

## QUESTIONING THE 500 EQUITY HOLDERS TRIGGER

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An obscure provision of the Securities Exchange Act of 1934 (Exchange Act)<sup>1</sup> has received unprecedented attention in recent months because of the prominent role it appears to be playing in Facebook’s decision on going public. Specifically, Exchange Act Section 12(g)(1) requires any company with “total assets exceeding [\$10,000,000] and a class of equity security . . . held of record by five hundred or more . . . persons” to register such security under the Exchange Act.<sup>2</sup> The measurement date for these thresholds is the last day of a company’s fiscal year. It then has 120 days from that date to register. Today, the practical effect of this rule is to force certain types of firms into the public markets earlier than is desirable. A shift from a shareholder-based trigger to one based on trading volume would preserve the Rule’s underlying policy concerns while mitigating this unintended effect.

A company registers by filing a Form 10 with the Securities and Exchange Commission (SEC).<sup>3</sup> Form 10 requires the company to disclose, among other things, a detailed description of its business, properties, transactions with management, legal proceedings, and executive compensation as well as its audited financial statements.<sup>4</sup> Once a company has a security registered under

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<sup>1</sup> Securities Exchange Act of 1934, 15 U.S.C. § 78 (2006).

<sup>2</sup> 15 U.S.C. § 78(g)(1)(B). Note that Section 12(g)(1) actually specifies a “total assets” cutoff of \$1 million, but Rule 12g-1 under the Exchange Act exempts issuers with \$10 million or less in total assets from the application of Section 12(g)(1), essentially setting the cutoff at \$10 million. *See* 17 C.F.R. § 240.12g-1.

<sup>3</sup> 15 U.S.C. § 78(12)(b).

<sup>4</sup> *See* U.S. Sec. & Exch. Comm’n, Form 10, pt. I, at 2–3, *available at* <http://www.sec.gov/about/forms/form10.pdf>.

the Exchange Act, it is required to file with the SEC annual, quarterly, and current reports and must comply with SEC proxy regulations.<sup>5</sup> Additionally, its directors, officers, and holders of ten percent or more of the total shares outstanding become subject to the short-swing profit rules under Exchange Act Section 16.<sup>6</sup> Basically, the company has the same SEC obligations as a public company but does not receive the benefits of going public, principally a large infusion of equity capital and liquidity for its stock.

Facebook has never been in a hurry to go public, especially because it has been able to privately raise plenty of capital. Widespread speculation, however, has the company filing to go public in April 2012. This is because Facebook has well over \$10 million in total assets and recently disclosed that it plans to surpass 499 shareholders this year.<sup>7</sup> December 31 is the last day of Facebook's fiscal year, so assuming it has 500 or more shareholders on that date, it will be required to file a Form 10 by April 29, 2012. People figure that Facebook will conclude that it might as well go public if it has to file public company reports regardless.

Google faced a similar situation in 2003. It had total assets of well over \$10,000,000 and more than 500 shareholders on December 31, 2003, the close of its fiscal year.<sup>8</sup> Thus, it ended up filing a Form 10 on April 29, 2004, the same day it filed its IPO registration statement. As Google noted in its registration statement: "By law, certain private companies must report as if they were public companies. The deadline imposed by this requirement accelerated our decision [to go public]."<sup>9</sup>

Section 12(g)(1) is not actually designed to pressure private companies to go public sooner than they otherwise would, although it had that effect on Google and appears that it will have the same effect on Facebook. Congress added it to the Exchange Act in 1964 "[t]o extend to investors in certain over-the-counter securities the same protection now afforded to those in listed securities by

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<sup>5</sup> 15 U.S.C. § 78(13).

<sup>6</sup> 15 U.S.C. § 78(16).

<sup>7</sup> See Anupreeta Das et. al, *Facebook Sets Stage for IPO Next Year*, WALL ST. J., Jan. 6, 2011, at A1.

