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# 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.

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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."

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