THE TWILIGHT OF EQUITY LIQUIDITY

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This Article argues that U.S. equity markets fail to offer a satisfactory listing venue for emerging firms. I contend that this lacuna is a manifestation of a flawed structure of equity-market regulation and that this void undermines entrepreneurship, jeopardizes the future of U.S. equity markets, and weakens the broader U.S. economy. To close this gap and respond to these concerns, I recommend a new theoretical structure for regulating equity markets. Under the "lifecycle model" I propose, regulations would adapt to firms as they age. The key change would be to establish a market specifically for newly-public young firms, where they would be subject to a regulatory regime that is strict enough to protect investors yet flexible enough to accommodate innovation and growth. As firms age, they would be moved to different markets, each set up to meet the unique regulatory challenges firms pose as they mature. This template is designed to offer entrepreneurial firms an attractive platform on which to list their shares while placing equity-market regulation on sound theoretical footing. In a brief Epilogue, I assess the implications of the recently-enacted JOBS Act on this argument and conclude that passage of the statute does not diminish the case for the lifecycle model.

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INTRODUCTION

Entrepreneurship and equity markets are mutually dependent. Equity markets depend on the arrival of vital young companies to replace older ones in decline. Entrepreneurs frequently compensate early-stage employees and investors with equity, the value of which is dependent upon the existence of a liquid secondary market upon which the equity can ultimately be resold.[1] In the United States, a healthy relationship between the two sides has long underpinned the success of

[1] Equity is typically granted to venture-capital investors in the form of convertible preferred stock. *See* Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 144 n.30 (2003).

each. More recently, however, this relationship has come under great strain.

In this Article, I argue that, thanks largely to a flawed regulatory structure, U.S. equity markets currently fail to offer many young companies a suitable venue on which to list their shares for secondary-market trading. The New York Stock Exchange (NYSE) and NASDAQ used to provide attractive platforms, but their appeal has faded and current regulations stymie the formation of reasonable alternatives. This lacuna undermines both entrepreneurship and U.S. equity markets—two central components of our economic infrastructure. Damage to these areas manifests itself in economic malaise: a less robust entrepreneurial ecosystem and weaker equity markets translate to enfeebled job growth, innovation, and wealth creation.

To rehabilitate the relationship between young firms and equity markets, I contend that securities regulators should adopt a lifecycle theory of secondary-market regulation. Under this approach, the regulatory structure would be keyed to the shifting regulatory challenges firms present as they grow older. There would be different markets and accompanying regulations for young firms, mature firms, and firms in decline. This template would provide an attractive listing venue for entrepreneurial companies without overly compromising investor protection. It would also provide a cohesive structure for regulating all aspects of the secondary market—something today's regulatory apparatus is sorely lacking.

Traditionally, firms went public on the NYSE or NASDAQ as a way to, among other things, provide their employees and investors with liquidity.[2] Such venues seemed ideal. They offered a highly liquid market on which early-stage shareholders could sell, and, thanks to comprehensive regulations, offered buyers a high level of investor protection. But their allure has waned. In the face of more costly regulations and other perceived downsides of a public listing, many entrepreneurs have turned their backs on these markets. Far fewer companies have gone public since 2000, than did so in the 1980s or 1990s.[3] This decline in initial public offerings (IPOs) would not be overly concerning if there were suitable alternatives to a public listing. If another venue was providing, or at least capable of providing, early-stage shareholders with a comparable opportunity to resell, then diminishing IPOs would signal a changing relationship between entrepreneurs and equity markets rather than portend the relationship's demise.

But there is no other suitable liquidity option. The securities laws do a thorough job of laying out what it takes to go public and what is

2 *See infra* Part I.A.
3 *See infra* Part I.C.

required of firms that do so, but regulation of the secondary market for securities in firms that eschew this path is underdeveloped and problematic. Shareholders in firms that stay private can sell pursuant to several exemptions from the securities laws. These exemptions, however, leave sellers with little liquidity, contain investor-protection loopholes, and are internally inconsistent.[4] Recently, markets like SecondMarket and the Portal Alliance have set up platforms for the exchange of private shares. But these markets are stymied by the exemptive structure pursuant to which they exist.[5]

Firms wishing to eschew the traditional IPO are not confined to these private markets, however. There are ways for firms to access the public markets without going through the customary IPO process and without complying with the rigid regulatory requirements associated with it. For instance, reverse mergers (i.e., transactions in which a private firm becomes a public one by merging with a public entity bereft of its own operations) provide a backdoor into the public markets.[6] Regulation A securities offerings similarly give firms more streamlined access to the public.[7]

But such mechanisms suffer from an assortment of shortcomings. One key drawback is that there is a seldom-recognized distinction between merely being public and being a public firm that trades on one of the premier exchanges (the NYSE or NASDAQ).[8] The latter does not necessarily follow from the former—particularly when a firm enters the public markets through a nontraditional path. In this case, a company may have difficulty qualifying for these elite trading platforms, which often means its shares will be relegated to trading on the over-the-counter (OTC) markets. These trading venues, though, have historically been of low quality. Recent industry innovations have likely improved matters, but such platforms remain a poor substitute for the established venues. Most troubling from the firm's perspective is that they offer little liquidity; from a broader perspective, many of these platforms are problematic because they offer little investor protection.[9]

A comprehensive analysis of the options available to young firms reveals that none of the alternatives to going public are satisfactory. What also becomes apparent is that there is no unifying theoretical

4 *See infra* Part II.A.1–3.

5 *See infra* Part II.A.

6 *See infra* Part II.B.1.c.

7 *See infra* Part II.B.1.b.

8 Unlike a traditional exchange, NASDAQ has no trading floor; rather its trades are conducted electronically. Graham Bowley, *Preserving a Market Symbol*, N.Y. TIMES, Apr. 26, 2011, at B1. Despite this distinction, NASDAQ is registered as a "national securities exchange" with the SEC and it is commonly referred to as an exchange. *See generally* The Nasdaq Stock Market, LLC, Exchange Act Release No. 34-53128, 71 Fed. Reg. 3550 (Sec. & Exch. Comm'n Jan. 23, 2006) (findings, opinion, and order).

9 *See infra* Part II.B.2.a.

structure for the regulation of the secondary market in securities. While the rules comprehensively regulate companies trading on the premier exchanges, outside of that arena, the regulations consist of a series of disconnected exemptions and rules that make little sense individually or together.[10] The result is that as the traditional stock market has become an increasingly unattractive listing venue, no satisfactory alternative has arisen to fill the void.

Addressing the needs of entrepreneurs therefore demands a broader rethink of the structure of secondary-market regulation. The lifecycle model I propose is based on the idea that the social costs and benefits of regulation change as firms age, and that a regulatory framework that is responsive to this evolving social calculus maximizes social welfare. Under this approach, the goal, therefore, is to fit regulations to firms as they mature.

The most important change would be the addition of a market specifically dedicated to newly-public emerging firms.[11] This market would be more lightly regulated than the premier exchanges, but maintain significant investor-protection safeguards.[12] After a certain period of time on this platform, firms would be forced to join exchanges suited for mature firms. I suggest one for the largest companies, another for firms mid-sized and smaller.[13] Finally, if firms are declining and can no longer meet listing standards for these exchanges, they would be removed. At this point, their shares would trade on a platform specifically designed for delisted firms.[14] Regulation of this market would be narrowly tailored to provide a layer of investor protection without overburdening these troubled companies. This lifecycle framework promises to provide entrepreneurs with a suitable liquidity option, while at the same time protecting investors, and establishing a foundation for the long-term viability of U.S. equity markets.

In Part I of this Article, I discuss the traditional nature of the relationship between the public equity markets and young firms, how it is breaking down, and how this threatens the future of entrepreneurship, the equity markets, and the broader U.S. economy. Part II then analyzes the alternatives to the traditional public offering to see if they offer viable substitutes to young firms and, as a result, reshape yet salvage the relationship between entrepreneurs and equity markets. I conclude that they do not. In light of this conclusion, in Part III, I offer a

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10 Professor Campbell has also criticized this area of the law. *See generally* Rutheford B. Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*, 52 WASH. & LEE L. REV. 1333 (1995); Rutheford B. Campbell, Jr., *Resales of Securities: The New Rules and the New Approach of the SEC*, 37 SEC. REG. L.J. 1 (2009).

11 *See infra* Part III.A.

12 *See infra* Part III.A.

13 *See infra* Part III.B.

14 *See infra* Part III.C.

proposal for reform. I present a new theory for how to structure the regulation of the secondary market for securities, as well as an alternative regulatory structure that aligns with it. Finally, while this Article was in press, Congress passed the Jumpstart Our Business Startups Act (JOBS Act).[15] Certain aspects of the statute are addressed in the body of the Article.[16] In addition, I have added a brief Epilogue that assesses one of the Act's key features—the so-called IPO On-Ramp. This component of the law was motivated by the concerns regarding the falling number of IPOs noted herein and has features that overlap with my proposal. I argue, however, that the On-Ramp is unlikely to provide much help and that the case for the lifecycle model remains compelling.

I. THE RELATIONSHIP BETWEEN ENTREPRENEURSHIP AND THE PUBLIC EQUITY MARKETS

The U.S. equity markets encompass more than the public markets. But the latter, particularly the NYSE and NASDAQ, have traditionally been by far the most important. These are the markets that have fostered entrepreneurship and these are the markets that have remained vibrant because of a constant influx of young firms. Now, though, the symbiotic relationship between entrepreneurs and these venues is deteriorating. While not dispositive of the state of the relationship between entrepreneurial firms and equity markets as a whole, it is certainly a bad sign.

A. *Liquidity, Public Equity Markets, and Entrepreneurial Finance*

The public equity markets have traditionally been important to entrepreneurs as a source of secondary-market liquidity. Secondary-market liquidity is something entrepreneurs care about because of the unique nature of equity. Most of the things we purchase are consumption goods; we use them, rather than resell them. Equity, however, is an investment asset that's value is wound up with both how easily we can sell it to someone else and how much we can get for it. Its value, in other words, depends on secondary-market liquidity. In a liquid secondary market, assets can be easily sold at a price approximating fair value.[17] Such markets usually have certain

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15 Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

16 *See infra* note 160 and accompanying text; *see also* notes 226 and 328.

