

Saint or Sinner?
The Efficacy of the Proposed “1,000 Shareholder” Amendment to Section 12(g)
By Cory White¹

Earlier this year Facebook closed a \$1.5 billion cash raise, \$1 billion of which came through the usage of a special purpose Goldman Sachs investment fund.² This allowed Facebook to pool the investment dollars of numerous investors while only recording one holder of record on its books, namely the Goldman investment fund. Some have suggested that, among other things, this was a move by Facebook to remain below the 500 equity holder registration threshold imposed by Section 12(g) of the Securities Exchange Act.³ A company that reaches this threshold will have to register its securities with the Securities and Exchange Commission and being periodic reporting. The upshot of this requirement forces privately held companies into launching IPOs to get the benefits of being publicly traded now that they are paying the costs. The SEC has traditionally noted that this registration requirement is in place to protect investors and preserve market integrity.⁴

In response to what they believe to be a hindrance to capital formation, Representatives David Schweikert (R-AZ) and Jim Himes (D-CT) have introduced a bill in the House that would bump up the threshold number to 1,000 equity holders in any particular class of security.⁵ The bill was introduced in June 2011 and is making its way through the House. As with any change to the securities laws, the goal is to balance investor protection with the legitimate business needs of the issuer. Do the benefits of the new bill outweigh the costs? As noted below, the answer is a cautious “yes.”

The Basics

Section 12 of the Exchange Act speaks to the registration of securities by issuers based on how those securities are both held and transacted. Perhaps the most common form of registration is found under Section 12(a), which requires registration with any national exchange prior to the security being traded on that exchange.⁶ If a company desires to be publicly traded, i.e. traded through the facilities of a national securities exchange, it needs to move under Section 12(a) and

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² “Goldman Offering Clients a Chance to Invest in Facebook,” Susan Craig and Andrew Ross Sorkin, New York Times, January 2, 2011 available at <http://dealbook.nytimes.com/2011/01/02/goldman-invests-in-facebook-at-50-billion-valuation/>; See also “Facebook Raises \$1 Billion from Investors Outside the US,” Associated Press available at http://wraltechwire.com/business/tech_wire/news/blogpost/8985765/.

³ “Facebook and the 500-Person Threshold,” Steven M Davidoff, New York Times, January 3, 2011, available at <http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/>; See also 15 U.S.C. § 78l(g).

⁴ Letter From Chairman Mary L. Schapiro to Chairman Darrell E. Issa, Response to March 22, 2011 Letter Concerning Capital Formation (Securities and Exchange Commission, April 6, 2011) pg. 17.

⁵ “Exclusive: New Stock Rules Proposed,” Dan Primack, CNN Money, June 14, 2011, available at <http://finance.fortune.cnn.com/2011/06/14/exclusive-new-stock-rules-proposed/>.

⁶ 15 U.S.C. § 78l(a).

the accompanying rules.⁷ This registration triggers the periodic reporting that publicly traded companies have to comply with under Section 13 of the Exchange Act.⁸ Trading on a national exchange is generally only viable after an IPO is launched, and trading on a national exchange allows the issuer to make up the costs of reporting. Consequentially, launching an IPO is generally the best method of offsetting the reporting costs associated with public trading.

Section 12(g) provides for another set of registration requirements and, unlike Section 12(a), provides for mandatory registration based on company size.⁹ Regardless of the private nature of a company, a company must register under Section 12(g) once that company reaches 500 record holders in any class of equity security, as recorded on the books and records of the company, and has over \$10,000,000 in total assets.¹⁰ The definition of “record holder” and the definition of “total assets” are both handled through SEC rules. As with 12(a) registration, 12(g) registration triggers continuing reporting requirements and makes the launch of an IPO prudent to offset the costs of reporting.

Finally, rule 12g5-1 notes that if a company records holders of record in such a way to knowingly and primarily circumvent Section 12(g), the beneficial owners of the securities will be treated like owners of record under the section and rules.¹¹ It should be noted that the SEC has rarely invoked this rule and has yet to invoke the rule when special purpose vehicles (SPVs), such as the Goldman-Facebook investment fund, are used to facilitate investments in private companies.¹² SEC Chairman Mary Schapiro did note that her staff is currently looking at the possible application of the rule to SPVs.¹³

The Big Change

Some lawmakers and regulators see the current “500 shareholder rule” of section 12(g) to be a hindrance to capital formation, which has always been a stated goal of the SEC and other financial regulators. Representatives David Schweikert (R-AZ) and Jim Himes (D-CT) have introduced a bill that will amend Section 12(g) to do the following:¹⁴

- Raise the shareholder of record threshold to 1,000 shareholders;
- Exclude from the threshold number certain employees granted securities as part of compensation packages; and
- Exclude from the threshold number accredited investors, as defined by SEC rule making.

⁷ 15 U.S.C. § 78l(a).

⁸ 15 U.S.C. § 78l(a).

