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# The Increasingly **Public Market** For **Private Companies**

Impact of §12(g) amendment on investment in non-reporting entities.

**BY BONNIE J. ROE**

THE HIGHLY PUBLICIZED equity offering by Facebook Inc. in early 2011 brought to light some of the tensions in markets for shares of companies that have not yet gone public. For more than a decade, capital has flowed to private companies through venture capital and private equity funds as well as individual investment. Investor interest in privately held companies has often surpassed interest in public markets, and investors have found ways to resell their shares through private markets, including electronic trading networks such as SecondMarket and Sharespost. Yet the level of available information about these companies and markets does not approximate that of public markets.

Some argue that potential IPO candidates are avoiding public markets because of the increased public company compliance costs resulting particularly from the Sarbanes-Oxley Act of 2002, as well as the Dodd-Frank Wall Street Reform Act of 2010. Behind this argument lies a concern that U.S. equity markets are becoming less competitive as compared to foreign stock markets where regulatory burdens are lower. This concern seems to have been a motivating force behind a letter, dated March 22, 2011, from Rep. Darrell E. Issa, Chairman of the Committee on Oversight and Government Reform of the U.S. House of Representatives, to Mary L. Schapiro, the Chairwoman of the Securities and Exchange Commission (SEC).

But the lack of a vibrant U.S. IPO market over the last few years may also be due to other market forces, such as the recent economic downturn or the comparatively easy availability of private financing, as Chairman Schapiro pointed out in her response to Rep. Issa. In addition, for various reasons it may be harder for smaller companies to get the attention of large U.S. investment banks in the IPO process than it was in earlier years. Whatever the reason, companies are taking a longer time to go from start-up to initial public offering, and some potential IPO candidates are deciding to stay private, at least for the time being. Yet the possibility of widely held investment or online trading in these companies while they remain private will require a significant rethinking of the regulatory structure governing when a company must register its securities with the SEC and begin reporting as a public company.

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Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act), as amended, is designed to force companies to register a class of equity securities under the Exchange Act once the securities of such class are held by 500 or more "holders of record." What constitutes a class of equity securities or a holder of record is not defined in the statute, and the interpretations do not necessarily reflect a consistent policy. A company that exceeds the 500 holder limitation at the end of its fiscal year must register its securities within 120 days thereafter. Companies having less than $10 million in "total assets" are exempt from the registration requirement.

The record holder definition is also critical for the rules governing when a company may "go dark," or cease reporting under the Exchange Act. Subject to certain limitations, under §12(g)(4) and Rule 12g-4 thereunder, an issuer of securities that are not listed on an exchange can terminate the registration of a class of securities that is held of record by less than 300 persons.

The SEC is reportedly in the early stages of considering changes to the 500 holder threshold for Exchange Act registration to take account of changes in public and private markets, and is considering whether beneficial rather than record owners should be counted in certain circumstances. The SEC is also reportedly looking into the secondary trading markets for private companies and the quality of information available to purchasers in these markets. Given that the leading secondary trading platform has reportedly experienced a fourfold increase in trading activity, this investigation is timely.

Various legislative proposals have also been made either to raise the threshold above 500 holders or exclude accredited investors and employee benefit plan participants from the count. This article will explore some of the consequences of changes to §12(g) of the Exchange Act or the regulations thereunder in light of the expanding markets for unregistered securities.

### §12(g) and Non-Reporting Companies

Section 12(g) was adopted in 1964 amid concerns that too many securities were being traded in over-the-counter markets without publicly available information or market oversight. The 500 holder line of demarcation was designed to enable small businesses to access private capital without registration, while protecting investors and maintaining market integrity by imposing Exchange Act registration and reporting requirements on larger market participants.

