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The New Exit in Venture Capital

Darian M. Ibrahim

William & Mary Law School, dmibrahim@wm.edu

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INTRODUCTION

Venture capital, for all its contributions in promoting our entrepreneurial economy,¹ is in trouble. The success of venture capital depends on the ability of venture capitalists (“VCs”) to exit their investments by taking the start-ups they fund public or selling them to a large company.² Initial public offerings (“IPOs”), the gold standard in venture capital success, have been decreasing significantly over the past decade.³ Sales to larger companies in the industry (trade sales) are only a second-best solution, and such sales alone are not sufficient to sustain the venture capital model.⁴ The poor exit markets that VCs are now experiencing may be more than a short-term aberration, and investors who see the writing on the wall have begun moving their money out of venture capital projects.⁵ Unless a solution to the exit problem can be found, venture capital may dry up for countless

1. See Press Release, Nat’l Venture Capital Ass’n, National Venture Capital Association Releases Recommendations to Restore Liquidity in the U.S. Venture Capital Industry (Apr. 29, 2009), available at http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=427&Itemid=93 (“[I]n 2008 public companies that were once venture-backed accounted for more than 12 million U.S. jobs and \$2.9 trillion in revenues, which equates to 21 percent of U.S. GDP.”).

2. For purposes of this Article, I use the term “start-up” to mean any rapid-growth private company, which is often technology-driven, that seeks funding from angel investors, venture capitalists, or venture lenders with the ultimate goal of exit through an IPO or trade sale. This definition encompasses a wide range of companies, from an entrepreneur starting out in his garage to a seven-year-old revenue-positive company that employs hundreds of people. The start-ups discussed in this Article are predominantly in their later stages rather than at their inception.

3. See *infra* notes 35–41 and accompanying text (offering numerical evidence of the severe decline in venture-backed IPOs between 1999 and 2009).

4. See *infra* notes 40–44 and accompanying text (describing the drawbacks of trade sales and the negative repercussions these sales have had on VC performance).

5. See *infra* note 50 and accompanying text (describing the “precipitous drop in investor commitments to [the VC] sector”).

entrepreneurs. No less than the future of U.S. innovation may hang in the balance.

This Article is the first to explore the emergence of a potentially game-changing *third* exit option in venture capital: secondary markets for the sale of individual ownership interests in private start-ups and venture capital funds.⁶ Unlike IPOs and trade sales, secondary markets operate at the individual investor level rather than at the start-up level. Because investors have different liquidity needs, an individual-investor option offers exit to those who need it—for example, to the serial entrepreneur who wishes to start another venture or to the VC whose fund is about to expire and who must return capital to his investors. Secondary buyers who take their place will have a fresh exit clock, a discounted purchase price, and the opportunity to invest in an asset class that was previously unavailable to them and includes some of the world’s most promising companies, including Facebook and Twitter. Not only do secondary markets make for more efficient outcomes at the individual-investor level, but they also lead to more efficient outcomes for start-ups, which will no longer be forced into premature, traditional exits to satisfy an individual investor’s liquidity needs. Moreover, secondary markets have the potential to solve some of the most vexing problems in venture capital, including the agency costs that can arise between VCs and entrepreneurs—a problem that corporate law has proven ill-equipped to handle.⁷

As the first examination of the new exit option in venture capital, this Article makes two main contributions to the literature. First, it describes the secondary markets that are emerging for both stock in private start-up companies and limited partnership interests in venture capital funds (together, the “VC secondary markets”). Gathering information on these markets was difficult due to their newness, rapidly evolving nature, and largely unregulated status, which means no reporting requirements. Although published information on these markets is sparse, several trade publications, blog entries, and newspaper stories provided some help. To collect

6. Scholars have observed that foreign VCs sometimes exit their investments through secondary sales. See Douglas J. Cumming & Jeffrey G. MacIntosh, *A Cross-Country Comparison of Full and Partial Venture Capital Exits*, 27 J. BANKING & FIN. 511, 522–24 (2003) (discussing secondary sales as among the exit options for Canadian VCs); Carsten Bienz & Uwe Walz, *Venture Capital Exit Rights* 4 (Mar. 2, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1140128> (listing partial sales as an exit option for VCs in Germany).

7. See *infra* notes 92–94 and accompanying text (describing the ability of parties who exercise control over start-up boards to favor their own class of shares without violating their fiduciary duties).

more information, I arranged interviews with individuals who have inside knowledge of VC secondary markets.⁸ The interviewees included large secondary market buyers, principals at electronic marketplaces that facilitate secondary market transactions, and lawyers involved in these transactions.⁹ While my description of VC secondary markets remains incomplete, it saves future researchers from starting from the same blank slate.

Moreover, the information that I gathered was sufficient to allow me to make a second contribution to the literature—namely, to develop a framework for analyzing the economic and legal issues presented by VC secondary markets. A complicated system may well be evolving; the general framework proposed here serves as a broad-brush effort to make sense of these markets as they currently exist and to contemplate their further development. It reveals that the new exit in venture capital is not only vitally important to the future of U.S. innovation from a practical perspective, but also a treasure trove for academics. VC secondary markets implicate numerous important issues in law and economics analysis, including lock-in, agency costs, opportunism, information asymmetries, incentive alignment, law-growth relationships, and the relative merits of market versus legal solutions to economic problems. For legal scholars, VC secondary markets present a unique factual situation—the possibility of a market exit for minority shareholders in start-ups, which are essentially closely held corporations. In other closely held corporations, minority shareholders must rely on the courts for potential relief from majority shareholder oppression.

This Article is divided into three main parts beyond the Introduction. Part I examines the venture capital model using the lens of lock-in. While business organizations scholars have debated the desirability of entities that lock-in capital, I argue that locking in both capital *and* the investors who contribute it is not beneficial. This more

8. To entice participation, I promised interviewees anonymity and confidentiality. While it would have been preferable to record and produce a transcript of each interview, I concluded that arranging the interviews to be confidential and anonymous would lead to more participation and more candid conversations—factors essential to understanding these emerging markets. Therefore, while I draw on these interviews to help me describe VC secondary markets, direct quotes and information resulting from these interviews are recited without citation.

9. I conducted full interviews of up to one hour each with six key participants in VC secondary markets. I also discussed these markets for shorter lengths with other contacts in entrepreneurial finance, most notably angel investors and venture lenders. My main omission was failing to interview secondary market sellers to better understand their motivations. On the other hand, seller motivation was the issue most often discussed in trade publications; also, I concluded that dedicated secondary market buyers, as repeat players, would understand the inner workings of the market better than one-time sellers.

severe “investor lock-in” creates extreme illiquidity and governance problems for investors, which greatly increases the cost of capital for firms. I then reveal that investor lock-in is embedded into the venture capital model, is getting worse, and correlates with a steep decline in investors’ commitment to this sector. Part I sets the stage for the argument that follows: that the best solution to the investor lock-in problem is the emergence of a market where investors can sell their ownership interests. The remainder of the Article applies that idea to the venture capital market, where it has not been applied before.

Part II is the heart of the Article. It describes the VC secondary markets that are emerging and develops a framework for understanding the major economic problems that they help to solve. The story begins with—and focuses on—the “direct” VC secondary market, or the market for stock in private start-up companies. Based on my interviews, I give my best estimate of market size, the major players, and other pertinent information. The discussion then moves into the theoretical advantages of the direct market, most notably that it increases liquidity for investors, reduces agency costs and thus the potential for opportunism in start-up governance, and mitigates VC-entrepreneur conflicts over traditional exit decisions. I also explain how the major potential downside of the direct secondary market—the potential to mute high-powered incentives for performance—is mitigated in practice. Finally, this Part compares the direct secondary market with the “fund” secondary market, or the market for limited partnership interests in venture capital funds. The fund market shares many attributes with the direct market, but it suffers from a unique problem: as the result of high levels of information asymmetry about the underlying assets in the fund, fund market buyers demand significant discounts. Despite this drawback, the fund market is an important new exit option for venture capital fund investors who need to rebalance portfolios or sell for other reasons.

Recognizing that VC secondary markets are quite new and are far from achieving a state of equilibrium, Part III looks ahead to how these markets might grow to become an even better solution to venture capital’s investor lock-in problem. I find that while secondary markets may currently be limited by high transaction costs and information costs relating to their newness, electronic marketplaces are sprouting up to facilitate secondary transactions and, in the process, are reducing these problems. Although electronic marketplaces will serve to increase secondary market activity, certain securities laws, coupled with a particular tax law and standard contracting practices in the venture capital industry, will have the opposite effect. Although some of these laws may be necessary to

protect investors, others might warrant an exemption for VC secondary market activity in order to encourage the growth of these markets.

I. THE ECONOMIC PROBLEM OF LOCK-IN IN VENTURE CAPITAL

A. *Locking in Capital or Investors?*

Business organizations scholars debate the desirability of entities, most notably corporations, that “lock in” capital contributed to the enterprise. Capital lock-in means that investors are not free to “redeem,” or withdraw, their capital from the entity once it is contributed.¹⁰ Instead, this capital is a permanent part of the entity’s capital structure unless the entity is dissolved.¹¹ The concept of lock-in is key to understanding the problems that the venture capital market now faces. Before turning to the problem of lock-in in venture capital specifically, this Section sets the stage with a general analysis.

Margaret Blair argues that capital lock-in allows corporations to attract investors, managers, and employees by assuring them that no investor can withdraw her capital on demand and threaten the firm’s stability.¹² Indeed, Blair attaches so much importance to this feature of the corporate form that she credits it for enabling the Industrial Revolution.¹³ Larry Ribstein is more skeptical of Blair’s claims, questioning both the premise that the capital lock-in feature is desirable and the concept that the corporate form is necessary to achieve it.¹⁴ Ribstein observes that, in economic theory, capital lock-in increases agency costs by eliminating the threat of capital withdrawal,

10. Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1, 26 (2004) (“[E]quity investors in corporations generally have no power, on their own initiative, to insist that the corporation buy back their shares or distribute corporate assets to shareholders.”).

11. *See id.* at 14 (describing the historical conception of capital contributions under which “shareholders or ‘members’ could not withdraw their capital unless the enterprise were to be formally dissolved”).

12. *See id.* at 43 (“Such a pre-commitment may be important in order for a corporation to attract complex, intangible, and firm-specific inputs from other participants in the enterprise, such as managers and skilled employees.”).

13. *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 389 (2003) (arguing that restrictions on capital withdrawals were among the features of corporations “that made the corporate form so useful in the development of modern industrial economies”).

14. *See* Larry E. Ribstein, *Should History Lock in Lock-In?*, 41 TULSA L. REV. 523, 524–25 (2006) (noting that the increased costs associated with lock-in and its availability to the partnership form call into question the true value of lock-in and its importance to the historical development of corporations).

which is “an important way to discipline the firm’s managers.”¹⁵ Kate Litvak similarly disputes the “popular hypotheses arguing that capital lock-in is fundamentally a good thing,”¹⁶ noting that it increases agency costs and the potential for self-dealing.¹⁷

Although there is healthy debate over the desirability of capital lock-in, I want to focus on a more extreme situation—one I call “investor lock-in.” In my terminology, investor lock-in means not only a situation of capital lock-in, but also the absence of a ready market where an investor can sell her ownership interests to a third party. Therefore, in capital lock-in, investors cannot look to the *entity* for liquidity; in investor lock-in, they cannot look *anywhere* for liquidity. For example, publicly traded corporations exhibit only capital lock-in. Shareholders in large public corporations do not have redemption rights, but ready markets such as the New York Stock Exchange (“NYSE”) and NASDAQ exist for selling shares to third parties. Closely held corporations, on the other hand, suffer from the more severe investor lock-in—minority shareholders cannot look to the corporation for redemption, *and* there is no ready market for selling shares to third parties.

Whatever the merits of capital lock-in, the more severe investor lock-in is not desirable. First, investor lock-in means extreme illiquidity for individual investors.¹⁸ Firms that lock in investors will see their cost of capital increase, perhaps significantly, and will have to sell more equity for less money to compensate investors for the extreme illiquidity.¹⁹ Second, investor lock-in leads to governance problems within the entity. Investors with no right to either withdraw capital or sell their ownership interests to third parties have no credible means to threaten exit when managers underperform or engage in self-dealing. Compare this to the public corporation situation of capital lock-in only, where investors can exercise the “Wall Street Rule” and sell their shares on the open market. The takeover market, in particular, reduces agency costs for public corporation investors in ways not available to their closely held corporation

15. *Id.* at 527.

16. Kate Litvak, *Firm Governance as a Determinant of Capital Lock-In* 3 (Univ. of Tex. Law Sch., Law & Econ. Research Paper No. 95, 2007), available at <http://ssrn.com/abstract=915004>.

17. *Id.* at 4.

18. See J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 6 (1977) (noting that minority shareholders in close corporations suffer from “a complete loss of liquidity”).

19. See *infra* pp. 23 for a numerical illustration of this point.

counterparts.²⁰ Therefore, investor lock-in has significant costs from both financial and governance perspectives. Even Blair, despite her support for capital lock-in, appears to concede the importance of a market release valve for individual investors.²¹

B. The More Extreme Investor Lock-in in Venture Capital

The previous Section revealed that, whatever the merits of capital lock-in, the more severe investor lock-in is harmful as a general matter. This Section asks whether venture capital suffers from investor lock-in.

To answer, we must first open the black box and separate “venture capital” into its two distinct relationships. First, investors (typically large endowments and pension funds)²² will commit capital to a venture capital fund that is organized as a limited partnership.²³ The VC serves as the fund’s general partner and the investors serve as the fund’s limited partners (“LPs”).²⁴ Second, the VC will draw down the LPs’ committed capital when it finds promising start-ups to invest in.²⁵ The venture capital structure is illustrated in Figure 1.

20. The takeover market for public corporations is thought to be effective at lowering agency costs despite well-known limitations, namely the ability of managers to enact roadblocks to takeovers. See LARRY E. RIBSTEIN, *THE RISE OF THE UNINCORPORATION* 206 (2010) (“A problem with [takeovers] for addressing corporate agency costs is that corporate agents necessarily have some say in how the market for control operates.”).

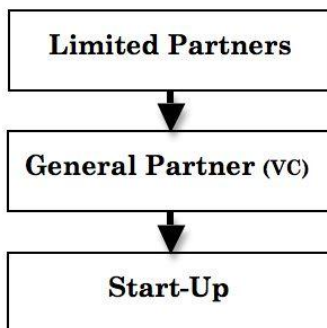
21. Blair, *supra* note 10, at 43 (noting that public corporations “provide a mechanism for locking in the capital used in the enterprise *without locking in the investors*”) (emphasis added). Likewise, taking a historical look, Ribstein states that “even if firms derived significant benefits from continuity, lock-in might also have imposed significant costs on owners who could not trade their shares.” Ribstein, *supra* note 14, at 529.

