CAPITAL FORMATION FOR INTERNET COMPANIES: WHY FACEBOOK STAYED PRIVATE FOR SO LONG AND WHAT THAT MEANS FOR INVESTORS

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I. INTRODUCTION

One of the basic distinctions in the world of business is that between public and private companies. Public companies are free to sell their shares to the public at large, thus tapping into an immense source of capital. With that right comes the obligation to disclose the company's financial position regularly, so investors can make informed decisions regarding the risks and benefits of buying the company's shares. In contrast, private companies neither have the ability to list their stock on a public exchange, nor have to bear the aforementioned disclosure obligations.

This basic distinction between public and private companies raises a difficult public policy question: how can the government help private companies raise capital, while also preventing the sale of securities of enterprises whose financial situation is largely unknown? Businesses typically start out as private companies. Providing avenues for them to acquire funding without burdening them excessively is critical for their growth, which in turn affects the growth of the economy. On the other hand, allowing the purchase of shares whose value cannot be estimated properly for lack of information exposes private-company investors to a substantial risk of loss should the company unexpectedly go bankrupt. Unable to recover such losses, investors would be less likely to buy private equity in the first place, which undermines the goal of capital formation.

U.S. Federal securities law strikes a balance between easing capital formation and protecting investors by limiting the number of investors a private company can have and the amount of capital it can obtain. A business can raise capital privately and grow only up to a certain point. Beyond that point, the company is deemed public and is required to register with the Securities and Exchange Commission (SEC) and disclose its financial situation to the investing public.

This Note examines the legal framework within which U.S. Internet companies choose whether or not to go public. The point at which an Internet company must register with the SEC is not clearly defined. As a result, Internet companies today can distribute their securities to hundreds of investors via unregulated secondary markets, amass substantial amounts of capital, and still remain private.

This Note argues that the unchecked growth of private Internet companies poses significant risks. By avoiding registration, private Internet companies evade the obligation to fully disclose their financial situation. As investors pour their money into Internet companies whose true financial situation they do not fully understand, private Internet companies may become overvalued. Such inflated valuations may be fuelling a new Internet bubble. Should the bubble burst with many Internet companies filing for bankruptcy, investors will likely lose their capital. Investor trust in private markets and the ability of private companies to obtain funding could be seriously compromised.

This Note concludes with a discussion of the SEC's options for extending greater protection to private-company investors and a recommendation that the SEC shore up its registration requirements and require greater disclosures from private issuers.

A. The Choice to Remain Private

Attracted by the amount of capital that can be acquired through an initial public offering (IPO), a number of Internet companies have elected to go public in the past year. Most notably, Facebook, the world's largest online social network, raised $16 billion in its controversial IPO on May 17, 2012.[1] Before Facebook's well-publicized stock price drop, the press explained that Facebook had expected a market capitalization of up to $100 billion in possibly "the largest Internet initial public offering ever."[2] On December 16, 2011, Zynga, a creator of online social games, raised $1 billion in its IPO.[3] A month earlier, Groupon, a company offering discount coupons online, also chose to go public. Groupon made $700 million, bringing its market capitalization to over $16 billion on the first day of trading.[4] In June 2011, Pandora, an Internet radio, also floated its stock. While Pandora brings in no revenue, it was able to raise $234.9 million, resulting in a valuation of $2.6 billion.[5] Last but not least, LinkedIn, an online social network for professionals, had an IPO in May 2011 and raised over $352 million.[6]

Yet, remaining private has proved to be no obstacle to capital formation for Internet companies thus far. While closely-held companies cannot list their stock on the public exchanges, they can offer their shares to

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1. Evelyn M. Rusli & Peter Eavis, *Facebook Raises $16 Billion in I.P.O.,* N.Y. TIMES DEALBOOK (May 17, 2012, 4:21 PM), http://dealbook.nytimes.com/2012/05/17/facebook-raises-16-billion-in-i-p-o/.

2. Evelyn M. Rusli, *Facebook Files for an I.P.O.,* N.Y. TIMES DEALBOOK (Feb. 1, 2012, 4:49 PM), http://dealbook.nytimes.com/2012/02/01/facebook-files-for-an-i-p-o/?scp=1&sq=facebook%20ipo&st=cse.

3. P.L., *Tech Listings: IPOville*, ECONOMIST BLOG (Dec. 16, 2011, 5:11 PM), http://www.economist.com/blogs/schumpeter/2011/12/tech-listings.

4. Evelyn M. Rusli, *Bankers Reap Windfall in Groupon I.P.O.,* N.Y. TIMES DEALBOOK (Nov. 8, 2011, 12:38 PM), http://dealbook.nytimes.com/2011/11/08/bankers-reap-windfall-in-groupon-i-p-o/.

5. Evelyn M. Rusli, *Pandora Prices Its I.P.O. at $16 a Share,* N.Y. TIMES DEALBOOK (June 14, 2011, 6:37 PM), http://dealbook.nytimes.com/2011/06/14/pandora-prices-its-i-p-o-at-16/.

6. Shira Ovide, *LinkedIn: Biggest Internet IPO Since Google,* WALL ST. J. BLOG (May 18, 2011, 5:55 PM), http://blogs.wsj.com/deals/2011/05/18/linkedin-biggest-internet-ipo-since-google/.

company founders, employees, and private equity investors who can then resell them on specialized secondary markets. SecondMarket, the largest of these private stock exchanges, provides an online platform where the shares of closely-held Internet companies are traded regularly. As the number of trades of a company's shares increases, so does the company's ability to demonstrate its popularity and attract additional private equity investors. Since these investors can then resell their shares on SecondMarket, the risk they bear in the initial purchase of securities is limited. Hence, investors are likely willing to pay more in the primary purchase of a given issuer's shares. Thanks to SecondMarket, private Internet companies can obtain capital much more easily.

Foursquare, an online service which allows consumers to broadcast their current location, offers a case in point. In May 2011, the press reported that Foursquare's shares had attracted a great deal of interest on SecondMarket.[7] In June, Foursquare received a $50 million private equity investment, even though the company had no revenue model in place.[8]

While the recent upsurge in Internet-company IPOs may suggest that going public is the preferred route to capital formation for U.S. businesses today, many have shunned that path. Staying private allows businesses to avoid the SEC's detailed disclosure requirements without hindering their ability to obtain funding and grow. In fact, as Barry Silbert, founder and CEO of SecondMarket, recently noted, American "companies are electing to remain private longer than in previous decades, and the average time a company remains private has essentially doubled in recent years."[9] While in the 1990s the median time companies stayed private prior to an IPO was three to five years, Facebook chose to remain private for close to eight

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7. Ben Popper, *Foursquare Is Most Wanted on Second Market,* BETABEAT (May 17, 2011, 12:23 PM), http://www.betabeat.com/2011/05/17/foursquare-is-most-wanted-on-second-marketed/.

8. *Betting the Farm: Zynga May be a Good Business, but the Tech Bubble Is Expanding*, ECONOMIST, June 30, 2011, at 79, *available at* http://www.economist.com/node/18897873.

9. *The Future of Capital Formation: Hearing Before the H. Comm. on Oversight and Government Reform,* 112th Cong. 53 (May 10, 2011) (written testimony of Barry E. Silbert, Founder and CEO, SecondMarket), *available at* http://purl.fdlp.gov/GPO/gpo16110 [hereinafter Silbert]. Mr. Silbert further explained that "From 1991 to 2000, there was an average of 520 IPOs per year, with a peak of 756 IPOs in 1996….Since 2001, the United States has averaged only 126 IPOs per year, with 38 in 2008, 61 in 2009 and 71 in 2010." *Id.* at 52-53.

years.[10] By January 2012, Facebook was already valued at $83.5 billion on private stock exchanges like SecondMarket.[11]

B. The Risks of Investing in Private Internet Companies

Mr. Silbert's own company, SecondMarket, has thrived on the general reluctance of U.S. businesses to have IPOs. Since its launch in 2004, SecondMarket has completed close to $700 million worth of private company stock transactions.[12] Over $150 million worth of unregistered Facebook stock was traded on SecondMarket.[13]

Moreover, SecondMarket has received a number of accolades reflecting its success. In 2010, AlwaysOn Media placed SecondMarket on the top of its "Global 250" list of best private companies worldwide.[14] Last year, SecondMarket was listed among the ten most innovative companies in finance by *FastCompany*[15] and was named a 2011 Technology Pioneer by the World Economic Forum.[16]

According to Barry Silbert, SecondMarket adds value by providing a safe avenue for investment in private companies. In May 2011, Mr. Silbert testified before the Congressional Committee on Oversight and Government Reform that SecondMarket was built on the principles of centralization, independence, and transparency.[17] In his view, SecondMarket brings "together buyers and sellers in a formalized, secure marketplace"[18] without standing "on either side of the transaction."[19] Moreover, SecondMarket aims to provide "detailed information about the asset [offered for sale] so that buyers and sellers can make informed investment decisions."[20] In short,

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10. Christopher Zinsli, *Was Zuckerberg Really That Slow to File Facebook's IPO?,* WALL ST. J. BLOG (Feb. 2, 2012, 5:12 PM), http://blogs.wsj.com/venturecapital/2012/02/02/was-zuckerberg-really-that-slow-to-file-facebooks-ipo/?KEYWORDS=facebook+ipo.

