CFO

Going Public by Accident

Private companies may unwittingly find themselves in the public eye when shares are traded too freely.

Russ Banham - CFO Magazine

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Facebook has long been associated with a blurring of the line between private and public. How many people, after all, have joined the social-networking site in order to tighten their ties to an inner circle of friends and family, only to find the details of their Bruce Springsteen obsession or pictures from their latest beach vacation distributed far more widely than they would like?

Recently, Facebook's finance department encountered similarly unsought public exposure. For years, the high-growth company has carefully guarded its status as a private company, despite strong public interest in its shares. But in late January, in conjunction with a $1.5 billion private placement led by Goldman Sachs, Facebook announced that it would soon be a de facto public company, as its shareholder ranks are slated to swell beyond the 500-investor limit for private companies. By April 2012, Facebook's financials will be out in the open for the whole world to see, even in the absence of an initial public offering.

While Facebook CFO David Ebersman contends that the company's slide into the public arena would have happened regardless of the Goldman investment, CFOs of other privately held companies would do well to heed a key lesson from the story: staying private may be harder to do these days.

That's because two ways of redistributing nonpublic shares — frothy unregulated secondary markets and a legally uncertain investment structure known as an investment pool — are becoming more popular. And each one can quickly have an unintended multiplier effect on the shareholder base.

Crossing the Line

How easy is it to breach the 500-shareholder threshold and inherit the financial-disclosure responsibilities of a public company? Imagine a fast-track Internet or biotech company with 100 employees. Each employee is given ownership stakes in the company via stock options. As the stock value increases and the employees seek liquidity from their holdings, they sell some units here and there. Maybe they sell shares to family and friends. Or maybe they sell their equity in the secondary markets that have sprung up to match speculative investors with equity holders in red-hot companies (last August, for instance, $40 million in Facebook shares were auctioned by a private exchange called SecondMarket; see "I'll Take Seconds" at the end of this article). With enough sales, the company could be on the brink of filing a 10-K and all the other financial documents that public companies must file.

While most are adept at keeping track of their stock, "every now and then there are private companies that have that 'Oh, no!' moment when they realize they're heading over 500 shareholders," says Michael Littenberg, partner at law firm Schulte Roth & Zabel. "Certainly, it's something to be sensitive to."

Counting shareholders can get even more complicated when myriad investors combine their funds into a special-purpose vehicle known as an investment pool, a popular structure that Goldman used for its Facebook investment. While Securities and Exchange Commission rules are clear that corporations, partnerships, trusts, and other organizations are to be treated as a single holder of securities of record, they do not specifically address the recent phenomenon of investment pools and whether they are different than these other types of entities.

Goldman, in fact, disallowed American clients from participating in the investment, reportedly because of an SEC inquiry into whether or not these investment pools are a vehicle to circumvent the rules.

Absent official word from the SEC, opinions vary on whether or not the investment pools subvert the intent of the Securities Exchange Act of 1934's Section 12(g), introduced in 1964. "In my view, these vehicles count as a single shareholder for purposes of the 500-shareholder rule," says Littenberg. But others, like Ralph De

Martino, co-chair of the securities practice group and partner in the Washington, D.C., office of law firm Cozen O'Connor, believe they are a "dangerous approach" to getting around it. Says De Martino: "Unless there is a valid business purpose for forming an investment pool, I can see the SEC saying it's just a ruse."

Perils of Publicity

Protecting privacy is a key concern for many high-growth-company finance executives. Gemvara CFO Eric Sockol, for example, anticipates that his company, a recently launched Internet jewelry retailer, will see a compounded annual growth rate of 100% over the next five years, fueled in part by a business model that lets shoppers customize their purchases without Gemvara having to carry inventory. "Right now, we want to be private, to execute our business strategy without being distracted by quarterly shareholder pressures and expectations," says Sockol, or, for that matter, spending millions of dollars on SEC compliance. "We just don't want those headaches — not yet," he says.

The risk of lawsuits may increase when "going public" happens incrementally, rather than as the result of a careful plan. "If the company breaches the 500-shareholder limit and must disclose its financials, it now runs the risk of not having told the same things to outsiders that it told insiders, and vice versa," says Peter Aronstam, a partner at B2B CFO, a CFO-services firm for growing companies. If the company's value falls, "the risk of litigation from outside investors rises appreciably."

Litigation aside, there is also the uncomfortable possibility of SEC-levied fines and penalties. "Say the SEC concludes that these pools have indeed circumvented the intent of Section 12(g)," says Denis Gagnon, former CFO of MMC Energy and also a partner at B2B CFO. "In a worst-case scenario, it could lead to all types of sanctions being thrown at the company, including fines levied against the CEO, the CFO, and board directors." In theory, a CFO could even be prohibited from taking a finance position at another public company or engaging in the securities business, he says.

Don't Share Your Shares

CFOs have several options for avoiding such problems. One, of course, is to tightly limit the number of shares given to employees. At Gemvara, for example, "we've got a formal process for deciding who gets what," says Sockol.

Private companies also can put restrictions on the shares or options they issue to prevent their trading without prior knowledge. Restrictions can include waiting for a specific event (like an IPO or the sale of the company), or a financial-performance target, or certain employee milestones, like retirement.

Rudolph Libbe Cos. has put a shareholder agreement in place that allows for share redemption under only three circumstances: retirement, death, or disability. "So far, we've been successful in staying under the limit," says Robert Pruger, CFO and treasurer at the private holding company, which contains 10 separate industrial subsidiaries. That's good, because "we have no intention of becoming public," he adds.

Tim Keating, CEO of Keating Capital, an investment advisory firm, also touts the use of such written restrictions. "It makes things pretty straightforward — you basically prohibit a secondary market in the shares from developing," he says. The only drawback: such restrictions may work only for employees. When the shareholder is an institutional investor, "you have little leverage," notes B2B CFO's Gagnon.

Another useful restriction is to require that the company or existing shareholders be given the right of first refusal on buying shares, says Brad Mahaney, a partner at law firm Wicks Phillips Gould & Martin. "You want to ensure that you have some control over what shareholders are planning to do with their securities," he says, in particular if one were to try to sell shares to a competitor.

Private companies can also protect themselves by issuing phantom stock rather than true equity. Phantom-stock plans require that a company adopt a mechanism for valuing itself and build in opportunities for employees to cash in their phantom shares at some point. The trigger can be based on a multiple of earnings or another performance criteria.

Yet another strategy is to apply for an exemption to the 500-shareholder limit of Section 12(g). The SEC, for example, allows exemptions for stock options issued under a written compensatory stock option plan. Companies can also appeal to the SEC for a "no-action" letter exempting them from providing information to prospective investors, which is required under the Securities Exchange Act's provisions for formal registration of securities. Facebook did just that in 2008, and received the SEC's blessing to issue unregistered restricted stock grants to employees and directors that were excluded from counting toward the 500-shareholder limit.

If all else fails, a private company can take comfort from the fact that it does not have to churn out a 10-K the minute the limit is breached — the SEC gives it 120 days after the end of its current fiscal year to register as a reporting company. But don't rest too easy. "Regardless of whether or not a private company is aware that it has breached the limit, it is now a de facto public company with all the associated reporting and disclosure requirements," says Gagnon. "Ignorance just isn't an excuse."

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