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Trading in Private Shares: El Dorado or Fools Gold?

By Keith Paul Bishop

American corporations once could be divided neatly into two categories. The smaller category consisted of publicly traded companies - those with shares that you could buy and sell on a stock exchange or in the over-the-counter markets. The much larger category was made up of privately held companies - those with shares that only very rarely changed hands, if at all. Now that distinction is disappearing as individuals and companies are using the Internet to trade shares of privately held companies. Although this trading is both open and notorious, it may not be legal and involves significant risks for all those involved - buyers, sellers, and the companies themselves.

To understand why Internet trading of private company shares is becoming popular requires a little background. The Securities Act 1933 requires registration of all offers and sales of securities in interstate commerce or by use of the U.S. mails, unless an exemption from the registration requirement is available. This is true whether the company issuing the security is making the offer, an "issuer transaction," or someone who acquired the securities is offering them, a "resale" or "secondary transaction." Section 4(1) of the Securities Act exempts transactions by any person so long as they are not an issuer, underwriter or dealer. If Section 4(1) did not exist, most secondary trading in shares would be subject to the expensive and time-consuming process of registration under the Securities Act.

There is a problem, however, because Section 4(1) excludes anyone who is an underwriter. The Securities Act defines an underwriter as someone who buys shares from an issuer with a view towards distribution. Obviously, if someone buys shares from a company and never resells them, there is no question of that person being an underwriter because the buyer obviously didn't acquire the shares with a view to distributing them. But what if a shareholder at some point decides to sell her shares? Would this make her an underwriter so that she could not rely on the Section 4(1) exemption? In other words, how long does someone have to hold on to shares before they can resell them pursuant to Section 4(1)? To bring some clarity to these issues, the Securities and Exchange Commission long ago adopted a safe harbor rule, known as Rule 144.

A big change occurred three years ago when the SEC amended Rule 144 to provide that if a shareholder has held shares in a company that isn't required to file reports with the SEC, a "non-reporting issuer," for at least a year, that shareholder could freely resell those shares as long as the shareholder wasn't in control of the issuer, i.e., an affiliate.

In the meantime, the brutal economic conditions of the last several years has forced many private companies to delay their plans for an initial public offering or to sell themselves. Thus, many shareholders of these companies have had to hold their shares longer than they may have expected or wanted. Formerly, it would have been difficult for these stockholders to find potential buyers of their shares. However, the SEC's amendment of Rule 144 coupled with the Internet's ability to communicate offers to enormous numbers of people at very low cost, has now seemingly made it possible for shareholders in private companies to legally sell and market their shares.

Of course, there can't be trading without buyers. To some, buying shares in a private company represents an opportunity to acquire shares at low prices in advance of a company's initial public offering. In the past, however, these potential buyers had a difficult time finding potential sellers. Again, the Internet has provided a technology that allows buyers to inexpensively locate potential sellers.

Although the SEC's amendments to Rule 144 has made it easier to trade shares in private companies, these

amendments did not affect existing state securities law requirements with respect to companies that do not file reports with the SEC. In many cases, sellers may be overlooking state securities laws. State law qualification requirements are not an issue for companies that file reports with the SEC because the National Securities Markets Improvement Act of 1996 has preempted state authority to require registration of a transaction in the securities of these companies that is exempt under Section 4(1).

The California Corporate Securities Law of 1968 requires that all resale transactions be qualified with the commissioner of corporations, unless the security or transaction is exempt from qualification. In many cases, a shareholder can rely on Corporations Code Section 25104(a). That statute exempts an offer or sale of a security by the bona fide owner if it is not accompanied by the publication of any advertisement and is not effected by or through a broker-dealer in a public offering. Because Corporations Code Section 25002 defines "advertisement" broadly to mean *any* written or printed communication published in connection with an offer or sale of a security, a solicitation disseminated broadly on the Internet is likely to preclude reliance on this exemption. If an Internet posting constitutes an "advertisement," then a prospective seller is also required by Corporations Code Section 25300 to file in advance the advertisement with the Commissioner. Violators of these requirements face potential criminal and civil liability.

Even if a shareholder may lawfully sell her shares under federal and state securities laws, that doesn't mean the shares can be resold. Many privately held companies have adopted provisions in their articles of incorporation that restrict transfer of shares. In other companies, share restrictions may be imposed by contract. There are many legitimate reasons for transfer restrictions, such as ensuring compliance with licensing laws or preservation of tax status or benefits.

Buyers should understand all of the things they don't get when they acquire shares in a private company. They don't acquire an interest in a company that is required to keep its books in accordance with generally accepted accounting principles, have its financial statements audited by an independent accountant, disclose material events and agreements in SEC filings, or make its financial condition and results publicly available in reports filed with the SEC. In many cases, a professional subject to regulation by the SEC, the Department of Corporations or the Financial Industry Regulatory Authority won't handle the transaction. Finally, buyers should understand that any market for the shares is likely to be sporadic and erratic.

Moreover, online trading of private shares has great potential for outright fraud. This fraud can take many forms. Because the market in private company shares is thin, it can be easily manipulated. In other cases, potential sellers may be tempted by online solicitations to buy at inflated prices. In fact, these offers to buy are just lures used by fraudsters to trick hapless shareholders into paying fees or giving access to their bank accounts.

Private companies also face a myriad of risks if their shares become actively traded. For example, they may find that they have inadvertently become subject to the SEC's registration and reporting requirements by virtue of having too many shareholders. If the trading results in a change in control, they could have licensing problems or they could trigger a default or breach of an anti-assignment contractual provision.

Internet trading of private company shares is extremely risky for all concerned. Anyone who plans to sell shares in a private company should make certain that they have considered both federal and state securities law requirements and considered whether the sale violates charter or contractual restrictions on transfer. Buyers should understand what they are not getting when they acquire private shares. Finally, companies should make certain that they have considered the possibility that secondary trading may arise without their knowledge or consent.

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