11. *Tracking Facebook's Valuation,* N.Y. TIMES DEALBOOK (Feb. 1, 2012, 1:20 PM), http://dealbook.nytimes.com/2012/02/01/tracking-facebooks-valuation/.

12. Silbert, *supra* note 9, at 50.

13. Tomio Geron & Scott Austin, *Hey, Want a Piece of a Twitter IPO?,* WALL ST. J., Oct. 18, 2010, at C3, *available at* http://online.wsj.com/article/SB1000142405270230389270457555714241649112.html.

14. *AlwaysOn Global 250 Overall Winner,* SECONDMARKET.COM (July 21, 2010), https://www.secondmarket.com/discover/awards/alwayson-global-250-overall-winner.

15. Dan Macsai, *The 10 Most Innovative Companies in Finance,* FASTCOMPANY.COM (Mar. 14, 2011, 1:19 PM), http://www.fastcompany.com/1738549/the-10-most-innovative-companies-in-finance.

16. *SecondMarket Selected as Technology Pioneer,* SECONDMARKET.COM (Sept. 21, 2010), https://www.secondmarket.com/discover/awards/secondmarket-selected-as-technology-pioneer.

17. Silbert, *supra* note 9, at 48.

18. *Id.*

19. *Id.* at 49.

20. *Id.* at 48.

through SecondMarket investors can safely purchase a piece of today's hottest Internet companies *before* the latter go public.

In spite of Mr. Silbert's testimony, I propose that investing through private stock exchanges like SecondMarket poses significant risks. At the outset, it is worth noting that some of the buyers on SecondMarket are private equity funds targeting the shares of specific Internet companies. These funds, also known as special purpose vehicles (SPVs), pool investors' money in order to purchase a larger share of a given Internet company, while also sparing investors the hassle of negotiating their purchases individually. In 2010, Felix Investments, LLC, a venture capital broker dealer specializing in technology-driven companies, was allegedly raising two $25 million funds to buy Facebook shares.[21] The brokerage and investment banking firm J.P. Turner & Co. was also allegedly putting together a $25 million fund specifically targeting Facebook stock.[22] Through SecondMarket, such SPVs can spend substantial amounts of money to obtain an equity stake in a closely-held Internet company.

It is quite plausible that the private equity funds buying stock on SecondMarket are paying too much. Despite the information SecondMarket provides about the assets traded on its platform, SPVs may still know very little about the future strategies and operational weaknesses of the Internet companies they are buying into. In March 2011, Peter Falvey, a managing director at the investment company Morgan Keegan, expressed his skepticism regarding the valuations of Internet companies whose shares were traded on secondary markets. "It's hard enough to get information on Facebook," he said. "I'm an accredited [investor][23], I have an M.B.A. in finance, how do I know what these things should be valued at?"[24] Moreover, the current shareholders of private Internet companies may have a right of first refusal on shares of their company.[25] If shareholders, such as key employees and founders, who may have a better understanding of the wellbeing of the company, are not buying shares traded on SecondMarket before an SPV does, it might be because the price is too high. Given the distinct possibility that uninformed SPVs are buying Internet-company stock at inflated valuations, SPVs could be fuelling a new Internet bubble.

In addition to the dearth of information on the financial position of private issuers, the volatile nature of Internet companies makes the

21. Geron & Austin, *supra* note 13.

22. *Id.*

23. Accredited investors can broadly be described as sophisticated or wealthy. *See* discussion *infra* Part II.B.

24. Evelyn M. Rusli, *Beyond Facebook, SecondMarket Opens Its Doors to Thousands,* N.Y. TIMES DEALBOOK (Mar. 10, 2011, 3:01 PM), http://dealbook.nytimes.com/2011/03/10/beyond-facebook-secondmarket-opens-its-doors-to-thousands/.

25. Geron & Austin, *supra* note 13.

investments by SPVs on SecondMarket particularly risky. To begin with, some Internet companies receive significant private equity investments prior to bringing in any revenue at all.[26] This brings up questions regarding the viability of such companies and the likelihood they will yield a return on investments. Moreover, the strong network effects driving up the valuations of certain Internet companies could quickly disappear. For example, in 2005, NewsCorp bought MySpace, a popular social networking site, for $580 million. In June 2011, The Economist reported that NewsCorp was preparing to sell MySpace for $100 million, the obvious reason being that Facebook's popularity had eclipsed that of MySpace.[27] Last but not least, the interdependence of Internet companies makes it harder to manage the risk of investing in them. Zynga, for instance, relies on Amazon's cloud computing service and obtains its users through Facebook.[28] Should a new social networking site, like Google+, rise to greater prominence than Facebook, Zynga investors will likely feel the effect. In sum, investors pouring their money into Internet-company stock likely need additional protections.

C. The Two Securities Acts: Traditional Sources of Investor Protection

The Securities Act of 1933 ("Securities Act"), and the Securities and Exchange Act of 1934 ("Exchange Act"), are the traditional sources of investor protection in the U.S. The Securities Act, also known as the "Truth in Securities Act," requires extensive issuer disclosures in public offerings of securities. Specifically, section 5 of the Securities Act makes the offer or sale of any security through interstate commerce conditional on having an effective registration statement for that security.[29] The goal is to provide prospective investors with adequate and reliable information in plain English regarding the issuer and the security it offers.[30] The Securities Act accomplishes this goal in two ways, namely (1) by limiting publicly available information regarding the security being offered to a registration statement and statutory prospectus, and (2) by ensuring that a prospectus, including a number of statutorily mandated disclosures, is delivered to the public along with the securities they purchased.[31] In short, when a company

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26. *See supra* pp. 3-4 (discussing lack of revenue model of Pandora and Foursquare).

27. A.D., *Is Facebook Worth the Price?,* ECONOMIST BLOG (June 29, 2011, 6:28 PM), http://www.economist.com/node/21523035.

28. *Betting the Farm, supra* note 8.

29. 15 U.S.C. § 77e(a) (2006).

30. *See* Thomas L. Hazen, SECURITIES REGULATION IN A NUTSHELL 49-53 (10th ed. 2009).

31. *Id.* at 55.

sells its shares, section 5 ensures that investors understand what they are buying.[32]

The Exchange Act provides investor protection beyond the initial public offering. The registration requirements of the Exchange Act extend to companies which never had an IPO but became *de facto* public by virtue of having a large number of shareholders of record. Under section 12(g)(1) of the Exchange Act, a company engaged in interstate commerce, whose total assets exceed $10 million, and which has a class of securities held of record by five hundred or more shareholders, must register those securities by filing a registration statement.[33] Thereafter, the company must file periodic disclosures with the SEC, solicit proxies from shareholders, and refrain from insider trading. Thus, section 12(g) serves to "improve investor protection by extending to the larger companies in the over-the-counter market the registration, reporting, proxy solicitation, and insider trading requirements . . . applicable to companies listed on an exchange."[34]

D. Private Equity Investors Are Not Subject to Traditional Protections

Closely-held Internet companies can avoid the registration requirements of both section 5 of the Securities Act and section 12(g)(1) of the Exchange Act. Neither the initial sale of Internet-company securities to employees and private equity investors, nor their subsequent resale on SecondMarket will necessarily be formally recognized as a public offering. Moreover, the secondary purchase of Internet-company shares by an SPV, which may have pooled the funds of hundreds of investors, may not make the Internet company *de facto* public. Thus, Internet companies today can pursue capital formation through the sale and resale of their securities without having to register with the SEC and disclose their true financial situation. When an Internet company chooses to list its stock on SecondMarket and stay private, its shareholders are not subject to traditional investor protections.

This Note explains why Internet companies can avoid the registration requirements of the Securities Act and the Exchange Act. Part II examines

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32. Thomas L. Hazen, THE LAW OF SECURITIES REGULATION 74 (rev. 5th ed. 2006) [hereinafter LAW]. The author notes that it is generally understood that individual investors do not read disclosure documents of the companies they invest in. However, the author cites *Wielgos v. Commonwealth Edison Co.,* 829 F.2d 509 (7th Cir.1989), as support for the proposition that "the relevant information [in the SEC disclosure documents] nonetheless is filtered into the market and is reflected by the price established by an informed market." *Id.* Moreover, the author proposes that even if investors do not read the SEC disclosures, the "knowledge that full disclosure has been made instills investor confidence and hence stability[.]" *Id.* at 75.

33. 15 U.S.C. § 78l(g)(1) (2006).

