A lot of secondary buyers are apparently coming from overseas

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We told you early last month that secondary businesses have been inundated with sellers in recent months, and that's not expected to change anytime soon. Nary a tech company went public in the first quarter. There's also the related issue of falling valuations, which has both institutional and individual shareholders nervously wondering whether to hang on to their holdings or get rid of them.

Helping to keep the whole flywheel going: secondary buyers who are coming from overseas to snap up startup stakes. So says Timothy Harris, a partner in the emerging companies and venture capital group of law firm Morrison Foerster who got us up to speed on the market earlier today.

Harris has his own agenda when it comes to secondaries — including helping startups decide whether to engage in transactions, how to structure them and to ensure companies have some degree of control over the process. But he spoke candidly about the good, the bad and the unexpected of what he's seeing. Our chat has been edited for length.

TC: The Financial Times wrote a piece recently proposing that some still-private companies have no plans to go public, ever, saying this was okay and even healthy.

TH: That's right. [The secondary market] is now one of the only ways that liquidity is provided to shareholders who don't want to sit on their often highly appreciated shares. There were no IPOs in the first quarter. And some companies are still so highly valued, who can buy them? Meanwhile, you have people who joined these private companies thinking they'd go public and that [an IPO exit] was how they were going to pay their college tuition or for elder care or for the mortgage on their house.

TC: The impulse to sell is understandable. But who's buying? Isn't it like catching a falling knife right now?

TH: I don't think that's true. I've advised some VCs [about] what I perceive to be incredible deals based on what I've read about these companies and what they are worth. It's like an art auction when the artists aren't yet dead or they're recently dead and it's not clear how much their pieces will be worth in the future. People took a gamble on Facebook before it went public; they gambled on Square. Others who are buying into unicorns are similarly hoping the companies will go public someday or else that they can turn around and sell the shares for more later.

TC: But again, who exactly is buying?

TC: Many of them are tourist investors from overseas — both high net-worth individuals, funds, and public companies — that are thrilled to return home and say, "We just bought fill-in-the-blank-hot company." They show up quite a bit and they appear relatively price insensitive, which makes them attractive to sellers. You also see investment bankers who represent someone who wants to buy or sell shares of certain companies. The angels and VC are also buying and selling to each other.

TC: It all sounds like a pyramid scheme. Who gets stuck at the end of the line?

TH: It's not like there's an end of the chain. Every seller acknowledges that their stock could go higher, but they have cash needs. Meanwhile, almost everyone on the buy side becomes a potential seller in the future. The secondary market is becoming like Nasdaq but with a lot less activity and fewer participants.

TC: Have you seen anyone suing a secondary seller because they feel duped, or do you expect we'll see that soon?

TH: There are a hundred ways that buyers and sellers can have access to different information; it's something the SEC is very concerned about.

In many cases, the seller is inside the company or left it recently or was an investor in the company and had information from board meetings. As a broad matter, sellers have an information advantage over buyers. But buyers legally acknowledge this information disadvantage. [When buying the shares], they release any claims they may make against the seller. Now, if you sell me shares of some hot startup, knowing the FDA is going to invalidate its new drug, heck yeah, I'll come after you, even if I did sign that information disadvantage document. It's like insider trading.

So I do think we'll see litigation between remorseful sellers and buyers in the future. But there's no prominent stream of [lawsuits yet].

TC: Your job is to protect companies, many of which have presumably grown savvy about secondary sales, especially in this market. What's one thing that they may be overlooking when it comes to employee sales?

TH: When sales involve common stock, there is an impact on the company. The IRS views the sales as an arm's length transaction between willing buyers and sellers who [then become] the best indicia they have [of the shares'] fair market value. So while companies are granting stock options to new recruits, they need to be figuring out what price to set. If they are granting options today, and they become aware of a secondary sale that occurred this morning, they have to [tie the options grant] to that price or risk running afoul [of the agency].

TC: Are you seeing more common shares or preferred stock trading hands right now?

TH: By volume, more common stock sellers, just because there are many more common shareholders, including current and former employees. The number of shares they hold tends to be small, though, so the dollar volume tends to be small.

By comparison, there are fewer preferred shareholders in the market, but when they do sell, they tend to be $50 million-and-up chunks of stock that they are moving.

I scratch my head [over it]. $50 million [in a secondary sale] is pretty nice day, but [you wonder] what do they know that the buyer doesn't know. That's what the SEC wants to know, too.

TC: In the interim, that's what foreigners are buying.

TH: Again, it's a lot of foreign investors and sovereign wealth funds and publicly traded companies in Asia. Those are big dollar amounts, so they tend not to be one Silicon Valley fund selling to another.