

BUSINESS MONDAY

How change in stock-holding period can alter dynamics of venture deals

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Morgenstern recently wrote a report that analyzed changes the Securities and Exchange Commission put into effect at the end of April in "Rule 144," which prescribes how long the owners of privately placed stock shares must hold them before selling. Under the old rules, the holding period for such shares, which are shares not offered to the public, was two years. Now it is one year.

Morgenstern's thesis, echoed by the SEC, is this: The change should help entrepreneurs gain better deals with venture capitalists — because the venture capitalists, who typically take privately placed stock in exchange for their investment, will face less risk in unloading their shares.

Venture capitalists pushed for the change, but at least some of them are skeptical about Morgenstern's theory. The skeptics argue that most early-stage venture investments are made with the expectation of holding the stock at least two years. In their view, the impact would be primarily on late-stage or "mezzanine" investments.

Morgenstern talked about the rule change recently with Mercury News Staff Writer Scott Herhold.



Morgenstern

months to sell your house, think you could sell your house for \$150,000? Maybe, yeah. If I gave you three days, what could you sell it for? Maybe \$100,000. Maybe \$92,000. Why? There's a price for illiquidity. When you have an illiquid security, you have something that a lot of people don't want to own to begin with. It's the old joke: When I go to sell it, sell it to whom? Because there are restrictions — there's how can I sell it, when can I sell it, five or six hoops to jump through. Each time you have a hoop that makes it harder to sell, the corollary is that fewer people are willing to buy it, and therefore that security is flat-out worth less.

Q But venture capitalists typically pass on the shares to their various limited partners, particularly after an initial public offering. They don't appear to me to take the real risk of illiquidity in that transaction.

A Oh, sure they do. When you talk about them distributing the stock, they still take the risk. Why did their limited partners give them money in the first place? Because of their expectation of return. Don't worry if the venture capitalist distributes or not. It's still his problem, because the ultimate risk/reward ratio must satisfy his investors.

Q Give us an example of how the new rules change the equation.

A Let's say the venture capitalist owns 50 percent of the company. He's got 25 limited partners. So each partner gets 2 percent of the company (after the initial public offering). Under Rule 144, in any calendar quarter, you can sell 1 percent of the issued and outstanding shares. Even if all of my partners owned 2 percent, it only takes two (three-month) quarters and they're out of there. Under the old rules, they had to hold the shares for two years after purchase. Now, typically, these guys are 100 percent liquid a year after the initial public offering, even if the securities they purchased were for a fast cash-burning, high-tech company, and were bought right before an IPO to fund the IPO. That's pretty desirable.

Q How does that translate in terms of the initial deal with the entrepreneur?

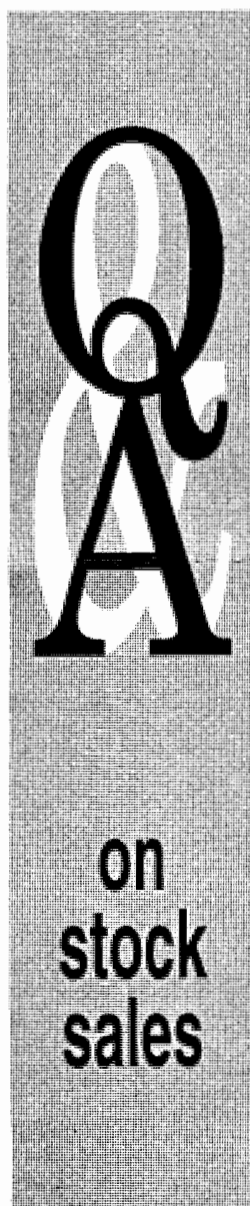
A The SEC says that when you buy a private security — a so-called "exempt" offering — you have to hold it for the specified holding period before you can sell it. That's how they make sure that an exempt offering doesn't turn into a disguised public offering. The idea was that if you held it for two years, we know that you didn't buy it for the purposes of being an underwriter. In all these deals, the holding period increases risk dramatically and therefore you have to buy the security at a much lower price.

Q How does that discount work?

A Take Glendale Federal Savings. You could go on the public market, call up your broker, and order 100 shares of Glendale Federal for \$50 per share. If Glendale Federal went through a private placement, they would sell it for a discount off the \$50, because the person who buys it can't resell it. Until a month ago, they couldn't resell it for two years. Now they can resell it in a year. So the discount is affected. Whereas before it might have been 50 percent, now it might only be 32 percent, or 27 percent.

Q What guarantee do we have that the market works the way you say it does? What guarantee do we have that the VCs won't essentially take the diminished risk as part of their own gain? Are the entrepreneurs going to know about this?

A If the entrepreneurs are represented by knowledgeable lawyers and accountants, they will. The price is a completely negotiable thing to begin with. In some cases, you're looking at marketplaces that don't exist. All it does is remove one major impediment, or the inconvenience of a major impediment. It will probably make more difference in private placement of public securities than in venture capital deals. But it will make a difference in each of them.



Q You're saying that the changes in Rule 144 would benefit companies in their negotiations with venture capitalists. Is that fair to say?

A Yes. Issuers typically offer restricted securities — private offerings — at a discount compared to prices in the public market. If you put that discount at 20 to 50 percent in recent years, you'd be in a comfortable range. That discount compensates the buyers — venture capitalists, whoever — for their inability to resell the securities before the requisite holding period. Since the amendments shorten the holding period, the purchasers will demand a smaller premium for their illiquidity. And the companies should be able to sell the securities at higher prices.

Q Can you explain how that principle works?

A Let's say your house is worth \$150,000. If I gave you six