The definition of "held of record" generally counts only those persons identified as owners on records of security holders maintained by or on behalf of the company. Like other entities, a venture capital or private equity fund will be treated as a single holder of record, regardless of how many investors there are in the fund. Exchange Act Rule 12g5-1(b)(3) provides that if the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of §12(g), the beneficial owners of such securities, not the holders of record, shall be tallied to determine if §12(g) applies. In her response to Rep. Issa, Chairwoman Schapiro noted that Rule 12g5-1(b)(3) has been invoked sparingly, and that the SEC staff was aware of only one opinion interpreting the rule, where the court found that an employee trust with hundreds of beneficiaries was not a device to avoid counting the employee beneficiaries as separate holders of record.[1]

In the case of shares held in "street name" through Cede & Co., each broker-dealer participant in the Depository Trust Company (DTC) system is treated as a separate holder, but the individuals who hold shares in their brokerage account through Cede & Co. would not be counted. The DTC system is the principal vehicle through which shares of publicly traded companies are held. Thus, publicly traded companies often have relatively few holders of record, consisting principally of the brokerage firms that participate in DTC. While shares of privately held companies are not usually held through DTC, there are some exceptions. Companies that have previously "gone dark" may have a significant percentage of their shares held through DTC, and shares may also enter the DTC system as a result of Rule 144A offerings, or through foreign markets or other means if they

BONNIE J. ROE *is a partner in the corporate group of Cohen & Gresser.*

are not at the time subject to limitations on resale under Rule 144 under the Securities Act of 1933, as amended (Securities Act).

The end result of these interpretations of the words "held of record" is that a company's securities can be held very widely, either through various investment vehicles or possibly through DTC, without triggering the 500 holder limitation. By contrast, if the record holders are primarily individuals, the 500 holder limitation is more meaningful.

One way that companies acquire significant individual record ownership is through the issuance of equity interests to employees. The SEC has treated options as constituting a separate "class" of equity security for purposes of §12(g), so that theoretically the 500 holder limit could be triggered by the options themselves only if grants were made to over 500 persons. Under Rule 12h-1 of the Exchange Act, however, compensatory options issued by a privately held company with no SEC reporting obligations are exempt from §12(g) if they meet certain criteria, including limitations on transfer, except to family members, to the issuer or upon a change in control. The same restrictions on transfer do not need to apply to the securities issued on the exercise of the option, however, and once the options are exercised, of course, the individual becomes a record owner of the underlying shares. Typically, fast growing technology companies have encountered difficulties with the 500 holder rule as a result of option exercises or grants of equity interests that do not conform to the conditions for the exemption for compensatory options under Rule 12h-1. No-action letter relief is sometimes available in the case of benefit plan interests that contain restrictions on transfer.

Another way that companies may exceed the 500 record holder limit is through the fractionalization of existing equity ownership interests through secondary sales. Shares issued in private offerings, like shares issued to employees under Rule 701 under the Securities Act, are restricted securities under Rule 144 under the Securities Act. Shares of a non-reporting company may be sold by a non-affiliate free of restriction under Rule 144 after a holding period of one year following their purchase from the issuer or an affiliate of the issuer. The principal restrictions on trading such shares are contractual provisions that are sometimes imposed by the company, giving the company or other shareholders a right of first refusal. An absolute prohibition on transfer might not hold up under state law. Some fractionalization of existing equity interests also occurs through intra-familial transfers, fund distributions and similar private transactions that are often not subject to contractual restrictions on transfer.

The absence of a market is usually the most significant constraint for shareholders wishing to dispose of shares of a non-reporting company. Under Rule 15c2-11 under the Exchange Act, brokers are not allowed to publish quotations for shares unless specified information is available with respect to the issuer (i.e., the issuer's Exchange Act reports, a prospectus under §10(a) of the Securities Act or an offering circular under Regulation A under the Securities Act). State securities laws also restrict brokers from engaging in such transactions. Subject to considerable compliance measures, however, companies like SecondMarket and Sharespost have developed trading platforms restricted to accredited investors, where holders of shares of non-reporting companies can sell their shares. The existence of these and other private company trading platforms raise significant and largely unexplored questions relating to the quality and quantity of information about the issuer and whether there has been selective disclosure or market manipulation. Moreover, through these market transactions, an issuer might easily exceed the 500 record holder limit.