22. See Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137, 158 n.86 (2003) (citing statistics indicating that sixty-six percent of venture capital fund investors are endowments and pension funds).

23. PAUL A. GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 10 (2d ed. 2004) (describing the limited partnership as the “dominant organizational form” for venture capital funds).

24. See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070–71 (2003) (describing the usual structure of venture capital funds).

25. The VC supplies only a very small percentage of the fund’s capital. *Id.* at 1071 (finding that a typical VC puts up only one percent of the fund’s capital).

Figure 1: The Venture Capital Structure

Both the top and bottom halves of the venture capital structure exhibit at least *capital* lock-in. On the top half of the structure, the default limited partnership rules would allow the LPs to redeem their capital at will,²⁶ but standard limited partnership agreements contract around that to provide for capital lock-in over the life of the fund, usually ten to twelve years.²⁷ Likewise, on the bottom half of the structure, start-ups are typically organized as corporations, with the VCs holding preferred shares and entrepreneurs and employees holding common shares.²⁸ Because corporate law does not allow

26. See RIBSTEIN, *supra* note 20, at 53 (“Partners can unilaterally dissolve the firm or compel the firm to buy them out.”); *id.* at 60 (limited partnerships retain the general partnership rule of “dissolution at will”).

27. GOMPERS & LERNER, *supra* note 23, at 23 (“Almost all venture and buyout funds are designed to be ‘self-liquidating,’ that is, to dissolve after ten or twelve years.”). Mitigating this capital lock-in somewhat, LPs pledge their capital up front but contribute it in stages, meaning they retain the option of failing to answer future capital calls. See Litvak, *supra* note 16, at 7 (“[I]nvestors’ call position in a venture fund is equivalent to having fully invested upfront and retaining a put option on the amount on yet-unpaid capital.”); see also RIBSTEIN, *supra* note 20, at 226 (“[I]nvestors may have significant flexibility to take their investments ‘out’ by refusing to follow through with a commitment to put them in.”). On the other hand, fund agreements allow VCs to impose severe penalties on noncontributing LPs, including forfeiture of the LP’s entire stake in the fund, making walkaway an undesirable means of circumventing capital lock-in. See Litvak, *supra* note 16, at 9 (“Penalty clauses are often written as long lists of various punishments, ranging from relatively mild (such as charging interest on delayed contributions) to severe (such as forfeiture of the defaulter’s entire stake in the fund).”); Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771, 786 (2004) (“[I]ndustry participants are aware that choosing a low penalty [for a venture capital fund investor’s refusal to answer a capital call] may trigger a ‘race to exit’ [by all fund investors, similar to a bank run].”).

28. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1740 (1994) (“Typically, the [start-up] corporation will have a complicated stock structure; the [VC] and other investors will generally receive preferred stock that is convertible into common; the founders and other employees will receive a combination of common stock and stock options

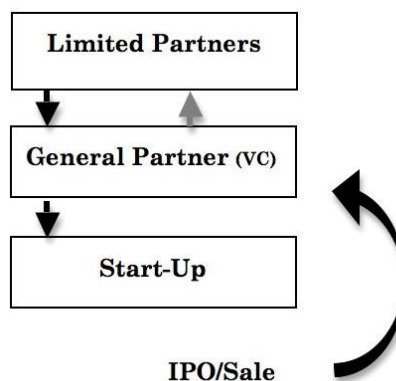
redemption at will, the start-up's corporate form achieves on the bottom half of the structure what contract achieves on the top—capital lock-in.²⁹

The more important question is whether venture capital also exhibits the problematic *investor* lock-in, meaning no redemption from the entity and no ready market for selling ownership interests to third parties. The answer is that venture capital *does* exhibit investor lock-in—how much depends on the state of traditional exit markets. Because venture capital funds and start-ups are privately held entities, there has traditionally been no market where individual investors could look for liquidity. Instead, all individual-investor exits were derivative of and dependent upon the *start-up's* exit. Recall that start-ups have successful exits through IPOs or through trade sales to larger companies in the industry.³⁰ These traditional exit paths are illustrated in Figure 2.

or warrants.”); Fleischer, *supra* note 22, at 144 n.30 (“The investment by the venture capital fund usually takes the form of convertible preferred stock; the entrepreneur takes the common stock, often subject to vesting requirements, and also may receive stock options.”).

29. VCs sometimes override the default rule by including redemption rights in their investment contracts. See D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 317 (2005) (listing the use of specific contractual provisions as one of three common mechanisms by which VCs preserve their ability to exit). But in general, this capital lock-in may be beneficial, as it assures LPs, VCs, entrepreneurs, and employees alike that the VC model will have time to work—that nascent start-ups which continue to perform can use the LPs' capital to engage in research and development, develop a prototype, and bring their product or service to market without the threat of liquidity shocks. See William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 53 (2009) (similarly describing a buyout fund as “by its very nature, a long-term proposition” and noting that “[p]rivate-equity funds share [the capital] lock-in characteristic with venture capital funds, as distinguished from hedge funds, mutual funds, bank deposits, and broker accounts, all of which are usually redeemable with shorter notice or even upon demand”). On the other hand, it removes one governance tool—the threat of capital withdrawal as a means of disciplining managers.

30. IPOs move start-ups from the private corporation to public corporation category and allow VCs, entrepreneurs, and employees to sell their shares in public markets. When the VC's shares are sold, it returns eighty percent of the profits to LPs, retaining twenty percent as its carried compensation. Trade sales allow VCs, entrepreneurs, and employees to sell their shares to a single buyer rather than in the public markets, and again all investors gain liquidity. See Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON. 3, 14 (1999) (empirical finding that most VCs take a carried interest of twenty percent). *But see* Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements* 3–4 (Am. Law & Econ. Ass'n Annual Meetings, Working Paper No. 61, 2004) (critiquing the Gompers and Lerner study on staleness and methodological grounds and concluding from an independent study that “the compensation of VCs varies significantly across venture firms”).

Figure 2: Traditional Exits

Because VCs will push for start-ups to exit through IPOs and trade sales before their funds expire, investor lock-in does not last indefinitely.³¹ When traditional exit markets are strong, such as the IPO market of the late 1990s,³² investor lock-in in venture capital is not severe because IPOs happen quickly. When traditional exit markets are weak, however, as in recent years, investor lock-in is severe. Because investor lock-in in venture capital is directly correlated with traditional exit opportunities, the IPO and trade sale markets deserve further analysis.

IPOs are the gold standard in VC success. The Internet boom of the late 1990s saw hundreds of VC-backed IPOs (i.e., 273 and 261 in 1999 and 2000, respectively)³³ and mind-boggling returns (e.g., a forty-two-fold return on investment)³⁴ that increased the cache of investing in this sector. But IPO markets have been dramatically worse ever

31. Conversely, typical close corporations do not have a growth trajectory leading to an IPO or trade sale and the liquidity those exits bring. Rather, they are lifestyle businesses run for the benefit of their founders, leading to investor lock-in with no end in sight. On the other hand, there is a chance for dividends in low-growth small businesses, whereas high-growth start-ups do not have free cash for that purpose, instead choosing to spend it on ramping up the business. See Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1205 (noting the lack of free cash in most start-up companies).

32. See Therese H. Maynard, *Spinning in a Hot IPO—Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023, 2023 n.1 (2002) (describing the IPO market of the late 1990s as a “hot-issue market” and, similarly, as a “bull market”).

33. See Douglas Cumming & Jeffrey MacIntosh, *Boom, Bust, and Litigation in Venture Capital Finance*, 40 WILLAMETTE L. REV. 867, 869 (2004) (citing statistics).

34. ANDREW METRICK, *VENTURE CAPITAL AND THE FINANCE OF INNOVATION* 89 (2007) (citing a forty-two-fold return-on-investment, the “highest reported multiple of all time,” for VC Benchmark Capital’s first fund, which contained eBay, whose 1998 IPO returned \$2.5 billion to the Benchmark fund on a \$5 million investment).

since.³⁵ One statistic is particularly jarring: the number of venture-backed IPOs was a meager *six* in 2008 and only *twelve* in 2009.³⁶ Although these dismal numbers can be partially attributed to the financial crisis, even the period of 2005 to 2007, a good time for the economy at large, saw nowhere near the earlier IPO levels.³⁷

While IPOs have fallen off dramatically, trade sales continue to occur. Still, trade sales have always been a second-best option for U.S. start-ups due to their lower returns for investors³⁸ and failure to align the incentives of VCs and entrepreneurs.³⁹ An *ex ante* focus on a trade sale exit means that VCs might pass on truly pioneering technologies when no industry leader exists to buy the start-up later.⁴⁰ Indeed, the reliance on trade sales has had significant negative repercussions on venture capital; when the IPOs of the Internet boom period recently dropped out of the ten-year measure of VC performance, average

35. See PAUL KEDROSKY, EWING MARION KAUFFMAN FOUND., RIGHT-SIZING THE U.S. VENTURE CAPITAL INDUSTRY 4 (2009), available at <http://www.kauffman.org/uploadedFiles/USVentCap061009r1.pdf> (discussing the effect of “shrinking exit markets” as a possible reason for the recent deterioration in performance of venture capital); Claire Cain Miller, *Venture Investment Continues to Shrink*, N.Y. TIMES BITS BLOG (July 13, 2009), <http://bits.blogs.nytimes.com/2009/07/13/venture-investment-continues-to-shrink/> (noting that VCs are suffering from a “troubled exit market”).

36. News Release, Nat’l Venture Capital Ass’n, Venture-Backed Exit Market Improves Marginally at Year End 2 (Jan. 4, 2010), available at https://encrypted.google.com/url?sa=t&source=web&cd=1&sqi=2&ved=0CBkQFjAA&url=http%3A%2F%2Fwww.nvca.org%2Findex.php%3Foption%3Dcom_docman%26task%3Ddoc_download%26gid%3D534%26Itemid%3D93&rct=j&q=VentureBacked%20Exit%20Market%20Improves%20Marginally%20at%20Year%20End&ei=B6OMTpFL5OLRAeCMmYcF&usq=AFQjCNEZUvEyMQNQlZlXD9GILPXu6TX-9Q; see also News Release, Nat’l Venture Capital Ass’n, Venture-Backed IPO Activity at Lowest Level in Seven Quarters 1–3 (Oct. 3, 2011), available at http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=794&Itemid=93 (reporting that just five companies went public during the third quarter of 2011).

37. There were only fifty-seven VC-backed IPOs in each of 2005 and 2006, and only eighty-six in 2007. See *supra* note 36.

38. Carsten Bienz & Tore Leite, *A Pecking-Order of Venture Capital Exits* 2 (CFS Workshop on Venture Capital and New Markets at the European Economic Association’s 2004 Annual Meeting, Apr. 2008), available at <http://ssrn.com/abstract=916742> (“Both empirical evidence and industry ‘gossip’ suggest that there exists a pecking order of exit channels: IPOs normally yield higher returns than trade sales.”) (citations omitted).

39. See *infra* notes 104–10 and accompanying text (explaining the divergent incentives and underlying motives of VCs and entrepreneurs in the context of IPOs and trade sales).

40. See DAVID WEILD & EDWARD KIM, GRANT THORNTON, MARKET STRUCTURE IS CAUSING THE IPO CRISIS—AND MORE 7 (2010), available at <http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf> (“[T]he lack of an IPO market has caused venture capitalists to avoid financing some of the more far-reaching and risky ideas that have no obvious Fortune 500 buyer.”).

returns plummeted from thirty-four percent to fourteen percent⁴¹ despite a healthy number of trade sales.⁴²

Therefore, whether investor lock-in is a problem in venture capital depends on whether the IPO market will return to its former glory. It is tempting to explain away the current weak IPO market as a short-term aberration. However, certain structural changes have occurred that suggest a long-term problem. First, there is the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”), which has been widely blamed for making IPOs too expensive for most young tech firms.⁴³ Several studies have attempted to measure the increased compliance costs from Sarbanes-Oxley that may be leading start-ups to forego the public markets.⁴⁴ Second, according to a white paper by the accounting firm Grant Thornton, the IPO crisis began before Sarbanes-Oxley and can partially be attributed to certain legislative and regulatory changes designed to level the playing field for retail investors in the stock market.⁴⁵ These regulatory changes included the “death star of decimalization,” which replaced the former fractional system of recording stock spreads in increments of \$0.25 per share with a system that records spreads of \$0.01 per share.⁴⁶ The elimination of the profits for market makers and traders embedded in the fractionalization system meant that there was little reason to continue covering small-cap stocks; instead, smaller spreads now meant a volume business. As Grant Thornton puts it, “[i]n a hyper-

41. Pui-Wing Tam, *Venture Funds Sweetening the Terms*, WALL ST. J., Nov. 22, 2009, at C1 (finding that the average venture capital fund return “fell to 14% for the 10 years ended June 30 [2009], down from 34% for the 10 years ended June 30, 2008”).

42. Further, there are too few trade sales to keep pace with the number of VC investments that require an exit. One commentator states that “U.S. venture capitalists invested in 23,935 deals between 2001 and 2007, but only 2700 or 11% of venture capital-backed deals had either IPO or M&A exits during this time period.” HANS SWILDENS, *INDUSTRY VENTURES, VENTURE CAPITAL SECONDARY FUNDS—THE THIRD OPTION 2* (2008), available at http://www.industryventures.com/pdf/Venture_Capital_Secondaries_White_Paper.pdf (citing Thomson Reuters, National Venture Capital Association, and PricewaterhouseCoopers data).

43. See KEDROSKY, *supra* note 35, at 5 (“Some have argued that the cause of poor returns, post-Sarbanes-Oxley, is that the IPO window never reopened for early-stage companies, largely eliminating the primary source of profitable exits for venture investors.”); Dale A. Oesterle, *The High Costs of IPOs Depresses Venture Capital in the United States*, 1 *ENTREPRENEURIAL BUS. L.J.* 369, 370 (2006) (“The higher ongoing costs are a significant bone of contention, particularly with the implementation of Section 404 of the Sarbanes-Oxley Act of 2002.”).

44. See Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 *YALE J. ON REG.* 229, 252 n.92 (2009) (citing sources on increased compliance costs for public companies post-Sarbanes-Oxley); Ehud Kamar et al., *Sarbanes-Oxley’s Effects on Small Firms: What is the Evidence?* 26 (Harvard Law Sch. John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 588, 2007), available at http://lsr.nellco.org/harvard_olin/588 (finding that there is ample evidence that the Sarbanes-Oxley Act increased public firms’ accounting and auditing costs).

