

Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.



ABOUT THE AUTHOR

Alexander J. Davie is an attorney based in the Nashville, TN area. His practice focuses on corporate, finance, and real estate transactions. He works mainly with emerging companies, venture funds, entrepreneurs, and startups. His firm's website can be found at www.alexanderdavie.com.

In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.

Bill Introduced in Congress to Permit Private Companies to Stay Private for Longer

Representative David Schweikert (R-AZ) recently introduced a bill called the "[Private Company Flexibility and Growth Act](#)," which promises to allow private companies to remain private for a longer period of time. Currently, if on the last day of a company's fiscal year, any class of securities of the company is held of record by 500 or more shareholders and the company has total assets of more than \$10 million, then it must register under the Securities Exchange Act of 1934. This brings upon it a multitude of responsibilities and obligations including filing annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and meeting proxy regulation requirements. With these added obligations, most companies will simply choose to go public (i.e. engage in an IPO), since they might as well gain the advantages of the public markets given that they will now be dealing with all of the compliance expenses that come along with them. An example of a company that is likely dealing with this issue now is Facebook. It has been widely reported that it is either past the 500 shareholder limit or soon will be, since its shares are held by many employees, some of which may have sold their shares to other parties. Many people believe that Facebook has no desire to go public, but will likely be forced to do so early next year. Is that fair?

Certainly Rep. Schweikert doesn't think so. His bill would make a couple of changes. First, it would increase the shareholder limit to 999 from the existing 499. Second, accredited investors and persons who received shares pursuant to an employee compensation plan would no longer count towards the limit. The second change is the far more important one, since it will allow private companies to grow to almost a limitless size without ever being required to go public. A vast majority of the shares of private companies are issued in one of two ways: (1) private offerings made only to accredited investors and (2) shares issued to employees as compensation.[1] Since the two largest categories of shareholders in a private company would no longer be counted towards the limit,



this bill would effectively do away with the requirement of companies to go public as they expand.

Since I also write a lot on private investment funds, I would also point out that this bill would be of significant benefit to some of the larger hedge funds and private equity funds. Large private funds tend to be so-called "(3)(c)(7)" funds. 3(c)(7) funds are offered only to qualified purchasers, which general speaking are individual investors with investment assets over \$5 million or companies with investment assets over \$25 million. Because of the Exchange Act's 499 investor limit, these funds cannot have more than 499 investors under current law. If this bill were passed, there would be no limit to the amount of investors that a 3(c)(7) fund could have, since any qualified purchaser would easily qualify as an accredited investor. Many people often incorrectly believe that the 3(c)(7) exception itself contains the 499 investor limitation. It does not; the limitation is in the Exchange Act. Thus this bill would allow the largest private hedge funds, private equity funds, and venture capital funds to get even larger.

I agree with the overall premise of this bill. I do think that companies should have more control over when and if they go public. I also think that the bill is unlikely to pass in its current form for a couple of reasons. First, regulators are likely to lobby against it rather aggressively. Since accredited investors and employee shareholders will no longer count towards the limit, the limit would be effectively eliminated. For a lot of

people in the securities regulation field, that would be a step too far, potentially undermining the investor protection policy goals of the Exchange Act. Second, I've already pointed out that large hedge funds will be unintended significant beneficiaries of the bill, and it will be too easy to paint this bill as something favored by "Wall Street." (And we would never want to do anything like that!)

That said, this bill is part of a conversation that is has begun over the last year. Even Mary Shapiro, chair of the SEC has [written about the possibility of loosening the 499 investor limit on private companies](#). I think that if some of the concerns mentioned above are addressed, the introduction of this bill moves us closer to the possibility of reforming the Exchange Act's limits on private companies.

Footnotes

[1] Some may point to Rule 12h-1(f), which exempts employee stock option holders from the 499 investor limit, if certain conditions are met. But this rule does not exempt actual employee stock holders from counting towards the limit, so the exemption on employee shareholders in this bill is a significant loosening of restrictions.

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