17 *See* Jonathan R. Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1012 (1990).

characteristics: they tend to have a plethora of buyers and sellers,[18] low transaction costs,[19] and high transparency.[20] In addition, on a liquid market, shares sell rapidly[21] and there is a high volume of transactions.[22] All else being equal, shares that can be sold on such a platform are worth much more.[23]

Everyone wants their shares to be more valuable, but equity value is of central import to entrepreneurs because equity is the key resource at their disposal. More valuable equity means that firms can (i) demand more work from their employees for less equity and cash compensation, and (ii) sell shares to investors at a higher price (demanding a so-called liquidity premium).[24] The ability to collect more services and cash for its equity benefits entrepreneurs in a number of ways. Higher equity valuations mean that firms can collect more money to grow their businesses and that, on the margin, more young firms will get funding.[25] Moreover, because firms can save on employee compensation, the cash they collect goes further, translating into more hiring, faster growth, and a greater ability to compete with existing firms. Finally, more valuable equity makes entrepreneurial endeavors more profitable for their founders and, therefore, more appealing to pursue. Founders make more money when they sell more valuable shares and, the higher the value of their equity, the less they need to part with to lure investors and employees. Without liquid secondary markets to boost the value of their stock, entrepreneurs would still exist, but there would be fewer of them, their businesses would grow more slowly, and they would find it more difficult to challenge established companies.

As noted above, the traditional source of secondary-market liquidity in the United States has been the public markets. The traditional way that firms provided access to the public markets was

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18 *See* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 321 (2000).

19 *See id.*

20 *See* Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACCT. & ECON. 233, 236 (2005) (discussing the results of an empirical study showing that increased disclosure significantly increased equity-market liquidity); Andrew Ang et al., Asset Pricing in the Dark: The Cross Section of OTC Stocks 2 (July 2011) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1817542 (citing theoretical and empirical work linking transparency and liquidity).

21 *See* Choi, *supra* note 18, at 321.

22 *See id.* at 324.

23 *See id.* at 321; Yakov Amihud & Haim Mendelson, *A New Approach to the Regulation of Trading Across Securities Markets*, 71 N.Y.U. L. REV. 1411, 1428–31 (1996); William P. Dukes, *Business Valuation Basics for Attorneys*, 1 J. BUS. VALUATION & ECON. LOSS ANALYSIS 1, 16 tbl.1 (2006) (compiling studies showing illiquidity discount for private shares (discussed *infra* Part II.A) of between 25.8% and 45%).

24 *See generally supra* note 1.

25 *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 23–24 (2012).

through an IPO.[26] After an IPO, employees and early-stage investors may resell their shares on the public market.[27] Even though, even in the best of times, not all start-ups went public, the prospect of lottery-like riches accompanying resale on the public markets has long underpinned an entrepreneurial ecosystem heavily dependent on equity compensation of employees, angel investors, and venture capitalists.[28] At the same time, IPOs have served as an opportunity for young firms to raise yet more capital.[29] The transaction's value in this regard is again linked to liquidity: firms can sell IPO shares to these new investors for more money because they can be freely resold on the public market.[30]

This equity-based structure of entrepreneurial finance long-served the interests of emerging firms. A breakdown would be worrisome, not just because it would harm these firms, but because, as discussed below, a setback for these firms would have deleterious consequences for the broader economy.

B. *The Importance of New Ventures to Equity Markets and the Economy*

The general notion that young companies are important is likely uncontroversial. In this Section, however, I flesh out this intuition, because doing so provides context for why the preservation of a healthy system of entrepreneurial finance is a key public policy concern. I focus in particular on the unique contribution such firms make to innovation, economic and job growth, and, as already noted, the future of the U.S. equity markets on which entrepreneurship itself currently depends.

One of the most attractive concepts in economics is Joseph

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26 In the 1980s, 90% of venture capital–backed firms went public. Aaron Lucchetti, *U.S. Falls Behind in Stock Listings*, WALL ST. J., May 26, 2011, at A1.

27 *See* William K. Sjostrom, Jr., *The Birth of Rule 144a Equity Offerings*, 56 UCLA L. REV. 409, 433 (2008). Exactly when certain shareholders are permitted to resell depends on whether and to what extent their shares are subject to a lockup agreement. *See id.* at 433 n.169. Often shareholders must also comply with a statutory waiting period. *See* P. GARTH GARTRELL, EXECUTIVE COMPENSATION FOR EMERGING GROWTH COMPANIES §§ 3:27–3:37 (2011). Cash-out during the IPO itself is possible, but rather uncommon. *See* Rajesh K. Aggarwal et al., *Strategic IPO Underpricing, Information Momentum, and Lockup Expiration Selling*, 66 J. FIN. ECON. 105, 106 (2002).

28 *See* Ibrahim, *supra* note 25, at 9.

29 *See* Sjostrom, *supra* note 27, at 432.

30 Equity financing itself is important because of the advantages it offers over debt. Unlike debt-holders, equity-holders do not demand periodic payments and cannot force a firm into bankruptcy. Such flexibility is important for a new firm. *See* J. CHRIS LEACH & RONALD W. MELICHER, ENTREPRENEURIAL FINANCE 449 (4th ed. 2012). Also, young firms often cannot obtain traditional debt financing and, even if they can, they are likely to be charged a high interest rate. *See id.* at 436–38. This is because they lack the collateral and operating history important to bank lenders. *See id.* at 433–36.

Schumpeter's notion of creative destruction.[31] The essential idea is that innovative products and ways of doing business evolve and displace existing practices.[32] Automobiles replaced the horse and buggy just as the personal computer has supplanted the typewriter. According to Schumpeter, it is this process of creative destruction that is at the heart of capitalism and drives the improvement of living standards over time.[33]

While innovations can come from anywhere, many have pointed to entrepreneurs as key drivers.[34] This theory that new ideas frequently come from outside the establishment has intuitive appeal and empirical support. The tendency for large firms to have slow growth provides indirect evidence that such firms have trouble innovating.[35] More directly, scholars and commentators have compiled an impressive list of examples of the outsider-innovator phenomenon.[36] Their impact seems to be the greatest in the world of technology: the personal computer was pioneered in Steve Jobs's garage;[37] Google in Susan Wojcicki's;[38] and Facebook in Mark Zuckerberg's dorm room.[39]

Entrepreneurs also contribute a great deal to economic growth. According to studies, differing levels of entrepreneurship explain between one-third and one-half of the difference in economic growth between countries.[40] The same holds true when comparing states and cities.[41] On a tangible level, economic growth is important because it translates into improved standards of living and a government that can more easily pay its debts.[42]

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31 *See* JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 83 (1942).

32 *See* W. Michael Cox & Richard Alm, *Creative Destruction*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS 104 (David R. Henderson ed., 2d ed. 2007), *available at* http://www.econlib.org/library/Enc/CreativeDestruction.html.

33 *See id.*

34 *See, e.g.*, *id.*

35 *See* Arthur M. Diamond Jr., *Schumpeter's Creative Destruction: A Review of the Evidence*, J. PRIVATE ENTER., Fall 2006, at 135–36 figs.1 & 2 (2006).

36 *See id.* at 137–38. *But see generally* Ashish Sood & Gerard J. Tellis, *Technological Evolution and Rapid Innovation*, 69 J. MARKETING 152 (2005) (noting that the conventional wisdom is that so-called "platform innovations" (for example, the change from cassettes to compact disks) come from new entrants, but challenging this wisdom based on a study showing that more recently platform innovations have come from incumbent firms).

37 Jared Bernstein, Editorial, *Small Isn't Always Beautiful*, N.Y. TIMES, Oct. 24, 2011, at A23.

38 *Our History in Depth*, GOOGLE, http://www.google.com/about/corporate/company/history.html (last visited Jan. 16, 2011).

39 *Management*, FACEBOOK, http://newsroom.fb.com/content/default.aspx?NewsAreaId=1 (last visited Jan. 29, 2011).

40 Russell S. Sobel, *Entrepreneurship*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS, *supra* note 32, at 154, *available at* http://www.econlib.org/library/Enc/Entrepreneurship.html.

41 *Id.*

42 *See* John V. C. Nye, *Standards of Living and Modern Economic Growth*, *in* THE CONCISE ENCYCLOPEDIA OF ECONOMICS, *supra* note 32, at 475, *available at* http://www.econlib.org/library/Enc/StandardsofLivingandModernEconomicGrowth.html; Catherine Rampell, *Sure Cure for the Debt Problem: Economic Growth*, N.Y. TIMES, July 31, 2011, at BU1.

Hiring is another area where young firms are essential. Politicians often lump small businesses and young ones together as job-creators.[43] But this is an oversimplification. New research demonstrates that it is not small firms that hire people, it is young ones.[44] While a high-level survey of the data may make it appear that small firms contribute to job growth, this is only because young firms are also frequently small.[45] When the data is more carefully parsed, it turns out that, in reality, it is young companies that are doing the hiring.[46] And their role in this regard is crucial. Between 1980 and 2005, hiring by emerging companies accounted for nearly all of the country's net job growth.[47]

Exploring the data further shows that the contribution young firms make to job growth is not spread evenly through their initial years. Rather, a substantial portion of job creation by emerging companies occurs after they go public.[48] One likely explanation is that hiring by some early-stage start-ups is offset by firing at others. Many brand new ventures fail, which dampens the aggregate job creation attributable to this group. Later-stage start-ups, though, succeed at a much greater rate. The large amount of hiring at these firms, therefore, is not offset by firing among firms of a similar age.[49] Also, these firms have typically raised a large sum through the IPO itself, and therefore have the funds to go on a hiring spree.[50]

The finding that newly-public firms are particularly significant carries an important regulatory insight: that we need to carefully scrutinize the costs of regulations imposed on these companies. In this context, dollars directed toward regulatory compliance come with a particularly high opportunity cost. While other firms might spend money saved on compliance on dividends and management perquisites,

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43 *See* Bernstein, *supra* note 37.

44 *Id.*; John Haltiwanger et al., *Who Creates Jobs? Small vs. Large vs. Young* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 16300, 2010), *available at* http://siteresources.worldbank.org/EXTABCDE/Resources/74556761292528456380/7626791-1303141641402/7878676-1306270833789/Parallel-Session-9-John_Haltiwanger.pdf.