⁹ 15 U.S.C. § 78l(g).

¹⁰ 15 U.S.C. § 78l(g); 17 C.F.R. §§ 240.12g-1-12g5-2.

¹¹ 17 C.F.R. §§ 240.12g5-1(b)(3).

¹² Letter From Chairman Mary L. Schapiro to Chairman Darrell E. Issa, Response to March 22, 2011 Letter Concerning Capital Formation (Securities and Exchange Commission, April 6, 2011) pg. 20.

¹³ Letter From Chairman Mary L. Schapiro to Chairman Darrell E. Issa, Response to March 22, 2011 Letter Concerning Capital Formation (Securities and Exchange Commission, April 6, 2011) pg. 21.

¹⁴ “Exclusive: New Stock Rules Proposed,” Dan Primack, CNN Money, June 14, 2011, available at <http://finance.fortune.cnn.com/2011/06/14/exclusive-new-stock-rules-proposed/>.

Representative Schweikert has noted that having regulators dictate when a company goes public is not necessarily the best thing for the capital markets.¹⁵ He has also noted that although the bill does affect giants like Facebook and Zynga, it is really aimed at smaller companies that, while prospering, do not have the resources to go public.¹⁶ The Congressman sees the current Section 12(g) as stunting the growth of these smaller privately held companies.¹⁷

The Pros

As with most things, there are both pros and cons to the piece of legislation introduced by Reps. Schweikert and Himes. First, the pros:

- 1) The new bill does facilitate capital formation, as it opens up more private capital to smaller companies. These companies will be granted greater control over how capital is raised, creating greater flexibility in capital acquisition.
- 2) Because smaller companies will be able to dictate more effectively when and how they go public, the bill reduces the cost of doing business for these companies while stimulating growth.
- 3) Finally, forcing companies to go public when they are not ready can cause instability in the public capital markets. The bill allows companies continued growth without subjecting the public markets to increased risk.

The One Big Con

Although other issues with the bill may be identified as the bill moves through Congress, the largest negative effect is the tempering of disclosure requirements. The necessary consequence of the new rule will be less public reporting by companies that have a significant amount of record owners and perhaps countless more beneficial owners. This one big con must be weighed against the pros to determine the viability of the new legislation.

The Verdict

SEC Chairman Mary Schapiro has noted that how holders are counted and how many trigger registration under Section 12(g) needs to be reevaluated.¹⁸ This is due to the change that capital

¹⁵ “Congressman: Private Stock Bill Could Become Law by Year-End,” Dan Primack, CNN Money, June 14, available at <http://finance.fortune.cnn.com/2011/06/14/congressman-private-stock-bill-could-become-law-by-year-end/>.

¹⁶ “Congressman: Private Stock Bill Could Become Law by Year-End,” Dan Primack, CNN Money, June 14, available at <http://finance.fortune.cnn.com/2011/06/14/congressman-private-stock-bill-could-become-law-by-year-end/>.

¹⁷ “Congressman: Private Stock Bill Could Become Law by Year-End,” Dan Primack, CNN Money, June 14, available at <http://finance.fortune.cnn.com/2011/06/14/congressman-private-stock-bill-could-become-law-by-year-end/>.

¹⁸ Letter From Chairman Mary L. Schapiro to Chairman Darrell E. Issa, Response to March 22, 2011 Letter Concerning Capital Formation (Securities and Exchange Commission, April 6, 2011) pg. 18.

markets have seen in the nearly 5 decades since 12(g) was passed. With this in mind and after considering the many advantages of the new legislation, it's safe to say that the benefits derived from the face of the legislation outweigh the costs. While any tempering of disclosure requirements should be met with scrutiny, it should be noted that many "private" companies today are able to escape registration and reporting because, while having beneficial owners well in excess of 500 shareholders, record holders still fall below 500 due to ownership of securities in "street name."¹⁹ The Commission has to yet to identify any serious disclosure issues with this very common practice.²⁰ It is also important to note that the securities fraud laws and regulations will still be in play for any securities based transactions and communications made to investors by private companies. The move to a 1,000 shareholder limit would not cause as serious a deficiency in reporting as it may initially seem, as the new law would move more in line with current market realities. Additionally, the securities fraud laws would still provide powerful investor protections. When weighed against the greater access to capital, reducing the cost of business by the smaller companies that are generally affected by the current rules, and insulating our public markets from certain companies and sectors not yet ready to go public, the benefits of the new law outweigh the costs.

¹⁹ Letter From Chairman Mary L. Schapiro to Chairman Darrell E. Issa, Response to March 22, 2011 Letter Concerning Capital Formation (Securities and Exchange Commission, April 6, 2011) pg. 18.

²⁰ Letter From Chairman Mary L. Schapiro to Chairman Darrell E. Issa, Response to March 22, 2011 Letter Concerning Capital Formation (Securities and Exchange Commission, April 6, 2011) pg. 18.