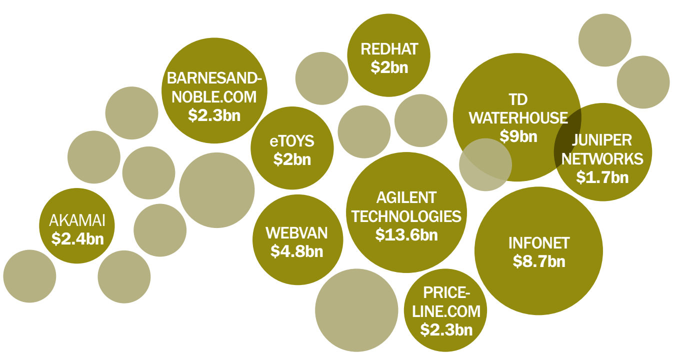
FOR THE FACEBOOK GENERATION, PRIVATE GETS MORE PUBLIC

BY DOMINIC MCMULLAN, BRUNSWICK, LONDON

Private stock marketplaces have added a new dimension to the capital markets. What does their growth mean for the economy, for public oversight and for the dialogue between companies and their investors?

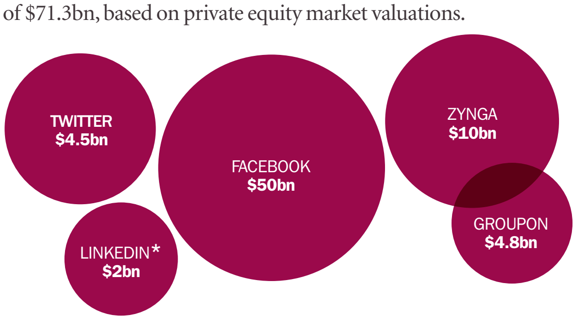
Since the 1990s boom in new public share listings...

In 1999, as the dotcom boom neared its peak, hundreds of companies floated. The 24 largest totaled $70.96bn market capitalization.



...private stock markets were spawned to fill the gap

In early 2011, five of the most prominent internet companies had a total value of $71.3bn, based on private equity market valuations.



Source: Morgan Stanley (February 2011)

* LinkedIn priced an IPO in May, 2011, valuing the company at $4.3bn; the shares subsequently traded significantly higher.

Stock markets have recovered since the financial crisis and there has been a resurgence of the initial public offering (IPO) pipeline this year. But the slump in public stock markets in recent years created a need for an alternative. Since the peak in 1996, when more than 900 companies launched IPOs, successive market crises took their toll: there were just 85 new US listings for 2008 and 2009 *combined*, according to Dealogic data. Private stock marketplaces, such as SecondMarket, sprung up to fill the gap. They have also proven to be a good training ground for companies, such as LinkedIn, that ultimately want to go public (see left). Also, these markets are one of a growing number of alternatives for companies that may want to stay private at a time when public company regulation has become too burdensome.

What are the implications of this new order in the capital markets? Felix Salmon, a finance blogger at Reuters and one of four people whose thoughts on the subject we sought, argues that with more alternatives for companies to raise new capital and for early investors to realize the value of their shares, a public listing is no longer as compelling as it once was. Furthermore, oversight of companies doesn't necessarily require them to go public. However, Salmon recognizes that something may be lost with the dwindling of the public markets: it will make it harder for people of ordinary means to buy a stake in growth companies.

The irony, as several of our contributors point out in the following pages, is that rules and regulations that were put in place to give investors a fairer deal may have become so burdensome and costly that they have deterred banks and companies alike. Catherine James, Head of Investor Relations at Diageo, says that while SEC rules may be understood by savvy investors, the fact that they are not universally understood means they are not having the desired effect. Indeed, they appear to be causing more ambiguity than transparency.

Even before the additional regulatory burden, trends in banking were conspiring against the public markets. Kathryn Coffey, an investment banker and private placement specialist, says the loss of the private capital ecosystem, especially leading "boutique" Wall Street investment banks as well as the dwindling quality of sell-side research, has meant a less friendly market for debutante growth companies.

