Before The IPO: A Private Market For Tech Shares

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Very soon, Facebook will go public. That means anyone will be able to buy shares of the social networking giant on the Nasdaq exchange. But sophisticated investors have already been buying pieces of Facebook and many other hot tech stocks, on private exchanges.

And now it seems that trading in private company shares is poised to grow, thanks to recent changes in the law.

Tradition says that the life cycle of a new company might look something like this: birth — the founder starts her business; childhood — angel investors and venture capital help the business to grow; and when the company makes an IPO, or initial public offering, it's reached adulthood.

But today, some companies are postponing that step. They're staying teenagers for longer, and hanging out in private, secondary markets, where investors like Talmadge O'Neill can find them.

"I've done investments in BrightSource, eHarmony, LinkedIn — which went public — Dropbox, and Redfin," O'Neill says.

He also invested in Facebook and Tesla, the carmaker.

O'Neill estimates that he has spent between $25 million and $30 million to buy stock on secondary markets.

It's a lot of cash. And O'Neill made every one of these purchases without ever seeing a quarterly earnings statement. In the market for private company shares, it's not required.

"Generally, on a lot of these things, you are really going by gut," he says. "You're saying, 'I like the product; I think the company is doing well. The news that I read on TechCrunch or All Things Digital, or any one of these technology blogs, it all looks good.' "

In just a few years, trading in private company shares has grown from practically nothing to several billion dollars' worth of transactions.

Fueling that growth is the boom in technology startups like Twitter, Hulu and Spotify. Employees at these companies sometimes get part of their pay in stock. After a few years, staffers may want to cash out. Secondary markets like SharesPost and SecondMarket match sellers to buyers.

It's a trend that worries Harvard Law professor John Coates.

"There's no agency looking over their shoulder to make sure that they don't have conflicts of interest," he says, "or know about problems that they're not revealing to the people trading on their exchanges."

The Securities and Exchange Commission doesn't directly oversee what are known as secondary markets. But it does require that all buyers be accredited investors with income above $200,000, or assets of $1 million or more.

The biggest platform for trading in private shares is SecondMarket, in downtown Manhattan. On its trading floor, men and a few women sit at computer terminals. Around the corner, there's a foosball table and a pantry, where all 100 or so employees are allowed to take a beer from the fridge on a Friday afternoon. SecondMarket is eight years old, and it has a startup atmosphere.

Ali Byrd, a senior vice president, says that SecondMarket has tightened its procedures and now requires companies to 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," he says.

Still, it's well short of the quarterly reports, internal controls and auditing required of public companies.

Earlier this year, SecondMarket laid off 10 percent of its staff. The likely reason is that its biggest attraction, Facebook, is about to go public. But even without Facebook, there are reasons to believe private markets will thrive.

Last year, SecondMarket's founder and CEO, Barry Silbert, appeared before Congress three times. He asked lawmakers for changes that would help his business grow: raising the number of shareholders a company can have before registering with the SEC, and lifting a ban on marketing private stock directly to investors.

In April, President Obama signed those changes into law, as part of the JOBS Act.

"I really do think the two pieces together are going to have a combined effect that's more powerful than any other piece of the bill," says Harvard's Coates, "and more powerful even than the backers of the bill may be expecting.

That's just a guess, of course. The more immediate effect will be that successful startups can push back the point at which they need to do an IPO. Instead, they'll be able to live up their teenage years in lightly regulated private markets.