<sup>8</sup> Google Inc., Registration Statement (Form S-1), at 36 (Apr. 29, 2004), available at <http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm>.

<sup>9</sup> Google Inc., Registration Statement (Form S-1), at iv (Apr. 29, 2004), available at <http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm>.

providing that the issuers of certain securities now traded over the counter shall be subject to the same requirements that now apply to issuers of securities listed on an exchange.”<sup>10</sup> Up until that time, many public companies whose shares were actively traded, but not on an exchange, were not subject to Exchange Act reporting requirements, proxy regulations, or short-swing profit rules. As the SEC recently noted, “the registration requirement of Section 12(g) was aimed at issuers that had ‘*sufficiently active trading markets* and public interest and consequently were in need of mandatory disclosure to ensure the protection of investors.”<sup>11</sup>

Number of record holders may have been a sensible proxy in 1964 for whether there was an active trading market in a company’s securities, but I do not think it is a sensible proxy today. There was no trading market in Google’s stock before it went public. One has developed recently for Facebook shares, but this has little to do with the number of Facebook shareholders. Rather, it is likely attributable to Facebook’s having over 500 million active users, making it perhaps the most well-known private company in the world.

More importantly, with the disappearance of the small IPO market over the last decade and a half, many companies are forced to remain private for much longer than similar companies had to in the past.<sup>12</sup> As a result, these companies have to do more rounds of private equity financing with each round adding more shareholders and getting the company closer to the 500-shareholder trigger. Unlike Google and Facebook, however, these companies do not have underwriters waiting in the wings to take them public when they do cross the 499 shareholder threshold. Thus, they may have to curtail their financing activities to ensure that they do not cross the threshold.

The bottom line is that Section 12(g) causes some companies to go public sooner than they otherwise would and constrains other companies’ ability to raise equity financing. Neither of these outcomes is desirable. Hence, the SEC

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<sup>10</sup> H.R. Rep. No. 88-1418, at 1 (1964), reprinted in 1964 U.S.C.C.A.N. 3013, 3027.

<sup>11</sup> Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-56010, 2007 WL 1953119 at \*2 (July 5, 2007) (emphasis added) (quoting Reporting by Small Issuers, Exchange Act Release No. 23,407, 1986 WL 703825 at \*2 (July 8, 1986)).

<sup>12</sup> See David Weild & Edward Kim, Grant Thornton LLP, Market Structure is Causing the IPO Crisis 7 (2009), available at <http://www.grantthornton.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20Sep%202009%20-%20FINAL.pdf>.

should adopt a new rule exempting from Section 12(g) private companies with no active secondary trading in their securities.<sup>13</sup>

In that regard, the new rule could define “active secondary trading” as a volume greater than an average of ten trades per month during a company’s fiscal year.<sup>14</sup> A company could control the number of trades in its stock by imposing a restriction on its shares requiring company approval in advance of any transfer, with the restriction automatically expiring if and when the company goes public.<sup>15</sup>

The benefit of this approach is that Section 12(g) will then generally only capture companies with securities that are actively traded and will therefore much more closely align with the purpose behind its enactment. As a result, companies such as Google and Facebook will be able to control the timing of becoming subject to Exchange Act registration and therefore will not be forced to go public earlier than they want. Additionally, private companies with no active secondary trading in their securities will be able to seek private equity capital without concern for ending up with more than 499 shareholders.

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<sup>13</sup> Although I do not raise it here, elsewhere I have argued that the SEC should adopt a new rule exempting private companies with 100 or fewer non-accredited investors from Section 12(g). *See* William K. Sjoström, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 BC L. REV. 639, 665–68 (2009). As I explain in that article, the SEC has ample authority under the Exchange Act to adopt Section 12(g) exemptions. *See id.* at 670–72.

<sup>14</sup> The rule could exclude from the count transfers made by gift, to family members, to trusts for estate planning purposes, and the like.

<sup>15</sup> The company would likely need to put the restriction in place prior to selling its shares to investors.