SecondMarket has seen sharp growth in private stock trading, but its very success – especially in creating a market for Facebook shares – has attracted the attention of the Securities and Exchange Commission (SEC). SecondMarket's founder and CEO, Barry Silbert, whose article appears on page 65, says the various stakeholders are striving to determine what is best practice. He argues that it is often in their best interest to give details about their operations and performance that go beyond regulatory requirements, especially if the ultimate aim is to go public.

The wind may be blowing in favor of private stock markets. The SEC has been in dialogue with companies, including SecondMarket, since early 2011 about setting rules for these new marketplaces. One SEC concern had been excessive valuations in the private stock markets. However, those worries should have been assuaged by the fact that LinkedIn's shares soared after IPO, suggesting the private market valuation was not inflated.

While it is clear that companies are staying private for longer, the nature of being private is changing radically. Kathryn Coffey argues that private companies need to communicate just as well as public companies from an early stage. "A good communications program is something that I advise my clients to think about from early on… even before they engage with public market capital providers," she says, adding that executives today need to be well versed not just in communicating their financial performance but their core values too.

Whether they are private or public, companies can face scrutiny from a variety of sources. Pharmaceuticals and food companies, for example, are subject to vigilant oversight from the Food and Drug Administration in the US, as well as a host of consumer watchdogs, as Felix Salmon notes. Also, companies such as Facebook and Twitter have featured heavily in the public debate about privacy as internet communication evolves new formats.

In private market environments like SecondMarket, companies are also well advised to nurture their profile long before they might want to create a market there. As Barry Silbert points out, the lead-in period for a company launching on SecondMarket is perhaps two years in order to generate a sufficient following. That is a very different timeframe to launching a traditional initial public offering.

Welcome to capital markets in the era of social networks.

Dominic McMullan is a Director in Brunswick's London office, having spent the last three years in the firm's New York office. He specializes in cross-border corporate reputation and transaction campaigns.

FELIX SALMON
— Reuters finance blogger

There are alternatives to declining public stock markets, though that opportunity will not be open to the average investor

The public stock markets in the West have been in decline for more than a decade. Since the dotcom bust in 2000, the market for initial public offerings has never fully recovered and the number of companies listed on American stock exchanges has nearly halved since its peak in the late 1990s.

Is this decline of the public stock markets against the public interest? Will companies increasingly operate under the radar of public scrutiny? Are there implications for our ability to value companies, or for the economy at large?

The reasons for the decline are pretty clear from the point of view of the companies. With slow-growth economies and low interest rates, it has been cheaper for companies, by and large, to raise money in the debt markets rather than by selling equity. At the same time, companies have been put off by increasingly onerous corporate governance rules, particularly those that came into effect with the passage of the Sarbanes-Oxley Act in 2002, a response to Enron and other corporate scandals that, amongst other things, saddled directors of public companies with a heavy legal liability. Many of the companies that went public during the dotcom boom surely wouldn't again opt to take on such a regulatory burden.

Also, companies now have many more ways to realize the value of their equity. Though the financial crisis has taken its toll, investors have grown in sophistication; for example, there is an active secondary market that allows private equity owners to exit a company without having to go to the public markets. Meantime, operators such as SecondMarket will facilitate controlled markets for private companies so their shares can be traded, rather like a sophisticated eBay for private company shares.

What about the question of valuation? Surely, the argument goes, a public market is needed in order to arrive at the best price for a company's shares? I think this is myth. The idea that there is some set of facts out there that if known to the world would allow a share to trade at the "correct" price is bogus. A company's stock is worth whatever someone is willing to pay for it and publicly traded share prices are often driven more by broad market moves than any specific understanding of the company.

You can determine a share's price via a public stock exchange or through various other means, such as in a controlled private market or by an agreed formula as law partnerships do. There is no particular reason to believe that one way is better than another. Indeed, private valuations will tend to better reflect a company's intrinsic value and be less susceptible to the vagaries of the stock market and its short-termism. In public markets, a company's relationship with its investors takes up an enormous amount of management time with questionable benefits. Arguably, private companies these days are able to achieve higher valuations than publicly traded ones.

