investors or “accredited investors” under securities laws) are essential to improve secondary markets’ performance and at the same time ensure investor protection. See, Mary Jo White, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (SEC Keynote, March 31, 2016) available at <https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html>.

³⁷⁹ Ibidem.

³⁸⁰ In 2015 the SEC brought its first enforcement case under these rules against a Silicon-Valley start-up who was offering investors swap contracts based on the value of pre-IPO shares. See, SEC Press Release 2015-123, SEC Announces Enforcement Action for Illegal Offering of Security-Based Swaps (June 17, 2015), available at <https://www.sec.gov/news/pressrelease/2015-123.html>.

cooperation among financial authorities has become necessary to strengthen the enforcement of anti-fraud provisions, guarantee transparency of trading, and ensure compliance with registration requirements.³⁸¹

5.1.3. REGULATORY REFORMS

As previously discussed, while secondary activities are a relatively nascent trend in Europe, they have been a mainstay of the U.S. venture capital industry for more than a decade.

Although the scale and frequency of secondary activities has increased across the United States, securities laws and the regulation affecting these trades has remained largely unchanged. Certain federal securities laws and the regulation adopted thereunder as currently in force are set so far behind, and thus generally disconnected from, recent market developments that they themselves are leading to unintended consequences.³⁸² For example, private companies, investors, intermediaries, and their legal advisors have urged the SEC to exercise its rulemaking powers and provide more certainty in the secondary trading of private company shares by formalizing the so-called Section 4(a)(1½) registration exemption, and clarifying eligibility criteria and required disclosure by secondary market participants.³⁸³ Representatives from the SEC have also acknowledged this need noting that additional guidance from the SEC - for example, with respect to a private resale exemption - would help the secondary market develop further.³⁸⁴

However, calls for regulatory reforms raise a fundamental trade-off: on one hand, there is the need to avoid a too lax regulation, which would inflate market bubbles and make fraud easier; on the other hand, there is the need to reject a strict regulation that might freeze market developments and frustrate innovation and opportunities for growth. Without losing focus on its core mission of protecting investors and maintaining fair, orderly, and efficient markets, the SEC should carefully take into consideration the existence of this tradeoff while reviewing any proposals for reform.³⁸⁵

5.2. SECONDARY MARKETS FOR PRIVATE COMPANY SHARES

Secondary markets for private company shares should strength their commitment to investor protection, market integrity and efficiency. In particular, they should intensify their efforts to develop a more fair, transparent and liquid exchange of private company shares.

5.2.1 STRICT COMPLIANCE WITH SECURITIES LAWS AND REGULATIONS

As a first step, secondary markets for private company shares should ensure full compliance with applicable regulatory requirements. This would require the adoption and enforcement of more robust internal procedures and policies to guarantee that the private sales executed on the platforms fully comply with applicable laws and regulation. When drafting internal procedures and policies, secondary markets

³⁸¹ See, SEC, Press Release 2012-43, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares, cit.

³⁸² *Ibidem*.

³⁸³ See, Steven Bochner, Keynote – How the Secondary Markets are Affecting the Capital Markets, cit.

³⁸⁴ See, Daniel M. Gallagher, Opening Remarks to the 2014 Government-Business Forum on Small Business Capital Formation, (SEC Public Statement, November 20, 2014), available at <https://www.sec.gov/news/public-statement/2014-spch112014dmg>.

³⁸⁵ Cfr., SEC, Letter from Mary Schapiro, SEC Chairman, to The Honorable Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform, cit.

should strictly follow guidelines and instructions released and periodically updated by relevant financial authorities.³⁸⁶

Secondary markets should also recruit specialized legal, compliance and operational teams on which rely to ensure strict compliance with legislative and regulatory requirements, monitor legislative and regulatory developments that may affect the secondary trading and its participants, and actively collaborate with regulators. Through their legal advice and specialized guidance, the legal, compliance and operational teams would help promote a culture based on transparency and integrity.³⁸⁷

5.2.2. MINIMIZING CONFLICTS OF INTEREST

To minimize conflicts of interest, secondary market for private company shares should avoid produce or pay for research, should not buy securities for their own account on their platform, they should not make investment decisions on behalf of investors on their platform, nor offload their regulatory obligations to third party broker-dealers.³⁸⁸

5.2.3. REGISTRATION REQUIREMENTS

Secondary market for private company shares should be required to register, and to register their trading platform, with relevant financial authorities.³⁸⁹ As a consequence of the registration, secondary markets for private company shares would become subject to extensive oversight by financial authorities, which, in turn, would increase investors protection and confidence and would help attract reputable and profitable growing private companies.³⁹⁰

