Barry E. Silbert, Founder & CEO, **SecondMarket**

Barry Silbert is the Founder and CEO of SecondMarket, the largest secondary market dedicated to creating liquidity for alternative investments, including private company stock, auction-rate securities, bankruptcy claims, structured products (ABS, MBS, CDOs), warrants/restricted stock and whole loans. SecondMarket has over 50,000 registered market participants on its online platform and has conducted billions of dollars in transactions across all of its asset classes.

SecondMarket was recently honored by the World Economic Forum as a 2011 Technology Pioneer. Earlier this year, SecondMarket was also recognized by *Fast Company* as one the "Ten Most Innovative Companies in Finance." In 2010, the company was recognized by AlwaysOn Media as the overall winner of the "Global 250" list of the top private companies in the world. In 2009, Barry was a category winner of Ernst & Young's Entrepreneur of the Year Award, a winner of Crain's Entrepreneur of the Year Award and was included on *Treasury & Risk's* list of the 100 Most Influential People in Finance. Barry was also recognized by *Fortune* as "One to Watch" in the publication's annual 40 Under 40 issue. In addition, SecondMarket was named one of the "Top Fifty Tech Startups You Should Know" by *BusinessWeek*.

Prior to founding SecondMarket in 2004, Barry was an investment banker at Houlihan Lokey, where he focused on financial restructurings, mergers and acquisitions, and corporate financing transactions. Before joining Houlihan Lokey, Barry worked at Bear Stearns, Smith Barney and Rydex Funds. Barry graduated with honors from the Goizueta Business School of Emory University, and holds Series 7, 24 and 63 licenses.

Barry is a frequent speaker at conferences on the topic of trading alternative assets and has appeared in many leading publications, including *The Wall Street Journal*, *The New York Times*, *The Washington Post, Financial Times*, *USA Today* and *Forbes*. Barry has been featured on *CNBC*, *CNN Money*, *Bloomberg News* and *Fox Business News.*

Barry is also an active angel investor with investments in a number of exciting start-ups, including Behind the Burner, ProFounder, RealDirect, Send-the-Trend, Slated, TapAd and Vator.tv.

Written Testimony

of

Barry E. Silbert

Founder and CEO, SecondMarket

to the

Committee on Oversight and Government Reform

U.S. House of Representatives

"The Private Company Burden: Solutions for Entrepreneurs, Job Creation and Innovation"

MAY 10, 2011

Good afternoon Chairman Issa, Ranking Member Cummings, and Members of the Committee. My name is Barry Silbert. I am the Founder and CEO of SecondMarket, which is the largest marketplace for alternative investments. I am grateful for the opportunity to testify this afternoon regarding this important subject that poses a significant challenge to our country. The issues raised in my testimony directly impact job growth and American global competitiveness.

First, I'd like to describe SecondMarket. Second, I will discuss the problems in the public equity markets that have made the markets inhospitable to growth-stage companies. Next, I will describe the important role that SecondMarket plays in the capital formation process and in affording access to capital. Finally, I will suggest certain regulatory changes that should be made to support growing private companies on their road to the public markets, while also maintaining a high level of investor protection.

My Background and the SecondMarket History

I was born and raised in Gaithersburg, Maryland and attended college at Emory University in Atlanta. After graduating in 1998, I started my career as an investment banker at Houlihan Lokey where I worked on some of the most prominent bankruptcies of the last decade, including Enron and WorldCom. Houlihan typically represented creditors, and the experience working on complex, problematic restructurings proved invaluable. It was this experience that led me to the idea for SecondMarket.

Upon emerging from bankruptcy, creditors in Chapter 11 cases would sometimes receive stock in the restructured company that was not saleable in the public markets. Oftentimes, these creditors would contact Houlihan to inquire about selling these instruments. When I asked my

colleagues how we could assist the creditors with these sales, it was suggested that I should pick up the telephone, start calling my contacts, and find buyers. I was struck that there was no centralized marketplace for these assets. Thus, the idea for SecondMarket was born: a transparent, centralized and independent marketplace where buyers and sellers could transact in alternative assets.

