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SEC Eyes Pre-IPO Share Sales as Private-Market Retail Access Expands

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During a time of several highly anticipated IPOs of high-profile private companies, the US Securities and Exchange Commission (SEC) continued to file enforcement actions against investment vehicles and related individuals in connection with the offer and sale of pre-IPO securities. Pre-IPO securities provide investors with an opportunity to invest in a private company that could potentially undertake an IPO. Investment vehicles purchase pre-IPO securities in various ways, including directly from the private company, from its shareholders or through investments in other investment vehicles holding the pre-IPO securities. Because pre-IPO securities are not widely available, high demand can exist for these shares, particularly among retail investors.

In one recent enforcement action, detailed more fully below, the SEC charged Andrew Spaventa and three entities he controlled in connection with unregistered securities offerings involving private funds that purportedly owned pre-IPO shares of several well-known private companies. The SEC alleged that the defendants told investors they would pay little to no upfront fees but, in fact, charged hidden fees through substantial markups on the pre-IPO shares.

In another recent enforcement action, the SEC charged an investment adviser and related individual for allegedly defrauding investors, including by falsely claiming that a fund already owned shares of a certain pre-IPO company, when at that point the fund did not hold any shares. In addition to fraud, the recent enforcement actions include numerous allegations of registration violations. See this TheFundLawyer blog post for a more detailed analysis of the alleged registration violations and private fund issues embedded in the SEC's recent enforcement actions.

These matters are likely a harbinger of more enforcement attention to the sales of pre-IPO securities as the SEC continues to promote retail access to private markets and offer important lessons for market participants.

Background

According to the SEC's complaint against Spaventa and the entities he controlled, the defendants raised $74+ million from 800+ investors, most of whom were retail investors, by offering interests in 11 private funds that were marketed as providing investors with direct exposure to highly sought-after pre-IPO companies. The SEC alleged that rather than purchasing pre-IPO shares directly for the funds, Spaventa primarily used two wholly owned entities to acquire interests in other funds that purportedly held the shares. Those entities then transferred their interests to the 11 funds through "equity transfer agreements" that Spaventa allegedly backdated.

As alleged by the SEC, the defendants did not disclose to investors the prices at which they acquired the pre-IPO securities or the value of those securities, and claimed that the prices paid by investors were calculated by reference to market value. However, the defendants allegedly marked up the prices when selling the pre-IPO securities to the private funds. According to the complaint, investors paid 27% to 91% above the defendants' acquisition prices. The SEC alleged that the defendants' private placement memoranda – which stated that they "may" receive income from the sale of pre-IPO securities to the private funds – were misleading because the defendants received such income from "every sale."

Spaventa has denied the SEC's allegations.

The SEC's charges

The SEC charged the defendants with violating the antifraud provisions of the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act) and the Advisers Act. The fraud charges are premised on the defendants' alleged misstatements concerning the funds' ownership of the shares, the amount of the markups and the value of the pre-IPO securities. According to the SEC, the defendants told investors that the funds they invested in purchased the shares directly from selling shareholders, when in reality, the defendants caused entities that they owned to acquire the pre-IPO securities from other pre-IPO investment funds, which in turn sold the pre-IPO securities to the funds marketed to investors at highly marked-up prices. The SEC also alleged that these transactions were principal transactions, and that the defendants failed to obtain the required investor consent.

In addition, the SEC brought charges for two registration violations. First, the SEC charged the defendants with violating the registration provisions under Securities Act Sections 5(a) and 5(c), which require securities sales to be registered with the SEC unless they qualify for an exemption. Second, the SEC charged the defendants with violating the broker-dealer registration requirements under Exchange Act Section 15(a)(1). According to the SEC, while not registered as a broker or dealer, the defendants' sales agents effected securities transactions in exchange for $12 million in commissions.

The SEC seeks injunctive and monetary relief, including enjoining Spaventa from associating with broker-dealers or offering securities through entities he controls, disgorgement of ill-gotten gains and civil penalties.

Takeaways

The case is particularly significant when viewed against the SEC's broader effort to expand retail access to private markets. Under Chairman Paul Atkins, the SEC has embraced what it calls the "responsible retailization" of private markets – the idea that everyday retail investors should not be excluded from investing in private assets. At the same time, Chairman Atkins has emphasized that facilitating retail investor participation in private markets must be accompanied by "preserving their protection with appropriate safeguards."

Most importantly, those safeguards include full and fair disclosures. The SEC's scrutiny of the sales of pre-IPO securities is primarily focused on the disclosures made to investors. Investment advisers and other market participants that sell pre-IPO securities to investors should accurately disclose, among other things:

1. Whether they already own the shares at the time they are soliciting investors, or whether they plan to buy the shares with the money they raise.
2. Who they purchased the shares from.
3. Whether they own the shares directly or through interests in other funds.
4. Whether and how much of a markup they are charging on the price of the shares.

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