

## SEC Releases Guidance Jeopardizing the Viability of Certain Pre-IPO Liquidity Products

**By Ethan L. Silver and William Brannan**

After a spate of pre-IPO focused security-based swap enforcement actions around 2015, the US Securities and Exchange Commission (SEC) has largely sat on the sidelines as the pre-IPO liquidity market has enjoyed significant growth and innovation. The SEC broke its silence on June 9th, releasing Compliance and Disclosure Interpretations (C&DIs) that question the continued commercial viability of secondary market forward contracts (Forward Contracts).

Often targeted to early investors and existing or former employees holding private stock (Private Securities) of late-stage technology companies, Forward Contracts are one of most popular types of pre-IPO liquidity solutions. Numerous broker-dealers and online platforms are estimated to have facilitated hundreds of millions, if not billions of dollars' worth of Forward Contracts over the last several years.

### What Are Forward Contracts?

Commonly a brokered product, Forward Contracts are bilaterally negotiated between buyers and sellers, often without the involvement of the underlying issuer of the Private Securities. In a typical transaction, a seller agrees to sell a buyer a specific number of Private Securities that they hold. Buyers pay for the Private Securities upfront and, because Private Securities typically are subject to various transfer restrictions, the seller agrees to physically

deliver the Private Securities to the buyer once they are freely tradeable (most typically as a result of an initial public offering (IPO) of the underlying company).

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) created a systematic regulatory framework for the over-the-counter derivatives market. Specifically, Title VII of the Dodd-Frank Act grants the SEC regulatory authority over security-based swaps. The Dodd-Frank Act amends Section 5 of the Securities Act of 1933 (Securities Act) so that it is unlawful for any person to offer to sell, offer to buy, or purchase or sell a security-based swap to any person or entity that is not an eligible contract participant (ECP) (for an individual to qualify as an ECP they must have at least \$10 million in total assets invested on a discretionary basis) without registering with the SEC.

Most employees wishing to obtain liquidity are not ECPs. However, most Forward Contracts are structured to rely on an exclusion from the definition of security-based swap (Physical Delivery Exclusion). The Physical Delivery Exclusion exempts from the definition of security-based swap any sale of securities for deferred shipment or delivery *so long as they are intended to be physically settled*.

### SEC Guidance

The SEC does not consider a Forward Contract to be "*intended to be physically settled*" if, at the time the parties enter into the Forward Contract, the underlying Private Securities (1) cannot be legally transferred, or (2) the transfer of the underlying Private Securities is restricted by contract (Guidance).

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Ethan L. Silver and William Brannan are partners of Lowenstein Sandler LLP.

In almost all cases, depending on the facts and circumstances of a particular Forward Contract, Private Securities may be legally and privately transferred pursuant to Section 4(a)(1) or Section 4(a)(2) of the Securities Act, as well as pursuant to what has become known as the ‘Section 4(a)(1½)’ exemption. However, almost all Private Securities are subject to some form of transfer restrictions, whether in the form of explicit restrictions on sale, transfer, pledge, entering into derivatives or other option transactions, etc., as well as issuer rights of first refusal (Transfer Restrictions).

Therefore, other than in the context of issuer-sanctioned transactions or liquidity programs (where any Transfer Restrictions can be specifically waived), Forward Contracts on Private Securities face significant regulatory and practical restrictions. Those market participants wishing to remain firmly within the bounds of the new Guidance must (1) seek issuer waiver of Transfer Restrictions, (2) significantly limit eligible counterparties to ECPs (that is, acknowledging that

the Forward Contract does not satisfy the Physical Delivery Exclusion and therefore constitutes a security-based swap, subject to, among other things, the ECP requirement), or (3) seek alternative structures.

### **Alternative Structures in the Pre-IPO Liquidity Market**

Fortunately, numerous liquidity product alternatives are unaffected by the Guidance. Despite having distinct economic characteristics, both traditional lending solutions as well as private financing arrangements (PFCs) remain available to market participants. PFCs in particular—structured as unique, primary issue private placements (that is, not resales of the underlying Private Securities as in the case of Forward Contracts) provide employees and other early stage investors with the ability to obtain liquidity, while simultaneously reserving some exposure to the market upside of the underlying Private Securities.