### Legislative Initiatives

This year has seen the introduction of two bills in the U.S. House of Representatives and one bill in the Senate calling for the amendment of the §12(g) 500 holder limitation. One of the proposed House bills and the proposed Senate bill, introduced by Reps. Himes, D-Conn., and Womack, R-Ark., and Sens. Hutchison, R-Texas, and Pryor D-Ark., respectively, are identical and seek to establish a 2,000 holder threshold for banks and bank holding companies,[2] which arguably deserve separate treatment because they are required to make their financial statements publicly available on their regulators' websites. The other proposed House bill, introduced by Rep. Schweikert, R-Ariz., would raise the threshold for registration for issuers generally to 1,000 holders of record, with a carve-out for accredited investors and persons who received the securities pursuant to an employee compensation plan.[3]

> The **absence of a market** can be a **significant constraint** for shareholders wishing to dispose of shares of a non-reporting company. However, companies have **developed trading platforms** restricted to accredited investors, where such holders can **sell their shares**.

The proposals have the backing of the American Bankers Association, and the 2010 Final Report from the SEC sponsored annual Forum on Small Business Capital Formation indicates that such amendments would have broad support from the small business and investment community. Indeed, raising both the asset threshold from $10 million to $100 million and record holders threshold from 500 to 2,000, each individually ranked in the top third on an ordered listing of priority recommendations solicited by the SEC for guidance from the participants in the Forum (considering the impact of the SEC's implementation of the Dodd-Frank Act on small business investing was number one).[4]

### Areas of Concern

It does not make sense to raise the threshold under §12(g), however, without also considering:

- How and when beneficial owners should be counted, particularly when shares are held through DTC;
- What the impact would be on the ability of companies to go dark and how that could affect existing investors in these companies; and
- What rules should govern the trading of securities of non-reporting companies.

Before raising the reporting threshold, it will also be important to consider whether the 500 holder rule actually inhibits private capital formation to any significant degree, or whether it would be possible to address any constraints that do exist through more limited measures, like excluding employees who acquired shares pursuant to an employee benefit plan in accordance with Rule 701 under the Securities Act. Ultimately in the case of Facebook, it was not the 500 holder rule, but restrictions on general solicitation, that appear to have caused Facebook to withdraw from a private offering in the United States earlier this year and seek investment only outside the country. Facebook is reportedly planning to register with the SEC in early 2012, either as part of an initial public offering or as required pursuant to §12(g).

The more investors there are in non-reporting companies, the more pressure there will be to facilitate trading in those shares. Yet the existence of online trading platforms for non-reporting companies presents some thorny issues that deserve full consideration in their own right. In addition to questions about the adequacy of information concerning the company at the time of investment or thereafter, there is the possibility of buyers or sellers having additional material information that they do not share with their counterparties, or engaging in other potentially manipulative trading activities. A starting point for potential regulation might be the implementation of procedures recently adopted by SecondMarket, which, among other things, permits trading only when the company consents, at times that the company determines that sales can be made, if the company also provides "material" information that is made available to potential investors. Yet this places the burden on the company to assure the integrity of the market and raises the question of the company's involvement in the offer or sale. If investment in large non-reporting companies becomes widespread and trading in the shares of such companies becomes more commonplace, there should be some assurance as to the availability and accuracy of information concerning the companies both at the time of purchase and thereafter and there should be some regular means to deter insider trading and other forms of market manipulation.

1. *Tankersley v. Albright*, 514 F.2d 956, 969-70 (7th Cir. 1975).
2. H.R. 1965, 112th Cong. (2011); S.556, 112th Cong. (2011).
3. H.R. 2167, 112th Cong. (2011).
4. Final Report, published June 2011, of the 2010 Annual SEC Government-Business Forum on Small Business Capital Formation.



COHEN & GRESSER LLP

800 Third Avenue
New York, NY 10022
Ph 212 957 7600
Fax 212 957 4514
www.cohengresser.com