34. S. REP. NO. 88-379, at 1 (1963).

the legal safe harbors allowing for the sale and resale of unregistered securities beyond the reach of section 5 of the Securities Act. Part III explains how the broad definition of shareholders of record under section 12(g)(1) allows *de facto* public companies to avoid registration. Part IV presents the SEC's options for extending greater protection to private-company investors and the challenges the SEC faces, and recommends that the SEC tighten its registration requirements and require greater disclosures from private issuers.

II. WHY SELLING STOCK ON SECONDMARKET IS NOT A PUBLIC OFFERING

A. Private Placements

A common way for private companies to raise capital without registering under the Securities Act is the private offering, also known as a private placement. Under section 4(2) of the Securities Act, transactions "not involving any public offering" are exempt from the registration requirements of Section 5.[35] Hence, companies who engage in private placements do not have to register.

Securities Act Rules 501-508,[36] jointly referred to as Regulation D, define a number of registration safe harbors for small offerings and private placements.[37] Through the Regulation D safe harbors, the SEC provided private companies with guidance regarding permissible sales of unregistered securities and eased capital formation for them. At the same time, the SEC sought to protect the investing public by limiting the scope of Regulation D offerings. Generally, both the amount of capital a company can raise, and the number of investors to whom it can issue securities in a Regulation D offering are limited.[38]

Furthermore, the SEC shielded the general public from the risk associated with private equity investments in Regulation D offerings through its prohibition on general solicitation. Under Rule 502(c), private issuers cannot advertise the sale of their securities in "any newspaper,

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35. 15 U.S.C. § 77d(2) (2006).

36. 17 C.F.R. § 230.501-508 (2011).

37. *See* 15 U.S.C. § 77c(b) (2006) (allowing the SEC to promulgate registration safe harbors "by reason of the small amount involved or the limited character" of a given offering); 15 U.S.C. § 77d(2) (2006) (allowing private placements compliant with Rule 505 to qualify as transactions "not involving any public offering" under section 4(2)).

38. Rule 504 allows private issuers to sell securities for an aggregate offering price of $1 million, 17 C.F.R. § 230.504(b)(2) (2011). Rule 505 allows for private placements of securities for up to $5 million, 17 C.F.R. § 230.505(b)(2)(i) (2011). In addition, Rule 505 requires that unregistered securities be issued to a maximum of 35 investors, 17 C.F.R. § 230.505(b)(2)(ii) (2011). Rule 506 contains an identical 35 investor limitation, 17 C.F.R. § 230.506(b)(2)(i) (2011).

magazine, or similar media or broadcast over television or radio" or at "[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising."[39] In other words, Regulation D offerings must target investors who have an existing relationship of trust with the issuer, or its underwriters, and need not be solicited through general advertising. Such investors are considered to have a greater capacity to handle risk, so they do not need to be protected by the extensive disclosures associated with a public offering.[40]

B. Accredited Investors: A Group of Privileged Buyers

Accredited investors are one of the groups of investors allowed to buy securities in private placements. Generally defined as those who are either wealthy or sophisticated, accredited investors are deemed not to require registration-level protections. In fact, accredited investors appear to be considered so savvy, they need next to no protection from the SEC. Under Rule 506, an issuer can sell an unlimited amount of securities to accredited investors.[41] More importantly, under Rule 502(b)(1), Regulation D issuers can sell their shares to accredited investors without providing any financial or management information at all.[42]

Given the SEC's liberal stance on private placements to accredited investors, the broad definition of this group of investors is somewhat surprising. Under section 2(a)(15)(ii), an accredited investor is "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe."[43] Rule 501(a) lists eight categories of accredited investors: (1) any bank, savings and loan association, investment company, and employee benefit plan; (2) any private business development company; (3) any nonprofit organization with total assets exceeding $5 million; (4) any director, executive officer, or general partner

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39. 17 C.F.R. § 230.502(c)(1)-(2) (2011).

40. In a recent letter to Congressman Darrell Issa, SEC Chairman Mary Schapiro explained that the purpose of the prohibition to general solicitation was "to ensure that 'those who would benefit from the safeguards of registration are not solicited in connection with a private offering.'" 3 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 3:34 (2d ed. 2011) (quoting Letter from Chairperson Schapiro to Chairman Darrell Issa, Apr. 6, 2011).

41. 17 C.F.R. § 230.506 (2011). Unlike Rules 504 and 506, Rule 506 has no limitation on the aggregate offering price. It only has a limitation on the number of purchasers, from which accredited investors are explicitly exempt under Rule 501(e)(1)(iv), 17 C.F.R. § 230.501(e)(1)(iv) (2011).

42. 17 C.F.R. § 230.502(b)(1) (2011).

43. 15 U.S.C. § 77b(a)(15)(ii) (2006).

of the issuer; (5) any person whose net worth (individually or together with her spouse) exceeds $1 million, not including the value of the person's primary residence;[44] (6) any person whose individual annual income exceeds $200,000, or whose annual income joint with that of her spouse exceeds $300,000; (7) any trust with assets exceeding $5 million not formed for the specific purpose of buying securities; and (8) any entity whose shareholders are all accredited investors.[45]

The inclusion of institutional investors and organizations with assets over $5 million under the definition of accredited investors makes intuitive sense. Institutional investors employ highly qualified staff to weigh the costs and benefits of a given investment and are presumably less likely to be misled by inadequate issuer disclosures. Likewise, organizations with assets of over $5 million are presumably managed by executives with "knowledge and experience in financial matters" sufficient to make them less naïve investors.

Still, the definition of accredited investors also includes individuals based on their net worth and annual earnings. The people described in Rule 501(a)(5) and (6) may very well be professionals with no training in finance or investment experience. They may not have the "financial sophistication" mentioned in section 2(a)(15)(ii) and may need to rely on others to manage their investment. Nevertheless, under Regulation D, they are treated just like institutional investors. Individual accredited investors are free to purchase an unlimited number of private-company securities without being offered any financial or management information about the issuer. They only need to find out about the private placement through means other than general solicitation.

C. The Role of SPVs in Private Placements

Should an investment bank have a pre-existing relationship of trust with a private issuer, or its underwriters, it could find out about the issuer's private placement without being solicited through general advertisement. Such a bank can then reach out to its clients privately and help them invest their capital in the private placement. The bank may even form an SPV on its clients' behalf and pool its clients' money in order to purchase a bigger stake in the closely-held business. Given that the bank presumably has superior financial expertise than its individual clients, it would manage the SPV's investment itself and charge its clients for these services. Should those clients be the individual accredited investors described in Rule 501(a)(5) and (6), the SPV itself would count as an accredited investor

44. Net Worth Standard for Accredited Investors, Exchange Act Release No. 33-9177, 76 Fed. Reg. 5307-01 (proposed Jan. 31, 2011).

45. 17 C.F.R. § 230.501(a) (2011).

under Rule 501(a)(8). At that point, the SPV itself could buy an unlimited number of shares in a closely-held company without seeing sufficient financial or management information from the issuer.

An Internet company can make a substantial amount of money by offering its stock to SPV buyers in a private placement. In January 2011, Goldman Sachs created an SPV in order to invest $1.5 billion in Facebook.[46] Participation in the SPV was allegedly conditional on a minimum investment of as much as $2 million.[47] Hence, the underlying investors in Goldman Sachs' SPV would necessarily be accredited. Given the amount of money the SPV was meant to pour into Facebook, the SPV itself was likely an accredited investor. As such, the SPV could buy unregistered Facebook shares for an unlimited aggregate price without receiving extensive financial disclosures.

It is quite possible that SPVs participating in Internet-company private placements do not understand the issuer's financial situation fully. In the context of private negotiations, an SPV buyer seeking to invest a significant amount likely has sufficient bargaining power to obtain certain disclosures. Given the private nature of the transaction, however, it is unclear just how much the issuer will be bound to reveal. Moreover, while the institution managing the SPV has economic incentives to please its clients and invest their money prudently, it also has an incentive not to find out all the risks associated with the investment and just close the deal. Without full disclosure from the issuer, the SPV manager would have an easier time convincing its clients to partake in the SPV in the first place and then reap the benefit of closing the equity purchase by charging its clients for its investment services.[48]

Given the large amounts of money SPVs can pour into Internet companies without knowing the latter's complete financial situation, SPVs may very well be overpaying for the company's stock. Thus, SPVs may be fuelling a new Internet bubble and exposing their underlying investors to significant risk of loss. While statutorily-mandated disclosures would play a

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46. Susanne Craig & Andrew Ross Sorkin, *Goldman Offering Clients a Chance to Invest in Facebook,* N.Y. TIMES DEALBOOK (Jan. 2, 2011, 11:31 PM), http://dealbook.nytimes.com/2011/01/02/goldman-invests-in-facebook-at-50-billion-valuation/.

47. *Id.* Facebook subsequently made an offering to non-U.S. investors alone because of concerns that the media attention received by Goldman Sachs' SPV may violate the prohibition to general solicitation, Liz Rappaport et al., *Goldman Limits Facebook Offering,* WALL ST. J., Jan. 18, 2011, at A1, *available at* http://online.wsj.com/article/SB10001424052748703396604576087941210274036.html. Moreover, the offering was worth $1 billion, not $1.5 billion as expected, *Tracking Facebook's Valuation, supra* note 11. Still, the fact that the SPV was formed with a private placement of this caliber in mind suggests that substantial capital infusions to private Internet companies through SPVs are quite plausible.