The broader question of public interest is less clear. The public stock markets are, of course, still enormous – valued at around $17 trillion in the US alone. An active public stock market has been for many decades a proxy of the broader economy's health and has provided a gateway for popular participation in the expansion of American capitalism. However, as fewer new companies are added to replace those that disappear through merger or failure, aging dinosaurs increasingly populate the public company world. There are fewer opportunities for ordinary investors to grab a piece of the action in new-industry companies, like Twitter or Facebook.

It doesn't necessarily follow that scrutiny of the corporate sector has to suffer. When companies go public you mainly get more transparency of their finances, which is often the least interesting bit of what they do. I do not buy the hypothesis that private companies are necessarily worse at communicating because they do not have the Securities and Exchange Commission breathing down their neck. There are many examples of public companies that are inscrutable in many important aspects, despite having to make public filings.

Conversely, there are other lines of public oversight that apply to both public and private companies – the Food and Drug Administration oversees companies on safety, for example. With companies like Facebook and Twitter, the public debate has focused on broader issues of privacy and the way that certain fundamental aspects of our lives are changing.

The opportunities to invest are becoming more restricted to the rich and privileged, but if those charged with broad oversight of private and public companies do their job, then it should keep them honest.

Felix Salmon is a finance blogger for Reuters. He has worked for various publications, including *Euromoney* magazine and *portfolio.com*. He also created the Economonitor blog for Roubini Global Economics *http://blogs.reuters.com/felix-salmon/*

BARRY SILBERT

— CEO, SecondMarket

The path to a public listing has changed radically – so has the way companies must communicate with the market

SecondMarket, founded in 2004, emerged from the fragmentation and failings of the financial markets and is now the largest centralized, transparent platform for buying and selling alternative investments.

Aiming to be a destination where investors could discover new opportunities in alternative assets, our first asset class was restricted securities in public companies. We've since expanded into other markets including bankruptcy claims, limited partnership interests, and structured products, such as auction-rate securities and mortgage-backed securities. In 2009, we launched our private company stock market, which has become our fastest growing investment class.

Anyone can sell assets on SecondMarket, but buyers must be "accredited investors," meaning they must have $1m in assets or earn more than $200,000 annually for three consecutive years. [SecondMarket is a FINRA-registered broker-dealer and a SEC-registered Alternative Trading System.]

> "IT BEGAN IN 2008 WHEN A FORMER FACEBOOK EMPLOYEE APPROACHED US TO SELL HIS SHARES"

We received significant public attention initially for creating a market in Facebook shares. It began in early 2008 when a former Facebook employee approached us and was interested in selling his shares. We conducted that first transaction and facilitated trades for friends of the original seller. We then spent about a year conducting due diligence to determine the long-term viability of the market, seeking input from private company CEOs, entrepreneurs, venture capitalists and others in the ecosystem, and determined there was a real lack of liquidity for private companies.

In April 2009, we officially launched the private company stock market as a response to fundamental problems in the US public stock markets, and that has broadened considerably in the past year. Over the past 15 years, there have been several systemic changes in the public markets, resulting in a lack of market support for growth-stage companies:

First, the shift to online brokerages from human brokers eliminated a key marketing channel for small- and mid-cap companies. For decades, brokers across the country made hundreds of thousands of calls per day recommending buying opportunities to investors. Those calls are rarely made today, as investors use online brokerages with much greater frequency.

Next, the market shift to decimalization meant that once the stock markets changed from quoting prices in fractions to quoting in decimals, trading margins were reduced. Profits that had funded equity research and sales support were significantly diminished and research reports for smaller companies essentially stopped being written, depriving companies of another critical marketing mechanism.

In 2002, Sarbanes-Oxley, [the law that tightened public company governance rules], also made being a public company much more expensive.

More recently, the proliferation of high-frequency trading has changed the dynamics of the public markets. More than half of the trading in public shares is done by high-frequency traders who require volume, velocity and liquidity that can only be found in large-company stocks.

