Facebook Restricts Stock Trading To Avoid Going Public

Facebook just took another move to avoid going public. In April 2010, Facebook implemented a policy that prohibits employees from selling their company stock unless a trading window is in effect, or from tipping outsiders on inside company information. In doing so, Facebook is reducing the risk that it will trigger Securities and Exchange Commission (SEC) rules that would require it to go public and file SEC public disclosures. On several occasions, founder Mark Zuckerberg has stated his desire to keep Facebook a privately held company.

The Legal Reasons Behind Facebook's Trading Policy

Facebook is concerned that employees may trade their stock on online sites like Sharespost.com, SecondMarket.com, and StartupExchange.com. These sites provide markets for private company and venture capital backed equities that otherwise could not be easily traded.

The new policy is designed to prevent legal problems that stock trades could cause. Since Facebook, as a private company, is not required to publicly release financial results under SEC rules, disgruntled investors might decide to sue the company if their investment goes bad. To the extent that investors are trading on any information, they would be trading on confidential information. This ties into the insider trading reminder, which is targeted more toward protecting Facebook employees and the company's reputation. Thus, the policy is designed to minimize the *legal risk* associated with the dissemination of confidential information.

The Business Motivation For Facebook's Policy

Of greater significance than reducing these legal risks, Facebook's trading policy is intended to reduce the *business risk* of having to go public. Facebook does not want to trigger the **500 shareholder rule**. Under that rule, a company must file a 1934 Securities Exchange Act registration statement if it has more than $10 million in assets and a class of equity securities with 500 or more shareholders. Filing an Exchange registration statement means that your company will become a **public company**, with all of the periodic reporting obligations under SEC rules. Shareholders, managers, and the board will become subject to reporting requirements. These periodic reporting obligations can be costly and time consuming for small companies.

Facebook is fully aware of the 500 shareholder rule. In 2008, it requested the SEC for an exemption from the 500 shareholder rule. The SEC granted the request and issued a no-action letter in the matter. That exemption concerned Facebook's issuance of unregistered restricted stock grants to employees, directors and consultants. However, Facebook is concerned that if the number of shareholders of common stock outside the company exceeds 500, it will again face the public reporting requirements. It is unclear whether the SEC would grant another exemption from the 500 shareholder rule.

In future posts, I will discuss (1) ways to deal with employee stock trading in startups and private companies, and (2) public company reporting obligations and implications for doing business. If you want to remain private, you must establish employee stock trading policies.

For now, suffice it to say that your company's operations, finance, and strategy will change substantially if it becomes a public company.

Douglas Y. Park
info@dypadvisors.com

DYP Advisors, Inc.
Business Strategy and Law for Competitive Advantage

http://www.dypadvisors.com