Did Facebook Feed Inside Information to the Big Boys … While Leaving the Individual Investor In the Dark?

By Washington's Blog
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Reader McFid – who has been a breach of fiduciary duty expert since 2003 – sent me the following article:

Today, The Daily Beast reports that certain underwriters may have lowered their revenue projections prior to the IPO AND may have informed some investors; but not all investors. I was jammed up last week and could not get the fact out of my mind that while on the road show that there would be private one-on-ones for certain investors. The general road shows surface questions, many questions over and over; there is no doubt that these questions (I wasn't there) were laser focused on revenues; whether new models compared to pre-IPO or ARPU (average revenue per user). The private one-on-ones cast extreme scrutiny on revenue numbers and assumptions – past present and future. NO DOUBT: When underwriters, no doubt listening, perhaps bristling and responding to potential investor's questions, probes and scrutiny – likely, as is often the case when more than two people look at the same set of numbers, raised some hard-to-dispose-of aka troubling issues causing them (apparently) to adjust projections DOWN; but they decided not to disseminate that to ALL investors. What are the future prospects? Some may ask with approximately 800 million users how many more would sign up in the future? And given the anti-climactic IPO fallout how many will remain active, revenue paying users?

Facebook's tagline ironically is, I believe, to promote a more open, transparent and connected world. Really? There can't be a more prominent example … of information assymetry; unequal, untimely and incomplete information – perhaps knowing, willful and intentional and approaching recission of all those IPO allocations – si?

Reuters reports:

Morgan Stanley selectively disclosed the change in Facebook estimates.

Business Insider confirms that this might be a big story:

The analysts cut their estimates because a Facebook executive told them to, a source tells us.

The information about the estimate cut was then verbally conveyed to sophisticated institutional investors who were considering buying Facebook stock, but not to smaller investors.

The estimate cut appears to have influenced the investment decisions of at least some institutional investors, dampening their appetite for Facebook stock, and crucially affecting the price at which they were willing to buy Facebook stock.

As I described earlier, at best, this “selective disclosure” is grossly unfair to individual investors who bought Facebook stock on the IPO (or at any time since).

At worst, it’s a violation of securities laws.

This latest chapter in the Facebook IPO story began this morning, when Reuters’ Alistair Barr reported that the research analysts at the company’s lead underwriters—Morgan Stanley, Goldman Sachs, and JP Morgan—had cut their earnings estimates for Facebook during the company’s IPO roadshow. This was highly unusual, if not unprecedented (I’ve been in and around the tech IPO business for almost 20 years, and I’ve never heard of it happening.)

Analysts cutting estimates is generally regarded as significant negative news for stocks. This is especially the case when the analysts who cut their estimates are thought to be very close to a company—and, therefore, to have particularly good information.

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The fact that some potential Facebook investors were told of the analysts’ estimate cuts and others were not would seem to be a major “selective dissemination” issue.

It is inconceivable that a reasonable investor would consider the sudden reduction of analysts’ estimates to be immaterial to an investment decision—especially if they analysts had privileged access to the company.

The SEC and FINRA appear to have acknowledged this, and they may now investigate what happened.

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One of the underwriter’s analysts has said he was told by a Facebook financial executive to cut his estimates.

According to another source with insight into the Facebook IPO process, until the underwriters’ analysts cut their estimates, demand for Facebook’s stock among sophisticated institutional investors was high. Once these investors heard about the estimate cut, however, they became more cautious about the IPO.

(Again, an estimate change like this during a roadshow is, at best, highly unusual, and it would be hard to interpret it as anything but negative. One institutional investor I spoke to said he has looked at more than 1,200 IPOs over the course of his career, and he has never heard of this before.)

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Meanwhile, during private roadshow meetings, Facebook executives were reportedly “signalling” to some sophisticated investors that Facebook’s advertising revenue would not grow as rapidly as some potential investors had hoped. Facebook’s advertising business is driven primarily by company-to-company sales efforts, not by the self-serve ads that drive

Google's business. Facebook executives reportedly made clear to sophisticated investors that this would limit the rate at which Facebook's ad business could grow.

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Individual investors, needless to say, were not likely aware that the research analysts at the company's lead underwriters had cut their estimates for the company. They were also, presumably, unaware that Facebook's Q2 was weaker than expected.

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According to one source (unconfirmed), based on the book of orders submitted by both institutional and retail investors, Morgan Stanley found that there were two distinct price levels at which investors were interested in buying stock.

Institutional investors, having digested the news of the underwriter estimate cut, were comfortable buying Facebook stock at $32 a share.

Retail investors, meanwhile, who were presumably unaware of the estimate cut, were comfortable buying Facebook at $40 a share.

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The SEC and FINRA have already said they may look into the Facebook IPO process. The Massachusetts Attorney General has also just announced that has subpoenaed Morgan Stanley over the issue.

And Reuters notes that investors have already filed a lawsuit claiming securities violations:

A different civil lawsuit was filed against Facebook, Mark Zuckerberg, IPO underwriters Morgan Stanley & Co and others alleging violations of securities laws.