All of these factors have made the public markets unsuitable for growth-stage companies. We believe SecondMarket can and should fill that gap. Until a decade ago, the IPO was the ultimate goal for entrepreneurs but times have changed. Today, companies are choosing to remain private or are taking longer to go public – nearly a decade on average, up from four-and-a-half years in the 1980s and 1990s. Thus, companies have a need for interim liquidity. SecondMarket can be seen as a kind of "spring training" for companies, giving them interim liquidity while they continue to grow and attract interest from analysts, so they will have the option to go public if they choose to.

SecondMarket allows potential buyers to research a profiled company and to express an interest in investing. Private company equity holders can also express interest in selling shares. SecondMarket provides this user-generated data to the companies so they can determine whether they want to create a managed market.

Once a company decides to work with us, we provide it with the tools to design a customizable market, setting its own terms and parameters – including who can buy and sell and the frequency of transactions. There are minimum regulatory requirements regarding information disclosure but the company decides how much additional information to provide.

In short, the company controls its market and shapes its message. After all, each company has its own strategic reasons to establish a customized secondary market – to provide interim liquidity; to create an acquisition currency; to consolidate its shareholder base; or to retain and attract employees. Communication with employees and other shareholders is important for added transparency.

As the private company market continues to evolve, SecondMarket is expanding. Last year, we completed more than $400m in transactions in 40 companies' stock. This year, we significantly revamped our online platform and added social components as well as information pages for thousands of private companies. The SecondMarket community now numbers more than 60,000. This is just the beginning for us.

Barry Silbert is the founder and CEO of SecondMarket. Established in 2004, it is the world's largest marketplace for buying and selling alternative financial assets, including private company stock.

CATHERINE JAMES

— HEAD OF INVESTOR RELATIONS DIAGEO

Rules meant to level the playing field for investors seem to have made quality company research *harder* to find

Size, as they say, matters. When it comes to the level of interest and scrutiny, it is less a question of public versus private than of the size and importance of the company involved. Does a private company like Facebook get any less press attention than Diageo? No. In fact, it probably gets more as there is an added dimension of public intrigue because of the levels of personal wealth involved, as well as concerns about issues such as privacy.

But I would make a clear distinction between the formal communications required of public companies (the regulatory filings, the reports and accounts) and those required by stakeholders (the owners, employees, government agencies and the like).

Investors, rightly or wrongly, assume that big companies will act in the best interest of all their stakeholders and the bigger the company the bigger the assumption. At this point, I think, the same standards apply to public and private companies alike when it comes to most public responsibilities. Even if a company does not have financial regulators forcing it to make disclosures, the media will no doubt act as a regulator-by-proxy.

There is very little chance that a private company, such as Facebook, could ignore its responsibilities as a leader in its industry. As was seen with the privacy issue, the media can be relentless when they latch onto an issue and ignoring them will only exacerbate the situation. So, I do not think that companies – the larger ones, in any case – avoid the public markets in order to avoid scrutiny. I think the end game has not changed: all the big companies want to come to the market eventually to fully realize the value of their equity because of the added transparency, and to get that "quality stamp" that the public markets can provide as a safety net for investors.

However, there are clearly problems in the public markets that need to be addressed; problems of communication and clarity. In particular, the Securities and Exchange Commission's (SEC) rules are not well understood by investors, or even by many investment analysts who investors rely on to interpret financial reports for them.

Any well-run company will have the internal controls in place to allow it to fulfill SEC obligations, but many investors do not fully appreciate what is required of companies and what protection SEC rules afford them. The really savvy investors will be able to scrutinize accounts for any digression from SEC rules and recognize red flags accordingly. This was the case for those who first picked up on weaknesses at Lehman Brothers – they properly understood the disclosures in the accounts.

However, some sectors are better served than others in terms of the quality of investment research. Certainly, this varies considerably from company to company.

In general, there has been a decline in the number of good research analysts doing in-depth, thematic research, as opposed to those just concentrating on stock-price movements. This means it is really difficult to attract the sort of investors that you want on your register – solid long-term investors – and this is especially the case if you are first coming to market. This has the effect of discounting the price investors are willing to pay for equity, which in turn makes companies more reluctant to come to the public markets.