45. WEILD & KIM, *supra* note 40, at 4.

46. *Id.* at 11.

efficient market, where trading spreaders and commissions are approaching zero, the company needs to be large enough to attract research and investors.”⁴⁷ This change has resulted in no coverage for most small-cap stocks, including VC-backed start-ups after an IPO. Exacerbating the decimialization problem, according to Grant Thornton, were certain other rule changes that drove analysts away from small-cap stocks, including the Manning Rule, Order Handling Rules, and Regulation FD (Fair Disclosure).⁴⁸ Both these reforms and the lingering effects of Sarbanes-Oxley suggest that public markets will not be nearly as hospitable a home for future start-ups.

These negative effects are showing. VCs are now locked into their investments for double the time they were a decade ago—from an average of three to four years then to more than seven years today.⁴⁹ Entrepreneurs and employees, who run start-ups for several years before attracting venture capital, are locked in for even longer. Venture capital fund investors see the writing on the wall. With VC returns now less than or equal to public-market returns on average, but with more risk and illiquidity, it is not surprising to find a precipitous drop in investor commitments to this sector. In the second quarter of 2009 alone, “just 25 [venture capital] funds raised \$1.7 billion,” which is “the smallest number of funds raising money since 1996 and the lowest dollar amount committed to venture funds since 2003.”⁵⁰ The lack of funding on the top half of the venture capital structure means less funding for start-ups on the bottom half of the structure. For the start-ups that can still attract venture capital, VCs will price the greater illiquidity into their investments and demand more equity. All of this could lead to less innovation.⁵¹ Consequently, the future of venture capital and our entrepreneurial economy could

47. *Id.* at 16.

48. *See id.* at 13 (discussing each of these rule changes).

49. *See* BASIL PETERS, EARLY EXITS: EXIT STRATEGIES FOR ENTREPRENEURS AND ANGEL INVESTORS (BUT MAYBE NOT VENTURE CAPITALISTS) 40 (2009) (graphing the increase in time to exit using DowJones VentureSource data); Lynn Cowan, *Investment in Early-Stage Firms Endures*, WALL ST. J., Feb. 23, 2009, at C2 (“[T]he time from purchase to sale may extend to seven years, instead of three to five years.”); Dan Burstein & Sam Schwerin, *Inside the Growing Secondary Market for Venture Capital Assets* 6 (Nov. 12, 2008) (unpublished manuscript) (on file with author) (finding that the median holding period for a venture capital investment “has recently risen to more than seven years, an all-time high...[and] a 40% increase over the median of a decade ago”).

50. Miller, *supra* note 35; *see also* Tam, *supra* note 41 (citing statistics on the recent decline in VC fundraising).

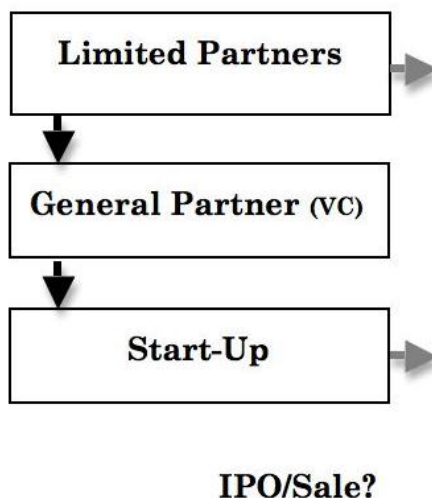
51. Claire Cain Miller, *With Private Trades, Venture Capital Seeks a New Way Out*, N.Y. TIMES, Apr. 22, 2009, at B9 (quoting David Weild as stating that the poor exit market for venture capital “is one of the greatest tragedies of our time” and that “[t]he source of U.S. innovation and competitiveness and job creation has been failed by the capital markets”).

depend on finding a solution to the exit problem. Otherwise, investor lock-in could plague venture capital for years to come.

II. SECONDARY MARKETS IN VENTURE CAPITAL: DESCRIPTION AND FRAMEWORK FOR ANALYSIS

While the previous Part revealed the dire exit situation in venture capital, this Part examines a potential solution: the emergence of secondary markets where individual investors in start-ups and venture capital funds can sell their ownership interests even before a start-up has its own exit event. This new exit option, a potential game changer in venture capital, is illustrated in Figure 3.

Figure 3: Secondary Market Exits



VC secondary markets offer an important release valve for the increasing pressure on traditional exits.⁵² Moreover, they have the potential to solve vexing problems in start-up and venture capital fund governance that are present even when traditional exit markets are strong. The discussion that follows focuses on the secondary market that is emerging on the bottom half of the venture capital structure: the market for the stock of private start-ups, known in the industry as the “direct” market.⁵³ This Part describes the direct secondary market,

52. This viewpoint has been stressed by prominent VC Fred Wilson, who opines that secondary markets are “badly needed” because “[n]ot everyone can wait until the [start-up] exit comes or the IPO market comes back.” Fred Wilson, *A Second Market is Emerging*, A VC (Apr. 23, 2009), http://www.avc.com/a_vc/2009/04/a-second-market-is-emerging.html.

53. *Direct Secondaries*, W CAPITAL PARTNERS, <http://www.wcapgroup.com/>

explores its main theoretical advantages, and evaluates its main theoretical limitation. Finally, the direct secondary market is compared with the secondary market that is emerging on the top half of the venture capital structure: the market for the sale of LP interests in venture capital funds, known in the industry as the “fund” market.

A. The Secondary Market for Start-up Stock (the Direct Market)

The direct market for start-up stock is the newer of the VC secondary markets, beginning when the dot-com bust left investors holding Internet stocks that they could no longer sell through public markets.⁵⁴ In the short time since, it has rapidly expanded to reach sales exceeding \$1 billion a year.⁵⁵ As discussed earlier, describing the direct secondary market is challenging due to its newness, rapidly evolving nature, and largely unregulated status, which means that the market is not subject to reporting requirements. As one interviewee admitted, the market is still “so young, it’s hard to draw a lot of trends.” Trade publications, newspaper stories, blog posts, and hand-collected data from original interviews with industry participants all helped, but the direct market description that follows remains incomplete.⁵⁶ The remainder of this Section offers a snapshot of direct market sellers, direct market buyers, and their respective motivations for selling and buying.

Sellers. Most sellers in the direct market are entrepreneurs and employees who hold start-up common stock. As the market blossoms, however, one interviewee told me that VCs are becoming more active sellers of their start-up preferred stock. According to that source’s data (which admittedly represents only one slice of this market), only a year ago entrepreneurs and employees made up seventy percent of the direct market sales by dollar amount and ninety percent by transaction volume, with VCs making up the

DirectSecondariesAbout/tabid/73/Default.aspx (last visited Oct. 5, 2011) (“A direct secondary transaction is the sale of a particular investor’s investment in a privately held, operating company to a new third-party investor.”).

54. See Burstein & Schwerin, *supra* note 49, at 1 (describing the direct secondary market as “[o]ne of the newer frontiers of secondary market activity”).

55. See SWILDENS, *supra* note 42, at 3 (citing direct secondary sales of \$1.25 billion in 2007, up thirty percent from the year before); see also Burstein & Schwerin, *supra* note 49, at 5 (“[I]f only two to three percent of the total volume of invested capital were to change hands in secondary transactions in a given year (a very modest ‘churn’ factor for most financial markets), we can envision a direct secondary market of \$6 billion to \$12 billion on an annual basis.”).

56. For an excellent description of an emerging secondary market for bankruptcy claims, see Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67 (2009).

balance. Very recently, however, entrepreneurs and employees were selling only fifty percent by dollar amount and seventy percent by transaction volume, meaning that VCs are increasingly turning to secondary sales for their exit woes.⁵⁷ Another interviewee, a large direct market buyer, told me that half of their deal flow comes from entrepreneurs and employees, while the other half comes from large financial institutions like Goldman Sachs or Oppenheimer or private equity firms who are holding start-up stock “for whatever reason.” This buyer purchases forty percent common stock and a good bit of preferred stock, diversifying by playing “up and down the capital structure.” Interestingly, none of the angel investors or venture lenders I asked sold in the direct market, nor did published sources mention them as notable direct market sellers. Although it is difficult to generalize from these limited data points, my prior work on both angels and venture lenders suggests rational reasons for each to eschew secondary markets.⁵⁸

Sellers’ Motivations. Entrepreneurs, employees, and VCs have their own idiosyncratic reasons for selling shares in the direct market. VCs will need to fund their other portfolio companies and return cash to LPs.⁵⁹ Employees whose compensation is tied up in options may have basic life needs like paying their rent.⁶⁰ Both entrepreneurs and employees may have all their financial and human capital tied up in the start-up and wish to diversify.⁶¹ “Serial” entrepreneurs may need capital to start their next venture. In notable examples like Facebook,

57. I was unable to independently confirm these figures.

58. While VCs need liquidity to return capital to LPs upon fund expiration, angels invest their own capital and are therefore not subject to the same “downstream pressure,” allowing them to wait longer for traditional exits rather than resort to secondary sales. Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1434–35 (2008). Moreover, as wealthy ex-entrepreneurs who invest only a small portion of their net worth in start-ups, angels do not face the same cash flow or diversification pressures as entrepreneurs and employees. Venture lenders similarly have not yet looked to secondary markets, but for different reasons. First, their loans to start-ups are of relatively short duration—two to three years—and thus not subject to the same investor lock-in concerns that equity investors face. See Ibrahim, *supra* note 31, at 1179. Second, venture debt has never been dependent on the start-up’s exit event, only on the continued supply of venture capital to repay loans in the meantime. *Id.* at 1184–85.

59. William K. Sjostrom, Jr., *The Birth of Rule 144A Equity Offerings*, 56 UCLA L. REV. 409, 433 (2008) (“Liquidity is particularly important to venture capital investors because it allows them to recycle their capital into other ventures.”); see also Burstein & Schwerin, *supra* note 49, at 9 (corporate VCs “will always be subject to strategy shifts, designed to serve the needs of the larger company business plan.”).

60. Burstein & Schwerin, *supra* note 49, at 6–7.

61. See Sjostrom, *supra* note 59, at 433 (liquidity “is important to a company founder because his ownership stake likely represents a large percentage of his net worth. Selling a portion of his holdings allows him to have a more diversified portfolio.”).

management's desire to stay private (for now at least) instead of going public, coupled with extremely high valuations, tempt employees and other shareholders into selling.⁶²

Further, entrepreneurs and employees are often able to obtain a good sales price. Common stock in start-ups is notoriously difficult to value. But one common method is to price it relative to the latest preferred stock price. Because common stock does not have all the bells and whistles of preferred stock, it will be worth less. Indeed, when granting stock options to employees, start-ups usually take the position that the stripped-down common stock is worth no more than ten percent of the latest preferred price (a ninety percent discount).⁶³ Conversely, the discounts are far less in direct market transactions. One interviewee claimed that a five to twenty percent discount from the latest preferred round is standard.⁶⁴ By way of a quantitative data point, Digital Sky Technologies recently bought both preferred and common shares of Facebook; it valued the preferred at \$10 billion and the common at \$6.5 billion—only a thirty-five percent discount.⁶⁵ One large buyer told me that his firm's preferred-to-common discount averages seventy-one percent, higher than others but still less than standard practice in option pricing.

The discounts are so low in the direct market because the start-ups sold there are well-known, later-stage companies like Facebook,⁶⁶

62. See Peter Lattman, *The Frenzy Over the Shadow Market in Facebook Shares*, N.Y. TIMES DEALBOOK (Dec. 28, 2010), <http://dealbook.nytimes.com/2010/12/28/the-frenzy-over-the-shadow-market-in-facebook-shares/>; see also *infra* note 66 on Facebook's significance to the direct market.

63. See Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 900–01 n.86 (2003) (noting that the rule-of-thumb “ten-to-one” preferred-to-common discount may actually be conservative, and that “[o]ne practitioner reported that 1000-to-1 valuation ratios are sometimes used”). On the other hand, it is assumed there is a fair amount of gaming that goes on here, with the goal being to keep option value low for tax purposes to help start-ups attract employee talent.

64. One interviewee explained that whether the preferred stock's liquidation and other preferences are likely to matter in practice for that particular start-up might also be taken into consideration in determining the appropriate preferred-to-common discount.

65. See Brad Stone, *Facebook Employees and Investors Can Finally Unload Stock*, N.Y. TIMES BITS BOG (July 13, 2009), <http://bits.blogs.nytimes.com/2009/07/13/facebook-employee.s-and-investors-can-finally-unload-stock/> (describing Digital Sky's tender offer to purchase up to \$100 million of Facebook common stock)

66. Trading in Facebook stock comprises a large part of the direct market. See Rafe Needleman, *How to Buy Private Stock Like Facebook*, CBS NEWS (July 2, 2009, 8:21 PM), http://www.cbsnews.com/stories/2009/07/02/tech/real_technology/main5130280.shtml (describing a direct market service for selling private company shares); Fred Wilson, *When You Are a Public Company Without Being Public*, A VC (Apr. 16, 2009), http://www.avc.com/a_vc/2009/04/when-you-are-a-public-company-without-being-public.html (describing the “active secondary market for employee shares in Facebook”). According to one interviewee, in March 2010, the median direct transaction occurring through one of the main electronic marketplaces was about \$1.3

LinkedIn,⁶⁷ and Tesla Motors.⁶⁸ Thus, the direct market is a “winner’s market” for mature start-ups rather than a market for lemons.⁶⁹ According to an interviewee, the percentage of a start-up’s stock that trades in the direct market increases exponentially each year beginning when the start-up is about five years old.⁷⁰ The sales prices fetched in the direct market, coupled with idiosyncratic reasons for selling, may explain why sellers would unload winners that may yet have a traditional exit. In addition, my interviewees revealed that most sellers unload only partial positions, not their entire holdings. Selling some stock now provides liquidity while still allowing sellers to participate in a later IPO or trade sale.

Buyers. With no shortage of willing sellers in the direct market, attention turns to the buyers. There are at least four large funds dedicated to direct market purchases: Industry Ventures,⁷¹ Millennium Technology Value Partners,⁷² Saints Capital,⁷³ and W Capital Partners.⁷⁴ As the direct market grows, one interviewee tells

million with the highly valued Facebook stock included, but only \$250,000 without it. The mean numbers at the time were \$2.3 million per transaction with Facebook included but only \$500,000 without it. I have been unable to confirm these figures, but if they are in the ballpark, the Facebook effect on the direct market is indeed significant.

67. See Eric Eldon, *LinkedIn, Like Facebook, is Letting Employees Sell Some Stock Early*, VENTURE BEAT (Aug. 4, 2008), <http://venturebeat.com/2008/08/04/linkedin-like-facebook-is-letting-employees-sell-some-stock-early/> (finding that LinkedIn is letting employees sell up to twenty percent of vested stock options on the direct market).