48. *See infra* p. 24 (discussing the economic incentives of SPVs to close the deal).

particularly important role in managing that risk, Regulation D mandates no such disclosures.

D. Limited Restrictions on the Resale of Unregistered Securities

Even though Regulation D offers little protection to accredited investors, it does prevent the risk associated with buying unregistered securities from spreading. As was already mentioned, [49] the general public cannot be solicited to partake in a Regulation D offering. Furthermore, an accredited investor may not resell her unregistered securities. Under Rule 502(d), securities acquired pursuant to the safe harbors of Regulation D "cannot be resold without registration under the Act or an exemption therefrom."[50] In effect, Rule 502(d) attempts to prevent the emergence of a secondary market for private-company stock. In the context of Internet companies, Rule 502(d) could also prevent an investment bubble from spreading beyond the initial private placement.

In fact, the investor protections afforded by Rule 502(d) are seriously limited by section 4(1)[51] of the Securities Act, and Securities Act Rule 144.[52] Together, sections 4(1), and Rule 144, allow security holders who are not underwriters to resell their securities in unregulated secondary markets.

Generally speaking, an underwriter is a middleman who takes securities from an issuer and resells them shortly thereafter. Underwriters serve as distributors of an issuer's securities to the investing public. Under section 2(a)(11), an underwriter is formally defined as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security."[53] Should an investor purchase securities directly from the issuer and subsequently resell them, she may be deemed to have taken the securities with the intent to distribute them and would therefore be an underwriter.

Because underwriters are instrumental in the distribution of securities to the public, the sale of a security by an underwriter is deemed a public offering and must be registered under section 5 of the Securities Act. Conversely, if the security holder is not an underwriter, she is not considered to be a distributor of securities and need not register the sale of her securities. Section 4(1) of the Securities Act provides an exemption from registration for "transactions by any person other than an … underwriter."[54]

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49. *See supra* pp. 9-10.
50. 17 C.F.R. § 230.502(d) (2011).
51. *See* 15 U.S.C. § 77d(1) (2006).
52. 17 C.F.R. § 230.144 (2011).
53. 15 U.S.C. § 77b(a)(11) (2006).
54. 15 U.S.C. § 77d(1) (2006).

In order not to be considered an underwriter and to be free to resell one's securities, an investor "must have both (1) not taken the securities from the issuer with the intent, at that time, to distribute the securities, and (2) not be making a distribution for the issuer."[55] Yet, many investors buy equity securities with the intent to resell them at a profit. Should they have to register the resale under section 5, investors would be much more reluctant to purchase securities in the first place. Thus, the definition of "underwriter" could hurt private companies' ability to raise capital. In order to address this problem, the SEC promulgated Rule 144.

Rule 144 establishes a number of objective criteria for determining when a person has the requisite intent to distribute the issuer's securities. If an investor meets the requirements of Rule 144, she is considered not to be engaged in distribution and not to have purchased the securities "with a view to distribution." Therefore, she is not an underwriter under sections 2(a)(11) and (4)(1) and may resell her securities without registration. If the investor happens to be an accredited SPV which originally obtained its securities in a private placement, the subsequent resale of its securities is no longer subject to the limitations of Rule 502(d).[56]

E. Rule 144's Safeguards

While Rule 144 facilitates the resale of unregistered securities, it also has a number of built-in investor protections. The application of Rule 144's safeguards depends on two broad criteria. The first one is whether the issuer is subject to the reporting requirements of the Exchange Act. Because reporting issuers file periodic public disclosures of their financial situation with the SEC, investors already have adequate information about these issuers' securities. Since there is no further benefit to requiring additional registration by reporting issuers, Rule 144 treats the resale of a reporting issuer's securities more leniently.

The second criterion is whether the holders of securities are affiliates or non-affiliates of the issuer. Broadly construed as the shareholders with voting rights, board members and executives of the issuer, affiliates are suspect because they have the power to influence an issuer's management decisions.[57] Should affiliates be allowed to resell their securities freely, they

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55. Lora C. Siegler, Annotation, Construction and Application of Securities and Exchange Commission Rule 144 (17 C.F.R. § 230.144 (2011) Concerning Resales of Securities Acquired in Transaction or Series of Transactions Not Involving Public Offering in Cases Brought Under Federal Securities Laws, 117 A.L.R. FED. 409 (1994).

56. 17 C.F.R. § 230.144 (2011), Preliminary Note.

57. Under Rule 144(a)(1), an affiliate is any person who directly or indirectly controls the issuer, is controlled by the issuer, or is under common control with the issuer, 17 C.F.R. § 230.144(a)(1) (2011). Rule 405 defines "control" as the power to direct

may wield their power over the issuer in order to further their own short-term pecuniary interest, make a quick profit on the resale, and then exit the market before the consequences of their actions affect the price of the issuer's shares.

Under Rule 144, affiliates are subject to a number of resale limitations. Affiliates may sell their unregistered securities only if the issuer provides current public information[58] comparable to the reporting requirements of the Exchange Act.[59] This requirement ensures that the purchasers of an affiliate's securities will be sufficiently informed about what they are buying, and it prevents affiliates from engaging in the aforementioned manipulative tactics. Furthermore, affiliates are subject to volume[60] and manner of sale[61] limitations and must give notice to the SEC by filing Form 144[62] when they resell their securities. These requirements serve to ensure that an affiliate's resales are small in amount and not widely advertised, which limits the incentives for affiliates to manipulate the issuer. Last but not least, affiliates of reporting issuers must hold their unregistered securities for six months before reselling them.[63] Affiliates of non-reporting issuers must hold their unregistered securities for a year.[64] Thus, affiliates are forced to bear the risks of owning securities before they can resell them, which in turn decreases the chance of buying for resale. In sum, Rule 144's procedural checks on the sale of affiliate-owned securities hinder the development of unregulated secondary markets for private-company securities and ensure that unregistered securities bought from affiliates are accompanied by adequate public information about the issuer.

In contrast to affiliates, however, non-affiliates can resell their unregistered securities freely after holding them for one year. Under Rule 144, non-affiliates are subject to no current information, volume, or manner of sale requirements and need not file Form 144 when they resell their securities.[65] Today, we have a booming retail market for unregistered securities held by non-affiliates, as is manifest by the success of SecondMarket.[66]

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management decisions "whether through the ownership of voting securities, by contract, or otherwise," 17 C.F.R. § 230.405 (2011).

58. 17 C.F.R. § 230.144(c) (2011).

59. LAW, *supra* note 32, at 231.

60. 17 C.F.R. § 230.144(e) (2011).

61. 17 C.F.R. § 230.144(f) (2011).

62. 17 C.F.R. § 230.144(h) (2011).

63. 17 C.F.R. § 230.144(d) (2011).

64. 17 C.F.R. § 230.144(d)(1)(ii) (2011).

65. *See* Revisions to Rules 144 and 145, Exchange Act Release No. 33-8869, 92 SEC Docket 110 (Dec. 17, 2007) (providing a helpful chart summarizing and comparing the requirements for affiliate and non-affiliate resales of unregistered securities under Rule 144).

66. Bloomenthal & Wolff, *supra* note 40, § 3:154.

F. The Gradual Weakening of Rule 144's Safeguards

The emergence of an unregulated market for private-company securities is the product of a gradual weakening of the safeguards of Rule 144 over the past two decades. In 1997, the SEC shortened the holding period requirement from two years to one year for affiliates, and from three years to two years for non-affiliates. The SEC justified these amendments to Rule 144 with the belief that "the shorter holding periods will not diminish investor protection, since they are sufficiently long to ensure that resales under Rule 144 will not facilitate indirect public distributions of unregistered securities by issuers or affiliates."[67]

However, in 2007, the SEC shortened the holding periods once again, this time from one year to six months for affiliates of reporting issuers and from two years to one year for non-affiliates of reporting and non-reporting issuers alike. Because "reporting issuers have an obligation to file periodic reports with updated financial information … that are publicly available," the SEC presumed that the market had sufficient safeguards with respect to affiliate resales of reporting issuers' securities.[68] Moreover, because "most abuses in sales of unregistered securities involve affiliates of issuers and securities of shell companies," the SEC concluded the market needed little protection from resales of unregistered securities by either type of non-affiliate.[69] In short, as the SEC facilitated the emergence of an unregulated market for private-company securities, it remained confident that investors would be sufficiently protected.