45 Haltiwanger et al., *supra* note 44, at 3.

46 *Id.*

47 *See* KAUFFMAN FOUNDATION, WHERE WILL THE JOBS COME FROM? 2 (2009), *available at* http://www.kauffman.org/uploadedfiles/where_will_the_jobs_come_from.pdf; *see also* Mathew Craft, *IPO Market—Usually a Catalyst for Growth—Has Stalled*, TIME MONEYLAND, Oct. 24, 2011, http://moneyland.time.com/2011/10/24/ipo-market-usually-a-catalyst-for-job-growth-has-stalled/ (reviewing anecdotal and empirical evidence of post-IPO hiring).

48 A study by IHS Global Insight estimated that 92% of job growth occurs post-IPO. While this figure is likely on the high end, a recent Kauffman Foundation study confirmed that significant job creation occurs after an initial public offering. *See* John Tozzi, *IPOs' Job-Boosting Power Is Overblown*, BLOOMBERG BUSINESSWEEK (May 21, 2012), http://www.businessweek.com/articles/2012-05-21/ipos-boon-for-jobs-is-overblown.

49 *See* Haltiwanger et al., *supra* note 44, at 2.

50 The median IPO in 2010 raised $100 million. WILMERHALE, 2011 IPO REPORT 4 fig. "Median IPO Offering Size—1996 to 2010" (2011), *available at* http://www.wilmerhale.com/files/upload/2011_IPO_Report.pdf.

these firms are likely to put it towards new hires.

Finally, young firms are key to the long-term viability of U.S. equity markets. Schumpeter's creative destruction applies to firms just as it does to products. As new firms innovate and grow, they displace established ones that have lost their competitive edge. For example, only 5 of the 100 largest firms in 1917 remain on the list today.[51] Only one-half of those listed in 1970 remained thirty years later.[52] This cycle of firms impacts equity markets. In the short term, if new firms are not added, an equity market loses its vitality. Since established firms tend to have lower growth, if yesterday's companies are the only ones on a market, it stagnates. The story worsens in the long term. Over time, without new firms joining its ranks, a once robust equity market will eventually fade away. Worse yet, if U.S. equity markets as a whole become unattractive, they will collectively languish and decay.

While intuition tells us that such a decline would negatively affect the U.S. economy, it is worth briefly discussing why this would be the case. First consider the impact on entrepreneurs. As discussed above, U.S. equity markets, in particular the public markets, traditionally underpinned entrepreneurial finance by providing early-stage employees and investors with the potential for liquidity.[53] If these domestic markets were no longer a viable alternative, young firms would be forced to look for other liquidity options. While alternatives do exist, they are all inferior.

One avenue would be to pursue a trade-sale. This is where an emerging firm is bought by an incumbent.[54] Trade-sales are suboptimal for several reasons. First, the prospect of a trade-sale is worth less to employees and investors than the prospect of true secondary-market liquidity. One reason is that trade-sales do not necessarily offer everyone the ability to liquidate their equity in the firm. It all depends on the structure of the acquisition. For instance, it is possible that venture capitalists cash out, but leave employees with stock in the acquirer, which may or may not be public.[55] Moreover, such transactions are suboptimal even for those who do cash out: on average, they provide existing shareholders with lower returns than public offerings.[56] The uncertainty and smaller payouts associated with trade-sales mean that, if

51 Cox & Alm, *supra* note 32.

52 *Id.*

53 *See supra* Part I.A.

54 *See* Ibrahim, *supra* note 25, at 2.

55 For a thorough discussion of trade-sales, see JOHN HAWKEY, EXIT STRATEGY PLANNING: GROOMING YOUR BUSINESS FOR SALE OR SUCCESSION 171–82 (2002).

56 *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 356 (2005) ("[S]ubstantial evidence suggests that the greatest financial returns are to be found in exiting into the public capital markets."); Carsten Bienz & Tore Leite, A Pecking-Order of Venture Capital Exits 2 (Apr. 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=916742.

they were the only realistic option, entrepreneurial firms would have to issue shares to employees and investors at a sizeable discount to what they could have demanded had there been a legitimate resale market.

In addition, a trade-sale undermines job-creation. If an entrepreneurial firm is simply merged into another, job growth is stymied. In fact, in the short term, jobs are likely lost as redundant employees are eliminated. IPOs create jobs; trade-sales kill them.

A second alternative is to list abroad. While this seems like a ready substitute, it comes with substantial drawbacks for the firm. The key issue is that going overseas involves significant transaction costs.[57] Doing so involves hiring counsel with special expertise and bending a business built against the backdrop of domestic corporate law to fit another country's regulatory scheme. Many firms, particularly smaller ones, would be unable to afford this. While over time these transaction costs would surely ease, going abroad would always cause these headaches. A suitable domestic exchange is an inherently better alternative.[58]

Declining U.S. equity markets would also hurt average investors. Many individuals depend on the performance of the stock market to fund retirement.[59] If new firms are not joining the market, then they would hold stock only in established ones, which, as discussed above, lack the growth prospects of newer entrants.[60] The result would be lower returns over time. What if, instead of listing at home, firms list abroad? In this case, investors would have to chase them overseas. But this is not so easy. It is currently difficult for individual investors to find brokers willing to execute small-scale transactions on foreign stock exchanges.[61]

Investors could garner some indirect exposure to such firms through international equity mutual funds. But many investors lack the disposition to do so. There is a well-documented home-country bias when it comes to investing.[62] A shift away from domestic equity markets would mean that investors would have to overcome this bias in order to earn the same returns that would be available to them on a healthy home equity market. Altering investor behavior, though, is always difficult.[63]

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57 *See* Stephen J. Choi & Kon Sik Kim, *Establishing A New Stock Market for Shareholder Value Oriented Firms in Korea*, 3 CHI. J. INT'L L. 277, 290 (2002).

58 *Cf.* Steven M. Davidoff, *Regulating Listings in A Global Market*, 86 N.C. L. REV. 89, 119–22 (2007) (discussing the rarity of listing abroad and the obstacles to it).

59 Much of this savings take place in 401(k) plans. *See* Jeff Schwartz, *Rethinking 401(k)s*, 49 HARV. J. ON LEGIS. 53, 53 (2012).

60 *See supra* note 35 and accompanying text.

61 Davidoff, *supra* note 58, at 136–37.

62 Nicholas Barberis & Richard H. Thaler, *A Survey of Behavioral Finance*, *in* 2 ADVANCES IN BEHAVIORAL FINANCE 1, 51 (Richard H. Thaler ed., 2005).

63 *Cf.* Jeff Schwartz, *Fairness, Utility, and Market Risk*, 89 OR. L. REV. 175, 244–46 (2010) (discussing limitations on investor education and de-biasing efforts).

Finally, forcing U.S. investors to look abroad for U.S. companies undermines investor protection. Rather than being subject to a regulatory regime thoughtfully designed to protect their interests, U.S. investors would have to take their chances with the legal regimes of foreign nations. While many offer reasonable safeguards against fraud and management abuse, investor-protection standards are certainly not universal.[64] Moreover, differentiating among legal standards is a task that average investors are ill-equipped to handle. This may lead some investors to eschew participation in foreign markets. Others may jump in without complete understanding. Most that diversify abroad will come out unfazed, but some will be swindled. For a number of reasons, therefore, it would be better if U.S. investors had a suitable domestic market in which to house their savings.

The previous Sections described the crucial role that public equity markets have played in supporting entrepreneurial finance and the crucial role that entrepreneurship plays in supporting the U.S. equity markets and the broader U.S. economy. Putting these two pieces together suggests that a breakdown in the relationship between public equity markets and entrepreneurship would greatly damage U.S. economic well-being. The next Section describes the great stress that this relationship is currently under.

C. *The IPO Desert*

Since the IPO is the traditional mechanism for giving early-stage employees and investors their coveted liquidity, one can gauge the health of the traditional relationship between the equity markets and entrepreneurial firms by looking at the frequency of these transactions. Diminishing numbers would be a sign of a trouble.

In fact, the decline in IPOs in recent times has been startling. An array of statistics bears this out. The number of IPOs during the 2000s was down 67% from the numbers in the 1980s and 1990s.[65] Moreover, this figure, alarming as it is, actually understates the drop-off: given that the economy has grown during that period, one would expect to see IPOs increasing in line with it. Relative to a baseline expectation of IPO growth, the picture is even gloomier.[66]

Digging deeper into the numbers reveals related trends as well. Public offerings by companies backed by venture capitalists have

[64] *See* Davidoff, *supra* note 58, at 96 (asserting that most developed countries have similar investor protections).

[65] *See* Xiaohui Gao et al., Where Have All the IPOs Gone? 7 (Apr. 12, 2012) (unpublished manuscript), *available at* http://bear.warrington.ufl.edu/ritter/Where%20Have_April_3_2012.pdf.

[66] *See id.*

declined in a manner consistent with the broader IPO market.[67] Venture-backed offerings even reached single digits in 2008.[68] In addition, in the 1980s, 90% of venture-backed firms went public; that number has now shrunk to 15%.[69] Where the decline has been most acute, however, is with respect to smaller IPOs. IPOs of under $50 million are down 82%.[70] In a reflection of their vertiginous collapse, during most of the 1990s, approximately 80% of IPOs were for under $50 million; after 2000, the number shrunk to 20%.[71] The downward trend has profoundly impacted public equity markets. Because delisted firms are not being replaced, there are 43% fewer companies now listed on NASDAQ and the NYSE than there were in 1997.[72]

What explains these statistics? Causation is notoriously difficult to establish and no convincing empirical research has emerged to pin the blame on one or two dominant factors. At this point, therefore, one can only theorize as to why going public has become less attractive. When approached from this angle, several likely candidates emerge.

Market conditions are likely a part of the explanation. The late 1990s saw a surge in IPO activity accompanying the Internet bubble. In stark contrast, the early part of the past decade was marked by a mild recession and the later part was swallowed by the largest since the Great Depression. Volatile and declining markets often accompany recessions—not ideal conditions for IPOs. But the shift from exuberant to unfavorable market conditions cannot be the entire story. First, the decline in IPOs of late stands in contrast to two decades of robust IPO activity; it is not a statistical anomaly resulting from a short-term spike. Second, the broader economic climate and its effect on the markets may partially explain dry spells during recessionary periods, but the decline continued through periods of economic prosperity and rising stock prices.[73] Finally, while recessions have been global, dropping IPOs have

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67 *See* WILMERHALE, *supra* note 50, at 4 fig. "Venture Capital–Backed IPOs—1996 to 2010."