68. See Josie Garthwaite, *SharesPost CEO: Why Cleantech, More than Web 2.0, Needs a Third Exit*, EARTH2TECH (July 22, 2009, 3:41 PM), <http://www.sharespost.com/press/media/Earth2Tech.7.22.2009.pdf> (noting that Tesla Motors stock was traded in SharesPost’s first transaction). Tesla Motors has since had a traditional IPO exit. See Lynn Cowan & Matt Jarzemsky, *Tesla Roars Out of the Garage*, WALL ST. J., June 30, 2010, at C3 (“Electric-car maker Tesla Motors Inc. generated the second-best initial public offering gain of the year [on June 29, 2010], even as the broader market fell sharply.”).

69. See Interview by Benjamin F. Kuo with Greg Brogger, CEO, SharesPost (June 17, 2009), available at http://www.socaltech.com/interview_with_greg_brogger_sharespost/s-0022276.html [hereinafter Brogger Interview] (“Companies [that SharesPost] has selected are those that are the most exciting, and high profile, that people will want to invest in. SharesPost does not cater to new start-ups, but to “mature companies, where there are already active, secondary markets. They are companies like Facebook, which has shares trading daily, or at least on a weekly basis.”).

70. This interviewee claims that maybe one percent of the stock will be sold in the secondary market in Year 5, two percent in Year 6, four percent in Year 7, eight percent in Year 8, sixteen percent in Year 9, and so on. Tax considerations may be one reason for this trend. Small business sellers who have held their shares for over five years receive favorable tax treatment under Internal Revenue Code Section 1202. 26 U.S.C. § 1202 (2006).

71. INDUSTRY VENTURES, LLC, <http://www.industryventures.com> (last visited Oct. 5, 2011).

72. MILLENNIUM TECHNOLOGY VENTURES, <http://www.mtvlp.com/index.php> (last visited Oct. 5, 2011).

73. SAINTS VC, <http://www.saintsvc.com> (last visited Oct. 5, 2011).

74. W CAPITAL PARTNERS, <http://www.wcapgroup.com> (last visited Oct. 5, 2011).

me that strategic buyers are also entering the market, but buying “only what they know.” Another interviewee tells me that late-stage VCs often buy their preferred shares from early stage VCs. This interviewee claims that “sixty to seventy percent of [later-stage VC financing rounds] have a secondary component to them.” In other words, late-stage VCs buy some of their shares from the start-up’s treasury and some from existing investors.

Buyers’ Motivations. Buyers have three primary motivations for participating in the direct market. First, it allows them access to an asset class previously limited to Silicon Valley insiders. The direct market gives buyers access “to the most significant growth companies of tomorrow.”⁷⁵ Second, because it is a market for well-known, later-stage start-ups, non-VCs may have an easier time evaluating start-up quality for themselves. A track record, coupled with the greater information available on start-ups that have gained some notoriety, reduces one of the main problems in start-up selection: information asymmetry.⁷⁶ Third, direct market buyers, themselves funds with investors to answer to, come into start-ups with a fresh exit clock. Therefore, while the VC’s fund may be set to expire, forcing it to seek even a suboptimal exit, direct market buyers essentially *start over* in waiting for a traditional exit. As long as traditional exits for winning companies are simply delayed, rather than gone altogether, direct market buyers will reap their spoils.

B. Benefits of the Direct Market

With some sense of the direct market in mind, this Section constructs a framework for analyzing the main benefits it offers participants in venture capital. The direct market’s most obvious benefit is that it increases liquidity for start-up investors. While improved liquidity is particularly important when traditional exit markets are weak, “there are many reasons for investors to participate in a more liquid marketplace *all the time*.”⁷⁷ Those reasons transcend

75. *SharesPost Launches to Bring Private Company Stock Liquidity to Early Stage Investors*, BUSINESS WIRE (June 16, 2009, 9:00 AM), http://www.businesswire.com/portal/site/home/permalink/?ndmViewId=news_view&newsId=20090616005461&newsLang=en [hereinafter *SharesPost Launches*]; see also *id.* (“The SharesPost community has already seen an increasing number of new posts to buy and sell shares of some of today’s most exciting private companies, including Facebook, LinkedIn, SolarCity, Tesla Motors, eHarmony, and more.”).

76. See Ibrahim, *supra* note 58, at 1412 (uncertainty involved in a start-up’s first few years “provides entrepreneurs with significant informational advantages over venture capitalists and increases agency costs by making it more difficult for venture capitalists to sort between good and bad entrepreneurs”).

77. Burstein & Schwerin, *supra* note 49, at 5.

the purely financial and speak to persistent problems in start-up governance. As this Section explains, the direct market can improve start-up governance by disciplining controlling parties, and it can minimize suboptimal start-up exits by providing a release valve for individual investors with idiosyncratic liquidity needs.

1. Increasing Liquidity

The most obvious benefit of the direct secondary market is that it makes start-up stock more liquid.⁷⁸ The increased liquidity offered by the direct market has both ex post benefits for individual investors looking to sell and ex ante benefits for nascent start-ups that need funding.

First, assume that investors are already invested in a start-up and now need liquidity, but no IPO or trade sale is on the horizon. Before the direct market came about, the transaction costs of trying to sell noncontrolling interests in private start-ups were prohibitive.⁷⁹ Finding a buyer might take substantial effort. In the absence of publicly available information, the buyer's own due diligence would be required, and substantial negotiation might ensue over the purchase price and other transaction details.⁸⁰ Further, the information costs for buyers would be extremely high. It is difficult for buyers to obtain information about companies operating in private, illiquid markets. This lack of information limits the class of buyers to those willing to perform their own due diligence on sellers. Illiquid markets have no mechanism through which new buyers can rely on the market prices

78. Liquidity has been defined in various ways. See LARRY HARRIS, *TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS* 394 (2002) (“[L]iquidity is the ability to trade large size quickly, at low cost, when you want to trade.”); Robert B. Ahdieh, *Making Markets: Network Effects and the Role of Law in the Creation of Strong Securities Markets*, 76 S. CAL. L. REV. 277, 285 (2003) (liquidity is the “minimization of trading friction”); Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 321 (2000) (liquidity allows investors “to purchase or sell a particular security quickly and at a low transaction cost”); Jonathan R. Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1012 (1990) (liquidity is “a market characteristic that assures investors that they can promptly purchase or dispose of stock at a price closely related to the market’s best estimate of the present value of the future income stream that the stock will generate for investors”).

79. See Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1583 (2005) (noting that transaction costs are “broadly understood as obstacles to efforts voluntarily to shift resources to their most valuable use”).

80. See Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. 1, 28 (1993) (“[A] client wishing to protect itself through private contracting faces three major sources of transaction costs: search costs, negotiation costs, and enforcement costs.”).

set by other traders (better known as the “efficient capital markets hypothesis” in public markets⁸¹).

The direct market is improving the liquidity of start-up stock for locked-in investors by lowering these transaction costs.⁸² With large funds dedicated to direct market purchases, buyers are now easier to find. Electronic marketplaces, discussed later, have the potential to expand the buyer pool even further.⁸³ At least one of those intermediaries, SharesPost, generates research reports on private start-ups and publicly posts buy-sell bids for their shares, reducing information costs for new buyers who wish to piggyback on the prices set by others. As repeat buyers, the large direct market buyers have developed form contracts for their purchases, reducing the transaction costs in papering sales. Electronic marketplaces also supply forms and ease the administrative aspects of sales such as the transfer of funds. The direct market is certainly not the NYSE—most start-ups are not well-known or far enough along in their development to participate—but it still improves liquidity for some start-up investors who find themselves in a position where it would be advantageous to sell.

Second, by improving liquidity for individual investors *ex post*, the direct market has the potential to increase the number of start-ups that will receive VC funding *ex ante*. A numerical example will illustrate the point.⁸⁴ In a hypothetical world of *perfect* liquidity, assume that VCs are willing to invest in start-ups that will produce an expected internal rate of return (“IRR”) of twenty percent. But, like corporate bondholders whose bonds are only infrequently traded,⁸⁵

81. See Zohar Goshen & Gideon Parchomovosky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 714 (2006) (“The two main determinants of market efficiency are share price accuracy and financial liquidity.”); Hetherington & Dooley, *supra* note 18, at 44 (“Liquidity is thus essential to the efficient allocation of resources in the capital market, and a system that freezes allocation at the time of initial investment is inherently inefficient.”); Macey & Kanda, *supra* note 78, at 1014 (“[T]he concept of liquidity is closely linked to the concept of market efficiency.”). See generally Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 413–16 (1970) (the seminal work on the efficient capital markets hypothesis); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554–58 (1984) (discussing market efficiency generally).

82. Liquidity is better thought of as a matter of degree rather than an all-or-nothing feature. See Choi, *supra* note 78, at 321 (“The degree of liquidity in a particular market depends in part on the volume of the market.”); Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 CALIF. L. REV. 1323, 1339 (2005) (increasing liquidity means “reducing the costs incurred by shareholders in buying and selling [start-up] shares”).

83. See *infra* Part III.A (explaining the role of electronic marketplaces in facilitating market growth).

84. I am most grateful to Brian Broughman for suggesting this example.

85. Finance studies from the corporate bond market reveal that investors price illiquidity into their investments. See George Chacko, *Liquidity Risk in the Corporate Bond Market* 15 (Jan. 15, 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=687619>

VCs will also price in an “illiquidity premium” given the risks of the investment. The VC’s illiquidity premium may be quite high, perhaps ten percent, given the real concern that the start-up will go belly-up and the VC’s shares will turn out to be completely illiquid. Coupling the VC’s twenty percent baseline IRR (perfect world) with the illiquidity premium of ten percent (real world), VCs will demand an IRR of at least thirty percent before investing.⁸⁶ That is the world as it existed before the direct market.

But now assume that the increased exit opportunities that the direct market offers reduce the illiquidity premium by half, to five percent. A new class of start-ups—those with expected IRRs between twenty-five and thirty percent—are now candidates for VC funding. To illustrate, consider two hypothetical firms, Start-up X and Start-up Y, operating in either a “low liquidity” or a “medium liquidity” world. Start-up X expects to generate a thirty-two percent return on its assets, while Start-up Y expects to generate a twenty-seven percent return on its assets. Only Start-up X clears the thirty-percent hurdle rate in the “low liquidity” world that existed before the direct market; Start-up Y will not receive funding in that world. However, *both firms* clear the twenty-five-percent hurdle rate in the “medium liquidity” world that now exists with the direct market. The following Table summarizes the change:

	Expected IRR	LOW LIQUIDITY (10% premium)		MEDIUM LIQUIDITY (5% premium)	
		VC Hurdle Rate	Financing Possible?	VC Hurdle Rate	Financing Possible?
Start-up X	32%	30%	Yes	25%	Yes
Start-up Y	27%	30%	No	25%	Yes

(“[L]iquidity risk is clearly an important factor in the pricing of corporate bonds.”); Long Chen et al., *Corporate Yield Spreads and Bond Liquidity 1* (Apr. 2005) (unpublished manuscript), available at <http://ssrn.com/abstract495422> (“[F]or the same promised cash flows, less liquid bonds will be traded less frequently, have lower prices, and exhibit higher yield spreads.”).

86. This thirty percent figure may even be conservative. See Robert P. Bartlett, III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 72 (2006) (“Among early-stage venture capitalists, for instance, it is generally assumed that an investment portfolio should yield an IRR of approximately 30 to 50 percent. Moreover, because many of these investments will ultimately be written off, VC investors commonly make individual company investments with the expectation that each will produce a 40 to 50 percent projected IRR after accounting for the venture capitalist’s fees and compensation.”) (citations omitted).

By increasing liquidity for individual investors ex post, the direct market should lead to more start-ups being funded ex ante.

2. Improving Start-up Governance

Beyond its direct financial benefits, the direct market can be an important governance tool for start-up investors. To understand how, it is first important to explore a persistent problem in venture capital—the allocation of control rights between VCs and entrepreneurs. In the early stages of the VCs' involvement, entrepreneurs will typically control the start-up at both the shareholder and director levels. This arrangement protects entrepreneurs against holdup by the VCs, but in turn it creates high agency costs for the VCs by making them vulnerable to entrepreneurial opportunism.⁸⁷ Entrepreneurs may mismanage their firms or use their control to extract private benefits, such as high salaries, at the VCs' expense.⁸⁸ To protect themselves against such contingencies, VCs may contract for negative covenants that prevent entrepreneurs from taking certain actions without VC consent.⁸⁹ These contracts will necessarily be incomplete, however, leaving VCs at some risk.

As the start-up progresses and VCs contribute additional capital, the control situation changes. VCs acquire more shares and more board seats, and at some point control shifts from entrepreneurs to VCs. As Gordon Smith observes, the VCs' "incremental increases in voting power via staged financing . . . are the key to an elegant contingent control mechanism embedded in most venture capital relationships."⁹⁰ Jesse Fried and Mira Ganor have discussed how the change in control can lead to the opposite problem that existed at the outset: high agency costs for entrepreneurs, who are now vulnerable to opportunism by VCs.⁹¹

87. In this setting I use the term "opportunism" broadly to mean not only self-dealing, but also managerial incompetence.

88. Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 989 (2006).

89. Smith, *supra* note 29, at 319 (explaining that in the early stages of their investment, VCs "use negative contractual covenants (often called 'protective provisions') and liquidation rights to limit that ability of entrepreneurs to act opportunistically").

90. *Id.* at 324.

91. Fried & Ganor, *supra* note 88, at 972 ("The second purpose of this Article is to show that common shareholders may be vulnerable to preferred shareholder opportunism when preferred shareholders control the board."); see also Brian J. Broughman, *Investor Opportunism and Governance in Venture Capital*, in VENTURE CAPITAL: INVESTMENT STRATEGIES, STRUCTURES, AND POLICIES 347, 347–48 (Douglas J. Cumming ed., 2009) (discussing situations in which VCs may act opportunistically at the expense of entrepreneurs).