Moreover, registration would allow secondary markets to gain additional flexibility in the type of activities they can undertake and the type of compensation they can receive.³⁹¹

5.2.4. INVESTORS' QUALIFICATION REQUIREMENTS

Secondary markets for private company shares should establish investors' disclosure obligations and reporting requirements and properly screen participants to the trading.³⁹² For example, investors should be required to submit relevant documentation, certify information relating to their financial conditions and expertise, and make representations and warranties to ensure they have the required sophistication and can meet applicable financial requirements.³⁹³ Investors could also be required to take admission

³⁸⁶ See, e.g., Barry Silbert, SecondMarket: Why wasn't Secondmarket part of the SharesPost/secondary market SEC action today? (Quora, March 15, 2012), available at <http://www.quora.com/SecondMarket/Why-wasnt-Secondmarket-part-of-the-SharesPost-secondary-market-SEC-action-today>; Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, cit., pp. 3-4.

³⁸⁷ Ibidem.

³⁸⁸ Ibidem.

³⁸⁹ See, SEC, Press Release 2012-43, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares, cit.; In the Matter of SharesPost Inc. and Greg Brogger, Adm. Proc. File No. 3-14800 (Filed March 14, 2012), cit. (In March 2012 the SEC charged SharesPost with engaging in securities transactions without registering as a broker-dealer. Following the SEC's investigation, SharesPost acquired a company with a broker-dealer license and its membership agreement was approved by the Financial Industry Regulatory Authority (FINRA)).

³⁹⁰ See FINRA, Pre-IPO Offerings—These Scammers Are Not Your Friends, cit.; SEC, Press Release 2012-43, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares, cit.

³⁹¹ See, David Weir, Interview - The Market for pre-IPO shares (Forbes Video Network), cit.

³⁹² SEC Press Release 2011-274, SEC Adopts Net Worth Standard for Accredited Investors Under Dodd-Frank Act (Washington, D.C., December 21, 2011), available at <http://www.sec.gov/news/press/2011/2011-274.htm>

³⁹³ See, Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates, Private Resales Under Securities Act Sections 4(a)(1) and 4(1/2), cit., pp. 4-5.

tests, which could be administered either by the secondary market itself, a financial authority, or an independent third-party.³⁹⁴ Qualification requirements and reporting obligations should be strictly enforced and compliance to them should be constantly monitored.³⁹⁵

5.2.5. INSIDER TRADING

Secondary markets should take relevant steps to minimize the risk of insider trading and the risk of aiding and abetting liability in connection with the trading activities conducted on their platforms.

Contractual arrangements regulating secondary trading in private company shares should include provisions designed to mitigate the risk of a trading participants acting on the basis of material non-public information, as well as the risk of private companies in which shares are being traded to incur liability for aiding or abetting insider trading. For instance, all sellers and buyers should be required to represent to the secondary market that they do not have possession or knowledge of material non-public information about the participating company or its affiliates and that they are not selling or buying their shares on the basis of any such information.

Moreover, secondary markets should give private companies sponsoring liquidity programs on their platforms the right to analyze the list of proposed sellers and buyers and exclude anyone that is likely to have material non-public information, as well as the right to establish trading windows to reduce the likelihood that a secondary sale and purchase of securities occurs on the basis of material non-public information.³⁹⁶

5.2.6. RESEARCH, REPORTS AND PUBLICATIONS

Secondary markets for private company shares should timely collect and report data relating to the trading history of the private companies in which shares are being traded, the volume of trading and completed transactions, and the types of participants submitting indications of interest to buy or sell private company shares.³⁹⁷ Periodic release of reports and analysis would help create a more transparent and efficient secondary trading for private company securities.

5.2.7. CLOSE COORDINATION WITH PRIVATE COMPANIES

Secondary markets for private company shares can elevate their activities and improve the efficiency and transparency of their trading by working closely with private companies in which shares are being traded on their platforms.³⁹⁸ Ongoing cooperation would benefit both the secondary exchanges (by helping reducing asymmetric information and increasing transparency of trading) and private companies (by giving companies greater control over the trading of their shares.)³⁹⁹

When a company uses a secondary market to conduct a liquidity program, the relevant market should require the company to provide disclosure to eligible buyers and sellers of financial, corporate and other

³⁹⁴ See, David Weir, Interview - The Market for pre-IPO shares, cit.