Having long ago decided I wanted to eventually start my own company, I left my Wall Street job and began drafting a business plan. Although the idea has evolved over time, I have always been committed to the notion of providing transparency and centralization to markets that had historically been fragmented and opaque. I founded SecondMarket in New York City in late 2004, and we opened for business in 2005. We started small and low-tech – just five guys in a tiny office with a few computers and phones.

The first illiquid asset class that we focused on was restricted securities in public companies. These are assets such as restricted stock, warrants and convertibles that are issued by public companies but not tradable in the public stock markets. Since that time, SecondMarket has experienced significant growth, as we have added several more asset classes that benefit from our core principles of transparency, centralization and independence.

What do these principles mean? Transparency means providing detailed information about the asset so that buyers and sellers can make informed investment decisions. It also means transparency into asset pricing. Centralization means bringing together buyers and sellers in a formalized, secure marketplace. Independence means we are not a subsidiary of another financial institution and, more importantly, we do not engage in proprietary trading. Thus, we do not use our own balance sheet to complete transactions. We are willing to sacrifice short-term

revenue opportunities because we believe that as a global marketplace, it is critically important that our participants recognize that we are not on either side of the transaction. We are always the marketplace connecting buyers and sellers, guiding our participants through the sales process, and handling the closing and settlement of the transactions.

Since launching the first asset class in 2005, we have added markets for structured products (e.g., auction-rate securities, mortgage-backed securities, etc.), bankruptcy claims and private company stock. These asset classes have unique characteristics, objectives and participants. However, they share the common thread that they are illiquid, alternative investments that benefit from a centralized marketplace.

While we have continued to add new asset classes, the size of our participant base has also grown. At the beginning of 2009, we had 2,500 registered participants on SecondMarket. At the outset of 2010, we reached 6,500. Today we have well over 50,000 participants and the number is constantly growing. Our technology has also evolved substantially as we have invested millions of dollars into our online platform, which provides centralization and efficiency to improve the user experience and streamline the sales process.

Moreover, we are no longer a few individuals in a small office. SecondMarket now employs approximately 135 people in New York and San Francisco, and we are hiring new employees every month. I should also note that SecondMarket has been a FINRA registered broker-dealer and operates an SEC-registered Alternative Trading System, or ATS.

SecondMarket is the leading marketplace for facilitating transactions in private company stock. We have completed trades in over 50 different companies, including Facebook and Twitter. In 2008, we completed $30 million in private company transactions. In 2009, that number rose to

$100 million and in 2010, we saw nearly a four-fold increase in transactional value. To date, we have conducted nearly $700 million in completed private company stock transactions. Across all of our asset classes, we have completed several billion dollars in trades.

SecondMarket has emerged as an innovative solution provider. We have helped retirees get liquidity when their auction-rate securities (which were often marketed as a cash equivalent) turned out to be long-term, illiquid investments. We have been part of the sales team working in conjunction with Deutsche Bank to help the Treasury Department sell TARP warrants. And we've helped dozens of private companies provide liquidity for their shareholders, many of whom reinvested their money into other startups.

Problems in the Public Stock Markets

For several decades, startup companies in the U.S. followed a familiar path. They raised angel capital, a few rounds of venture capital, and went public within five years. The vast majority of IPOs were for companies raising $50 million or less, even adjusted for inflation. Smaller public companies could thrive in the public markets, with equity research coverage and market makers driving investor interest in growth-stage companies. Somewhere along the line the market structure changed, and the public markets became inhospitable to smaller public companies.

Although SecondMarket is not a research company, we closely follow research findings from industry observers and analysts.[1] Several factors have been recognized by these market observers as contributing to the problems in the American public stock markets:

- Online Brokers – although the introduction of online brokerages helped to make trading less expensive, these online brokers disintermediated retail brokers who helped buy, sell and market small-cap, under-the-radar public companies to investors. Stockbrokers collectively made hundreds of thousands of calls per day to their clients to discuss small-cap equity opportunities, and the proliferation of online brokerages decimated the profession. Those brokers provided a critical marketing tool for the country's small-cap companies.
- Decimalization – stock prices used to be quoted in fractions, and the difference between fractions created profit for firms providing market making, research and sales support. When the markets began quoting prices in decimals, trading spreads were reduced and profits were significantly cut. It became unprofitable to market small-cap equity.
- Sarbanes-Oxley – the legislation is often blamed for the problems in the public markets, but most observers believe it is not the most significant factor in companies electing to remain private. Nonetheless, corporate compliance with the Sarbanes-Oxley Act has certainly increased costs for public companies.
- Global Research Settlement – once the investment banks began funding equity research, conflicts of interest emerged and positive equity reports began to be written for

[1] *See* "A Wake-Up Call For America," David Weild and Edward Kim, Grant Thornton Capital Markets Series, Nov. 2009; "Market Structure is Causing the IPO Crisis – and more," David Weild and Edward Kim, Grant Thornton Capital Markets Series, June 2010; "It's Official: The IPO Market is Crippled – and it is hurting our country," Alan Patricof, *Business Insider*, Jan. 2011; "Wall Street's Dead End," Felix Salmon, *The New York Times*, Feb. 2011; "Welcome to the Lost Decade (for Entrepreneurs, IPOs and VCs)," Steve Blank, July 2010.

undesirable companies. This issue caused state Attorneys General to get involved, eventually resulting in the global research settlement. The result was that research reports stopped being written for small-cap public companies and, consequently, a significant marketing mechanism for small-cap companies was eliminated.

- High-Frequency Trading – although high-frequency traders bring significant liquidity to the public markets, they require the volume and velocity that can only be found in large public companies. A recent report stated that high-frequency traders conduct more than half of the trades taking place in the U.S. equity market, and those traders essentially ignore small-cap companies.[2]
- Average Hold Period – over the past forty years, the average time that a public market investor holds stock has dropped from approximately five *years* in 1970, to less than three *months* today. This further highlights the fact that investors are now focusing their attention on short-term earnings performance, versus long-term, business-building initiatives.[3]

Virtually all of these developments emerged from either well-intentioned policy decisions or the natural evolution of the markets in an electronic age. Nonetheless, taken in the aggregate, these (and other) factors have made the public markets undesirable for many companies. Throughout the 1980's and 1990's, the regulatory environment and overall market structure actively supported high-growth private companies joining the public markets. From 1991 to 2000, there was an average of 520 IPOs per year, with a peak of 756 IPOs in 1996.

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[2] "High-Frequency Boom Time Hits Slowdown," Jeremy Grant, *The Financial Times*, April 2011 (citing data from The Tabb Group).

[3] "Investing Dying as Computer Trading, ETFs & Dark Pools Proliferate," John Melloy, *CNBC*, Jan. 2011.

Today, the lack of a properly functioning public market structure is strikingly obvious. Since 2001, the United States has averaged only 126 IPOs per year, with 38 in 2008, 61 in 2009 and 71 in 2010.[4] Companies are electing to remain private longer than in previous decades, and the average time a company remains private has essentially doubled in recent years.[5]

Simply put, the lackluster IPO market is not providing the solution for investors and early employees who need liquidity. M&A is an alternative option for companies to obtain liquidity; however, acquisitions often result in job losses and stifled innovation. The growth market is a significant and vital part of the capital formation process, and the systemic failure of the US capital markets to support healthy IPOs inhibits our economy's ability to create jobs, innovate and grow. Clearly, a new growth market must emerge.

The SecondMarket Solution

We were first approached about facilitating trades of private company stock in late 2007. A former Facebook employee contacted us and asked if we could help him sell his stock. He had read about how we facilitated transactions in restricted stock in public companies. Since Facebook was not a public company, the stock was unregistered and Facebook did not have any plans for an IPO. We facilitated the transaction and then took a step back to assess the viability of the market. Once we understood that companies were remaining private much longer than in prior years, and that systemic changes in the public markets make it difficult for companies to go public, we were convinced that we could help to fill the role of a new growth market.

[4] "Market Structure is Causing the IPO Crisis – and more," David Weild and Edward Kim, Grant Thornton Capital Markets Series, June 2010.