With control rights residing with either entrepreneurs or VCs, one side is always left open to the potential for opportunism by the other. Before the direct market, the law was an obvious place to look for a solution to the opportunism problem. Fiduciary duties are designed for this very purpose. However, fiduciary duties have not been able to solve the opportunism problem in start-ups. First, when entrepreneurs are in control, fiduciary duties will not provide a remedy for oppressed VCs because preferred stock has long had only contractual rights, much like debt.⁹² Should VCs fail to protect themselves from an unforeseen contingency in their investment contracts, they are out of luck. The failure of a fiduciary remedy for VCs was evident in the case of *Equity-Linked Investors v. Adams*, where the Delaware Chancery Court allowed the entrepreneur-controlled board to pursue a risky strategy that had the potential to benefit the common shareholders but was more likely to wipe out the little existing value left for the preferred shareholders.⁹³ Second, while it might appear that fiduciary duties would be more effective in the reverse situation—VC-controlled boards acting opportunistically toward common-holding entrepreneurs—that may not be the case. In *Orban v. Field*, the Delaware court allowed VCs to sell the start-up for an amount less than their liquidation preference, wiping out the common shareholders.⁹⁴ The combined effect of these cases has led Fried and Ganor to describe fiduciary duties in start-ups as “control-contingent,” meaning that whoever controls the board can effectively favor their own class of shares without violating their fiduciary duties.⁹⁵

Beyond fiduciary duties, a few other constraints on opportunistic conduct in start-ups might exist, including reputation markets,⁹⁶ shareholder voting,⁹⁷ and independent directors who cast

92. See Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443, 444 (1996) (concluding “that the preferred stockholder ought not to think of himself or herself as a stockholder at all and should plan to rely exclusively on his or her contract as the source of rights”).

93. 705 A.2d 1040, 1041 (Del. Ch. 1997). Because VC preferred stock comes with a liquidation preference, any residual value in the start-up on dissolution goes to satisfy that preference before the common shareholders receive anything.

94. No. 12820, 1997 Del. Ch. LEXIS 48, at *32 (Apr. 1, 1997) (finding no breach of the duty of loyalty to the common shareholders because they had no legal right to receive any portion of the sale proceeds).

95. Fried & Ganor, *supra* note 88, at 992–93 (“Together, *Equity-Linked* and *Orban* indicate that the courts have adopted what we call a ‘control-contingent’ approach to fiduciary duties: The identity of those controlling the board affects the content of the board’s duties.”).

96. It is unclear to what extent reputational considerations deter opportunistic conduct in start-ups. Compare Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 262–63 (1998) (arguing that

tie-breaking votes.⁹⁸ But with each of these solutions far from perfect, the direct market presents a welcome alternative. In public corporations, the threat of exit is thought to be an effective constraint on opportunism.⁹⁹ Before the direct market, however, that threat had never been credible in the start-up context.¹⁰⁰ With the emergence of the direct market, that has changed.

There are several reasons why the threat of a direct market exit may work exceptionally well at reducing agency costs in start-ups. First, the inputs of the various parties are highly observable in start-

close geographic proximity of VCs and entrepreneurs in places like Silicon Valley enhance the importance of reputational considerations), *with* Fried & Ganor, *supra* note 88, at 1005 (“[R]eputational considerations may not always prevent VCs from acting in ways that reduce aggregate shareholder value.”), and D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 174 (1998) (hypothesizing that the reputational market in venture capital is informationally inefficient because of lack of central location where such information can be traded among entrepreneurs). Smith has since observed that the emergence of websites like THE FUNDED, where entrepreneurs post about their experience with particular VCs, have some potential to remedy the “no central location” problem and consequently enhance the reputation market in this setting. D. Gordon Smith, *The Funded*, THE CONGLOMERATE (Aug. 7, 2007), <http://www.theconglomerate.org/2007/08/the-funded.html>.

97. Shareholder voting is unlikely to be an effective constraint on opportunism in start-ups because most actions do not require a shareholder vote, and those that do typically allow the preferred to vote with (and overwhelm) the common on an “as-if-converted” basis. Fried & Ganor, *supra* note 88, at 1001–03. California law, on the other hand, does require a class vote, giving common shareholders some power to extract value from the preferred on exit. See Brian Broughman & Jesse Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384, 390 (2010).

98. Some scholars assume that independent directors on start-up boards are likely to side with VCs, or whichever party has control at the time of the dispute. See Fried & Ganor, *supra* note 88, at 988 (stating that independent directors are “not truly independent of the VCs”); Smith, *supra* note 29, at 327 (noting that independent directors will either be appointed by the entrepreneurs or the VCs, depending on who holds more equity at the time). Brian Broughman’s recent empirical work suggests that independent directors may be more neutral than previously believed and play a true arbitrating role on contentious decisions. Brian Broughman, *The Role of Independent Directors in VC-Backed Firms* 25–31 (Oct. 13, 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1162372>.

99. For the seminal law-and-economics work on the how markets can reduce agency costs in public corporations, see Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); see also Hetherington & Dooley, *supra* note 18, at 43 (“[T]he existing business organization regulatory system depends to a far greater extent on competitive market restraints than on legal restraints.”); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal’s Role in Corporate Law*, 84 GEO. L.J. 1, 6–7 (1995) (“A developed market for shares can be an investor’s most valued protection, offering liquidity that often is more useful than any legal provision.”).

100. An important qualification must be made here. VCs have always retained the right to “exit” start-ups by declining to continue their staged financing. See Smith, *supra* note 29, at 316 (“[T]he credible threat of exit by venture capitalists may work to minimize the temptation toward self-dealing by the entrepreneurs who manage venture-backed companies.”). However, this exit, like the LP’s right to exit a venture capital fund by refusing to answer future capital calls, essentially wipes out the value of the VC’s current shares, making it a suboptimal solution and not a fully credible threat.

ups. While public shareholders are dispersed, are passive, and suffer from information asymmetries about managerial performance, the opposite is true in start-ups. Entrepreneurs and VCs are active participants in the enterprise and routinely observe each other's performance. Therefore, they are in a better position to observe opportunism and threaten exit as a result. They also realize each other's relative importance to the team, which can make the threat of exit more credible for highly valued team members. Second, while shifting control rights always leave VCs or entrepreneurs vulnerable to opportunism from the other, the threat of exit through the direct market works *no matter who* is in control. Whichever party is experiencing high agency costs can look to the direct market for an out, thus reducing the importance of having control and the precision required in drafting investment contracts to address the issue. Third, by allowing aggrieved parties to sell their shares, the direct market can reduce the transaction costs that would otherwise be incurred in ineffective litigation. Now disgruntled shareholders in start-ups can turn to the direct market rather than seek a fiduciary remedy in court, which the *Equity-Linked* and *Orban* cases show has a low probability of success. Finally, the impediments to a well-functioning public takeover market, such as poison pills, do not appear to pose a problem in private start-ups, although rights of first refusal provisions in option grants (discussed later) might play a similar role in making direct market sales more difficult.¹⁰¹

3. Mitigating VC-Entrepreneur Conflicts Over Traditional Exits

The third main benefit of the direct market is to solve another vexing problem in venture capital—the fact that traditional exits often do not align the incentives of VCs and entrepreneurs. This misalignment can produce suboptimal outcomes for individual investors that are forced into a premature exit that leaves money on the table; it can also lead to suboptimal outcomes at the start-up level. As Fried and Ganor observe, “VC-controlled boards may prematurely push for liquidation events, such as dissolution or mergers, that hurt common shareholders more than they benefit the preferred, thereby reducing total shareholder value.”¹⁰²

IPOs are not the main problem here. Because IPOs produce higher dollar returns and allow VCs to fulfill their implicit contract to

101. See *infra* notes 184–86 and accompanying text (discussing rights of first refusal in stock option grants).

102. Fried & Ganor, *supra* note 88, at 972.

return control to entrepreneurs,¹⁰³ both parties will generally favor an IPO exit. As Paul Gompers has found, however, young VCs trying to establish a reputation may “grandstand” by taking start-ups public prematurely.¹⁰⁴ Thus, there are some circumstances under which VCs and entrepreneurs will not be aligned on the timing of IPOs.

The more common tension, however, arises when the traditional exit under consideration is a trade sale. IPOs, even premature ones, return entrepreneurs to a position of control, while entrepreneurs in acquired start-ups may be replaced or relegated to a lesser position within a large organization.¹⁰⁵ Therefore, the assumption is that entrepreneurs will seek to delay trade sales to continue extracting private benefits from running an independent start-up.¹⁰⁶ Conversely, VCs are assumed to push for trade sales because their funds may be expiring, because they need to show LPs successful exits for fundraising purposes, or because trade sales are a safe way for VCs to recoup their investments through liquidation preferences.¹⁰⁷

Under a new account that is emerging from angel investors, however, the story is the exact opposite. The new claim is that entrepreneurs (and angels) desire even small-dollar trade sales because they produce high returns for early investors, but that VCs choose to wait for higher-value exits.¹⁰⁸ For a trade sale under \$30 million, entrepreneurs might receive a hundred-fold return on investment due to purchasing their shares at the start-up’s inception, and angels who invest at a slightly higher valuation still make a ten-

103. See Black & Gilson, *supra* note 96, at 246 (noting that an IPO allows the VC to return control of the start-up to the entrepreneur).

104. Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133, 134 (1996).

105. See Thomas Chemmanur et al., *The Exit Choices of Entrepreneurial Firms 2* (Mar. 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1536024> (“The disadvantage of an acquisition is that the entrepreneur is likely to lose his control benefits while in an IPO he remains in control of the firm.”).

106. See Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in BRIDGING THE ENTREPRENEURIAL FINANCING GAP 54, 57 (Michael J. Whincop ed., 2001) (“Because the entrepreneur reaps private benefits from his involvement with the firm . . . he may be unwilling to sell or liquidate the firm, or to step down as CEO where doing so is the most financially attractive alternative available to the investor.”); Smith, *supra* note 29, at 318 (“[T]he entrepreneur may receive private benefits from retaining ownership of the company that are unrelated to the company’s value.”).

107. Cf. Fried & Ganor, *supra* note 88, at 994 (proposing that VCs may choose “lower-risk, lower-value investment strategies” due to their “debt-like cash flow rights”).

108. See generally PETERS, *supra* note 49. My conversations with angel investors have revealed that many of them agree with Peters’s assessment of the exit situation.

fold return.¹⁰⁹ Bringing in VCs changes the picture dramatically, however. VCs invest larger dollar amounts at higher valuations, so the same \$30 million trade sale that paid off handsomely for entrepreneurs and angels might fetch only a three- to four-fold return for VCs.¹¹⁰ Should every start-up in the VC's fund produce such a return, the VC might meet its IRR target.¹¹¹ But the ugly truth is that most start-ups in the fund will produce *no* return. Consequently, the ones doing well must produce more than a three- to four-fold return to make up for the duds. On those fund winners, then, the economics cause VCs to pass on the low-dollar trade sales and swing for the fences in the hopes of an IPO or larger trade sale later. The effect is to lock in entrepreneurs and angels—who would have been perfectly happy with the earlier trade sale—for many more years with no certainty of a larger return to come. In fact, because of the liquidation preferences in VC preferred stock, unless the start-up has a much larger exit in the future, entrepreneurs and angels may see *nothing* from the exit.

Importantly, the direct market has the potential to mitigate these conflicts over traditional exits *no matter which* account of the conflict is correct. When VC and entrepreneur incentives are not aligned, the direct market provides a solution. The party seeking the early exit can sell in the direct market, while the other party can hold its shares and wait for the start-up to have a traditional exit. As one interviewee told me, “One real advantage of direct market sales is that they give a different release valve than selling the whole company. They allow the shareholders who want to be shareholders in there at all times on a revolving basis.” The direct market not only leads to more efficient outcomes at the individual-investor level, but should also lead to more efficient outcomes at the start-up level. All current investors will be focused on long-term value creation, as opposed to the pre-direct market situation, where one party's liquidity needs could force the start-up into a suboptimal exit.¹¹²

109. *See id.* at 45 (describing an actual exit where angels would have made at least a ten-fold return on investment and entrepreneurs a one-hundred-fold return).

110. *Id.* at 38 (“From the VC partner's perspective, [a three-to-four-fold return] effectively guarantees they have failed.”).

111. *See* Bartlett, *supra* note 86 and accompanying text (asserting that VCs target IRRs of at least thirty percent).

112. *See SharesPost Launches*, *supra* note 75 (“By creating liquidity for shareholders in need of an exit, SharesPost reduces the pressure on company management to accept a sub-optimal but immediate ‘liquidity event.’”).

C. The Direct Market's Potential to Mute High-Powered Incentives

The preceding discussion explored the three main benefits of the direct market: increasing liquidity, improving start-up governance, and mitigating VC-entrepreneur conflicts over traditional exits. The direct market does, however, also present a potentially significant downside: the muting of high-powered performance incentives that are embedded in the venture capital structure. As Albert Hirschman has explained, when it comes to organizational behavior, there is a tradeoff between the ability to exit and the incentive to exercise voice.¹¹³ The more difficult it is to exit, the more incentive there is to exercise voice, and vice versa.

Before the direct market offered individual start-up investors the opportunity to exit—which was the only way for them to obtain liquidity—they were highly motivated to exercise voice. Fund investors incentivize VCs to perform by placing time limits on current funds and dangling capital for future funds. VCs, in turn, perform by monitoring start-ups and contributing value-added services.¹¹⁴ Likewise, VCs instill high-powered performance incentives in entrepreneurs and employees by compensating them with start-up stock and stock options.¹¹⁵ Before the direct market, appreciation in this equity could only be realized if the start-up achieved a traditional exit, causing entrepreneurs and employees to work diligently for start-up success.

By unraveling the ties that bind liquidity and traditional exits, the direct market has the potential to make these performance incentives less important. By permitting exits on an individual-investor level, the direct market can upset carefully structured arrangements that lead to start-up success. Should VCs sell their shares in the direct market, they would no longer have incentives to monitor entrepreneurs or contribute value-added services. Should

113. ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 114–15 (1970); see also John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 89 (2010) (“[Easy] exit almost completely eliminates mutual fund investors’ incentives to use fee liability, voting, and boards of directors.”).

114. See Bienz & Walz, *supra* note 6, at 8 (“More illiquidity increases the incentive of the active monitor (the VC) to pursue his task.”).

115. GOMPERS & LERNER, *supra* note 23, at 131 (“Managers and critical employees within a [start-up] firm receive a substantial fraction of their compensation in the form of equity or options. This tends to align the incentives of managers and investors.”); Gilson & Schizer, *supra* note 63, at 880 (“An overwhelming percentage of management’s compensation depends on firm performance. The potential for dramatic appreciation in the value of stock and options thus offsets low salaries.”).

entrepreneurs sell their shares, they would no longer share in the equity upside of a traditional exit, and therefore would be less motivated to put in the long hours necessary to achieve it. Indeed, they may have no desire to continue working at the start-up at all.¹¹⁶ In short, by making exit easier, the direct market has the potential to leave less incentive for start-up participants to exercise voice.