The SEC loosened the requirements of Rule 144 in order to ease capital formation for private companies. In its cost-benefit analysis of the 2007 amendments, the SEC explained that significantly reducing the burden of Rule 144 compliance[70] would lower the cost of capital for private companies since the costs of resale of securities would drop. Moreover, the shorter non-trading period and easier transferability would increase the liquidity of an issuer's securities and decrease the risk associated with holding such securities. As a result, issuers could demand higher premiums and offer lower discounts in the initial transfer of unregistered securities to affiliates and non-affiliates alike. Under the 2007 amendments, private

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67. Revision of Holding Period Requirements in Rules 144 and 144, Exchange Act Release No. 33-7390, 62 Fed. Reg. 9242 (Feb. 28, 1997) (to be codified at 17 C.F.R. pt. 230).

68. Revisions to Rules 144 and 145, *supra* note 65, at 8.

69. *Id.* at 9 (internal citation omitted).

70. *Id.* at 27 ("[W]e estimate that 60,500 notices on Form 144 are filed annually for a total burden of 121,000 hours. . . . [T]he amendments that we are adopting will reduce the burden . . . by a total of approximately 37,139 burden hours.") *Id.*

companies would be able to raise capital more cheaply and easily without having to go through an IPO.[71]

At the same time, the SEC was fully aware of the risks associated with the 2007 amendments to Rule 144. The Commission considered a possible "substitution effect, where companies might choose to rely more on private transactions than on public transactions to raise capital" as well as "a movement of certain investors from public transactions to private transactions."[72] These are the very phenomena Mr. Silbert brought up in his description of the lackluster IPO market before the Congressional Committee on Oversight and Government Reform in May 2011.[73]

The SEC also noted a number of problems associated with a lack of transparency in private transactions involving unregistered securities. The SEC acknowledged "the risk that the market will not be informed about the nature of [private placements of securities and their subsequent resales], given that these transactions are not required to be registered and given the changes to the Form 144 filing requirements."[74] In fact, unregistered "securities of non-reporting companies could be resold by non-affiliates without current information on the issuer ever being publicly available. This, in return, could lead to less efficient price formation."[75] Once again, it was the very problems of insufficient information and questionable valuations that Peter Falvey at Morgan Keegan raised with regard to purchasing Facebook's unregistered stock.[76] In hindsight, the SEC proved to have accurately predicted the costs of loosening the requirements of Rule 144.

Back in 2007, however, the SEC concluded that its amendments to Rule 144 would lead to an overall gain by promoting capital formation and the competitiveness of private companies, "particularly smaller businesses that do not have ready access to public markets."[77]

G. The Emergence of Secondary Markets for Unregistered Securities

The 2007 amendments were the last link in a chain of regulations which allowed for the emergence of a booming market for private-company securities. Under Regulation D, issuers were already free to transfer their securities to accredited investors without providing sufficient management or financial information or registering the transaction under the Securities

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71. *Id.*at 7.
72. *Id.*at 31.
73. *See supra* p. 4 and note 9.
74. Revisions to Rules 144 and 145, *supra* note 65, at 31.
75. *Id.*
76. *See supra* p. 6.
77. Revisions to Rules 144 and 145, *supra* note 65, at 33.

Act. Under Rule 144, accredited investors could then resell their unregistered securities subject to a number of limitations. Following the loosening of these limitations in 1997 and 2007, however, accredited investors who were also non-affiliates of the issuer – as would be the case for investors who had a pre-existing relationship with the underwriter but nothing to do with the issuer and whose SPV bought securities with relatively low voting power – could resell their unregistered securities freely following a one-year holding period. An unregulated market for unregistered securities was finally possible, and SecondMarket became very successful.

Thereafter, capital formation for private companies became much easier. With the emergence of a vibrant secondary market for unregistered securities, a private issuer could measure demand for its securities more easily by considering the secondary trades in its securities and the values for which the latter were trading. An issuer could then use this information as a marketing tool to attract additional equity investments. For example, an issuer whose shares were in demand on SecondMarket could argue for an implied valuation of its business based on the high SecondMarket price of its shares. Since non-affiliates of the issuer would be free to resell their securities after a one-year holding period, they would bear less risk and be willing to pay more for the issuer's unregistered securities. In sum, as the SEC had predicted, private issuers were able to sell their equity for higher prices without having to register.[78]

Unfortunately, the risk that a new Internet bubble would emerge and grow also increased significantly. As was previously discussed,[79] when an SPV pools the money of accredited investors[80] in order to purchase equity in a private placement, it can provide the issuer with a substantial capital infusion without having received sufficient management and financial information. In short, the SPV may very well be overpaying in the private placement. However, the same SPV (assuming it is a non-affiliate of the issuer) could expect to get an even higher price for its unregistered shares

78. Note that private secondary markets were already valuing Facebook at $83.5 billion in January 2012. *Tracking Facebook's Valuation, supra* note 11. This figure is not far off from Facebook's alleged expectation to be valued somewhere between $75 and $100 billion in its IPO. Rusli, *supra* note 2. On May 17, 2012, Facebook's IPO resulted in a $104 billion valuation of the company. Rusli, *supra* note 1. Since Facebook's stock price fell immediately thereafter, the $104 billion valuation was arguably inflated, possibly as a result of inflated valuations on private secondary markets.

79. *See supra* Part II.C.

80. This Note assumes that investors who pool their money in SPVs are accredited. This assumption is based on the fact that when Goldman Sachs organized an SPV to buy shares of Facebook, it made participation conditional on a minimum investment of $2 million, Craig & Sorkin, *supra* note 46. Individuals who can spend $2 million of their own assets are accredited under Rule 501(a)(5), 17 C.F.R. § 230.501(a)(5) (2012).

upon resale. There are two reasons for this. First, the buyers in the secondary transaction, like the SPV, never received adequate reliable information about the issuer and may not be able to value the issuer's securities accurately. Second, access to the initial Registration D offering was likely restricted, so demand for a particular private Internet company's securities may not have been met.[81] Thus, it is likely that a second SPV would come along, pool the money of numerous investors, and pay exorbitant sums in order to acquire the first SPV's securities on SecondMarket. Then, the issuer could point to the high prices paid for its securities in secondary markets and attract more SPVs in the next private placement. As the line of SPVs continues, so the Internet bubble grows. Both issuers and investors benefit until the bubble bursts.

While the 2007 amendments to Rule 144 were meant to ease capital formation for small businesses, large companies like Facebook benefitted from billion dollar investments without having to register the transaction under section 5 of the Securities Act. Given the lucrative nature of transferring limited equity shares to any number of SPVs without having to undergo extensive financial and management disclosures, companies like Facebook can take a long time to go public. The number of IPOs in the U.S. remains low in part due to the substitution effect considered by the SEC in 2007. As the resales of unregistered securities held by non-affiliates multiply, so do the shareholders of private Internet businesses, making some of the latter *de facto* unregistered public companies.

III. WHY *DE FACTO* PUBLIC COMPANIES MAY NOT HAVE TO REGISTER

Even if a business never goes through an IPO it can become *de facto* public by virtue of the number of its shareholders of record. When an Internet company transfers shares to founders, employees, and private equity investors, naturally the number of its shareholders increases. When the latter resell their shares on Second Market the number of the company's shareholders could expand even further. As a result of this indirect distribution process for unregistered securities, the business which was once closely-held could grow to the point of being *de facto* public.

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81. Back in October 2010, Ted Hollifield, a partner at the law firm Dorsey & Whitney LLP, was already expressing qualms regarding the growing demand for private-company stock, available for sale on SecondMarket. "Certainly I'm very concerned with the level of enthusiasm I'm seeing for these acquisitions," he said. "Because I think there is a tendency to just overlook just how thinly traded the shares are and how little information is available to purchase companies such as Facebook without doing any evaluation," Geron & Austin*, supra* note 13.

A. Section 12(g): A Balanced Approach to Investor Protection

Section 12(g) of the Securities Exchange Act of 1934 was meant to provide protection to the shareholders of *de facto* public companies. Under Section 12(g)(1),[82] every issuer engaged in interstate commerce which has assets exceeding $10 million[83] and a class of equity securities held of record by five hundred or more shareholders, must register the said security and comply with the periodic reporting requirements of the Exchange Act. Section 12(g) extends the safeguards of the Exchange Act to large private companies in order to provide "to investors in certain over-the counter securities the same protection now afforded to those in listed securities."[84] Thus, on its face section 12(g) remedies the transparency problems associated with the distribution of unregistered securities on secondary markets and prevents the artificial inflation of Internet-company valuations.

Section 12(g) advances the goal of investor protection without placing excessive burdens on capital formation for private companies. The scope of section 12(g) is limited by broad total asset, class of security, and shareholder of record requirements. While section 12(g)(1)(B) calls for registration by companies whose assets exceed $1 million, the SEC increased the threshold amount to $10 million via Exchange Act Rule 12g-1[85] in order to protect small businesses from the burdens of periodic reporting[86] and encourage capital formation.