[5] *Id.*

The SecondMarket approach is premised on the notion that there is not a "one-size-fits-all" model for private companies. Each company has its own goals and objectives. Some companies value control and flexibility, others are more concerned with liquidity and valuation. Thus, we allow companies to dictate the essential elements of their marketplace, such as identifying eligible buyers and sellers, setting the amount or percentage of shares to be sold, and determining the frequency of transactions. Some companies want only former employees to sell, and some want only existing shareholders to buy. Some permit weekly trading, but many prefer to establish quarterly or annual liquidity events. Some choose to allow an open market where buyers and sellers negotiate the share price on a one-off basis, and some elect to run an auction.

When a company uses SecondMarket to set up a liquidity program, we require the company to provide financial disclosures to eligible buyers and sellers. Companies are increasingly comfortable with the mechanics of our market as they recognize that information they provide is only available to the companies' selected buyers and sellers in a secure, online data room administered by SecondMarket.

In developing the private company market, SecondMarket has become an important part of the capital formation process. By helping companies provide interim liquidity to shareholders, we essentially operate as a bridge to an IPO for companies that eventually want to go public, or as an alternative option for companies that wish to remain private.

Suggested Regulatory Changes

SEC Chairman Mary Schapiro recently informed this Committee that the SEC is reviewing the regulatory landscape to lessen the burdens on private companies. In his State of the Union address this year, President Obama ordered a review of all government regulations. He added:

"When we find rules that put an unnecessary burden on businesses, we will fix them."[6] I applaud the steadfast commitment of the SEC and the Administration, and I believe there are regulatory fixes that can and should be made at this time. Rule changes in this area would directly impact companies' ability to access capital more readily and cheaply, help companies retain existing employees and hire new ones, and bolster American global competitiveness. At a time when our lawmakers, policymakers and regulators debate how best to create new jobs, I believe a few minor changes to the regulatory rules could have a major impact on job creation.

Venture-backed companies fuel job growth in this country.[7] According to the Kauffman Foundation, startups create an average of three million new jobs annually and the most new net jobs in the United States.[8] It is essential that the regulatory framework recognizes this dynamic and permits these startups to flourish.

Over the past few years, I have developed strong relationships with executives at numerous private companies. These executives are often concerned that they are not ready or able to successfully navigate the public markets. They are also concerned about regulatory hurdles that restrict their ability to remain private. The concerns are varied, but two particular regulatory hurdles are often identified:

- The so-called "500 Shareholder Rule" codified in Section 12(g) of the Exchange Act, which compels private companies to become public reporting companies once they have

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[6] Remarks by the President of the United States in the State of Union Address, The White House, Jan. 2011.

[7] Venture-backed companies in the United States account for more than 12 million jobs, or 11% of the total private sector employment. *Venture Impact: The Economic Importance of Venture Backed Companies to the US Economy,* National Venture Capital Journal and IHS Global Insight, 2009.

[8] *The Importance of Startups in Job Creation and Job Destruction*, Kauffman Foundation Research Series: Firm Formation and Economic Growth, July 2010.

exceeded 499 shareholders and have more than $10 million in assets at the end of any fiscal year.

- The prohibition against "general solicitations" and "advertising" in connection with private placements of unregistered securities, which has been interpreted to mean that potential investors must have a pre-existing relationship with an issuer or intermediary before the potential investor can be notified that unregistered securities are available for sale.

These two regulatory restrictions have been in place for several decades. The shareholder threshold – which, incidentally, was initially set at 750 before being reduced – was established in 1964 and worked well for several decades. For many years, companies were going public within a few years of founding, and were not getting close to the shareholder count. That, however, is no longer the case.

The pay structure at startup companies generally involves giving employees below-market salaries along with options which vest over several years. The options are an economic incentive that allows employees to realize the financial upside of contributing to a successful startup. The companies prefer to give equity in lieu of cash compensation because startups generally need to conserve capital in order to grow the business. Option holders do not, in fact, count against the 500 Shareholder Rule, so awarding options to employees does not adversely impact the shareholder count until the option holders exercise the options. However, in the new reality of companies taking nearly a decade to go public, option holders are often fully vested well before an IPO, and shareholders who exercise their options *are* counted under Section 12(g).