68 *See* Ibrahim, *supra* note 25, at 12. The number of venture-backed IPOs has climbed since, but the overall trend is still downward. *See* WILMERHALE, *supra* note 50, at 4 fig. "Venture-Capital Backed IPOs—1996 to 2010."

69 Lucchetti, *supra* note 26.

70 Gao et al., *supra* note 65, at 7; *see also* DAVID WEILD & EDWARD KIM, MARKET STRUCTURE IS CAUSING THE IPO CRISIS—AND MORE 5 exhibit 1 (2010), *available at* http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf (showing the decline in IPOs of under $50 million).

71 *See* WEILD & KIM, *supra* note 70, at 10 exhibit 6. Adjusting for inflation does not significantly alter these figures. *See id.*

72 Felix Salmon, *Wall Street's Dead End*, N.Y. TIMES, Feb. 14, 2011, at A27; *cf.* Gerald F. Davis, *The Twilight of the Berle and Means Corporation*, 34 SEATTLE U. L. REV. 1121, 1135 fig.1 (2011) (charting the listings decline). The steep decline is also related to a spate of delistings. *See infra* note 91 and accompanying text.

73 *See* Gao et al., *supra* note 65, at 7.

not been.[74] The U.S. is not the only country to experience recent IPO softness, but the stark descent in the U.S. is among the steepest, which suggests that there is something less appealing about the U.S. markets themselves.[75]

Along these lines, the increasing cost of securities regulation as it pertains to public companies likely shoulders a portion of the blame. Public companies have always been subject to a high level of regulation. The long-standing regulatory template calls upon firms to file a registration statement with the SEC when they go public, which is vetted by the SEC,[76] and contains a copious amount of information.[77] Once public, firms are required to comply with the ongoing disclosure obligations of the Securities Exchange Act of 1934 (Exchange Act).[78] Among other things, this means filing quarterly and annual reports, and updating the market about material events.[79]

Compliance with this regime has never been cheap, but recent regulatory reforms have added to the expense.[80] According to a recent survey, compliance currently costs firms on average $2.5 million when they initially go public and about $1.5 million each year thereafter.[81] A primary source of added expense is the Sarbanes-Oxley Act of 2002,[82] which has frequently been signaled out as a cause of IPO softness.[83] In its immediate aftermath, the statute nearly doubled the cost of being public for smaller firms.[84] Section 404 of the Act, which requires that companies have external auditors and top company management attest to the presence of a robust system of internal controls, has been

74 *See* ERNST & YOUNG, GLOBAL IPO TRENDS 2011, at 3 fig.3 (2011), *available at* http://www.ey.com/Publication/vwLUAssets/Global-IPO-trends_2011/$FILE/Global%20IPO%20trends%202011.pdf (showing mostly flat global activity); Silvio Vismara et al., Europe's Second Markets for Small Companies 45 fig.1 (Jan. 4, 2012) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1957140 (showing more consistent activity in Europe from 1995 to 2009); *cf.* Davidoff, *supra* note 58, at 105, 108–09 (discussing growing markets in Europe and Asia); Lucchetti, *supra* note 26, at A1 (charting growth in international listings against decline in the U.S.).

75 *See* Cecilia Caglio et al., Going Public Abroad 23 & 44 tbl.10 (Dec. 8, 2011) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572949 (finding recent decreases in IPO activity in the U.S., France, and Germany, but increased activity in the United Kingdom, Australia, and Canada).

76 *See* SEC ACCOUNTING AND REPORTING MANUAL § 3.27 (2011).

77 *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 149–208 (2004) (describing the contents of registration statements).

78 15 U.S.C. §§ 78a–78pp (2006); *See* LOSS & SELIGMAN, *supra* note 77, at 509–17.

79 *See* LOSS & SELIGMAN, *supra* note 77, at 509–17.

80 *See* IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 21 & n.1 (2011), *available at* http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

81 *See id.* at 9.

82 Pub. L. No. 107-204, 116 Stat. 745 (2002).

83 *See* Gao et al., *supra* note 65, at 2.

84 *See* Lucchetti, *supra* note 26. Costs, however, have declined as firms have grown accustomed to their statutory obligations. *Id.*

particularly burdensome.[85] According to a 2005 study, the cost of initial compliance with the rule ranged from $1.5 million, for smaller firms, up to $7.3 million, for larger ones.[86] Though costs decrease after the first year, they remain substantial over time.[87] Moreover, while an increased regulatory burden falls on all firms, the costs tend to be felt most acutely by emerging ones. These firms tend to be smaller, making the costs loom proportionally larger, and they have not been around long enough to routinize the process.[88]

Representatives of smaller companies have complained repeatedly to Congress and the SEC about escalating costs[89] and surveys indicate that compliance obligations are among the biggest concerns entrepreneurial firms have with going public.[90] While it seems that companies gripe about the costs of compliance no matter the regulatory regime, in this case the concerns appear credible. Not only are they usually related to Sarbanes-Oxley—a legitimately costly regulatory change—but they are consistent with related developments. While young firms are choosing not to enter the public markets, there has also been an uptick of delisting from the major exchanges.[91] Moreover, some firms have taken the once-blasphemous step of registering their shares on more lightly regulated markets outside the country, in particular, the United Kingdom's Alternative Investment Market.[92] Finally, the U.S. markets used to be a destination for foreign firms looking to list abroad,

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85 *See* COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 115–31 (2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf; Cyrus Afshar & Paul Rose, *Capital Markets Competitiveness: A Survey of Recent Reports*, 2 ENTREPRENEURIAL BUS. L.J. 439, 449 (2007); Stephen M. Bainbridge, *Corporate Governance and U.S. Capital Market Competitiveness* 19–31 (UCLA School of Law, Law-Econ Research Paper No. 10-13, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1696303.

86 CRA INT'L, SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES: SURVEY UPDATE 5–7 (2005).

87 SEC ADVISORY COMM. ON SMALLER PUBLIC COS., FINAL REPORT 25 n.62 (2006) [hereinafter ADVISORY COMM. REPORT], *available at* http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf; Joseph A. Grundfest & Steven E. Bochner, *Fixing 404*, 105 MICH. L. REV. 1643, 1646 (2007). The SEC and Congress have also adopted measures aimed at reducing the compliance burden. *See* Bainbridge, *supra* note 85, at 25–31.

88 *See* ADVISORY COMM. REPORT, *supra* note 87, at 33–34 (discussing disproportionate costs of external auditors and Sarbanes-Oxley section 404 compliance); Afshar & Rose, *supra* note 85, at 450–51; Bainbridge, *supra* note 85, at 24 (citing statistics showing the disproportional impact of Sarbanes-Oxley on smaller firms).

89 *See, e.g.*, ADVISORY COMM. REPORT, *supra* note 87, at 24–25.

90 *See* IPO TASK FORCE, *supra* note 80, at 38; Gao et al., *supra* note 65, at 2 n.3.

91 *See* Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 136 (2009); Michael K. Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers with Quoted Securities*, 39 IND. L. REV. 309, 310 (2006).

92 *See* Lucchetti, *supra* note 26; Graham Bowley, *Fleeing to Foreign Shores*, N.Y. TIMES, June 8, 2011, at B1; Press Release, Comm. on Capital Mkts. Regulation, Latest CCMR Study Shows Improvement in U.S. Share of Global IPO Market, at 1 (Aug. 18, 2011), *available at* http://www.capmktsreg.org/pdfs/2011.08.18_Q2_press_release.pdf.

but that is no longer as much the case.[93] The common feature in all of these is that costs are repeatedly singled out as a key explanation.[94] Given all of this, rather than dismiss corporate complaints as the usual grumblings, they should be taken seriously. While they cannot be the entire explanation—indeed, the downward slope in IPOs started before Sarbanes-Oxley[95]—they are likely a key factor.

In the same vein, increased regulatory costs, particularly those associated with Sarbanes-Oxley, may have chilled IPOs in a more indirect fashion in that they increased regulatory uncertainty. A firm that goes public subjects itself not only to current regulations, but also to the risk that future regulations will be more onerous. The prospect of unknown and increasing future costs is certainly a reason to think twice. While this has always been the case, the Sarbanes-Oxley legislation sent the signal that this risk was real and material.

True, if firms are genuinely caught off guard, they could delist. But delisting from the premier exchanges is not easy. The process is cumbersome, and firms that delist are severely penalized: when a company takes this action, its shares may still trade on the OTC markets, but the value of its shares drops dramatically.[96] Going public therefore means agreeing to be subject to unpredictable and likely escalating regulatory costs, escape from which is highly problematic.[97]

Expenses associated with litigation have also heightened in recent decades. In addition to increased compliance costs, public firms face greater exposure to suit. All firms, including private ones, are subject to rule 10b-5, which outlaws securities fraud,[98] but only public firms can be sued under section 11 of the Securities Act of 1933 (Securities Act), which provides expansive liability for misstatements made in public offerings.[99] Similarly, for public firms, share-price drops can trigger

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93 *See* Davidoff, *supra* note 58, at 101 & chart 1C.

94 *See* HARRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE LEARNED; HOW TO FIX IT 72–73 (2006) (discussing costs as an explanation for declining foreign listings); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1788 (2011) (citing empirical studies pointing to costs as an explanation for delisting); Fried, *supra* note 91, at 144 (discussing costs as a reason for delisting); Jose Miguel Mendoza, *Securities Regulation in Low-Tier Listing Venues: The Rise of the Alternative Investment Market*, 13 FORDHAM J. CORP. & FIN. L. 257, 287–89 (2008) (discussing costs as a reason for listing abroad); Greg Ip et al., *Trade Winds: In Call to Deregulate Business, A Global Twist—Onerous Rules Hurt U.S. Stock Markets, but So Do New Rivals*, WALL. ST. J., Jan. 25, 2007, at A1 (discussing costs as a reason for listing overseas).

95 Sarbanes-Oxley was signed into law in 2002, but declines started in the late 1990s. *See* WEILD & KIM, *supra* note 70, at 4.

96 *See* Fried, *supra* note 91, at 136.

97 *See* Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 682–84 (2002).