Although these are serious concerns, there are several ways in which they are mitigated in practice. First, interviewees told me that many entrepreneurs and employees who sell in the direct market no longer work at the start-up, such as “forgotten founders.”¹¹⁷ Those individuals who have moved on are no longer exercising voice over start-up affairs with or without the direct market. Second, interviewees revealed that entrepreneurs and employees who still work at start-ups—the ones whose performance is a concern—will sell only partial positions in the direct market, not their full ownership interest. One reason for selling only some shares instead of the full allotment is to be able to participate in the upside of a traditional exit down the road.¹¹⁸ Another reason for partial sales is that stock options vest in stages, and securities laws require sellers to hold vested options for a least one year prior to selling.¹¹⁹ This means that it is not possible to sell a full allotment even for those who desire to. Finally, interviewees reveal that VCs too sell only partial positions. When they sell to other VCs, the transaction functions as a kind of ex post syndication arrangement. Reputation constraints should cause VCs to seek high-caliber replacements that might bring a different set of value-added services to the table, such as a financial services orientation.¹²⁰

116. OLSONOMICS, <http://www.ericjohnolson.com/blog/2009/04/23/secondary-markets-for-private-company-stock-whats-happening-and-what-are-the-issues/> (Apr. 23, 2009, 11:35) (“Part of the stability of startups lies in the fact that everyone is in it together for the long term. . . . If founders, investors, board members and employees can suddenly liquidate their stock fairly easily what is left to keep them around?”). *But see* Needleman, *supra* note 66 (quoting SharesPost CEO Greg Brogger as stating that incentives to work for traditional exits are “now largely moot, since those transactions aren’t happening in this economy”).

117. A “forgotten founder” is someone who was with the start-up at the outset, no longer works there, but retains a potentially significant ownership interest.

118. *See* Brogger Interview, *supra* note 69 (“[Sellers] are not necessarily looking to sell all of their position in a company, but want some amount of liquidity for their shares.”).

119. *See infra* notes 159–60 and accompanying text (discussing Rule 144’s one-year holding period).

120. For example, one large direct market buyer told me that his firm provided value-added financial services, such as reorganizing capital structures to make the start-up a more attractive IPO candidate and discussing with start-up management any concerns found during the buyer’s due diligence review. *See* Burstein & Schwerin, *supra* note 49, at 7 (“Secondary transactions can also work well as tools to streamline capital structures prior to an IPO by buying the interests of

For all of these reasons, the direct market does not mute high-powered performance incentives to the degree it might first appear. Start-up participants have increased opportunities for individual exits, which have the benefits previously explained, but are still motivated to exercise voice and help the start-up achieve a traditional exit.

D. Comparing the Direct Market with the Market for Limited Partnership Interests in Venture Capital Funds (the Fund Market)

This Section turns to the top half of the venture capital structure: the market for limited partnership interests in venture capital funds, known in the industry as the “fund” market. The fund market is about a decade older than the direct market,¹²¹ but its real growth coincided with the emergence of the direct market in the last ten years.¹²² In the aggregate, the fund market appears to be roughly the same size as the direct market, with over \$1 billion in LP interests resold per year.¹²³ The fund market is also private, still evolving, and

smaller shareholders and rendering the cap table more efficient in the eyes of underwriters and institutional investors.”).

121. See Brett Byers, *Secondary Sales of Private Equity Interests*, ALTASSETS KNOWLEDGE BANK (Feb. 18, 2002), <http://www.altassets.com/private-equity-knowledge-bank/industry-focus/article/nz3269.html> (“Dayton Carr and Arnaud Isnard of Venture Capital Fund of America (VCFA) raised the first private equity fund in 1986 to purchase private equity interests . . . on a secondary basis from investors needing liquidity.”); *Firm*, LEXINGTON PARTNERS, <http://www.lexingtonpartners.com/#!/firm/> (last visited Oct. 5, 2011) (“Principals of Lexington Partners pioneered the development of the secondary market for private equity interests more than 20 years ago.”).

122. See Burstein & Schwerin, *supra* note 49, at 1 (“The leading secondary funds in 2008 . . . with billions of dollars dedicated to secondary investing, are now bigger than the leading primary private equity funds of the 1990s.”).

123. See *Limited Partnership Secondary Transactions Volume*, PENSIONS & INVESTMENTS (Jan. 12, 2010), <http://www.pionline.com/article/20100112/CHARTOFTODAY/100119971>. NYPPEX, the source of these figures, tracks secondary sales of LP interests in *all* alternative asset classes, including venture capital funds, buyout funds, and hedge funds. Institutions typically devote ten percent of their investment portfolios to these alternative asset classes. See, e.g., DOUGLAS A. CUMMING & SOFIA A. JOHAN, *VENTURE CAPITAL AND PRIVATE EQUITY: AN INTERNATIONAL PERSPECTIVE* 72–73 (2009) (“Institutional investors rarely commit more than 10% of their investment portfolio to private equity funds” because of the perceived risk of such investments); Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245, 264 (2009) (“[P]ricing rules have generally led mutual funds to invest only in publicly-traded liquid securities and to avoid illiquid assets such as venture capital, private equity, or restricted shares of public companies. Recognizing the difficulties of valuing illiquid securities, the SEC has recommended that funds limit investment in illiquid assets to no more than 10% to 15% of fund assets.”); *id.* at 267 n.85 (discussing how New York’s pension funds allocate up to fifteen percent to “prudent alternative companies”). Then, at least according to the rule of thumb I have heard (though I do not have empirical support for this), they devote ten percent of that figure to venture capital. Therefore, to estimate fund market sales for venture capital alone, the NYPPEX figures were multiplied by ten percent.

therefore difficult to describe. Original interviews and trade publications again helped with the task. The remainder of this Section compares the fund market with the direct market. It begins by exploring fund market sellers and their motivations for selling, moves on to buyers and their motivations for buying, and concludes by applying the same theoretical framework developed for the direct market to the fund market to explore its main benefits and drawbacks.

Sellers and Their Motivations. While direct market sellers include entrepreneurs, employees, and VCs, fund market sellers consist mostly of the large endowments, pension funds, and other institutions that invest in venture capital funds.¹²⁴ The common reason why these institutions sell in the fund market appears to be to rebalance their portfolios.¹²⁵ Because endowments and pension funds typically devote only ten percent of their portfolios to alternative assets, including venture capital, events such as the financial crisis that devastate traditional investments result in alternative asset values exceeding ten percent. LPs in this position will sell to bring alternative assets back down to ten percent. Another motivation for fund market sales is to transfer future capital call obligations from cash-strapped sellers to fund market buyers.¹²⁶ Fund market sales can also lock in tax losses on losing investments to offset gains on profitable ones.

Buyers and Their Motivations. As in the direct market, fund market buyers include both funds dedicated to these transactions and opportunistic buyers. The dedicated funds purchase LP interests in not only venture capital, but also buyout funds, hedge funds, and other private equity. They include Coller Capital,¹²⁷ HarbourVest

124. See Fleischer, *supra* note 22 and accompanying text; see also Catherine Craig, *Five Buy Record \$3bn CALPERS Portfolio*, FIN. NEWS, Feb. 5, 2008, <http://www.efinancialnews.com/story/2008-02-05/five-buy-record-calpers-portfolio-2> (describing CALPERS' sale of \$3 billion in private equity fund interests, including LP interests in venture capital funds, as "the largest secondaries fund divestment of its kind").

125. See Burstein & Schwerin, *supra* note 49, at 3 (explaining that LPs' motivations for selling in the fund market include "[r]ebalancing and diversifying portfolio allocations or relieving the concentration of value/net worth"). According to Sebastien Burdel, investment principal at fund market buyer Coller Capital, "surveyed LPs rank portfolio management ahead of liquidity needs as the key reason why they would sell in the secondary market." *Private Equity Secondary Funds: Are They Players or Opportunistic Investors?*, KNOWLEDGE@WHARTON (Aug. 5, 2009), <http://knowledge.wharton.upenn.edu/mobile/article.cfm?articleid=2302&page=2> [hereinafter *Players or Opportunistic Investors?*].

126. See Burstein & Schwerin, *supra* note 49, at 3 (stating that fund market sales have the benefit of "[a]leviating the need [for LPs] to allocate follow-on capital for existing investments").

127. COLLER CAPITAL, <http://www.collercapital.com/> (last visited Oct. 5, 2011).

Partners,¹²⁸ Lexington Partners,¹²⁹ Pantheon Ventures,¹³⁰ and Paul Capital.¹³¹ According to my interviews, these buyers are motivated less by the opportunity to own the underlying interests in any one start-up than by the steep discounts that they can expect when buying an LP's entire portfolio. While direct market buyers can cherry pick winning start-ups on which information is available, fund market buyers must take an LP's entire bundle of uncertain assets.¹³² Because buyers cannot adequately evaluate the assets that they are buying, they assume the worst and discount the entire portfolio accordingly.¹³³ The bundle approach leads to discounts of at least fifty percent and perhaps sixty to ninety percent, as seen at the peak of the financial crisis.¹³⁴ Consequently, while the direct market is a seller's market where the owners of Facebook and LinkedIn go to sell, the fund market is a buyer's market, which for sellers may be only the "best of several bad alternatives."¹³⁵

Theoretical Framework. The theoretical framework constructed for the direct market largely maps onto the fund market as well. Recall that at the start-up level, the direct market increases liquidity, improves start-up governance, and mitigates VC-entrepreneur conflicts over traditional exits. On the downside, the direct market threatens to mute high-powered incentives for performance embedded in the venture capital structure, but these concerns are mitigated in

128. HARBOURVEST, <http://www.harbourvest.com/> (last visited Oct. 5, 2011).

129. LEXINGTON PARTNERS, <http://www.lexingtonpartners.com/> (last visited Oct. 5, 2011).

130. PANTHEON, <http://www.pantheonventures.com/> (last visited Oct. 5, 2011).

131. PAUL CAPITAL, <http://www.paulcap.com/> (last visited Oct. 5, 2011).

132. As one interviewee put it, "fund market buyers have to take the bundle of 10–20 companies, where buyers in the direct market cherry pick the best ones."

133. One interviewee was not so charitable, describing fund market buyers as "vulture funds" who are "waiting on LPs to default and then buying [their interests] for cents on the dollar."

134. See Anne E. Ross et al., *Secondary Trading of Limited Partnership Interests in Private Equity Funds—Recent Developments*, FOLEY & LARDNER LLP 1 (July 2009), <http://www.foley.com/abc.aspx?Publication=6155> (noting that discounts in the fund market "have been reported to be as high as 50 to 70 percent"); *id.* at 2 ("[T]he parties typically fix a 'cut-off date' as of a recent net asset value (NAV) determination. The parties then negotiate a premium or discount to NAV as of the cut-off-date. In this market, except in very rare circumstances, the purchase price will likely be a discount to NAV."); Gillian Wee, *Stanford Said to Offer Sequoia Stakes in Fund Sale (Update 1)*, BLOOMBERG (Oct. 9, 2009), http://www.bloomberg.com/apps/news?pid=20601087&sid=aRqnoF6eud_w (noting that fund market prices were "as low as 10 cents to 40 cents on the dollar" in early 2009, and median bid had rebounded to "52 cents on the dollar in the September [2009] quarter").

135. Ross et al., *supra* note 134, at 1; *id.* (stating that the fund market is "a 'buyers' market' in which institutional investors and new funds of funds with access to capital have the opportunity to buy private equity fund limited partnership interests in the secondary market at discounts from face value").

practice. The fund market has a slightly different drawback than the direct market, but very similar advantages.

First, like the direct market, the fund market increases liquidity for LPs. This not only provides a release valve for already committed investors ex post, but also increases the amount of capital that VCs are able to raise ex ante.¹³⁶ Second, the fund market is an important tool for improving venture capital fund performance because it can reduce LPs' agency costs with VCs. Before the fund market, LPs reduced agency costs with VCs by limiting fund duration and making a large portion of VC compensation dependent on performance.¹³⁷ Unlike in start-ups, however, LPs never had the opportunity to exercise voice over fund governance because partnership law strips them of their limited liability status should they do so.¹³⁸ Thus, before the fund market, LPs were left with no voice and no exit. The fund market now allows for exit and, as a result, can improve fund governance by disciplining VCs.¹³⁹ Third, while VCs and entrepreneurs may have misaligned incentives over traditional exits at the start-up level, VCs' and LPs' incentives are aligned over all types of traditional exits at the fund level. Both want exits within the fund's set time limit that are as large as possible, and neither delays traditional exits to extract private benefits the way entrepreneurs might. Finally, while the main potential downside of the direct market is to mute the high-powered performance incentives embedded in the venture capital structure, the fund market structure contains no embedded performance incentives for LPs. As noted, LPs are by law passive investors whose only contribution to the success of the fund is financial capital. In sum, the fund market seems to have all of the benefits of the direct market with a different drawback: low sale prices for sellers.

136. See *supra* notes 84–86 and accompanying text for a numerical example illustrating this point at the start-up level.

137. Gilson, *supra* note 24, at 1090 (“The venture capital fund’s fixed term, together with the operation of the reputation market, responds to this agency cost problem.”); *id.* at 1089 (“[In venture capital], the bulk of the GP’s compensation comes in the form of a carried interest . . . distributed to the general partner when realized profits are distributed to the limited partners. Thus, the compensation structure aligns the GP’s interests in the fund’s success with those of the investors.”).

138. *Id.* at 1088 (“[T]he legal rules governing limited partnerships prevent investors from exercising control over the central elements of the venture capital fund’s business. Most important, the investors are prohibited from insisting on an approval right of the GP’s investment decisions.”).

139. See Birdthistle & Henderson, *supra* note 29, at 53–54, 72 (similarly arguing that “the creation of a robust secondary market in private-equity investments” is a good solution to the agency cost problem between LPs and GPs in buyout funds and that a “well-functioning market solution is clearly preferable to the vagaries of judicial process”).

III. THE FUTURE OF SECONDARY MARKETS IN VENTURE CAPITAL

The previous Part focused on VC secondary markets as they currently exist. However, these markets are still in their infancy and must continue to develop for their benefits to be fully realized.¹⁴⁰ With the newness of VC secondary markets in mind, this Part looks to the future and identifies the main factors that will likely influence their development. The discussion explores factors that will both further and hinder market growth. It begins by explaining how electronic exchanges are being developed to facilitate direct and fund market transactions and thus move secondary activity from isolated transactions to true markets. It then turns to certain securities laws, a tax law, and standard contracting practices in venture capital that could provide a countervailing force to electronic marketplaces and actually hinder market growth. Once again, the focus is on the direct market, with much of the discussion equally applicable to the fund market.