³⁹⁵ Ibidem.

³⁹⁶ See, Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, cit., p. 5.

³⁹⁷ See, Evelyn M. Rusli, As S.E.C. Watches, Secondary Market Seeks Transparency, cit..

³⁹⁸ See, Barry Silbert, SecondMarket: Why wasn't Secondmarket part of the SharesPost/secondmarket SEC action today? cit..

³⁹⁹ See, Steven Bochner, Keynote – How the Secondary Markets are Affecting the Capital Markets, cit..

material information, whose completeness and accuracy should be certified in writing by an independent auditor, director, member of a board committee or an authorized representative of the company.⁴⁰⁰ The secondary market should work closely with private companies and ensure that the information provided by the companies will be accessible only to selected eligible buyers and sellers and stored in secure online data rooms administered by the exchange.⁴⁰¹

5.2.8. ADDRESSING VALUATION PROBLEMS

Secondary markets should strive to provide investors with timely price discovery and efficient pricing mechanisms. Ensuring appropriate and fair pricing is a necessary condition to increase depth and liquidity of the market and create and maintain investor confidence.⁴⁰²

5.3. PRIVATE COMPANIES

5.3.1 PRIVATE COMPANIES AND SECONDARY MARKETS

By strengthening their collaboration with secondary markets, private companies in which shares are being traded on secondary market platforms can play a very active role in improving the efficiency and transparency of the trading.

However, as previously discussed, increased involvement may also pose a concern for U.S. companies of being deemed a “broker-dealer” or “underwriter” under U.S. federal securities laws.⁴⁰³ To minimize this risk, private companies should follow certain operating guidelines including the following: first, a private company should limit its involvement to ministerial matters consistently with the SEC staff interpretations (in particular, it should not conduct transactions for the accounts of others, operate the secondary market, receive any compensation for its participation in the secondary trading, including transaction-based compensation, or any of the other “hallmarks” of broker-dealer activity);⁴⁰⁴ second, a private company should ensure that all solicitation activities and the transfer of funds and securities are handled by a registered broker-dealer and subject to regulation as such;⁴⁰⁵ third, if the private company is involved in establishing the prices for securities sold on the secondary market platform or otherwise interposes itself between buyers and sellers, it should consider adopting a price system where the price is set by an independent third party expert to ensure impartiality of valuation.⁴⁰⁶

⁴⁰⁰ See, Goodwin Procter LLP, *Disclosure Requirements and Best Practices in Secondary Transactions of Private Company Stock*, cit. pp. 4-5.

⁴⁰¹ *Ibidem*.

⁴⁰² See, Dan Burstein and Sam Schwerin, *Inside the Growing Secondary Market for Venture Capital Assets*, cit.

⁴⁰³ See, Chapter 4.

⁴⁰⁴ See, e.g., Gibson, Dunn & Crutcher LLP, *Potential Risks Facing Companies Participating in SecondMarket*, cit., p. 3; Morgan, Lewis & Bockius LLP, *Summary Analysis of Certain Securities Law Issues*, cit., p. 4.

⁴⁰⁵ *Ibidem*.

⁴⁰⁶ In order to avoid the disruptive effect of some sellers getting better prices than others, for instance, the secondary market platform may be structured so that all sales within a given marketing period are at the same price. The price then can be set through (i) independent evaluation (e.g., by using the issuer’s Section 409A valuation); (ii) negotiations by the issuer directly with one or more buyers; or (iii) a modified Dutch auction or other competitive pricing process, possibly with the issuer setting the reserve price. See, Professional Project Services, *SEC No-Action Letter* (June 22, 2006); TEOCO Corporation, *SEC No-Action Letter* (October 20, 2005); Marshalls Finance LTD, *SEC No-Action Letter* (June 15, 1993) (given a scenario of interposition of the issuer itself between buyers and sellers, the no-action letters favor a fixed price system at a price set by an independent valuation expert, although the SEC has not imposed a fixed price requirement as a condition to granting no-action relief).

Furthermore, as previously discussed, U.S. private companies should take all necessary steps to ensure compliance with Rule 3a4-1 under the Exchange Act, which would provide a safe harbor from broker registration to employees or associated persons with the private company sponsoring a liquidity program.