98 *See* 17 C.F.R. § 240.10b-5 (2012).

99 Securities Act of 1933 § 11, 15 U.S.C. § 77k (2006); *see* LOSS & SELIGMAN, *supra* note 77, at 1227–28.

class-action lawsuits alleging that glowing public disclosures released prior to a collapse were fraudulent.[100] Private firms face no such risk. While increased liability exposure has long been a feature of being public, the expense associated with it has risen in recent years as plaintiffs and their attorneys have more aggressively pursued alleged misconduct.[101] Another likely explanation for rising litigation costs is Sarbanes-Oxley. The statute introduced increased civil and criminal sanctions and failure to comply with its requirements represents new grounds for liability.[102]

A final issue that has arisen is that smaller companies are having difficulty garnering analyst coverage.[103] Thanks to regulatory changes and other factors, compensation for stock trades, which has traditionally been used to fund research, has dropped.[104] As research budgets have shrunk, analysts have reduced their coverage of smaller firms, which, because of their size, elicit relatively fewer trades, and are therefore less profitable to cover.[105] As a result of this dynamic, by 2004 less than half of small-cap companies received any analyst coverage.[106] Diminished prospects for coverage make going public less attractive, particularly for smaller firms. This is because less analyst coverage means less liquidity,[107] and less liquidity makes shares less attractive for public investors. To make up for this, smaller firms have to discount IPO shares, which in turn reduces the value of joining the public markets.[108]

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100 *See* Jonathan Macey, Editorial, *The SEC's Facebook Fiasco*, WALL. ST. J., Jan. 20, 2011, at A15.

101 *See* Afshar & Rose, *supra* note 85, at 463–67; Bainbridge, *supra* note 85, at 8; John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1536 & n.7 (2006).

102 *See* BUTLER & RIBSTEIN, *supra* note 94, at 77–79; Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 429 & n.55 (2003).

103 *See* ADVISORY COMM. REPORT, *supra* note 87, at 72; Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39, 76 (2007); Kris Frieswick, *Where's the Coverage?*, CFO MAG. (Jan. 20, 2005), http://www.cfo.com/article.cfm/3516678/c_3576955?f=home_todayinfinance.

104 *See* ADVISORY COMM. REPORT, *supra* note 87, at 72.

105 *See* WEILD & KIM, *supra* note 70, at 11, 14. *But see* Gao et al., *supra* note 65, at 15–17 (arguing that post-IPO analyst coverage has not decreased over time).

106 ADVISORY COMM. REPORT, *supra* note 87, at 72 & n.144.

107 WEILD & KIM, *supra* note 70, at 15; Darren T. Roulstone, *Analyst Following and Market Liquidity*, 20 CONTEMP. ACCT. RES. 551, *passim* (2003).

108 *Cf.* Gao et al., *supra* note 65, at 15–16 (discussing the relationship between analyst coverage and value). Declining analyst coverage and increasing regulatory costs are most frequently blamed for the drop in IPOs. But two other theories have emerged recently. In Congressional testimony, both Professors Coffee and Coates surmised that the decline in small-company IPOs may be a result of the growing institutionalization of the securities markets. The reasoning is that large institutions are less interested in smaller-company stock offerings. As a result, as the markets have become more and more dominated by large institutions at the expense of individual investors, demand for these firms has softened. *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 2 (2011)

The lack of IPOs, regardless of the exact cocktail of factors that explains it, demonstrates that the traditional relationship between entrepreneurs and equity markets is under stress. This is a disturbing red flag. Because a healthy relationship between entrepreneurs and equity markets is crucial to the success of both, a sign that it is fraying suggests that each is in trouble. More specifically, the dearth of IPOs suggests that U.S. equity markets are losing their vitality and that entrepreneurs lack access to a suitable liquidity platform. Such developments would represent a troubling erosion in the U.S. economic infrastructure.[109]

To fully appreciate the ramifications of declining IPOs, however, the issue must be viewed through a broader lens. IPOs have traditionally provided the crucial link between entrepreneurial firms and liquid secondary markets. But the securities laws provide other potential avenues to equity liquidity. An analysis of these alternatives reveals the scope of the problem and allows for greater insight into potential reform.

If firms have access to secondary-market liquidity without conducting a traditional IPO on the NYSE or NASDAQ, then reform may be unnecessary or at least less urgent. Alternative equity markets that are accessible without an IPO may have developed and may provide reasonable substitutes. Entrepreneurship and equity markets can theoretically survive and prosper even if IPOs disappear and the venue for secondary-market liquidity shifts from the NYSE and NASDAQ to some other platform. It is liquidity that matters, not the mechanism for providing it.

The type of reform that may be advisable also turns on the viability of IPO substitutes. If it turns out that the alternatives are unsuitable, then reform to salvage the entrepreneur-market relationship is essential. But attempting to bring back IPOs may not be the best course. Rather, reform to some other aspect of the securities laws or to the entire structure of securities regulation may be advisable. We cannot determine the best way forward without knowing what other options

(statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School); *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 22–23 (2012) [hereinafter *Examining Investor Risks*] (statement of John C. Coates IV, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School). On the other hand, Professors Xiaohui Gao, Jay Ritter, and Zhongyan Zhu argue in a forthcoming paper that, because of technological change, it has become more profitable for an increasing number of small firms to exploit their products as part of a larger firm rather than as independent ones. Thus, firms are opting to merge with incumbents rather than go through with IPOs and continue as independent companies. *See* Gao et al., *supra* note 65, at *passim*. As is the case with the more prominent theories purporting to explain IPO declines, neither of these claims likely provides the sole explanation, but it is reasonable to think that they point to contributing factors.

109 *See supra* Part I.B.

are available. The next Section analyzes the alternatives for secondary-market liquidity that currently exist in order to resolve these issues.

II. ALTERNATIVE SOURCES OF SECONDARY-MARKET LIQUIDITY

A surface-level review of the structure of securities regulation reveals multiple alternatives to the traditional IPO on the public markets. A deeper study of the substance of these alternatives reveals, however, that they are all grossly inadequate. Broadly speaking, if a firm wishes to avoid an IPO, it could stay private or go public through a less involved process. But neither avenue offers shareholders much liquidity. Moreover, what becomes apparent in going through these options is that the overarching structure for secondary-market regulation is deeply flawed. The failure to offer a suitable liquidity alternative is one problem; beyond that, the framework poses investor-protection concerns and is internally inconsistent. Rather than cooling anxieties about the lack of IPOs, a view of the area through a wider lens reinforces them and suggests the need for broad-based reform.

A. *Markets for Private Shares*

The public market is the focal point of securities regulation, but markets for private shares now exist in its shadow. Their legal foundation is in section 4(1) of the Securities Act,[110] and in Securities-Act Rules 144[111] and 144A.[112] For a great while, there were no formal markets to facilitate equity transactions based on these provisions, but that has changed in the last several years. SecondMarket and SharesPost have arisen (these primarily accommodate sales under section 4(1) and rule 144), as has the Portal Alliance, which operates pursuant to rule 144A. While these markets have generated publicity and positive academic commentary,[113] I find that they have little to offer. Markets are built on a regulatory foundation, and the exemptions upon which these markets are founded are ill-suited to support healthy liquidity platforms.

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110 15 U.S.C. § 77d(1) (2006).

111 17 C.F.R. § 230.144 (2012).

112 *Id.* § 230.144A.

113 *See, e.g.*, Ibrahim, *supra* note 25, *passim*; Sjostrom, *supra* note 27, *passim*; Andrew Ross Sorkin, *An Exchange Without the Volatility*, N.Y. TIMES DEALBOOK (Sept. 27, 2011), http://dealbook.nytimes.com/2011/09/26/secondmarket-an-exchange-without-the-volatility/.

1. Private Markets and the Registration Requirement

Section 4(1), rule 144, and rule 144A are exceptions to the centerpiece of securities regulation—the registration requirement. Before exploring these rules in detail, it is necessary to understand how they fit in with this mandate.

Section 5 of the Securities Act requires the registration of all transactions in securities.[114] Note the breadth of this directive. The section requires the registration not only of initial offerings, but also of secondary-market transactions between shareholders. But registration is costly. That being the case, outside of an IPO, issuers try to avoid it, as do shareholders looking to resell.

To escape registration, these parties must find an exemption from this blanket requirement. Securities issuers look to section 4(2), which exempts private offerings by issuers,[115] while resellers of securities in secondary-market transactions look to section 4(1). The latter rule excuses from registration transactions not involving an issuer, underwriter or dealer.[116] The provision has been read to exempt ordinary secondary-market transactions on the public stock exchanges,[117] which is why transfers on the NYSE and NASDAQ are free of regulatory friction.

The exemption has a more limited application, however, with respect to transactions in the securities of private firms. When selling so-called private shares, there is a significant risk that the seller will be considered an "underwriter"—a result that disqualifies the transaction from exemptive treatment.[118] Whether a reseller is an underwriter depends on section 2(a)(11) of the Securities Act, which defines the term broadly—as any person who purchased a security from the issuer with a "view to . . . distribution."[119] This broad definition is designed to prevent an end-run around the registration requirement. Without this backstop, an issuer could conceivably sell its shares to one set of shareholders in a private offering exempt from registration under section 4(2) with the idea that this group would then flip the shares to the public. By providing that those who purchase shares with a "view to . . . distribution" cannot take advantage of 4(1), the rule plugs this loophole.

At the end of the day, the permissibility of resale without

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114 *See* 15 U.S.C. § 77e (2006).

115 *See id.* § 77d(a)(2).

116 *See id.* § 77d(a)(1).

117 *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 4.26 (6th ed. Supp. 2012).

118 *Id.* § 4.26-27.

119 *See* 15 U.S.C. § 77b(a)(11).

registration under section 4(1) —and, as a result, the entire regulatory structure for the resale of private shares—essentially boils down to the interpretation of this key language. Given its central import, it is perhaps not surprising that this phrase is the subject of a common-law interpretation (the so-called section 4(1½) exception), as well as two safe harbors—rules 144 and 144A.

2. Section 4(1½)

The common-law approach, while logically unassailable, has led to unsatisfactory doctrine. In defining the central language, courts have held that "view to" is essentially synonymous with intent and that a "distribution" is essentially synonymous with a public offering.[120] Putting this together, the inquiry, as interpreted by the courts, is, in looking at the facts and circumstances of both the initial sale and the resale transaction, does it appear that the person attempting to resell bought with an intent to flip the shares to the public.[121] If so, the resale transaction does not qualify under section 4(1).