The broad statutory definition of a "class" of securities also promotes capital formation. Under section 12(g)(5), a "class" includes "all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges."[87] Hence, preferred stock and common stock usually count as separate classes of securities. Since an issuer is required to look at the number of shareholders of each class, rather than its total number of shareholders, an issuer can have up to 499 shareholders of preferred stock and up to 499 shareholders of common stock without having to register either security.[88] Thus, the broad definition of "class" of securities under section 12(g)(5) allows for liberal capital formation before the safeguards of the Exchange Act are triggered.

82. 15 U.S.C. § 78l(g)(1) (2006).

83. 17 C.F.R. § 240.12g-1 (2011).

84. H.R. REP. NO. 88-1418, at 1 (1964).

85. 17 C.F.R. § 240.12g-1.

86. Relief from Reporting by Small Issuers, Exchange Act Release No. 37-157, 61 SEC Docket 2092 (May 9, 1996) ("The proposal to increase the asset threshold [from $5 million] to $10 million was designed, in part, to increase the utility of the Commission's small offering exemptions … a principal benefit of which is that companies conducting such offerings do not automatically become subject to Exchange Act reporting."); *Id.*

87. 15 U.S.C. § 78l(g)(5) (2006).

88. Bloomenthal & Wolff, *supra* note 40, § 7:6.

Finally, while section12(g)(1)(B) requires registration from every issuer with "a class of equity security… held of record by five hundred or more … persons," the SEC eased the regulatory burden on private companies by defining "held of record" broadly. Exchange Act Rule 12g5-1(a) provides that "securities shall be deemed to be 'held of record' 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."[89] As SEC Chairman Schapiro explained, "[t]he Commission used this definition to simplify the process of determining the applicability of Section 12(g) by allowing a company to look to the holders of its securities as shown on records maintained by it or on its behalf."[90] Presumably, an issuer that wants to avoid registration can keep track of the number of its shareholders easily and make sure it does not cross the five hundred shareholders threshold. Thus, the five hundred shareholders requirement, like the total assets and class of security limitations of section 12(g), seeks to impose minimal burdens on capital formation by private companies.

B. The Use of Street Names

Given certain historical changes, however, section 12(g) may no longer offer a balanced approach to investor protection. Since the adoption of Rule 12g5-1 in 1965, the way securities are held in the US has shifted substantially, and the SEC's intentionally broad interpretation of "held of record" may leave investors unprotected.

In 1968, the number of trades on the NY and American stock exchanges exploded and it became practically impossible to transfer a physical stock certificate from buyer to seller fast enough. The resulting paperwork crisis lasted until 1971 when the way securities were held changed and stock certificates were physically immobilized. Since then, banks and broker-dealers have adopted the practice of maintaining accounts with securities depositories like the Deposit Trust & Clearing Corporation (DTC). Following a sale of securities on the stock exchanges, DTC simply debits the account of the selling bank or broker-dealer and credits the account of the buying one. In the mean time, physical stock certificates representing the shares traded by all of DTC's broker-dealers and banks are stored in a vault and held of record by DTC's nominee, CEDE & Co. Today, the vast majority of public-company shareholders do not appear on the company's records. Instead, shareholders are represented by nominees

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89. 17 C.F.R. § 240.12g5-1(a) (2011).

90. *The Future of Capital Formation: Hearing Before the H. Comm. on Oversight and Government Reform,* 112th Cong. 15 (2011) (statement of Mary L. Schapiro, Chairman, Securities and Exchange Commission)-[hereinafter Schapiro].

like CEDE & Co. and their shares are held of record in nominee or "street" name.[91]

Due to the use of street names, most shareholders of publicly-traded companies are no longer counted under Section 12(g)(1). As Chairman Schapiro explained, "One broker may own a large position in a company on behalf of thousands of beneficial owners. However, since the shares are all held 'in street name,' those shares count as being owned by one 'holder of record.'"[92] That holder is usually a depository nominee. Hence, when a publicly-traded company turns to its record to count its shareholders for section 12(g)(1) purposes, it most likely sees only a few listings in the names of nominees like CEDE & Co. The five hundred shareholders requirement is triggered more rarely, which allows publicly-traded companies to avoid registration under section 12(g)(1).

Since companies whose stock is listed on a U.S. securities exchange still have to register under section 12(g)(2)(A), the use of street names by publicly-traded companies appears to pose no major risk for the investors in those companies. However, it does create problems in the private-company arena.

C. SPVs as a Means to Avoid Registration Under Section 12(g)

The use of street names by public companies has opened the door to special purpose vehicles as a means for private companies to avoid registration under section 12(g)(1). Just as CEDE & Co. could be the name of record for hundreds of owners of a listed stock, an SPV may represent hundreds of private equity investors. So long as the SPV is the buyer on the issuer's records, the SPV would count as a single shareholder under the current definition of "held of record." Thus, an issuer selling securities to an SPV could benefit from the capital of hundreds of investors and grow to the point of being *de facto* public without having to register under section 12(g)(1).

When Goldman Sachs set up an SPV to buy Facebook stock, the press reported that the SPV "would be managed by Goldman and considered just one investor, even though it could conceivably be pulling investments from thousands of clients."[93] In response to Goldman's investment, the SEC reportedly sent letters of inquiry to SecondMarket and others, asking about

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91. Stephen J. Nelson, *Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities* (July 3, 2003), *available at* http://www.sec.gov/rules/petitions/petn4-483.htm.

92. Schapiro, *supra* note 91, at 16.

93. Bloomenthal & Wolff, *supra* note 40, § 7:11.10 (quoting Andrew Ross Sorkin & Evelyn M. Rusli, *Goldman Offering Clients a Chance to Invest in Facebook*, N.Y. TIMES DEALBOOK (Jan. 2, 2011), http://dealbook.nytimes.com/2011/01/02/goldman-invests-in-facebook-at-50-billion-valuation/).

the use of SPVs to invest in private company stock.[94] Yet, there is no evidence that the SEC pursued further action. The use of SPVs to avoid registration of *de facto* public companies remains legal.

When SPVs are used to avoid the safeguards of the Exchange Act, private-company investors are exposed to greater risks. Unlike CEDE & Co., the institutions which create and manage SPVs make a profit from their clients' investments. For instance, the brokerage firm J.P. Turner, reportedly raising a $25 million fund to buy Facebook stock, was expected to take "a one-time 6% sales commission, a one-time 4% management fee and a one-time 2% expense reserve fee," or $3 million in fees, if it closed the $25 million deal.[95] J.P. Turner's fund would also charge interest "ranging from 20% of profits on capital contributions less than $150,000 to 5% of profits on capital contributions equal to or in excess of $350,000."[96] Thus, the J.P. Turners and Goldman Sachs that are investing in today's hottest Internet companies have economic incentives to convince their clients to pool their money and join an SPV. Arguably, the said investment institutions also have an incentive not to disclose the risks associated with SPV investments fully to make the SPV appear more appealing.[97] Given the SEC's intentionally broad definition of "held of record," *de facto* public issuers are subject to no statutory requirements to disclose those risks either.

In the absence of traditional protections, private-company investors are left to their own devices. As we saw in Part II,[98] section 5 of the Securities Act did not prevent the emergence of an unregulated market for unregistered securities and possibly a new Internet bubble. While section 12(g)(1) of the Exchange Act holds a promise to remedy the transparency issues associated with such markets and prevent the inflation of Internet-company valuations, the current regulatory scheme does not allow that promise to come to fruition.

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94. *Id.* (citing Richard Teitelbaum, *Facebook Drives SecondMarket Broking $1 Billion Private Shares*, BLOOMBERG.COM (Apr. 27, 2011, 12:01 AM), http://www.bloomberg.com/news/2011-04-27/facebook-drives-secondmarket-broking-1-billion-private-shares.html).

95. Geron & Austin, *supra* note 13.

96. *Id.*

97. One accredited investor who had the opportunity to partake in J.P. Turner's Facebook fund suggested that the fund's disclosures were somewhat misleading. "'If they told you up front that there's a lot of risk and you could lose it all, that's a different story,' the investor said. 'But that's not how they pitched it. They pitched it as a fund that will get you into the IPO.'" Geron & Austin, *supra* note 13. Given the ample incentives for Internet companies to remain private and the lack of management information available even to accredited investors, the said IPO may come much slower than investors are lead to believe it would.

98. *See* discussion *supra* Part II.G.

IV. WHAT THE SEC CAN DO TO PROTECT PRIVATE EQUITY INVESTORS

While the story told in Parts II and III of this Note appears to be grim for investors, it need not be that way. The SEC could either tighten the requirements of Regulation D and Securities Act Rule 144, thus minimizing the risks associated with the indirect distribution of unregistered securities, or shore up investor protections under section 12(g) of the Exchange Act and make it so that the indirect distribution of unregistered securities eventually leads to registration. The SEC would likely turn to the latter solution first because in this arena it already has the tools to protect private-company investors.

