Hunting for Hot Stocks, Some Investors Head to Private Markets

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It was a car that first got Talmadge O'Neill interested in private-market shares. Specifically, the Tesla Roadster, an all-electric sports car, he bought in July 2009.

"After a couple weeks of showing this off, I felt like, 'Wow, this is a company I really want to invest in,'" said O'Neill, a former technology executive living in Southern California. "And so I started looking around. Gee, how can I invest in this company? I'm not a major venture capitalist, I don't have a name in Silicon Valley, how do I do this?"

O'Neill googled the question, and that led him to SharesPost and SecondMarket, two private markets where Tesla stock could be bought online. O'Neill purchased $290,000 worth of the company, and followed it up later with a $3 million stock buy. He was hooked.

Since then, O'Neill has spent more than $25 million on a variety of stocks that had yet to hit the open market, including eHarmony, DropBox, Facebook, and LinkedIn (which went public in May 2011). It's a drop in the bucket. Last year, more than $9 billion in private company shares changed hands on private exchanges, according to NYPPEX securities advisor.

How the Private Market Works

The growth of secondary markets like SharesPost and SecondMarket mirrors the increasing time it takes for new companies to go public.

"In 2000 it took a company about four years from its founding to its IPO. In 2010, it took a company about ten years to do the same," said Jason Jones, the founder of HighStep Capital, a fund that invests in internet companies. "As a result, there's a lot of unnecessary tension that's built up, there are lots of antsy investors and employees and founders of companies."

Secondary markets relieve that tension by acting as a matchmaker, connecting sellers and buyers. Still, the market is not nearly as liquid as, say, the New York Stock Exchange. Many companies only allow their stock to be traded once or twice a year. They may set a floor price, and can nix sales they don't approve of.

The Securities and Exchange Commission doesn't directly oversee secondary markets. It does have some regulations for people that want to use them. But it does require all individual buyers to be accredited investors with over $1 million in assets (excluding their home), or annual income above $200,000.

John Coates, a professor of law and economics at Harvard University, said that cutoff includes about ten percent of the U.S. population, including many people who have done well for themselves, but who may not be shrewd stock pickers.

"You know, a plumber, an electrician, over the course of a good career, will have a decent shot of accumulating a million dollars by the time they get to retirement," Coates said.

Picking Stocks in the Dark

Investors buying stock privately will never see a quarterly earnings statement, and may know no more about the company than what the news media has reported.

“Generally on a lot of these things you're really going by gut,” O’Neill said. You’re saying ‘I like the product. I think the company’s doing well. The news that I read on TechCrunch or AllThingsD[igital] or any one of these technology blogs, it all looks good.’”

Not long after O’Neill made his second, $3 million purchase of Tesla shares, the company filed to go public, and he learned it had lost $31 million so far that year.

“If I had actually known what the financials looked like, I would not have invested in Tesla,” he said.

Fortunately for O’Neill, the IPO was successful and he was eventually able to sell the shares at a substantial profit.

Still, the lack of transparency is worrying to critics, including Coates. “There's no agency looking over their shoulder to make sure that they don’t have conflicts of interest or know about problems that they’re not revealing to people trading on their exchanges,” he said.

Regulators are starting to show an interest in secondary markets. In March, SharesPost settled charges with the SEC for failing to register as a broker-dealer, and two private funds were charged with deceiving investors about hidden fees.

Inside One Private Market

The biggest platform for trading private shares is SecondMarket, which has headquarters at 26 Broadway, near the bronze sculpture of a charging bull that symbolizes Wall Street. About 100 people work here, and around 30 more in a satellite office in San Francisco. The 8-year-old company has the playful atmosphere typical of a tech startup: a large neon nerf gun was on display on the trading floor, and there’s beer in the pantry refrigerator.

SecondMarket’s Ali Byrd, senior vice president responsible for the private shares market, is sensitive to the charge that the company is provides an unsupervised space where newbies and dilettantes can get burned. Byrd said SecondMarket now requires companies disclose their financial condition to buyers.

“And that level of disclosure is pretty high in terms of the financial performance, the risk factors, and in many instances access to the management of the company,” Byrd said.

Jason Jones noted that all transactions on SecondMarket now require not only the signoff of the buyer and the seller, but also the company whose shares are being sold. In effect, Jones said, this marks the end of the platform’s freewheeling early days.

“Phase Two is becoming much more institutional,” Jones said. “People have figured out how it’s going to work, and marketplaces like SecondMarket and SharesPost are changing their business models to clean up the rough edges.”

Congress Lends a Hand

Last year, SecondMarket’s baby-faced leader, Barry Silbert, appeared three times before Congress. He told lawmakers some fast-growing startups don’t want to go public right away, and Congress could help them by making two changes to the law. First, raise the number of shareholders a company can have before it must make financial disclosures to regulators. Second, overturn the longstanding ban on marketing individual private stocks directly to investors.

In Early April, President Barack Obama signed those two changes into law, as part of the JOBS Act. Companies will now be permitted to have up to 1,999 record-holders before filing public disclosures of their finances, up from 499 (although a single record-holder, like a major bank, may represent dozens or even hundreds of shareholders).

The JOBS Act was promoted as a measure to encourage more young companies to go public. But Coates believes it could have the opposite effect: by making it more attractive to stay private, the law could instead encourage companies to prolong their teenage years in the lightly-regulated secondary markets.

“I really do think the two pieces together are gonna have a combined effect that’s more powerful than any other piece of the bill,” said Coates. “More powerful even than the backers of the bill may be expecting.”