Courts employ a multifactor analysis to conduct this inquiry. To help decide the issue of intent, courts look at how long the securities have been held—the longer the better. After three years, there is an irrebuttable presumption that there was no intent to resell.[122] To get at whether the resale constitutes a public offering, the courts turn to the common-law analysis developed to interpret this phrase in connection with section 4(2), which provides that "transactions by an issuer not involving any *public offering*" need not be registered.[123] This borrowing of analogous precedent is what explains the section 4(1½) moniker for an exemption that is technically under section 4(1).

Bringing over the section 4(2) jurisprudence results is an ungainly analysis. Essentially, the rule for section 4(1½) is that a resale to a limited number of sophisticated and informed investors, with whom the seller has a preexisting relationship, who themselves do not intend to flip the stock, is permissible, so long as the seller held the shares for a sufficient amount of time.[124] As the ambiguity of the language suggests, the boundaries of these criteria are hazy.[125]

Such haziness means that this rule is ill-suited to serve as the foundation for a liquid market. It is often stated that markets hate

120 *See* Ackerberg v. Johnson, 892 F.2d 1328, 1335–37 (8th Cir. 1989).

121 *See id.*

122 *See* J. WILLIAM HICKS, RESALES OF RESTRICTED SECURITIES § 6:13 n.3 (2011).

123 15 U.S.C. § 77d(a)(2) (emphasis added).

124 *See generally* J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 §§ 9:109–:129 (2012).

125 *See* Sjostrom, *supra* note 27, at 420.

uncertainty. In this instance, the platitude rings true. Outside of clear cases, it is difficult to tell what transactions qualify under the 4(1½) framework.[126] This dampens liquidity because few relish the opportunity to take part in transactions that could later be deemed unlawful. Sales also involve high transaction costs, another liquidity killer, as seller and buyer attempt to determine whether the legal prerequisites are met.

The rule's nebulous boundaries are not its only problem. As mentioned above, after three years shares can be freely resold. While it is always nice to have a black-line rule, the substance of this one is dubious. Allowing individuals to resell freely after three years undermines investor protection, stymies liquidity, and runs counter to the remainder of securities law. The lack of any requirement that current information be provided to would-be purchasers invites unscrupulous sellers to unload valueless securities on the unsophisticated. Scrupulous sellers, meanwhile, will have difficulty finding buyers. Markets that lack regulation also lack liquidity.[127] Finally, the lack of any regulation is completely at odds with a central component of the securities-law framework. The rules only allow for sales and resales to ordinary investors in typical public companies if current and comprehensive information is available.[128] Yet under section 4(1½), provided a security has been held for at least three years, nothing is required. This distinction cannot be justified on policy grounds.

Taken as a whole, the rule fails to provide a foundation for liquidity or consistent investor protection. As such, it does not appear suited to operate as the basis of an alternative secondary market. Consistent with this analysis, until SecondMarket and SharesPost, nobody tried to make a market based on this exemption. In fact, the usual advice was to steer clear.[129]

That the rule is ill-suited to facilitate secondary-market transactions is understandable given how this rule fits in with the structure of securities regulation. As noted above, the jurisprudence with respect to this section was not created with the idea of secondary-market liquidity; rather, it was developed to further the legislature's

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126 *See id.*

127 *See* Bushee & Leuz, *supra* note 20, at 260–61 (finding that new disclosure requirements on the OTC Bulletin Board increased liquidity); Ibrahim, *supra* note 25, at 21–22 (describing the difficulty of reselling in unregulated private markets); Christian Leuz et al., *Why Do Firms Go Dark, Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181, 184 (2008) (describing increased liquidity as a key benefit of mandated disclosure); Ang et al., *supra* note 20, at 2 (citing theoretical and empirical support for the proposition that less transparent markets are less liquid).

128 *See supra* notes 77–79 and accompanying text.

129 *See* 1B HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, GOING PUBLIC HANDBOOK: GOING PUBLIC, THE INTEGRATED DISCLOSURE SYSTEM AND EXEMPTION FINANCING § 2:77 (2006).

intent to prevent public offerings from escaping regulation through disguise as private ones.[130] The common-law test accomplishes this objective.

That the legislation is solely focused on preventing unregistered public offerings and gives no attention to constructing a sensible regulatory framework for the resale of private shares is a troubling gap. Rather than fill this fundamental hole, the SEC promulgated rule 144, which adds some clarity to this area, but little else.

3. Rule 144

In an effort to provide greater certainty to the application of section 4(1), the SEC enacted rule 144 in 1972.[131] The rule lays out when a person "shall be deemed not to be an underwriter . . . within the meaning of section 2(a)(11) of the Securities Act."[132] Clarifying underwriter status in turn clarifies when section 4(1) is available for resellers. Although the rule addresses a range of issues, for our purposes, its most important aspect is how it treats those who wish to sell their shares in private companies. Though the rule does not expressly repudiate the common-law approach to this issue just described, the SEC's intent was clearly to marginalize it. In its adopting release, the Commission put investors in private shares "on notice" that they will have a "substantial burden of proof" in establishing a resale exemption other than rule 144 and that investors attempting to do so should proceed "at their [own] risk."[133]

At the outset, rule 144 makes a key distinction between affiliates and nonaffiliates. The rule for nonaffiliates is straightforward: shares cannot be resold prior to one year, but thereafter they can be resold at will.[134] For affiliates, the rule is much more demanding. Technically, an affiliate is a person or entity that "directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, [the] issuer."[135] Though not determinative, a key consideration is whether the seller is an officer, director or owner of greater than 10% of the issuer's securities.[136]

Affiliates face a panoply of important restrictions in reselling their

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130 *See* HICKS, *supra* note 124, at § 9:1; *supra* note 119 and accompanying text.

131 *See* Notice of Adoption of Rule 144, Securities Act Release No. 33-5223, 37 Fed. Reg. 591, 1972 WL 121583, *3–4 (Jan. 11, 1972); LOSS & SELIGMAN, *supra* note 77, at 432.

132 17 C.F.R. § 230.144(b) (2012).

133 *See* Notice of Adoption of Rule 144, 1972 WL 121583 at *2.

134 17 C.F.R. § 230.144(b); *see also* 1 STUART R. COHN, SECURITIES COUNSELING FOR SMALL & EMERGING COMPANIES § 14:6 (2011).

135 17 C.F.R. § 230.144(a)(1).

136 American-Standard, SEC No Action Letter, 1972 WL 19628, at *1 (Oct. 11, 1972).

shares. Like nonaffiliates, those affiliated with the company may not sell prior to one year.[137] Thereafter, they may sell, but they may only sell a limited amount,[138] and such sales may only be made through unsolicited brokerage transactions or similar means.[139] Moreover, certain information must be made available to prospective purchasers.[140] Specifically, the broker executing the transaction must provide, upon request, information about, among other things, the issuer's state of incorporation, the nature of its business, its financial status, and the identity of its officers and directors.[141]

Rule 144 poses a number of theoretical and practical problems. Looking first at the regulation of nonaffiliate transactions, the one-year rule poses the same concerns as the three-year rule under the 4(1½) doctrine.[142] It lays the groundwork for an unregulated marketplace in the resale of private securities once the holding period is complete. Again, this runs counter to the overriding investor-protection purpose of securities law and chills liquidity.

The treatment of affiliates is no better, but the problem is just the opposite. The number of restrictions on sale renders the exemption nearly useless. Most problematic is the requirement that sales be conducted through an unsolicited brokerage transaction. Though there are a couple of limited exceptions, this rule basically mandates that brokers sell shares in a particular private company only to people who come to them seeking to purchase such shares.[143] This passivity is unlikely to lead to many sales for the vast majority of little-known privately-owned companies. The lamentable result of the rule, therefore, is an unregulated market for shares owned by nonaffiliates and essentially no market for shares owned by affiliates.

Up until a few years ago, the discussion of section 4(1½) and rule 144 would have ended there. But the reluctance of firms to go public has created such a demand for liquidity, that entrepreneurial ventures have sprung up seeking to offer venture capitalists and employees a marketplace to resell based on these two exemptions.[144] The most prominent is SecondMarket; its most prominent rival is SharesPost.

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137 17 C.F.R. § 230.144(d)(1)(ii).

138 *See id.* § 230.144(e).

139 *See id.* § 230.144(f)–(g).

140 *See id.* § 230.144(c)(2). In addition, the SEC must be provided notice of the transaction. *Id.* at § 230.144(h).

141 *Id.* §§ 230.144(c)(2), 240.15c2-11(a)(5)(i)–(a)(5)(xvi).

142 *See supra* note 127 and accompanying text.

143 *See* 17 C.F.R. § 230.144(g)(3)(i)–(iv).

144 *See* Sorkin, *supra* note 113 (relating the decline in IPOs to the rise of SecondMarket).

4. SecondMarket and SharesPost

SecondMarket and SharesPost provide internet platforms that allow holders of private shares to resell them. To pass muster under the securities laws, the transactions these companies facilitate must comply with one or the other of the two exemptions listed above.[145]

The main innovation is that these markets allow early-stage investors and employees to list private shares in a place where interested purchasers can survey them.[146] The key limitation is that both of these markets only allow wealthy individuals and institutions (so-called "accredited investors") to purchase.[147] While the arrival of these companies has likely improved the liquidity of private shares, the model presents only a stop-gap measure to satisfy pent up demand driven by the lack of IPOs rather than a long-term solution.

The brief history of SecondMarket and SharesPost reveals rapid growth in a marketplace fraught with transaction costs and thin in liquidity. Both companies have seen the value of completed transactions jump over the past several years. In 2011, the value of private-share transactions was $6.9 billion,[148] more than 40% greater than 2010's total of $4.6 billion, which was itself 40% greater than the figures for 2009.[149]

The size and trajectory of these figures are impressive, but what the numbers do not show is what actually transpires on these markets. While it is tempting to picture these platforms as places where private shares are fluidly bought and sold—a perception that SharesPost at one time encouraged by including a stock ticker on its website[150]—this is not the case. In reality, these platforms contain hallmarks of illiquidity. A 2011 Wall Street Journal article described the markets as "boring" and

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145 *See* Ibrahim, *supra* note 25, at 40 n.157; Scott D. McKinney, *Securities Registration: Facebook and the Challenge of Staying Private*, 25 INSIGHTS, Feb. 2011, at 2, 5–6 (2011), *available at* http://www.hunton.com/files/Publication/41fae5d0-e5f2-4874-8661-36ce0cfd66a6/Presentation/PublicationAttachment/82433900-f23d-4b78-bbd7-3dca3dc3ffdb/Facebook_McKinney_2.11.pdf.

