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Facebook and the 500-Person Threshold

By Steven Davidoff Solomon January 3, 2011 4:03 pm

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Goldman Sachs's investment in Facebook once again raises the issue of whether the Securities and Exchange Commission will force the social networking company into an initial public offering. In particular, this issue arises because of the special purpose vehicle that Goldman plans to create in order to allow its clients to invest up to \$1.5 billion in Facebook.

The reason lies on the technical shores of the federal securities laws. The Securities Exchange Act of 1934 sets forth certain requirements for companies to register their shares with the S.E.C.

Specifically, Section 12(g) requires that a company register its securities with the S.E.C. if it "has total assets exceeding \$1,000,000 and a class of equity security ... held of record by five hundred or more ... persons..."

The S.E.C. by rule-making has raised the \$1 million threshold to \$10 million. But either way, Facebook certainly exceeds this asset threshold.

The issue comes with the 500-person requirement. This speaks only of shareholder-of-record ownership. Shares can be held "of record" or "beneficially," but the rule is only set off based on the number of shareholders who hold shares "of record."

The S.E.C. defines "of record" for these purposes to mean securities held "by each person who is identified as the owner of such securities on records of security holders maintained by or on behalf of the issuer."

Record ownership is thus clear. It is the shareholders who are recorded as such on the books of the company that issued the securities.

But in the case of most public companies, shares for most investors are not usually held of record but beneficially. In such instances, the shares are held of record by a third party, usually a broker, on behalf of the shareholder. For example, if you buy shares through Charles Schwab, that discount brokerage firm will serve as the record owner and you will be the beneficial owner. The shares are held this way for administration ease. Otherwise, every share trade would have to be recorded on the company's books. Instead, there is only one entry on the books of the company for all shares held by Charles Schwab for its clients.

In fact, most brokers actually use another entity known as Cede & Company, the nominee name of the Depository Trust Company, a large clearing house, for their record ownership of stock, and so there is only one entry for many brokers all of whom have thousands of beneficial owners they hold shares for.

The consequence is that companies with thousands of shareholders will often have fewer record holders.

We do not know the number of record holders of Facebook shares, but in the case of Facebook, this appears to be how Goldman is planning to get around the S.E.C.'s reporting rule. Goldman will form a special purpose investment vehicle for its super-wealthy clients to invest in Facebook.

Technically, there would then be only one shareholder of record here, the investment vehicle. However, the S.E.C. has anticipated this type of runaround. The S.E.C.'s definition of record holder also states that:

If the [company] knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of [the Securities Act], the beneficial owners of such securities shall be deemed to be the record owners thereof.

The underlying 500-person rule was enacted in 1964 to ensure that investors in significant companies had sufficient information to make their investment decisions, with size here set by the number of shareholders. It was designed to curb a private trading market which had sprung up on the over-the-counter market.

You can argue that sophisticated shareholders can fend for themselves and that this rule is not necessary, but nonetheless this is the rule. And in any event, there are smart, sophisticated investors and not-so-smart ones. This type of hot money activity being invested here may be exactly what the S.E.C. wants to pick up.

But whatever you might think of the rule itself, Goldman's planned special purpose vehicle and any other vehicles formed certainly appear to be cutting it close. Legally, it appears the S.E.C. would have grounds to force Facebook to begin reporting its financial results publicly if indeed the Goldman vehicle puts Facebook over the 500-person threshold. Of course, the S.E.C. inquiry into private stock trades reported last week by DealBook may be an effort to force Facebook to do so, based on other such investment vehicles. The Goldman vehicle may be the kicker.

Finally, it is important to note that even if Facebook is deemed to exceed the 500-shareholder threshold, it would not be required to conduct an initial public offering. Rather, it would merely begin "reporting" to the S.E.C. This would mean it must start filing quarterly and annual reports with the S.E.C. along with other items. These reports would include Facebook's audited financial information.

The company can still stay private even if it is forced to begin reporting to the S.E.C. However, in the case of Google, which faced with a similar choice several years ago, it chose to go public. Google decided that if it was going to have to release its nonpublic financial and other information to the S.E.C. and the public, it might as well get its bang for the buck and do it in connection with an I.P.O. Though not required to do so, Facebook would probably come to the same conclusion if the S.E.C. brings this reporting requirement to a head.

Facebook knows all of the above. However, if a company exceeds the 500-shareholder limit, then it is only required to start reporting within 120 days of the last day of its fiscal year it exceeded this amount. If Facebook has a fiscal year that coincides with the calendar, this would give the company until May 2012 before the

requirement takes effect. So Goldman's investment may be exactly in contemplation of such an event next year.

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