A. Shoring Up Investor Protection Under Section 12(g)

At the time of the adoption of Exchange Act Rule 12g5-1 in 1965, the SEC left the door open for amendments to the definition of "held of record" which would better protect the interests of investors. In 1965, the SEC refused to embrace "the provision that securities registered in the name of a broker, dealer, or bank or nominee for any of them, and held in customers' accounts [i.e. securities held in "street name"], shall be counted as held of record by the number of separate accounts for which the securities are held."[99] However, the SEC also explicitly set out to "determine in the light of experience whether inclusion of these accounts at a future date is necessary or appropriate to prevent circumvention of the (Exchange) Act and to achieve the intended coverage on a uniform and acceptable basis."[100] Since the current definition of "held of record" allows for the use of SPVs to avoid registration and poses significant risks to investors, experience seems to have already shown that Rule 12g5-1 should be revised so that the people pooling their money in SPVs would count as shareholders of record and *de facto* public companies would have to register.

Even in its current form, Rule 12g5-1 allows the SEC to go behind the record of shareholders when section 12(g)'s requirements are intentionally circumvented. Rule 12g5-1(b)(3) provides that "[i]f the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of section 12(g)…. of the act, the beneficial owners of such securities shall be deemed to be the record owners thereof."[101] In her April 2011 letter to Congressman Darrell Issa, SEC Chairman Mary Schapiro explained that the anti-circumvention provision of Rule 12g5-1 was "meant to prevent companies that would otherwise be

99. Adoption of Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-7492 (S.E.C. Jan. 5, 1965).

100. *Id.*

101. 17 C.F.R. § 240.12g5-1(b)(3) (2011).

subject to registration from evading important investor protection by using artificial means to keep the number of investors below the thresholds that require registration, such as by creating holding companies or other special purpose entities."[102] Since SPVs are precisely the form of holding securities of record Chairman Schapiro was referring to in her letter, the SEC could simply choose to apply the anti-circumvention provision to SPVs and effectively force *de facto* public issuers to comply with the registration requirement of Section 12(g).

Thus far, the SEC has suggested it will likely not enforce Rule 12g5-1(b)(3). In the same letter to Congressman Issa, Chairman Schapiro noted that the anti-circumvention provision has been "invoked sparingly."[103] She added that the SEC had found only one case interpreting Rule 12g5-1(b)(3) and pointed to *Tankersley v. Albright*.[104] The *Tankersley* court held that an employees' trust, which had majority control of a company, should be counted as a single shareholder under Rule 12g5-1. The trust was not a device used to avoid registration because (1) it was created prior to the adoption of Rule 12g5-1 and (2) it served the important purpose of providing incentive to employees "to work diligently to increase company production…, to stay in the employ of the company," and "to share in the company's growth."[105] Given that the one judicial decision the SEC considered in connection with the anti-circumvention provision refuses to enforce that provision, it appears very unlikely that the SEC itself will be enforcing Rule 12g5-1(b)(3).

In contrast, Chairman Schapiro indicated on several occasions that the SEC is likely to amend the definition of "held of record" in order to protect SPV investors. In her April 2011 letter to Congressman Issa, she acknowledged the problems associated with SPVs holding unregistered securities and noted that such entities raised the following policy questions: "If SPV investors are not counted, does this approach undermine the goals of Section 12(g)?" In addition, Schapiro wondered "If the SPVs are traded on private markets, should some level of information be required?"[106] A month later, Chairman Schapiro openly declared, "I believe that both the question of how holders are counted and how many holders should trigger registration need to be examined."[107] It is, therefore, evident that the SEC is considering shoring up investor protection by amending Rule 12g5-1(a).

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102. Letter from Chairperson Mary L. Schapiro to Chairman Darrell E. Issa, April 6, 2011, *available at* http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

103. *Id.* at § 7:11.14 (quoting Letter from Chairperson Schapiro to Chairman Darrell Issa, Apr. 6, 2011).

104. Tankersley v. Albright, 514 F. 2d 956 (7th Cir. 1975).

105. *Id.* at 970.

106. Bloomenthal & Wolff, *supra* note 36, § 7:11.14.

107. Schapiro, *supra* note 91, at 16.

B. Challenges to Investor Protection Under Section 12(g)

Before the SEC extends adequate protection to private-company investors, it must meet a series of important challenges. In March this year, Congressman Issa sent a letter to Chairman Schapiro, asking (1) whether the popularity of SPVs among accredited investors suggested that the five hundred shareholders rule was restricting an important source of capital for American companies, (2) whether the SEC would exempt issuers who disclosed their financial statements to investors from the five hundred shareholders rule, (3) whether the SEC would exempt qualified institutional buyers (QIBs)[108] from the five hundred shareholders rule, and (4) whether the SEC would eliminate the anti-circumvention provision altogether.[109] In short, Congressman Issa suggested that the use of SPVs had demonstrated an important opportunity for capital formation, which should be taken advantage of by liberalizing the safeguards of section 12(g) of the Exchange Act for accredited investors and QIBs while tightening the disclosure requirements of Regulation D or Securities Act Rule 144.

In May 2011, Barry Silbert made a more radical proposal. In his view, Congress and the SEC should "strive to maximize the pool of accredited investors that have access to [private placements]"[110] in order to promote capital formation and fuel growth in the US economy.[111] With this goal in mind, Mr. Silbert suggested the "elimination of the prohibition on general solicitations in the context of private placements and resales of unregistered securities, provided that the ultimate purchaser meets the accredited investor qualifications."[112] He also proposed "[a] significant increase or elimination

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108. Qualified institutional buyers (QIBs) are like institutional accredited investors. Under Securities Act Rule 144A(a)(1), qualified institutional buyers fall into roughly three categories. The first is a list of institutional investors which own or invest "on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the [institutional investor]" 17 C.F.R. § 230.144A(a)(1)(i). With the exception of banks and savings and loans associations, this list is similar to the list of institutional investors deemed to be accredited investors under Regulation D Rules 501(a)(1), 501(a)(2), and 501(a)(3). Bloomenthal & Wolff, *supra* note 40, § 4:4. The second category of QIBs includes any dealer registered under the Exchange Act "that in the aggregate owns and invests on a discretionary basis at least $10 million of securities of issuers that are not affiliated with the dealer" or is involved in certain riskless transactions on behalf of other QIBs. 17 C.F.R. §§ 230.144A(a)(1)(ii)(iii). Finally, the third category of QIBs includes any bank and savings and loans association which "owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with it and that has an audited net worth of at least $25 million[.]" 17 C.F.R. § 230.144A(a)(1)(vi).

109. Bloomenthal & Wolff, *supra* note 40, § 7:11.12.

110. Silbert, *supra* note 9, at 57.

111. Mr. Silbert advocated for change to the regulatory scheme affecting private companies which "would directly impact companies' ability to access capital more readily and cheaply . . . and bolster American global competitiveness." *Id.* at 55.

112. *Id.* at 58.

of the 500 shareholder threshold" or in the alternative "an exemption for accredited investors and Qualified Institutional Buyers from the shareholder count."[113] In essence, Mr. Silbert was asking that Congress or the SEC make it easier for companies to remain private for longer by requiring no adequate reliable public disclosures from issuers who would be free to solicit QIBs and accredited investors in any way they like.

Mr. Silbert correctly observed that the SEC had already decided that QIBs and accredited investors did not need registration-level protections.[114] Securities Act Rules 144A(b) and 144A(c) provide an exemption from the definition of underwriter for QIBs.[115] Hence, the sales of securities to QIBs are exempt from registration under Section 4(1) of the Securities Act. As was previously discussed,[116] under Regulation D issuers can also sell stock to accredited investors without registering the transaction. Having alluded to these regulations, Mr. Silbert concluded that the preferential treatment of QIBs and accredited investors meant that their exemption from the five hundred shareholders rule "would not breach the SEC's investor protection mandate."[117]

However, Mr. Silbert failed to mention some risks associated with his proposals. As we saw in Part II, even accredited investors may be in need of greater protection given the lack of statutorily mandated disclosures from issuers, the difficulty of valuing private stock, the incentives of SPV managers not to reveal the risk associated with SPV investments, the incentives for issuers to charge more for their securities given the potential for resale, and the distinct possibility that a new Internet bubble may be arising. Should accredited investors and QIBs who already bought into a private company qualify as non-affiliates of the company – a condition which may be easy to meet under the definitions of "affiliate" and "control"[118]– they would be perfectly free to resell all of their securities after a one-year holding period, thus facilitating the further growth of a potential Internet bubble. In short, while Mr. Silbert's proposals would likely lead to an explosion of trades on SecondMarket, in which he has a financial interest, they would also significantly increase the risk of loss for private-company investors in the event the Internet bubble bursts.