So, what are the ramifications for communications? Clearly, the SEC rules and regulations need to be explained and understood better. Investors tend to judge our financial disclosures without understanding our context. That is the anomaly with the SEC regime: their rules are not having the desired effect. In fact, they are causing more ambiguity than transparency.

Catherine James is Head of Investor Relations at Diageo. She joined Grand Metropolitan, a Diageo legacy company, in 1984 as a financial analyst and has held various senior finance positions in the group.

KATHRYN COFFEY
— BANKER AND PRIVATE PLACEMENT SPECIALIST

The disappearance of the old ecosystem means companies must learn to engage a new milieu of financiers

When did the public markets become so unfriendly for companies, especially for the growth-oriented enterprises that featured so much during the boom times?

I think the big change came when Eliot Spitzer, New York's zealous state attorney general (before he became its disgraced governor), forced through his settlement with Wall Street's top 10 investment banks in 2003, changing the nature of equity research in the industry. The Spitzer deal, which was the culmination of his investigation into artificial stock price inflation and other alleged offences, forced a definitive separation of research from investment banking, making research beholden to trading desks. Thus, the focus of the banks' equity research departments turned to larger, actively-traded companies that provided a wider range of capital markets opportunities for the banks.

But even before the Spitzer deal, the range and quality of company research was shrinking. The trend was typified by the disappearance of the so-called CHARM group – five leading "boutique" Wall Street banks that were particularly influential in championing growth companies looking to debut on the public markets. All these banks – Cowen & Company, Hambrecht & Quist, Alex. Brown, Robertson Stephens and Montgomery Securities – were acquired at the end of the 1990s and disappeared into larger banking groups.

The refocus of investment research on very large-cap companies led to a brain drain from the banks, with the best research talent switching to buy-side firms or hedge funds. So, the high-profile research being disseminated by the banks became less and less supportive of the kind of companies that venture capitalists and others were looking to take public. All these changes meant there was no longer an army of people – trained bankers and syndicate desks – who were passionate about taking the next generation of companies to the public markets. The ecosystem of that world disintegrated and that created a lot of public company orphans.

To some extent, the old regime has been replaced by different market infrastructure. The expansion of capital pools such as secondary funds, as well as the various private market exchanges, have replaced some of the old bank functions. But all investors need to recycle their capital – venture firms need to return capital to partners, angel investors need to support the next start-up, owners and employees need a liquid market to sell their shares. In my view, eventually a company will want to go public, even if that is now happening much later in their life cycle.

What are the implications for communications? Companies need to consider carefully all these new and varied relationships with the capital markets. I advise my clients to think about communications strategy well before they engage with venture firms, private equity, or the public markets. This must go broader and deeper than just financial information; they must communicate their corporate values as well. They must also be well versed in the capital markets milieu. They must know that investors who take large stakes in companies often will try to exert influence and company executives must be able to withstand scrutiny of their strategy and their values.

It is good to be proactive. Some private company executives are skilled at preparing substantive reports with real insight into their industry and how they fit within it. I believe doing this forms meaningful relationships with their investors long before the company may go public. If a company discloses the reasons behind a disappointing quarter or a significant customer loss, for example, its willingness to be upfront creates goodwill and gives it breathing room.

Private and public companies need to devote time to communicate with all stakeholders, particularly their largest shareholders. That can be difficult for the public market "orphans," especially given the added burden of the Securities and Exchange Commission's Fair Disclosure rule ("Reg FD"), introduced in 2000, which requires them to make material non-public information widely available in a timely fashion. The irony of Reg FD and the Spitzer settlement is that while they were intended to give retail investors a fair chance, they have landed them with the task of digesting an enormous amount of complicated information without the filter of experienced research analysts. This means companies need to adopt proactive communications strategies – especially for their largest shareholders and especially around times of capital raising.

Kathryn Coffey is an independent consultant to senior management and investors of later stage private companies in high growth industries. She has had various senior banking roles, including head of the private placement groups at Seven Hills LLC and Deutsche Bank Alex. Brown.