5.3.2 INSIDER TRADING POLICIES AND CONTROL PROCEDURES

A private company may incur liability if, for instance, it fails to establish, maintain and enforce insider trading policies and control procedures reasonably adequate to prevent insider trading by employees. Given the increased secondary trading in private company securities, private companies should consider adopting comprehensive insider trading policies and procedures,⁴⁰⁷ which should then be periodically reviewed and updated, and rigorously enforced.⁴⁰⁸ The adoption of insider trading policies and procedures will help a private company mitigate the risk of liability for securities fraud or control person liability and build a meaningful defense if the company becomes the subject of an investigation action.

In addition, private companies should consider implementing a window-blackout policy for directors, officers and other employees who are regularly exposed to insider information and should establish procedures for enforcing special blackout periods when material developments arise (e.g., fundraising, negotiation of material acquisitions or dispositions).⁴⁰⁹

Private companies organizing liquidity programs could also reduce the risk to incur liability for securities fraud or control person liability in connection with the establishment of such programs by providing buyers in the secondary trading of their securities with the same information made available to sellers (either employees or shareholders), subject to confidentiality restrictions as needed.⁴¹⁰

Finally, if their shares trade in the secondary market, private companies should develop procedures to monitor and review company disclosures or other publicly available information that may impact secondary trading in their shares, as well as monitoring what material, non-public information is available to directors, employees and others who may be selling shares in the secondary market.

5.4. SECONDARY TRADING BUYERS AND SELLERS

Buyers and sellers in secondary markets can play a significant role in increasing liquidity and efficiency of trading through timely disclosure, proper due diligence and accurate risk management and valuation.

⁴⁰⁷See, Brad Stone, Silicon Valley Cashes Out Selling Private Shares, *cit. See, also, John Carney, Facebook Launches Insider Trading Policy* (CNBC, April 5, 2011), available at http://www.cnbc.com/id/42434413/Facebook_Launches_Insider_Trading_Policy. See, also, Gibson, Dunn & Crutcher LLP, Potential Risks Facing Companies Participating in SecondMarket, *cit.*, pp. 5-6; Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, *cit.*, pp. 4-5.

⁴⁰⁸ See, Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, *cit.*, p. 5.

⁴⁰⁹ See, Ari B. Lanin, Building a Better Insider Trading Compliance Program, *The Corporate & Securities Law Advisor* (Aspen Publisher, Volume 25 Number 3, March 2011), pp. 6-7; Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, *cit.*, p. 5 (noting that “many private companies do make financial and other material non-public information available to all or most of their employees, and may have an obligation to do so under Rule 701 in connection with their equity compensation programs. Thus, a private company insider trading policy may restrict all employees (and may even attempt to restrict former employees for a particular period of time post-employment) to specified “window periods” during which the company may sponsor a liquidity program”).

⁴¹⁰ See, Morgan, Lewis & Bockius LLP, Summary Analysis of Certain Securities Law Issues, *cit.*, p. 5 (stating that “the Liquidity Program Sponsor may post on the private SecondMarket website the same information it makes available to its employees under Rule 701. If officers, directors and others with access to a greater level of information are also sellers, the issuer may need to consider either posting additional information, or making sure that the market is timed such that the insider-sellers do not possess material non-public information other than Rule 701 information.”).

When dealing with information asymmetry, the best strategy would be to eliminate any information gap existing between buyers and sellers.⁴¹¹ This might be relatively easier to accomplish when the relevant information is contained in documents such as a company's historical financial statements, charter and bylaws, which are typically documents that do not contain confidential and competitively sensitive information, and are public or already distributed to a large group of shareholders.⁴¹² In addition, the information gap between the parties may be reduced by providing buyers and sellers with information and documents similar to those that U.S. private company are required to disclose under Rule 701 adopted under the Securities Act.⁴¹³

However, in certain circumstances bridging the information gap between the parties by disclosure of material non-public information possessed by only one party to the trade may not be a viable approach due to the existence of a valid and enforceable confidentiality agreement or other contractual arrangements that restrict disclosure, or because of the sensitive nature of the information at issue (e.g., information concerning the development of new products or new business or investment strategies).⁴¹⁴ In these circumstances, the party that possesses the material, non-public information should either refrain from trading, or postpone the trading until the material, non-public information has become public.⁴¹⁵ In alternative, the parties may rely on a "big boy letter"⁴¹⁶ or similar non-reliance representations in the transaction documents.

