Going Public before the IPO

Author : D. Gordon Smith

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Darian M. Ibrahim, The New Exit in Venture Capital, 65 **Vand. L. Rev.** 1 (2012).

For some employees and investors, Facebook did not make the decision to pursue an initial public offering (IPO) fast enough. So when a former employee of Facebook needed to sell some shares in the company, he approached SecondMarket, which describes itself as "the leading marketplace for alternative investments." In 2009 Facebook shares began trading on SecondMarket and SharesPost, another leading market for shares in companies that are moving toward an IPO. These new markets – called private secondary markets – are the hottest new development in securities trading.

Although we have much to learn about private secondary markets, the first article out of the gates is well worth reading. In *The New Exit in Venture Capital*, Darian Ibrahim relies on interviews, trade publications, blog posts, and newspaper stories to study these emerging markets. He focuses most of his attention on the so-called "direct market," which involves the trading of stock in startup companies, as opposed to the trading of interests in investment funds. Ibrahim aims to contribute to the still vibrant literature on venture capital investing, but his description of direct private secondary markets should have a much broader audience.

Traditionally, the venture capital cycle begins with the creation of an investment fund that venture capitalists use to invest in portfolio companies. Venture capitalists typically invest in stages, building a portfolio company from startup to the point where the company can be sold, either through an acquisition by a larger company or through an IPO. Upon the sale of the company or shortly thereafter, venture capitalists extract their investments and any return on those investments, and they distribute much of that money to their fund investors. The cycle then begins afresh with a new fund.

With the decline in IPO activity over the past decade, Ibrahim argues that venture capitalists face a liquidity gap, which could impair the formation of funds at the start of the venture capital cycle. Playing off the debate relating to "capital lock-in," Ibrahim argues that the dearth of good exit options for venture capitalists creates a form of "investor lock-in," usually associated with traditional close corporations: "minority shareholders cannot look to the corporation for redemption, and there is no ready market for selling shares to third parties." (P. 7). Unlike capital lock-in, which may have some beneficial features, Ibrahim argues that investor lock-in is almost all bad for venture capitalists and their portfolio companies, raising the cost of capital and creating governance problems.

Private secondary markets promise some relief from investor lock-in. While most sellers in these markets are entrepreneurs and startup employees, Ibrahim found that venture capitalists were becoming increasingly active as sellers in private secondary markets. The buyers include various investment funds, strategic buyers (other companies looking to gain a foothold toward acquisition), and even some late-stage venture capitalists.

According to Ibrahim, buyers are motivated by a desire to own hot new companies whose shares would otherwise be inaccessible. Also, the companies whose shares trade in direct private secondary markets are "well-known, later-stage companies." So, investors find the evaluation of these companies easier than the evaluation of early-stage startups. Buyers may also be motivated by the prospect of relatively quick exits: "As long as traditional exits for winning companies are simply delayed, rather than gone altogether, direct market buyers will reap their spoils." (P. 20).

This last point raises a troublesome question for Ibrahim's thesis: do these markets work without IPOs? Ibrahim cited three companies as examples of the companies whose shares are sold in direct private secondary markets: Facebook, LinkedIn, and Tesla Motors. All three of these companies subsequently executed IPOs. Indeed, SharesPost claims to be "changing the way companies, investors and shareholders … transact in the pre-IPO economy."

Thus, it appears that direct private secondary markets observe a fundamental law of investing which I discussed in my paper, *The Exit Structure of Venture Capital*: "Before [people] invest, they plan for exit." If direct private secondary markets are designed to fill the liquidity gap created by the dearth of IPOs, as Ibrahim suggests, it is not clear that these new markets will be up to the task. Ultimately, it seems, we need a vibrant market for IPOs if the venture capital cycle is to operate effectively.

The future of direct private secondary markets is uncertain, but Congress attempted to encourage the development of those markets with the recent passage of the Jumpstart Our Business Startups (JOBS) Act. Among other things, the JOBS Act facilitates "crowdfunding" by allowing early-stage companies to raise up to $1 million through small investments from non-accredited investors. The JOBS Act also broadens the appeal of offerings under Regulation D, which may not only encourage more primary offerings, but also more secondary sales.

Private secondary markets have become an important new component in the system for financing innovative companies. Ibrahim's paper is an excellent introduction to these new markets, and an important contribution to the field of law and entrepreneurship. Brian Broughman organized an excellent panel of papers on private secondary markets at the recent Annual Meeting of the Law & Society Association, and interested readers should look to those papers for the latest new developments in this literature.

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