

SEC Insights - May 2012

The Secondary Market for Private Shares

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Since the adoption of the Sarbanes-Oxley Act ("SOX") in 2002, the cost of becoming, and maintaining status as, a public company has significantly increased. Meanwhile, private companies (particularly in the social networking, mobile and technology fields) have been attracting and retaining employees by granting them stock options or shares of restricted stock. Management of many of these companies has found it advantageous to raise capital in private transactions at increasingly higher valuations and to defer going public. As a result, (i) employees had little or no access to capital markets to derive liquidity for their equity positions and (ii) outside investors typically could not participate in the upside potential of these companies. Consequently, the secondary market has evolved to provide liquidity to employees and early stage investors and an opportunity for investors outside the companies, such as hedge funds and special purpose funds ("Private Funds"), to participate in their growth.

A secondary market transaction is a negotiated private sale of securities of an issuer whose securities are not publicly traded. Some transactions are effected directly from seller to buyer and in some instances one or both parties may be represented by a broker-dealer who earns commissions on the sale or purchase. Buyers and sellers may find one another through networking, their individual brokers or intermediaries. Prices are bargained for, but the market tends to be set by the prices of trades effected through the recognized intermediaries and platforms and the prices of publicized investments by venture capital or other investment firms.

Legal Basis

Section 4(1) of the Securities Act of 1933, as amended (the "1933 Act") exempts from registration transactions by any person other than an issuer, underwriter or dealer. Thus, a holder of restricted securities who is neither an issuer nor a dealer can sell his or her securities in a private sale without registration provided that the holder is not deemed to be an underwriter of the securities. Section 2(11) of the 1933 Act, in turn, defines an "underwriter" as, inter alia, "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...."

Rule 144, the non-exclusive safe harbor from the definition of underwriter, establishes criteria that, if followed, will demonstrate that a person is not engaged in a distribution of securities. Following changes to Rule 144 adopted in late 2007, non-affiliates holding restricted securities of non-reporting companies (e.g. private companies) are permitted to make unlimited public re-sales of such restricted securities. Such resales need not comply with any other Rule 144 provision (e.g. current market information, volume limitations, etc.). While Rule 144 provides a safe harbor for public resales, a holder of restricted securities who desires to resell such securities under Section 4(1) must sell in a transaction that is sufficiently private so that the seller is not deemed to an underwriter. Over the course of time, the so-called "Section 4(1 1-2) exemption" has developed which, in effect combines elements of Sections 4(1) and 4(2) of the 1933 Act to allow these resales.

Restrictions on Transfer

In addition to the 1933 Act's resale restrictions, sellers are generally bound by contractual restrictions on the transfer of their shares contained in the restricted stock purchase or option exercise agreements under which they obtained their shares and/or the issuers' certificates of incorporation or by-laws. The term "Transfer" is usually defined broadly to include any direct or indirect sale, exchange, pledge or encumbrance of the shares. Under these restrictions, which are subject to limited exceptions, no Transfer of shares may be made without the written consent of the issuer. Most issuers also prohibit any Transfers by transferees from the initial stockholders.

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Under the terms of most restricted stock purchase or option exercise agreements, any stockholder wishing to Transfer shares must first submit to the issuer a written notice of the stockholder's intention to Transfer the shares (a "Transfer Notice"). The Transfer Notice must include the principal terms of the proposed Transfer, including the name of the transferee, the amount and type of consideration being given by the buyer to the seller, the proposed date of the Transfer and any other material terms.

In addition to the outright ban on Transfers, restricted stock purchase agreements or option exercise agreements typically include provisions granting a right of first refusal (a "ROFR"). The ROFR permits the issuer (or its designee) to elect to purchase the shares on substantially the same terms as those proposed in the Transfer Notice within a prescribed period of time after its receipt of a Transfer Notice. In some instances, particularly where the shares to be transferred consist of preferred stock, other early stage investors in the issuer may also have ROFRs and/or co-sale rights entitling them to also sell shares along with the seller.

Documenting and Closing a Secondary Market Transaction

The core document for effecting the purchase and sale of shares on the secondary market is the stock transfer agreement (also sometimes called a stock purchase agreement) (the "STA"). The STA contains the principal terms of the sale (i.e. the number of shares to be sold, purchase price and similar economic terms) and the seller and the buyer's representations and warranties. Ancillary documents for effecting the purchase and sale of the shares are the stock powers and the opinion of seller's counsel. The seller executes the stock power in order to effect the Transfer to the buyer. The buyer executes the stock power in blank to enable the issuer to effect ROFR or co-sale Transfers. As a condition to Transfer, issuers generally require that seller deliver an opinion of its counsel that the Transfer is being effectuated in accordance with, or exempt under, the 1933 Act.

Assuming the ROFR is not exercised, the parties proceed to a closing. Generally, the seller and the buyer execute and deliver the STA to the issuer for its approval. Most issuers require that all stock certificates be held in escrow by issuer's counsel to facilitate Transfer in the event of a ROFR exercise. Accordingly, buyers only receive photocopies of the certificates. Once all documents are approved, a virtual closing is conducted with the purchase price being wired by the buyer to the seller and the STA signatures and the opinion of seller's counsel being released to the parties. Subsequently, the issuer issues a new stock certificate in the name of the buyer.

Effects of the Jumpstart Our Business Startups (JOBS) Act on the Secondary Market

The JOBS Act is intended to stimulate growth for small businesses by easing the registration and reporting requirements of the 1933 Act, the Securities Exchange Act of 1934 (the "1934 Act") and the other Securities Exchange Commission (the "SEC") rules and regulations. While the jury is still out on the ultimate impact that the JOBS Act will have on the capital markets, it is reasonable to expect that certain provisions thereof, including the relaxation of the ban on general solicitation in "crowdfunding" activities or for accredited investors, and the increase of the number of record holders from 500 to 2,000 before an issuer needs to become a reporting company under the 1934 Act, will only enhance the growth of the secondary market.

***Mitchell Littman** is a founding partner of Littman Krooks LLP and leads the firm's corporate and securities department. The firm has a significant presence in the private secondary market, representing numerous broker-dealer sponsors and private partnerships in fund formation, private placement of fund interests and purchases of over \$300 million of shares of such well-known companies as Facebook, Twitter, LinkedIn and various other emerging growth technology companies.*

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