A. The Role of Electronic Marketplaces in Facilitating Growth

In 2009, VC secondary markets got a significant boost. Two electronic marketplaces, SharesPost and SecondMarket, launched as platforms for intermediating secondary market transactions. SharesPost was founded by Greg Brogger,¹⁴¹ a former entrepreneur and Wilson Sonsini securities lawyer, and focuses entirely on direct market transactions. SharesPost is structured as an online bulletin board where potential buyers and sellers post buy and sell bids for shares in the world's leading start-ups. According to the *Wall Street Journal*, in its first three months of operation, SharesPost attracted "7,000 registered users" and hosted "more than \$1 million in private company share transactions."¹⁴²

SecondMarket also launched its venture capital operations in 2009, although it has been facilitating secondary sales in bankruptcy claims and other illiquid assets for longer.¹⁴³ Within venture capital,

140. *Id.* at 54 (noting that secondary markets in private equity "may yet be years away from providing sufficient liquidity to mitigate agency costs significantly in this environment").

141. *About Us*, SHARESPOST, <http://www.sharespost.com/pages/about> (last visited Oct. 5, 2011).

142. Pui-Wing Tam, *SharesPost Ramps Up*, WALL ST. J. DIGITS BLOG, (Sept. 3, 2009, 6:00 PM), <http://blogs.wsj.com/digits/2009/09/03/sharespost-ramps-up/>.

143. SECONDMARKET, <http://www.secondmarket.com/> (last visited Oct. 5, 2011). SecondMarket began under the name Restricted Stock Partners. *See* Miller, *supra* note 51 ("[SecondMarket] operates seven other markets for illiquid assets, including ones for restricted public equities and bankruptcy claims.").

SecondMarket intermediates transactions in both the direct and fund markets.¹⁴⁴ While SharesPost's status as a passive bulletin board limits the amount of hands-on intermediation it may do, SecondMarket is structured as a broker-dealer and therefore provides more active assistance to buyers and sellers.¹⁴⁵

SharesPost and SecondMarket increase liquidity for individual investors in several ways. Recall that sales of private company stock are often plagued by high transaction costs and information costs, including difficulties matching buyers and sellers, a lack of information requiring extensive due diligence, and the costs of negotiating and papering transactions. VC secondary markets, despite improving upon the prior state of affairs, still suffer from these problems. Savvy sellers may be able to find the major funds dedicated to secondary purchases, but other opportunistic or nondedicated buyers will remain elusive. Further, direct market buyers who have identified a start-up of interest will not know which of its entrepreneurs, employees, or VCs is interested in selling. Thus, the transaction costs of matching buyers and sellers may prevent a would-be transaction. In instances where parties are able to connect, buyers will have to perform due diligence, and both parties will have to negotiate price, find securities law exemptions for resale, navigate contractual restrictions on sales, and draw up sale documents.

While transaction costs and information costs will be high in isolated transactions, SharesPost and SecondMarket now offer a "central location for trading," something commonly associated with our very notions of a market.¹⁴⁶ By offering a central site, SharesPost and SecondMarket make it easier for buyers and sellers to find one another. Rather than Twitter employees having to approach dedicated

144. According to an interviewee, SecondMarket launched its direct market operations in April 2009 and its fund market operations a few months earlier, in January 2009. While I know of no other electronic marketplaces operating in the direct market, many operate in the fund market, such as the PORTAL Alliance operated by NASDAQ and NYPPEX. See Birdthistle & Henderson, *supra* note 29, at 76–77 (noting that NYPPEX "hosts over \$10 billion secondary market in private-equity interests"); Elena Schwieger, Comment, *Redefining the Private Placement Market After Sarbanes-Oxley: NASDAQ's PORTAL and Rule 144A*, 57 CATH. U. L. REV. 885, 899–905 (2008) (describing the PORTAL Alliance and its predecessors). These intermediaries handle transactions in buyout funds, etc., that dwarf the dollar amounts seen in venture capital fund transactions.

145. See *infra* notes 169–76 and accompanying text (discussing the significance of these status differences).

146. See Ross P. Buckley, *The Transformative Potential of a Secondary Market: Emerging Markets Debt Trading from 1983 to 1989*, 21 FORDHAM INT'L L.J. 1152, 1162 (1998) (noting that a "central location for trading" is integral to the concept of a market). *But see* Macey & Kanda, *supra* note 78, at 1014 (arguing that market professionals rather than organized securities exchanges actually provide the economic benefits of market activity).

direct market funds, or those funds having to figure out which Twitter employees might be willing to sell, each simply visits Twitter's bulletin-board page on the SharesPost website and directly posts its buy-sell bids.¹⁴⁷ As electronic marketplaces, these intermediaries are harnessing the power of technology to facilitate secondary market growth.¹⁴⁸ Once buyers and sellers are matched, the electronic marketplaces allow for efficient price discovery by posting recent buy-sell bids and the latest contract price (SharesPost)¹⁴⁹ and by providing third-party research reports on private start-ups (SharesPost and SecondMarket).¹⁵⁰ The electronic marketplaces also significantly reduce transaction costs in papering deals by offering standardized sales contracts, e-signature options, and escrow services for transferring funds.¹⁵¹ For all of these reasons, SharesPost and

147. See Needleman, *supra* note 66 (noting that one of SharesPost's value-added services is that it "connects buyers and sellers").

148. See Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 58 (1998) ("By reducing the search and information costs associated with small business capital formation, Internet technology offers new potential for small businesses to raise capital.").

149. Better pricing information on private start-up stock has applications beyond direct market exits, including more reliable 409A valuations and FAS 157 calculations. See Sjostrom, *supra* note 59, at 434 (noting that NASDAQ's PORTAL trading system "establish[es] a market price that a company could use as part of a phantom stock or other market-priced-based incentive compensation plan"). But start-up management may actually *dislike* greater transparency on common stock pricing, coupled with the lower discounts seen in the direct market, because it will make it more difficult to attract new employees with cheap stock options. It should be noted that data points are still few and far between for most start-ups listed on SharesPost, and transactions must become much more frequent to come close to resembling an efficient capital market on par with the NYSE.

150. See Brogger Interview, *supra* note 69 (interviewing SharesPost CEO Greg Brogger on SharesPost's connections with third-party research analysts VC Experts and Next Up); Needleman, *supra* note 66 ("Since these private companies don't have open, audited books where potential investors can study up on the companies, Sharespost collects analysts' research on the companies in its market to help buyers and sellers agree on a value for shares being transacted."); Press Release, SecondMarket, SecondMarket Ecosystem to Bring Transparency to Illiquid Assets (Mar. 26, 2009), available at <https://www.secondmarket.com/discover/pressreleases/secondmarket-ecosystem-to-bring-transparency-to-illiquid-assets> (SecondMarket's Ecosystem offers buyers and sellers free access to critical resources for trading illiquid assets, including valuation, research, data, analytics, legal and transaction advisory services).

151. See *SharesPost Launches*, *supra* note 75 (quoting SharesPost's CEO Greg Brogger for the proposition that by "providing an automated contract process and integrating escrow services, SharesPost is the first company to bring true liquidity to the private equity market"); *id.* ("SharesPost offers its members a library of standardized agreements to contract and handle transaction restrictions such as rights of first result."); *SharesPost Overview*, SHARESPOST, <http://www.sharespost.com/pages/overview> (last visited Oct. 6, 2011) ("Follow simple step-by-step process for entering into contract with the buyer or seller. You can download contracts to implement your transaction to review with your attorney. Once you click to indicate you wish to execute a particular contract, our partner Echosign will email you a link to a page where you can electronically sign it.").

SecondMarket now allow secondary transactions to “be closed for a fraction of the cost, time[,] and hassle of traditional secondary transactions.”¹⁵²

In terms of intangibles, one interviewee believes that the electronic exchanges will also grow VC secondary markets by “injecting trust” into the process for wary buyers and sellers. Although the fund market sees transactions between sophisticated institutions, direct market sellers are likely to be entrepreneurs and employees who do not regularly engage in these transactions and may be wary of being “taken.”¹⁵³ By increasing transparency, the electronic marketplaces can induce more entrepreneurs and employees to participate. Further, while the electronic exchanges are much different than well-established stock exchanges, it has been observed that “[l]isting on an exchange can provide a valuable filter to investors, informing them that the securities listed are of high quality.”¹⁵⁴ SharesPost already imposes some quality control limitations on the start-ups it will list,¹⁵⁵ making it possible to imagine a future where listings on the electronic marketplaces can signal a start-up’s quality to potential buyers.

B. Legal Impediments to Growth

While electronic marketplaces should grow VC secondary markets, there exist certain securities laws, a particular tax law, and standard contracting practices in venture capital that provide a countervailing force against growth. This Section explores each of these potentially limiting factors.

Resale Restrictions: Securities Laws. Because start-ups and venture capital funds are privately held entities, sales of their securities must be exempt from public registration by the Securities and Exchange Commission (“SEC”). Secondary market transactions are actually resales, since the primary distribution was from the entity (the start-up or venture capital fund) to the initial investor. When the initial investor sells to a new investor in the secondary market, a resale exemption must be found. Private resales of securities find a general exemption from registration under the so-

152. *SharesPost Launches*, *supra* note 75.

153. One interviewee told me that the institutional culture of the fund market made it more difficult for electronic marketplaces to attract that business.

154. Macey & Kanda, *supra* note 78, at 1023.

155. See Garthwaite, *supra* note 68 (explaining that start-ups listed on SharesPost must have \$100 million market capitalization, meaning that winning, later-stage start-ups are the ones likely to be listed).

called section 4(1-1/2) of the Securities Act of 1933.¹⁵⁶ But because that section does not provide the concrete guidance that the parties will desire, they will often look to two safe harbor resale exemptions promulgated by the SEC: Rules 144 and 144A.¹⁵⁷ These exemptions provide the parties with predictability, but that predictability comes at a cost; namely, there are several requirements in the exemptions that could butt up against market growth.

First, Rules 144 and 144A limit the class of buyers and sellers. Rule 144A allows resales only to “qualified institutional buyers” (commonly known as “QIBs”), or institutions that own and invest on a discretionary basis at least \$100 million in the securities of nonaffiliated entities.¹⁵⁸ Thus, that exemption will only be available when selling to a large institution, such as a dedicated fund. Conversely, Rule 144 allows anyone to buy, but imposes a one-year holding period on sellers.¹⁵⁹ According to my interviews, it is unlikely that start-up employees or LPs in venture capital funds will look to secondary markets for liquidity within the first year; however, the Rule contains an important qualification for stock *options*. Rule 144 does not count the length of time that a stock option is held; rather, the holding period begins when the option is actually exercised.¹⁶⁰ Consequently, Rule 144 is not available to resell recently exercised stock options.¹⁶¹ Rule 144’s holding period may become more difficult to satisfy should secondary markets begin to see resales of *resales*. Currently, interviewees tell me that both direct and fund market resales are almost always “one and done,” meaning that the securities

156. See Employee Benefit Plans, Securities Act Release No. 6188, 19 SEC Docket 465, 496 n.178 (Feb. 1, 1980) (acknowledging the existence of the Section 4 (1–1/2) exemption).

157. See *Legal*, SHARESPOST, <http://www.sharespost.com/pages/legal> (last visited Oct. 6, 2011) (“[W]e believe we have constructed the SharesPost process such that Buyer and Seller can generally make use of a Section 4(1) exemption, and in some cases, Rule 144.”); *Regulatory*, NYPPEX PRIVATE MARKETS, <http://www.nypdex.com/Webpages/regulatory.aspx> (last visited Oct. 6, 2011) (“NYPPEX relies upon the current interpretations by the Securities and Exchange Commission and the Courts of Section 4(2) of the Securities Act of 1933, as amended, Rule 144A, Rule 144, and Regulation D to conduct its private trading businesses.”).

158. 17 C.F.R. § 230.144A(a)(1)(i) (2011) (defining “qualified institutional buyer”); *id.* § 230.144A(d)(1) (requiring that securities be sold only to a QIB or to an entity the seller reasonably believes is a QIB).

159. *Id.* § 230.144(d)(1)(ii) (2011). The holding period is shortened to six months for exempt resales of reporting company securities. *Id.* § 230.144(d)(1)(i).

160. Mira Ganor, *Improving the Legal Environment for Start-up Financing by Rationalizing Rule 144*, 33 WM. MITCHELL L. REV. 1447, 1449 n.11 (2007) (“In the case of options, the date the option is exercised, rather than the date the option is granted, marks the beginning of the holding period for the share issued pursuant to the option.”).

161. See Needleman, *supra* note 66 (on SharesPost, “only vested shares...can be traded”).

come to rest with the first secondary market buyer (until a traditional exit).

Second, Rules 144 and 144A both require disclosure about the start-up or venture capital fund under certain circumstances.¹⁶² Because these are private entities that receive no direct benefit from the resale, they may be reluctant to cooperate with the disclosure requirement. Venture capital funds are also notoriously secretive,¹⁶³ making cooperation an even greater hurdle in the fund market. Public companies are tasked with mandatory disclosure in part to overcome these limits on cooperation,¹⁶⁴ but these rules do not apply to private entities. Thus, their cooperation will be required to permit secondary transactions in the situations that require disclosure.

Finally, Rule 144 imposes two additional restrictions for sellers who are “affiliates” of the entity.¹⁶⁵ Interviewees tell me that relatively few sellers will rise to the level of affiliates, but, for those that do, the additional strictures could limit secondary market growth. First, affiliates are subject to a limitation on the volume of securities that can be sold.¹⁶⁶ This restriction is designed to ensure that large shareholders do not flood the market.¹⁶⁷ Second, Rule 144 requires that affiliate sales be made through brokers’ transactions that comport with certain rules.¹⁶⁸

162. 17 C.F.R. § 230.144(e)(2) (information requirements under Rule 144); *id.* § 230.144A(d)(4) (disclosure requirements under Rule 144A); *see also* Sjostrom, *supra* note 59, at 428 (discussing the disclosure requirement under Rule 144A).

163. *See infra* note 187 and accompanying text (explaining that VCs avoid certain investors so as not to trigger disclosure requirements).

164. *See* STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 26–30 (2d ed. 2008) (discussing justifications for mandatory disclosure).

165. 17 C.F.R. § 230.144(a)(1) (“An affiliate of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.”).

166. The maximum amount that a particular shareholder can sell over a three-month period is the greater of (a) one percent of the company’s outstanding shares, or (b) the average reported weekly trading volume of the company’s securities during the four previous weeks. *Id.* § 230.144(e)(1)(i)–(ii).

167. *See* Ganor, *supra* note 160, at 1451 (criticizing the selling-volume limitation because it “allows each restricted shareholder to sell the same amount regardless of how many shares [he] owns. Thus, the last share purchased by an investor bears a much higher liquidity risk than the first share.”).