146 *See Private Company Stock*, SECONDMARKET, https://www.secondmarket.com/private-company?t=fl (last visited Jan. 16, 2012); *Benefits of SharesPost,* SHARESPOST, https://welcome.sharespost.com/benefits-of-sharespost/for-investors (last visited Oct. 2, 2012); Ibrahim, *supra* note 25, at 37.

147 See *Private Company Stock*, *supra* note 146; *Legal*, SHARESPOST, https://welcome.sharespost.com/legal/ (last visited Oct. 2, 2012); Steven M. Davidoff, *Private Markets Offer Valuable Service But Little Disclosure*, N.Y. TIMES DEALBOOK (Nov. 22, 2011, 4:37 PM), http://dealbook.nytimes.com/2011/11/22/private-markets-offer-valuable-service-but-little-disclosure (last visited July 3, 2012).

148 *Emergence of the Secondary Market*, SECONDMARKET, https://www.secondmarket.com/discover/resource/emergence-of-the-secondary-market (last visited Sept. 27, 2012).

149 Steven Russolillo, *Global Finance: Public Problem: Private Markets Grapple with Tech IPOs*, WALL. ST. J., Oct. 31, 2011, at C3.

150 *The Private Capital Market Place*, SHARESPOST, https://www.sharespost.com (last visited Feb. 12, 2012).

"void of much action."[151] The author observed that the "numbers of buyers and sellers remain fitfully small" and that on SharesPost "real trades remain rare, with listings showing trades that grew stale months ago."[152] Echoing this sentiment, another article noted that on these markets "days or weeks can go by without shares of even big private-company stocks changing hands."[153] Moreover, when trades do happen, they are mired in transaction costs. On the public markets, trades happen instantaneously. But on these private platforms, buying and selling is "time-consuming and bureaucratic."[154] For example, while Facebook was trading privately, buying a share would take a week to accomplish.[155] Overall, as the above description illustrates, despite appearances to the contrary, these markets are quite illiquid.[156]

Part of the sluggishness stems from the issuer's continued involvement in the sales process. On these platforms, buyers are not only investigating the value of the shares under consideration, but also frequently have to work through various transfer restrictions, such as rights of first refusal, in favor of the issuer.[157] The companies may drag their feet in providing relevant information or in deciding whether to enforce or waive their rights to intervene in transfers.

Legal rules also slow things down. I already discussed how section 4(1½) is a compliance nightmare and how rule 144's myriad requirements for affiliate resales make such sales virtually impossible. In addition to these rules is yet another complication—section 12(g) of the Exchange Act.[158] Prior to the JOBS Act, this law required that companies with greater than $10 million in assets and more than 499 shareholders file Exchange Act reports.[159] The new statute leaves the structure of the rule in place, but raises the shareholder threshold to 2,000, so long as the firm has no more than 499 unaccredited

151 Dennis K. Berman, *The Game: My Dead Grandma, Facebook Investor*, WALL. ST. J., Apr. 12, 2011, at C1.

152 *Id.*

153 Richard Teitelbaum, *Facebook Drives SecondMarket Broking $1 Billion Private Shares*, BLOOMBERG MARKETS MAG., Apr 26. 2011, http://www.bloomberg.com/news/2011-04-27/facebook-drives-secondmarket-broking-1-billion-private-shares.html.

154 Udayan Gupta, *Secondary Markets Find Way to Buy and Sell Shares of Privately Held Companies*, INSTITUTIONAL INVESTOR, Apr. 18, 2011, www.institutionalinvestor.com/Popups/PrintArticle.aspx?ArticleID=2805538.

155 *Id.*

156 Davidoff, *supra* note 147; *see also* Teitelbaum, *supra* note 153 ("These private secondary markets give the illusion, but not the reality, of liquidity . . . . They are matching systems, and the broker does not function as a dealer committing its own capital. In a period of market distress, liquidity will vanish." (quoting Professor Coffee)).

157 *See* Ibrahim, *supra* note 25, at 39–41.

158 15 U.S.C. § 78*l*(g)(1) (2006).

159 *See id.*; 17 C.F.R. § 240.12g-1 (2012) (changing the dollar threshold to $10 million from the statutorily prescribed $1 million).

investors.[160] Since crossing the size and shareholder caps means that a firm must disclose like it is a public company, once a firm runs up against these boundaries, the usual response is to go public.[161] Indeed, this is the rule that drove Facebook to its much-ballyhooed IPO.[162]

Section 12(g) has a clear negative impact on SecondMarket and SharesPost in that it forcibly removes companies from their grasp. Less obviously, however, it also erodes liquidity with respect to the stock of companies while there. To avoid a forced public offering, private companies must minimize the number of shareholders. This gives them an incentive to do what they can to disrupt sales. Moreover, even if a company is amenable to a transaction, it would surely prefer sale to existing shareholders or to a single buyer of a block of shares rather than a broad dissemination to a number of investors. Working through these issues bogs the process down. While the JOBS Act reform surely eases company concerns, it is unlikely to eliminate them. Rather, the fear of crossing even the more forgiving numerical shareholder limitations will likely feed continued company intervention and accompanying delays.

Liquidity aside, it is also questionable whether these platforms provide sufficient investor protection. When Groupon and Zynga, two notable companies that had listings on both markets, filed for public offerings, they were forced for the first time to disclose information in the federally-mandated format subject to SEC review. Not until then was it revealed that the two firms were using questionable accounting tactics.[163] That this came up only after the firms filed to go public shows the value of transparency, standardized reporting, and government oversight—all of which are lacking on SharesPost and SecondMarket.[164]

160 JOBS Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012). The statute also instructs the SEC to draft rules to exclude employees who receive their shares pursuant to certain employee compensation plans. *See id.* §§ 502–503. For a more comprehensive discussion of the JOBS Act changes to the shareholder threshold, see Michael D. Guttentag, *Patching a Hole from the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. (forthcoming 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2091874.

161 *See* Petter Lattman, *Share Rules Could Prompt an Offering by Facebook*, N.Y. TIMES DEALBOOK (Dec. 28, 2010, 9:01 PM) http://dealbook.nytimes.com/2010/12/28/focus-on-private-shares-could-push-a-public-offering (describing how Section 12(g) likely drove Google and Microsoft to the public markets).

162 Steven M. Davidoff, *Facebook May Be Forced to Go Public Amid Market Gloom*, N.Y. TIMES DEALBOOK (Nov. 29, 2011, 7:58 PM), http://dealbook.nytimes.com/2011/11/29/facebook-may-be-forced-to-go-public-amid-market-gloom.

163 *See* Steven M. Davidoff, *Grouponomics and Zyngametrics, but Few Sound Numbers*, N.Y. TIMES DEALBOOK (Oct. 11, 2011, 7:20 PM), http://dealbook.nytimes.com/2011/10/11/grouponomics-and-zyngametrics-but-few-sound-numbers; Evelyn M. Rusli, *Ahead of I.P.O., S.E.C. Pressed Groupon on Accounting*, N.Y. TIMES DEALBOOK (Dec. 28, 2011, 7:05 PM) http://dealbook.nytimes.com/2011/12/28/ahead-of-i-p-o-s-e-c-pressed-groupon-on-accounting/.

164 To its credit, SecondMarket generally requires two years of audited financial statements. It did not, however, require this of Facebook, and SharesPost has no such requirement.

Finally, there are signs that these markets may fade from the scene just as quickly as they rose. Two trends threaten their existence. First, despite the recent weakness in the IPO market, the flashy high-tech firms that fueled the growth of SecondMarket and SharesPost have been marching toward the public exchanges. Facebook is the most recent—and most important—example. Transactions in Facebook stock accounted for a whopping 39% percent of SecondMarket's transactions in the last quarter of 2010.[165] Without the likes of Facebook and its ilk, it is unclear whether these private markets can survive.[166]

Second, many private companies frown upon allowing their employees to sell their shares on these markets.[167] To accommodate them, lawyers for start-ups are now structuring equity compensation in a way that prevents employees from making use of these sales platforms.[168] In addition, SecondMarket has rejiggered its business model.[169] Whereas its founder once described SecondMarket as an "Ebay" for private securities,[170] the company now sells itself as a "reasonable partner" with emerging firms that can help them set up "controlled liquidity platforms."[171] Previously, employees could sell through SecondMarket without going through their employers;[172] now SecondMarket will not do business with them, unless the employer is a SecondMarket client.[173]

As the Web 2.0 boom subsides, future employees sign away their

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Davidoff, *supra* note 147.

165 Julianne Pepitone, *Secondmarket Trading Doubles in Private Company Stock*, CNNMONEY (Jan. 22, 2011, 9:43 AM), http://money.cnn.com/2011/01/21/technology/secondmarket_q4/index.htm.

166 *See* Evelyn M. Rusli & Peter Lattman, *Losing a Goose That Laid the Golden Egg*, N.Y. TIMES DEALBOOK (Feb. 2, 2012, 9:26 PM), http://dealbook.nytimes.com/2012/02/02/losing-the-goose-that-laid-the-golden-egg/; Steven Russolillo, *SecondMarket Cuts Staff by 10% Before Facebook IPO*, WALL ST. J., Apr. 2, 2012, at C10; Lee Spears, *SecondMarket Acts to Offset Facebook Fees Selling Wine, Art*, BLOOMBERG BUSINESSWEEK (May 17, 2012), http://www.businessweek.com/news/2012-05-17/secondmarket-acts-to-offset-facebook-fees-selling-wine.

