Lessons For Investors From the Facebook IPO

by Dan Brecher on May 28, 2012

Facebook highlights one of the most significant risks of pre-IPO investing—the value of the stock can go down as well as up. While Facebook's initial public offering of stock raised $16 billion for the social media company, many investors have suffered steep losses as the value of the stock continues to decline.

In the latest legal news surrounding the IPO, three Facebook investors have filed a lawsuit in New York, alleging the company and its underwriters failed to properly disclose changes to analysts' forecasts. The lawsuit seeks class-action status.

"Pre-IPO" investing involves buying a stake in a company before the company makes its initial public offering of securities. Because the shares are unregistered and sold in private transactions (often called "private placements"), they are illiquid; as a result, they are a higher risk investment than purchases of publicly traded securities.

Several of the most important risks are summarized below:

The Offering May Not Be Legal: Before a company can sell its securities to the public, the securities offering must either be registered with the Securities and Exchange Commission or fall under one of several exemptions. If the company fails to satisfy these criteria, the stock offering may be illegal and the securities could be worthless. You would be entitled to rescind the purchase, assuming there was a moneyed company able to re-purchase the securities from you..

The Securities Would Be Illiquid: Because pre-IPO shares are not traded publicly, you may have an extremely difficult time selling your securities if you want to liquidate before the company goes public. There are many reasons why the company may never go public: a collapse in the market, the specific industry falling into disfavor because of an oil spill, nuclear plant accident, advances in competing industries or illness or death of the key employee, as just some examples we have experienced in offerings, including those involving our clients.

The Value of Shares Is Unpredictable: The value of the securities once the company does go public is also extremely speculative. As the Facebook case highlights, stocks that seem red hot can flop if they are overvalued. Purchasers of Facebook stock in recent pre-IPO private transactions paid prices substantially higher than the price to which the stock retreated soon after the Facebook IPO.

Pre-IPO Investments Are Often Made With Insufficient Information. Pre-IPO shares are susceptible to fraud. In April, the SEC issued an Investor Alert warning investors about investment frauds that purport to offer investors the opportunity to buy pre-IPO shares of companies. Many of these scams are promoted through e-mail and the Internet. They entice investors by offering the opportunity to “get in on the ground floor” of a company and promising high returns. However, in some cases, the company may not be legitimate or the promoter may not have access to the shares. Therefore, it is imperative to research the investment, read the offering documents and check the reputation of the stock promoter.

What I have warned about here is not as applicable when the pre-IPO offer is made through a recognized reputable brokerage firm. I have represented numerous securities firms that have served as pre-IPO placement agents for bridge financing to companies that were preparing to go public and needed capital to bridge the period before they were able to get approvals from the SEC to proceed with the offerings. In periods of greater stability in the stock market, investing in private offerings at discounts from the contemplated IPO pricing proved to be very successful investment opportunities for savvy investors. Those days may return, but for now, “those were the days.”

For more information about the risks and benefits of pre-IPO investing, we recommend consulting with one of our experienced securities attorneys.