Last but not least, the SEC must consider a legislative challenge to investor protection. Following Mr. Silbert's exposition of his proposals to the Congressional Committee on Oversight and Government Reform – of which Congressman Issa is the Chairman – Congressman Issa and twenty

113. *Id.*
114. *Id.* at 57.
115. 17 C.F.R. § 230.144A(b)-(c) (2011).
116. *See supra* Part II.A.
117. Silbert, *supra* note 9, at 58.
118. *See supra* note 57.

six other representatives sponsored the Private Company Flexibility and Growth Act.[119] The bill seeks to amend section 12(g) of the Exchange Act to increase the shareholder of record threshold from five hundred to one thousand persons.[120] It also declares accredited investors exempt from the definition of "held of record."[121]

While the Private Company Flexibility and Growth Act does not go so far as to limit the prohibition on general solicitation in private placements, it does "strive to maximize the pool of accredited investors that have access to (private offerings)," to use Mr. Silbert's expression. Since SPVs aggregating the money of accredited investors may be accredited investors themselves under Securities Act Rule 501(a)(8), SPVs would likely be explicitly exempt from the safeguards of section 12(g). Issuers would be free to tap into the capital of hundreds of accredited investors without having to register their securities under the Exchange Act. Since issuers are already exempt from registration under the Securities Act for transactions with accredited investors under Section 4(2) and Rule 506, such issuers would seemingly never have to have an IPO either.

Should the Private Company Flexibility and Growth Act not pass, the SEC could still shore up protection for private-company investors by amending the definition of "holder of record" to refer to an SPV's underlying investors or simply apply the anti-circumvention provision of Rule 12g5-1 to SPVs. Under either scenario, the SEC would require banks and broker-dealers to make a record of the investors for whom they are buying or selling securities and give issuers access to that record. These changes to the regulatory regime would do away with street names and make it so that SPVs can no longer be used to avoid registration for *de facto* public companies.

Should the Private Company Flexibility and Growth Act pass, however, the SEC would have to look for other avenues of investor protection. Since SPVs do not count as shareholders of record under the bill, any amendment to the definition of "holder of record" in Rule 12g5-1(a) aiming to preclude SPVs from counting as a single shareholder would be irrelevant. In fact, even the anti-sham provision of Rule 12g5-1 would no longer apply to SPVs. If SPVs are not shareholders of record, they could not logically be used to circumvent the five hundred shareholders rule and registration requirements of section 12(g). Thus, neither amending Rule 12g5-1(a) nor enforcing its anti-circumvention provision would be a viable option.

119. Private Company Flexibility and Growth Act, H.R. 2167, 112th Cong. (2011).

120. H.R. 2167.

121. H.R. 2167; *See also* Private Company Flexibility and Growth Act, S. 1824, 112th Cong. (2011) (proposing that the shareholder of record threshold be increased to two thousand persons).

C. Tightening the Requirements of Regulation D and Rule 144

Should the SEC fail to shore up investor protection under section 12(g) of the Exchange Act and make it so that the indirect distribution of unregistered securities eventually leads to registration, it could try to tackle the distribution of unregistered securities directly. The most obvious way to do that would be to make the resale of private-company shares on SecondMarket a public offering. In this way, the SEC would preserve private placements as a crucial mechanism of capital formation for closely-held businesses while preventing the risk associated with a lack of transparency and inefficient valuations in private transactions from spreading more widely.

Yet, a blanket ban on the resale of unregistered securities would impose too heavy a burden on capital formation for private companies. Going that route would require that investors who resell their holdings no longer be exempt from the definition of "underwriter" under section 2(a)(11) of the Securities Act. Investors who purchase equity securities in a private placement often do not intend to hold their securities interminably. Requiring them to register the resale would likely make them reluctant to buy into a private company in the first place. Without Rule 144's safe harbor from the definition of "underwriter," private companies would have a much harder time obtaining capital.

Given that the distribution of unregistered securities on private secondary markets is here to stay, the SEC could limit the risks associated with it by tightening its disclosure requirements for private companies. Admittedly, this strategy would place a greater regulatory burden on private companies and make capital formation harder. Yet, the burden need not be excessive. Providing more information to investors would make it easier for them to make well-reasoned investment decisions, likely generate trust in the market, and prevent the emergence of a new Internet bubble, all of which would help capital formation in the long run.

To begin with, the SEC could require that Regulation D issuers selling securities to accredited investors provide the latter with the information they are already required to offer to non-accredited buyers under Rule 502(b)(2). This would minimize the possibility of issuers demanding and SPVs paying overly inflated prices for private-company shares, thus making the primary sale of unregistered securities less risky for investors.

Further, the SEC could improve the information available to buyers in the secondary market for unregistered securities by amending Rule 144. First, the SEC could extend the current public information requirement of Rule 144(c) to include secondary transactions by non-affiliates. In that case both affiliates and non-affiliates would be allowed to resell their securities only if the issuer provides current public information comparable to the reporting requirements of the Exchange Act. This regulatory change would eliminate the risk of no adequate reliable financial information ever being made available to the secondary purchasers of unregistered securities. Second, the SEC could repeal its 2007 amendments to Rule 144 and require non-affiliates to file Form 144. The latter proposal would diminish the risk that the market will never be informed about the existence and nature of secondary transactions by non-affiliates. Should the SEC implement these changes to Rule 144 and require greater disclosures from Regulation D issuers, it would mitigate the lack of transparency associated with today's sales and resales of unregistered securities.

Finally, the SEC could push issuers towards voluntarily disclosing more financial and management information. The SEC could accomplish this goal by bringing the holding periods for unregistered securities under Rule 144 back to their 1997 levels. While this option would necessarily make capital formation harder, investors would not be entirely reluctant to buy equity in private companies because they could still resell their securities. Furthermore, having to hold their securities for two years would force non-affiliate investors to evaluate the risk of buying private equity more carefully. In order to appease non-affiliates' concerns, private issuers would likely agree to provide more extensive disclosures of their financial situation. This would foster a more trustworthy primary market for unregistered securities and nip overinflated valuations in the bud. Since the secondary non-affiliate purchasers would also have to hold their securities for two years, they would likely be more careful too and demand more information about the companies they are buying into. Thus, both primary and secondary private equity investors would be better protected and the emergence and growth of a new Internet bubble could be avoided.

V. CONCLUSION

Capital formation for private companies poses a difficult policy problem: how to allow small businesses to grow without exposing investors to too much risk and undermining their willingness to invest in the first place? U.S. Federal securities law deals with this question by drawing a line beyond which private companies must register with the SEC and disclose their financial situation publicly in order to obtain more funds and grow. Private issuers can raise capital from limited groups of investors in Regulation D offerings without having to register the transaction under section 5 of the Securities Act. Furthermore, accredited investors who bought into a Regulation D offering can resell their unregistered securities under Securities Act Rule 144. However, should a private company engaged in interstate commerce grow to the point of having over five hundred shareholders of record and total assets exceeding $10 million, it would be required to register with the SEC pursuant to section 12(g) of the Exchange Act.

Today, Internet companies in the U.S. have the option of pursuing extensive capital formation without incurring the cost of registration. The point at which an Internet company must go public is no longer clearly defined as a result of two developments: (1) the emergence of unregulated secondary markets for unregistered securities following the 2007 amendments to Rule 144 and (2) the use of SPVs to avoid the registration requirements of section 12(g). With the emergence of platforms like SecondMarket, on which the stock of private Internet companies is regularly traded, unregistered securities have become more liquid. Issuers are able to market their securities more easily and obtain higher prices in private placements. As demand for Internet company stock rises in a stagnant IPO market, accredited investors have chosen to pool their money into SPVs to buy a larger slice of their preferred Internet company. Thus, private Internet companies can benefit from substantial capital infusions while their shareholder base is growing. However, because SPVs count as a single shareholder of record under section 12(g), Internet companies do not have to register under the Exchange Act.

The unchecked growth of private Internet companies poses significant risks for investors. Private issuers are not required to disclose their financial information to accredited investors buying into a private placement under Securities Act Rule 506. Following the 2007 amendments to Rule 144, accredited investors unaffiliated with the issuer can turn around and resell their unregistered securities after a year without adequate financial information about the issuer ever being disclosed. Given that SPVs are paying extraordinary sums for shares of issuers whose true financial situation they may not understand fully, private Internet companies today may very well be overvalued. Because the safeguards of section 12(g) of the Exchange Act are not enforced against SPVs, the inflated valuations of Internet companies may grow unchecked, leading to a new Internet bubble.

Currently, there is no clear stopping point to the growth of a potential Internet bubble. As the primary and secondary transactions with SPVs multiply, so the bubble grows. Should legislative efforts like the Private Company Flexibility and Growth Act succeed, accredited investors, including SPVs, would no longer count towards the five hundred shareholder threshold at all. Thereafter, Internet companies could seemingly grow and remain private up until the bubble bursts.

The SEC has ample avenues to prevent the growth of a new Internet bubble. Should requiring issuers to report the number of their beneficial shareholders under section 12(g) prove to be too burdensome a solution, the SEC could focus on ensuring the availability of adequate financial information about private issuers. Requiring financial disclosures from issuers as a prerequisite to security purchases by accredited investors and current public information as a prerequisite for resales of unregistered securities would ameliorate the transparency and inefficient valuation issues associated with private company stock. Moreover, increasing the holding periods for affiliates and non-affiliates alike will make it harder for issuers to obtain capital without informing their investors of their true financial situation.