Practitioners that have discussed the use of big boy letters in the context of U.S. secondary transactions in private company securities executed on SecondMarket have been cautious in recommending the use of such letters.⁴¹⁷ In particular, they have noted that: (i) big boy letters do not eliminate the risk of insider trading liability because the provisions set forth in Section 29(a) of the Exchange Act generally bar any waiver of a Section 10(b) claim; (ii) although courts that have examined the relation between Section 29(a) and the use of big boy letters in private actions have taken the position that a big boy letter undermines two essential elements of a private party's Section 10(b) claim (the proof of a deceptive act or omission and proof of detrimental reliance), it is unlikely that courts would give the same deference when a big boy letter is executed by a non-sophisticated investor; (iii) unless the party that has executed the big boy letter refrains from further trading of the securities for a period sufficient to break a chain of reliance, downstream purchasers may still bring a claim for liability under Section 10(b); and (iv) big

⁴¹¹ See, Goodwin Procter LLP, *Disclosure Requirements and Best Practices in Secondary Transactions of Private Company Stock*, cit., p.1.

⁴¹² *Id.*, pp. 4-5.

⁴¹³ *Ivi*, p.4 (noting that "[i]ssuers that have already disclosed 701 Information to a large number of non-management employees are generally more willing to allow a party to a secondary transaction to disclose that information as well. Also, absent some other special knowledge about the issuer, disclosure of 701 Information to an accredited investor buyer may both close an information gap and help to satisfy a seller's § 4(1½) disclosure requirements when the Rule 144 safe harbor is not available. In this circumstance, disclosure of at least 701 Information is best practice to satisfy 4(1½) disclosure requirements").

⁴¹⁴ *Ivi*, pp. 6-7.

⁴¹⁵ *Ivi*, pp. 5-6.

⁴¹⁶ The non-insider party may use a "big boy letter" to represents that (i) it is sophisticated; (ii) it is not relying on any statements or omissions of the insider in entering into the transaction; and (iii) it will not sue the insider for engaging in the transaction while in the possession of material, non-public information. Although the use of a "big-boy letter" may provide some comfort to the parties involved in the secondary market trading, it is worth to note that a "big boy letter" does not (i) eliminate the risk of insider trading liability because of Section 29(a) of the Exchange Act; (ii) eliminate the possibility of "downstream further purchasers" bringing a Section 10(b) claim unless the signatory agrees to refrain from further trading of the securities (or refrain for a period of time sufficient to break the chain of reliance); and (iii) affect SEC enforcement proceedings. See, Goodwin Procter LLP, *Disclosure Requirements and Best Practices in Secondary Transactions of Private Company Stock*, cit., pp. 5-7.

⁴¹⁷ *Ivi*, p. 7.

boy letters do not bar SEC enforcement actions because detrimental reliance and damages are not elements of a securities fraud claim brought by the SEC.⁴¹⁸

5.5. CONCLUSION

Over the past few years, secondary sales and purchases of private company shares have been primarily executed as one-off transactions to provide interim liquidity and reduce pressure on private companies along the way towards their IPO or M&A exit.

Looking ahead, secondary trading of private company shares is expected to increase in volume and frequency and the liquidity funds and secondary markets that help structure, control and manage such trading are expected to grow in relevance and become a more vital component of the private capital markets.

The importance of the activities conducted through liquidity funds or on secondary market platforms is explained by the potential that such funds and markets have for increasing transparency and efficiency of secondary transactions, thus expanding the depth and liquidity of the secondary trading.⁴¹⁹ The need for liquidity that has been driving the development of liquidity funds and secondary markets appears to be a constant and not merely the outcome of contingent circumstances:⁴²⁰ investors constantly need liquidity to finance new projects, companies are in continuous need for liquidity to grow and develop their business activities, and employees and their family need liquidity on an ongoing basis to satisfy their personal needs. Liquidity funds and secondary markets can efficiently address this need by providing a reliable source of recurring liquidity for companies' investors and employees. In so doing, they can also facilitate attraction of prospective investors and talent by private companies, can help private companies expand and consolidate their business activities, and thus can contribute significantly to economic growth and job creation by supporting a financial environment in which private companies can thrive.

⁴¹⁸ In particular, the SEC has taken the position that a big boy letter does not foreclose potential insider trading liability under the misappropriation theory. See *SEC v. Barclays Bank*, Litigation Release No. 20132, 2007 WL 1559227 (May 30, 2007).

⁴¹⁹ See, Steven Bochner, Keynote – How the Secondary Markets are Affecting the Capital Markets, *cit.*

⁴²⁰ See, Dan Burstein and Sam Schwerin, *Inside the Growing Secondary Market for Venture Capital Assets*, *cit.*, p. 5.

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