The significance of this development cannot be overstated. The 500 Shareholder Rule has created a disincentive for private companies to hire new employees, or acquire other businesses for stock, as these private companies are fearful of taking on too many shareholders. Application of the rule also discourages companies from providing stock option-based compensation to employees, removing one of the great economic incentives attracting the country's best and brightest employees to startups. The rule must be reexamined in light of the new reality that companies are remaining private much longer than in previous decades.

The prohibition against general solicitations is similarly problematic. Under many of the existing SEC exemptions for private placements, only "accredited investors" are eligible to purchase private company stock. An individual must meet certain financial standards to qualify as an accredited investor, and the definition was recently amended in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to exclude an individual's primary residence from the calculation. The SEC and Congress recognize that sophisticated, accredited individual and institutional investors have greater capacity for risk and do not require the enhanced protections provided to the average retail investor.

As previously noted, the prohibition against general solicitations and advertising requires issuers and intermediaries to have a pre-existing relationship with the accredited investor in order to make offerings available. In fact, if a non-accredited individual even *views* an offering of unregistered securities, the entire offering may be in violation of the prohibition against general solicitations.

Frankly, if only accredited investors are eligible to purchase unregistered securities, shouldn't we strive to maximize the pool of accredited investors that have access to the offering? It should not

matter that non-accredited individuals know that unregistered securities are available for sale. No one prohibits car manufacturers from advertising, even though children under the legal driving age are viewing the advertisements. The general solicitations prohibition unnecessarily limits the pool of potential investors, thereby restricting companies' ability to raise capital to fuel growth.

Given the foregoing problems in the regulatory landscape, I would respectfully propose the following solutions:

1. A significant increase or elimination of the 500 shareholder threshold.
2. If the threshold is increased but not eliminated, an exemption for accredited investors and Qualified Institutional Buyers from the shareholder count. The SEC has determined that these investors do not require registration-level protection. Thus, implementation of this exemption would not breach the SEC's investor protection mandate.
3. If the threshold is increased but not eliminated, an exemption for naturally well-informed employee-shareholders from the shareholder count.
4. An elimination of the prohibition on general solicitations in the context of private placements and resales of unregistered securities, provided that the ultimate purchaser meets the accredited investor qualifications.

These rule changes would significantly ease the pressure on growth-stage companies in this country. It is important to note that these concepts did not originate from SecondMarket.

Rather, industry experts and participants have for many years advocated the implementation of these exact changes.[9]

In 2009, the SEC kindly invited me to participate in its Small Business Capital Formation Forum. I accepted the invitation and participated in a panel regarding the state of small business capital formation. I also listened to multiple panelists advocate for some or all of these changes. In fact, for several years, the Forum's participants have recommended to the SEC the proposals we are making today.

I recognize that passage of Dodd-Frank significantly added to the SEC's rulemaking responsibilities, and implementation and enforcement of these new rules will be challenging. Nonetheless, I believe the problems facing growth-stage companies in this country must be addressed, and these tailored, straightforward recommendations are steps in the right direction. Failure to adapt to the fundamental new reality that companies remain private longer will restrict job growth, stifle innovation, and weaken America globally.

Conclusion

In summary, I want to thank Chairman Issa, Ranking Member Cummings, and the members of the Committee for the opportunity to participate in this important Hearing. I also want to thank the SEC for consideration of these rule changes. As SEC Chairman Mary Schapiro indicated in her letter to Chairman Issa on April 6, 2011, "…..facilitating capital formation, along with protecting investors and maintaining fair and orderly markets, is the mission of the Securities and Exchange Commission." Along those lines, it is imperative that decades-old rules and regulations are updated to reflect the new realities of market structure, technology, and

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[9] *See, e.g.,* Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, April 2006 (advocating eliminating the prohibition against general solicitation).

information flow to better support the thousands of innovative, growth-stage companies in our country. In this period of slow economic growth and increasing global competitiveness, we need to support these types of companies with all available resources and ensuring cost-effective access to capital is an important first step.

Thank you.