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Pre-Public Funding — Lessons From Facebook

Law360, New York (January 12, 2012, 2:49 PM ET) -- Recent developments relating to Facebook and its efforts to raise capital privately, while avoiding triggering a requirement to become a U.S. Securities and Exchange Commission public reporting company, have piqued the interest of some private equity funds.

The first development was the much-publicized effort by Goldman Sachs to create a fund for investment by its accredited clients in Facebook before a widely expected initial public offering. Because Goldman's private placement generated national media attention that seemed inconsistent with a securities law prohibition on "general solicitations," Goldman limited the offering to foreign investors, although the SEC later disclaimed any role in Goldman's decision (Letter dated April 6 from Commissioner Mary Schapiro).[1]

However, in certain situations the Facebook structure would seem to offer some interesting possibilities for nonpublic portfolio companies who need additional private funding (i.e., are not yet ready for a public offering), but may be constrained by the limited funds left in its sponsor private equity fund. The portfolio company itself may have had a bumpy history, but holds real prospects (at least in the mind of the sponsor). Short of dry powder, the sponsor would probably first look to other funding sources. But, other private equity funds might be reluctant to participate in the necessary amounts and other financing sources (such as banks) might be unavailable.

Some of these sponsors may have another potential source of funding based on their extensive contacts with high net worth investors, family offices and other investors who might well be interested in relatively small investments in the portfolio company. A special vehicle fund, a la Facebook, could be an attractive way to "herd" all these investors into one fund controlled by the sponsor and that would subject every investor in the SPV to identical terms. Ideally, this structure would avoid numerous separate negotiations on the terms of the investment, although larger investors in the SPV could still have a lot to say.

There is one other advantage to this approach. A portfolio company that has had some ups and downs may have had several rounds of financing and a very substantial number of stockholders (including management stockholders) of record. Once a private company has more than 499 stockholders of record (and $10 million or more in assets), it must register with the SEC and provide the quarterly and annual reports mandated by the SEC's periodic reporting system, a definite downer for a private company that is not yet ready in terms of cost and otherwise for a public unveiling. Under current rules, however, the SPV would count as only one stockholder of record, thus not triggering the filing requirement.

But are there legal limitations to this approach? For one thing, all the investors in the SPV must be accredited investors, which after Dodd-Frank means an individual or joint net worth with a spouse of at least $1 million, not counting the primary residence, or $200,000 in annual income ($300,000 with a spouse) for the past two years with a reasonable expectation of reaching the same income level in the current year. This standard would not normally pose too much of an obstacle for an SPV.

In addition, the SPV could not have more than 100 accredited investors or, as an alternative, only qualified purchasers who, if individuals, must have not less than $5 million in investments in order to avoid having to register as an investment company. However, an SPV should permit a substantial fundraising for the portfolio company while permitting the participating investors to make relatively modest investments.

In light of the issue raised by the Goldman offering, where runaway media attention caused Goldman to cancel its offering to U.S. persons, care should be taken to limit a private placement to only those investors who are known to the sponsor and who can be counted on to honor an obligation to keep the offering materials and the fact of the proposed offering confidential. With evidence of rigorous controls, a case could be made to the SEC or to a court that the right approach is to deem the offer private where the sponsor and its associates take meaningful steps to keep the offering out of the press. Speed in closing the offering could also help if it can be shown that the offering was fully subscribed prior to any significant media attention.

While Regulation D does not require that an offering to only accredited investors receive any specific disclosure package, SPV offerings need to meet the requirements of Rule 10b-5 so that a disclosure document in the form of a private placement memorandum is, as a practical matter, prepared. Care would need to be taken to meet the antifraud provisions of the securities laws so that the placement memorandum is a fair description of the portfolio company, although none of these requirements would be unique to normal private placement practice.

A somewhat more challenging question is whether the SPV could in effect be used to avoid forcing the portfolio company to prematurely become a public reporting company, something Facebook has been careful to avoid. An Exchange Act provision requires any domestic issuer that has 500 or more holders of record of a class of equity securities and total assets exceeding $10 million as of the end of the company's most recent fiscal year to become a full-fledged Exchange Act reporting company within 120 days.

Facebook was careful not to cross that line until after Dec. 31, 2010, because it was not prepared to face up to the reporting requirement prior to April 2012. Although breaching the 499 equity shareholder limit is not a likely occurrence with the vast majority of private equity fund investments, it can be true if the portfolio company has accumulated a large number of stockholders of record through large management holdings (other than through stock options that do not ordinarily count for purposes of the Exchange Act provision) and many rounds of financing, such as follow on investments.

It can also be true, as presumable in the case of Facebook, of highly successful companies where there is great interest in the marketplace (even though the company is not yet public) causing employee with shares obtained in the exercise of options to sell to third parties, which can lead to the real possibility that the number of record shareholders rises to 500 or more.

The Exchange Act provision in question that looks to record ownership can lead to unintended results. The SEC itself has recognized this issue by pointing out the anomaly of counting every stockholder of record in a very literal sense under Section 12(g)(1) of the Exchange Act and Rule 12g5-1, so that stock held in street name (which could actually represent thousands of investors in a particular security) only counts as one holder of record. In the same way, the SPV would count as only one holder of record, although there would be a substantial number of actual investors.

An SPV set up solely to avoid Rule 12g5-1 would run afoul of SEC anticircumvention provisions, but there could be other reasons for the SPV, such as the issuers' concern with dealing directly with numerous additional stockholders and the attendant costs, the possibility of creating advantageous voting and control provisions within the SPV, etc. In any event, the anticircumvention provision under Rule 12g5-1 has been used only "sparingly." Of perhaps more concern is that the SEC has said that it will take another look at the rule, including the degree to which it permits investment activity without the benefits of the fuller disclosures per the public company Exchange Act reporting requirements would provide.

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[1] In a nicely timed article published in the November 2010 issue of Business Lawyer, the ABA Committee on Federal Regulation of Securities said that the prohibition against general solicitation found in Regulation D was becoming increasingly unworkable: "In the current environment, it is hard to control faxes, e-mails, and text messaging and, even more, their forwarding. Offerees feed information about private placements to publications that report them." The ABA Committee suggested that absent the involvement of the issuer or, in our case, a fund sponsor — or a person acting on their behalf, the offering should be able to proceed under Regulation D and without registration.