168. *See* 17 C.F.R. § 230.144(f)(1) (requiring that securities be sold through either brokers’ transactions, transactions with a market maker, or a “riskless principal transaction”); *see also* *SharesPost Partners with Independent Brokers to Enable Secondary Market Transactions*, ENHANCED ONLINE NEWS (Apr. 19, 2010), http://eon.businesswire.com/portal/site/eon/permalink/?ndmViewId=news_view&newsId=20100419005727&newsLang=en. Alternatively, the transaction could occur directly with a market maker or in a “riskless principal transaction,” but neither of those avenues are currently available in the direct or fund markets. 17 C.F.R. § 230.144(f)(1)(ii), (iii).

Securities Law Restrictions on Electronic Marketplaces. Securities laws do not just limit resale transactions, but they limit the operation of the electronic marketplaces themselves. Electronic marketplaces seek to avoid registering as formal “exchanges” like the NYSE or NASDAQ.¹⁶⁹ The SEC has generally exempted electronic marketplaces such as SharesPost and SecondMarket from exchange status. SecondMarket takes advantage of SEC exemptions that allow electronic matching systems to register as broker-dealers instead of exchanges.¹⁷⁰ SharesPost, on the other hand, avoids both exchange *and* broker-dealer registration through its structure as a passive bulletin board. To stay within the narrow bulletin-board exemption created by SEC No-Action Letters,¹⁷¹ SharesPost cannot advise buyers or sellers on the merits of any transaction or handle any funds (instead deferring that task to an escrow agent).¹⁷² Therefore, while SecondMarket collects a success fee of two percent per side per completed transaction,¹⁷³ SharesPost can only charge a monthly fee (currently thirty-four dollars) to buyers and sellers, leaving its escrow agent to collect five-thousand dollars per transaction.¹⁷⁴ One commentator calls it “bizarre” that SharesPost would not “go for a

169. For the definition of an exchange, see Exchange Act Rule 3b-16(a), 17 C.F.R. § 240.3b-16(a). For reasons why electronic marketplaces would seek to avoid exchange status, see Andrew R. Thompson, Note, *Taming the Frontier? An Evaluation of the SEC's Regulation of Electronic Marketplaces*, 1999 COLUM. BUS. L. REV. 165, 188:

A decision to register as an exchange imposes upon the intermediary the cost of SRO functions (*inter alia* they must establish and enforce rules for their members), fair access provisions, and significant disclosure and transparency requirements. Additionally, a decision to register as an exchange requires a site to accept only registered broker/dealers as members, thereby eliminating the ability of an exchange to have institutional investors and individuals as members.

(citation omitted).

170. See Fisch, *supra* note 148, at 72 (“More controversial are alternative trading systems that allow investors to bypass the exchanges through electronic matching systems and bulletin boards. Currently these systems are regulated, for the most part, as broker-dealers.”).

171. See *id.* (stating that the SEC has exempted the operators of bulletin boards from the regulatory requirements applicable to exchanges and broker-dealers); see also Internet Capital Corp., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1104, at *5–8 (Dec. 22, 1997) (stating that the SEC will not seek enforcement against a bulletin board for failure to register as an exchange).

172. See Internet Capital Corp., SEC No-Action Letter, *supra* note 171, at *9 (relying on the fact that a bulletin board would not “provide information regarding the advisability” of buying or selling stock in determining that the SEC would not seek enforcement for failure to register as an exchange); Needleman, *supra* note 66 (noting that U.S. Bank serves as escrow agent for SharesPost transactions).

173. Miller, *supra* note 51.

174. Needleman, *supra* note 66.

small piece of the action,”¹⁷⁵ but its reason is to avoid the “transaction-based compensation” that is evidence of broker-dealer status.¹⁷⁶ In short, the electronic marketplaces must tread carefully and structure their business models accordingly to continue to operate outside of the SEC’s purview.

Resale Restrictions: Tax Law. In addition to Rule 144’s limits on the volume that affiliates may resell in both the direct and fund markets, there is a particular tax law that imposes another volume restriction on the fund market. Specifically, section 7704 of the Internal Revenue Code, along with Treasury Regulation 1.7704 promulgated thereunder, increases the tax burden on “publicly traded partnerships” (“PTPs”).¹⁷⁷ Because this law applies to partnerships rather than to their individual investors, it is likely to play a greater role in limiting the ultimate size of the fund market.

As limited partnerships, venture capital funds qualify for flow-through taxation so long as they are not considered PTPs. PTPs, on the other hand, are double taxed under the corporate rules.¹⁷⁸ Thus, VCs and their LPs will avoid PTP status and its extra layer of tax at all costs. There are two possible ways that a partnership can become a PTP: (1) when its interests are traded on an established securities market; or (2) when its interests are readily available on a secondary market.¹⁷⁹ Venture capital funds are concerned with the secondary market rule, which applies if investors are able to buy and sell their fund interests in a manner that approximates the level of liquidity available to a shareholder on a public stock exchange.

Two important safe harbors from PTP status help venture capital funds and their LPs stay within what the Internal Revenue Service deems to be an acceptable level of private market liquidity. The first safe harbor exists for funds with only a de minimis amount of their interests trading, defined as less than two percent of the total interest in partnership capital or profits during any taxable year.¹⁸⁰ A second safe harbor exists for sales that are conducted through a

175. *Id.* (“Bizarrely, Sharespost does not collect a piece of these transactions. Brogger [SharesPost’s CEO] doesn’t want to make his company a brokerage.”).

176. *See* Birchtree Fin. Servs., Inc., SEC No-Action Letter, 1998 WL 652137, at *1 (Sept. 22, 1998) (“The Division has taken the position that the receipt of securities commissions or other transaction related compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer.”).

177. *See* 26 U.S.C. § 7704(a) (2006) (treating PTPs as corporations); *id.* § 7704(g)(3) (imposing 3.5% tax on the gross income of certain PTPs); 26 C.F.R. § 1.7704 (2011) (interpreting 26 U.S.C. § 7704).

178. *See* 26 U.S.C. § 7704(a) (treating PTPs as corporations).

179. *Id.* § 7704(b)(1)–(2); 26 C.F.R. § 1.7704-1(a) (2011).

180. 26 C.F.R. § 1.7704-1(j) (excluding otherwise-exempt transfers).

“qualified matching service” (“QMS”). The QMS safe harbor allows for a five-fold increase in volume, or up to ten percent of the fund trading in a taxable year.¹⁸¹ Due to the increased activity allowed under the QMS safe harbor, SecondMarket has qualified as a QMS for its members.¹⁸²

Resale Restrictions: Standard Contracting Practices. Additional limits on VC secondary market growth may be self-imposed. We saw that start-ups and venture capital funds may not wish to provide the disclosure that is sometimes required by Rules 144 and 144A.¹⁸³ These entities also have certain standard contracting practices that may hinder secondary market growth. In the direct market, stock option grants to start-up employees typically include rights of first refusal (“ROFR”) in favor of the company, according to my interviewees. Start-up management might include a ROFR provision out of concern that unfettered secondary sales to a large number of buyers will cause the start-up to surpass five-hundred shareholders and thus become subject to reporting requirements as a public company.¹⁸⁴ Although it is unlikely that start-ups will spend their limited cash on share repurchases, the inclusion of a ROFR in an option grant can delay or deter sales to direct market buyers.¹⁸⁵

In the fund market, VCs typically reserve the right to refuse sales of LP interests in their limited partnership agreements.¹⁸⁶ There are several reasons why VCs might be reluctant to approve fund market sales. First, there is the concern that too many LPs may attempt to trade and lead the fund to PTP status. Second, while direct market sales do not seem to come with any stigma to the start-up, as

181. *Id.* § 1.7704-1(g).

182. Daniel Hausmann, *SecondMarket Launches QMS Practice*, DOW JONES LBO WIRE, Feb. 27, 2009, available at <https://www.fis.dowjones.com/article.aspx?aid=DJFLBO0020090224e52p001e1&r=wsjblog&s=djflbo&ProductIDFromApplication=15>. NYPPEX has also qualified as a QMS for its members. See *Our Company*, NYPPEX, <http://nyppex.com/company.php#> (last visited Oct. 19, 2011) (listing QMS as a service NYPPEX provides).

183. See *supra* note 162 and accompanying text.

184. Companies with more than 500 shareholders and whose total assets exceed \$10 million must register the securities under the Exchange Act and thereby come under the periodic reporting requirements of Section 13(a). See Securities Exchange Act of 1934 §§ 12(g), 13, 15 U.S.C. §§ 78a, 78m, 78o (2006); see also *id.* § 12(f)(1) (raising the asset requirement to \$ 10 million). On the contrary, employee sales to dedicated funds such as Industry Ventures or Millennium may serve to reduce the number of shareholders and streamline the start-up’s capital structure.

185. See David I. Walker, *Rethinking Rights of First Refusal*, 5 STAN. J.L. BUS. & FIN. 1, 5 (1999) (“Rights of first refusal discourage potentially high-valuing third-party bidders from entering a contest to purchase . . .”).

186. See Ross et al., *supra* note 134 (“[G]eneral partners must consent to a transfer of equity interests from the seller to the buyer . . .”).

leading start-ups are being sold, VCs may worry that fund market sales at steep discounts might signal dissatisfaction with VCs' performance. Third, certain LPs will be subject to disclosure requirements about their investment performance, and VCs typically will avoid having those LPs as investors in their funds.¹⁸⁷ Fourth, for VCs, fund market sales create administrative hassle with little payoff. In the past, new LPs would also commit to a given VC's next fund, providing some upside to the substitution for VCs. But these "stapled" transactions have now "all but vanished from the market."¹⁸⁸ Finally, one interviewee claims that VCs are "allergic" to robust fund market trading because they fear it will find its way onto the SEC's radar screen. VCs lobby heavily to avoid having additional SEC rules apply to them. In sum, VCs may refuse fund market sales for any of these reasons, and doing so will limit fund market growth.

Reasons for the SEC to Limit VC Secondary Markets. How the SEC will look upon the further development of VC secondary markets is an open question. On the one hand, should a wider class of buyers participate in these markets, especially noninstitutional buyers, the SEC would have a legitimate interest in protecting those investors. As Jill Fisch observes, "Companies with small capitalizations present disproportionate risks of both business failure and fraud. These risks may be magnified by Internet-based securities transactions."¹⁸⁹ Similarly, Donald Langevoort notes that "investment frauds have always been, and will always be, heavily concentrated among new and unfamiliar ventures."¹⁹⁰ Most start-ups fail, and the venture capital model depends on a portfolio strategy to compensate for those losses. Will individual direct market buyers sufficiently diversify, or will they put too much weight on the glitz of hot names that may be less-than-sound in their revenue models? Importantly, are the limited information and data offered on a website like SharesPost giving novice investors a false sense of security that they too can invest in this extremely difficult-to-predict sector? Perhaps the large funds who

187. See Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 738, 738 n.88 (stating that venture capital funds will try to avoid accepting public investment).

188. *Players or Opportunistic Investors?*, *supra* note 125.

189. Fisch, *supra* note 148, at 58.

190. Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 2 (1998) (citation omitted) ("The realization that investment frauds have always been, and will always be, heavily concentrated among new and unfamiliar ventures operates as a strong counterweight to the deregulatory impulse."); Needleman, *supra* note 66 ("I still fear that people could get taken in this [direct] market due to the relative lack of oversight and control compared with public market . . .").

buy in VC secondary markets are the only ones with adequate skill, expertise, and time to fully investigate and select/price transactions.

Although the investor protection rationale is certainly legitimate in this context, Langevoort suggests that the SEC may also limit private market growth for public choice reasons. He observes that private market growth depends on whether the SEC “is willing to permit the kind of threat to the role of organized exchanges that a deep and liquid market for private securities would pose.”¹⁹¹ As an example, Langevoort is puzzled by the persistence of the ban on general solicitations in private placements, including resales under Rule 144A.¹⁹² He suggests that the SEC may adhere to that ban despite heavy criticism because without it, private “market[s] would come to dominate the public ones, freezing non-accredited investors out of direct participation (with the inevitable reduction in the SEC’s own claim to resources).”¹⁹³

CONCLUSION

Investors can readily buy shares in publicly traded companies, but, until recently, they have been unable to own a piece of private start-ups like Facebook or Twitter without working there or investing in exclusive venture capital funds. Now that venture capital has become a \$400 billion worldwide asset class,¹⁹⁴ however, start-up stock and LP interests in venture capital funds have begun trading in private secondary markets. Venture capital is the latest in a long line of asset classes for which secondary markets have developed.¹⁹⁵ Secondary markets offer initial investors a new path to liquidity, offer

191. Langevoort, *Angels on the Internet*, *supra* note 190, at 11; *see also* David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311 (1987) (applying a public choice model to the SEC’s insider trading rules and enforcement); Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527, 529–30 (1990) [hereinafter Langevoort, *SEC as a Bureaucracy*] (framing public choice broadly as not only actions that serve the external interests of some constituency, but also “self-serving institutional” actions).

192. *See* Langevoort, *SEC as a Bureaucracy*, *supra* note 191, at 531 (discussing the SEC’s “niggardly approach” to developing safe harbor rules); Sjostrom, *supra* note 59, at 445 (“While Rule 144A does not expressly prohibit general solicitation, practitioners have long held the view that it is nonetheless disallowed under the rule . . .”).

193. Langevoort, *Angels on the Internet*, *supra* note 190, at 25 (citation omitted).

194. Burstein & Schwerin, *supra* note 49, at 4.

195. Other secondary markets have emerged for assets including insurance policies, home mortgages, and distressed debt. *See, e.g.*, Neil A. Doherty & Hal J. Singer, *The Benefits of a Secondary Market in Life Insurance Policies*, 38 REAL PROP. PROB. & TR. J. 449 (2003), available at <http://ssrn.com/abstract=387321>.

buyers access to a previously untapped class of assets, and produce governance benefits for traded firms. The realization of these benefits in venture capital should lead to a net increase in the total amount of entrepreneurial activity. Given the surplus that entrepreneurial activity produces for society, VC secondary markets should be studied by academics and encouraged by policymakers. This Article is the first to study VC secondary markets and the issues they implicate in law and economics analysis. The law and lawyers will play an important role in shaping these markets. As this Article has revealed, certain securities and tax laws may impede secondary market growth, and carve-outs for this activity should be considered by policymakers. Until such carve-outs might come to pass, however, lawyers will play a prominent role in navigating the current legal framework for secondary market sales. As one large secondary buyer observes, “Given that potentially significant corporate and securities law issues can arise in situations where restricted securities in private companies are bought, sold, or transferred, we expect the role of legal advisors with expertise on the issues of the secondary marketplace to grow considerably in the next few years.”¹⁹⁶ As a result, lawyers who can acquire transactional and regulatory expertise in this area will become increasingly valuable in Silicon Valley and beyond.

196. Burstein & Schwerin, *supra* note 49, at 9.