167 *See* Wade Roush, *SecondMarket Attempts to Sell Startups on the Value of Letting Employees Trade Their Stock*, XCONOMY (Aug. 18, 2011), http://www.xconomy.com/san-francisco/2011/08/18/secondmarket-attempts-to-sell-startups-on-the-value-of-letting-employees-trade-their-stock/?single_page=true; Brad Stone, *Silicon Valley Cashes Out Selling Private Shares*, BLOOMBERG BUSINESSWEEK, Apr. 21, 2011, http://www.businessweek.com/magazine/content/11_18/b4226070179043.htm#p1.

168 *See* McKinney, *supra* note 145, at 3–5; Davidoff, *supra* note 162; Ari Levy & Douglas MacMillan, *Twitter, Square Are Said to Bar Investors From Trading Shares on Exchanges*, BLOOMBERG (Aug. 8, 2011), http://www.bloomberg.com/news/2011-08-06/twitter-square-are-said-to-bar-investors-from-trading-shares-on-exchanges.html.

169 *See* Roush, *supra* note 167.

170 *See* Teitelbaum, *supra* note 153.

171 Roush, *supra* note 167.

172 *See id.*

173 *Why SecondMarket Is Not Part of an SEC Inquiry*, SECONDMARKET, https://www.secondmarket.com/discover/resource/why-secondmarket-is-not-part-of-an-sec-inquiry (last visited July 3, 2012).

right to sell on these platforms, and SecondMarket transitions to a more restrictive model, the relevance of these venues will likely decline. Today, however, they offer a limited but useful service in helping to bridge the gap between insiders looking to sell and outsiders looking to buy. But they should not be mistaken for liquid markets. And this should come as no surprise. As described above, these markets are built on regulatory exemptions that were not designed to underpin platforms of equity liquidity. This backdrop inherently limits their vitality.

5. Rule 144A

Rule 144A provides the final regulatory exemption permitting resale of private shares. Like rule 144, this provision provides a safe harbor from underwriter status under section 2(a)(11)[174] and, therefore, allows those who comply to safely resell their shares under section 4(1). Unlike rule 144, however, this regulation is unconcerned about whether sellers are affiliated with the issuer and contains no holding-period requirement. There is also no limit on the amount of securities that may be sold. Thus, anyone may resell an unlimited amount of private shares immediately under rule 144A.

Rather than such constraints, the limitations for rule 144A sales are focused mainly on the buyer. For the exemption to apply, sellers may only sell to those they "reasonably believe" to be qualified institutional buyers (QIBs).[175] Generally speaking, these are companies that invest at least $100 million in securities of non-affiliated issuers and registered broker-dealers with over $10 million in assets.[176] QIBs also have the right to certain information. If they so request, firms must provide QIBs with material financial and business information about the firm.[177] Finally, the rule includes a provision that limits the type of securities that are eligible: its nonfungibility requirement restricts the 144A market to securities that do not belong to a class currently traded on a U.S. national securities exchange.[178]

Rule 144A is a drastic departure from prior regulations in that it makes no real pretense about conforming to any reasonable understanding of the word "underwriter." The lack of a holding-period

174 *See* 17 C.F.R. § 230.144A(b) (2011).

175 *Id.* § 230.144A(d)(1).

176 *See id.* § 230.144A(a).

177 *Id.* § 230.144A(d)(4). Specifically, issuers must provide "a very brief statement of the nature of the business of the issuer and the products and services it offers; and the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available)." *Id.*

178 *Id.* § 230.144A(d)(3). There are other less substantive requirements as well. For a fuller discussion, see LOSS & SELIGMAN, *supra* note 77, at 434–38.

requirement means that shareholders can—like an underwriter—immediately flip their shares. The rule's information requirement is another departure from section 4(1½) jurisprudence and rule 144. Under these exemptions, once the seller has held shares for a certain amount of time, no information is required. The requirement under 144A, however, never expires. While this may be laudable, it also creates a strange result: it means that QIBs—an extremely select group—have more protection than buyers of shares under rule 144 or 4(1½)—which could be anyone.

The reason 144A is different is that it was enacted with a different goal in mind. Unlike the exemptions previously discussed, which are tied to the idea of preventing unregulated public offerings, rule 144A is aimed at creating a new secondary market. Indeed, according to the rule's adopting release, a key goal was to facilitate "a more liquid and efficient institutional resale market for unregistered securities."[179]

Although the rule and this ambition apply to unregistered securities more broadly, its use in connection with shares of private U.S. issuers is all that matters here. With respect to this type of security, the rule's impact has been muted. For a great while, there were no markets specifically designed to facilitate transactions for such shares under 144A.[180] This changed with the launch of several new trading venues a few years ago, but these platforms have met with little success.

6. 144A Equity Markets

In 2007, several investment banks launched 144A equity markets. JP Morgan, for instance, launched 144A Plus and Goldman Sachs launched the GS Tradable Unregistered Equity OTC Market (GSTrUE).[181] Hopes were high for these platforms after Oaktree Capital Management, a prominent fund advisor, privately sold $880 million of its own equity on GSTrUE in May 2007.[182] The sale was structured as a "144A offering," which is a transaction in which an issuer uses mechanisms traditionally associated with public offerings to privately sell its securities on the 144A market.[183] This was the first substantial 144A offering of equity in a U.S. company.[184]

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179 Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Securities Act Release No. 6862, 55 Fed. Reg. 17,933, 17,934 (Apr. 30, 1990) [hereinafter Restricted Securities Release].

180 Sjostrom, *supra* note 27, at 431.

181 *Id.* at 430.

182 *Id.* at 410.

183 *See id.* at 429 (describing the 144A offering process).

184 *Id.* at 410; Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 339 (2008).

But it also appears to have been the high point for the 144A equity markets. A liquid resale market for Oaktree's shares never developed. In the spring of 2011, the Wall Street Journal reported that the firm had "been averaging four or five trades a month since its launch . . . [and that] [s]ome months have seen no trading at all."[185] This resulted in a steep liquidity discount: shares were thought to be trading at about 43% below their estimated value on the public market.[186] In spring of 2012, Oaktree finally went public. As part of the transaction, it ceased trading on GSTrUE; in its prospectus the firm acknowledged that there had "not been an active trading market" for its shares and that "only a limited number" of QIBs "registered to participate" on the GSTrUE platform.[187]

Oaktree was not the only investment firm to experiment with 144A. Shortly after Oaktree joined GSTrUE, Apollo Global Management, LLC, a private equity fund, also conducted a 144A offering on the market.[188] But Apollo was more circumspect than Oaktree; its transaction was merely a pre-IPO. As part of the offering, Apollo obligated itself to register its shares within 240 days.[189] Even during its short time on the market, though, liquidity was scarce. In 2010, only seven trades occurred and investors were complaining about their inability to sell their shares.[190] Likely as a result of the experiences of these two firms, 144A equity platforms never gained much traction. They eventually consolidated into one venue—NASDAQ's Portal Alliance.[191] But this platform has been unable to attract listings.[192]

Lack of liquidity prevents 144A markets from providing a suitable substitute to the public exchanges.[193] That participation is limited to QIBs likely explains their shallowness.[194] Fewer buyers means less liquidity, and there just are not that many QIBs.[195] Also, QIBs are not

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185 Gregory Zuckerman, *Hot Idea Falls Short at Goldman*, WALL. ST. J., Apr. 7, 2011, at C1.

186 *Id.*

187 Oaktree Capital Group, LLC, Prospectus (Form 424B4), at 232 (Apr. 11, 2012).

188 Davidoff, *supra* note 184, at 339.

189 William K. Sjostrom, Jr., *Carving A New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 660 & n.185; *cf.* Joseph R. Magnas, *Using Rule 144A Equity Offerings to Supplement or Replace IPOs During Volatile Markets*, 4 BLOOMBERG L. REP. 51 (2010), *available at* http://www.mofo.com/files/Uploads/Images/101220-Using-Rule-144A-Equity-Offerings-to-Supplement-or-Replace-IPOs-During-Volatile-Markets.pdf (describing the advantages of using the 144A market as a pre-IPO forum).

190 Zuckerman, *supra* note 185.

191 *See* Sjostrom, *supra* note 27, at 430–31.

192 Zuckerman, *supra* note 185.

193 *See* WEILD & KIM, *supra* note 70, at 17 (criticizing the 144A market's illiquidity); Reinhardt Krause, *Private Share Market May Supplant IPOs*, INVESTOR'S BUS. DAILY, Nov. 11, 2009, *available at* 2009 WLNR 22533306 (same).

194 *See* WEILD & KIM, *supra* note 70, at 15; Phil Wahba, *Private Placements Little Comfort for IPOs*, REUTERS (Dec. 5, 2008), http://www.reuters.com/article/2008/12/05/us-markets-stocks-ipos-idUSN0546573420081205.

195 *See* Restricted Securities Release, *supra* note 179, at 17,947 tbl. (showing that about 300 banks and savings and loans hold greater than $100 million in securities).

the ideal buyers for many firms. In particular, they have traditionally shown little interest in smaller companies. On the stock market, it is not QIB-type investors that drive liquidity for these companies. It is small investors.[196] In barring participation by this group of potentially interested buyers, rule 144A renders this platform less appealing to smaller firms.[197]

Thus, like section 4(1½) and rule 144, this rule fails to frame a suitable alternative equity market. In the end, the three rules pertaining to the secondary market for private shares all come up short. They are inconsistent with each other and do not offer a reasonable regulatory template for the exchange of private shares. As a result of this dubious foundation, the shadow markets based upon them fail to offer real liquidity, raise investor-protection concerns, or both.

B. *Nontraditional IPOs and Nontraditional Markets*

The traditional IPO, which launches a company onto the NYSE or NASDAQ and into the sweet-spot of securities regulation, is well-trodden and familiar. The nuances of the securities laws, however, allow for public companies of various shades. There are many companies that, while nominally public, are not subject to all of the rules normally accompanying public-company status. Although some of these firms trade on the premier exchanges, many end up trading on the OTC markets. In this Section, I analyze the nontraditional avenues to becoming a public company and the nontraditional markets to which these frequently lead. Just as above, the goal is to determine whether these options offer a suitable alternative to traditional IPOs; just as above, I find that these alternatives fall short.

1. Alternatives to the Traditional Public Offering

a. Smaller Reporting Companies

Public-company regulation is not one-size-fits-all. So-called "smaller reporting companies" (SRCs) may opt for a lower regulatory tier, which allows them to go public and stay public without complying with the entirety of regulations to which others are subject.[198] While this

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196 WEILD & KIM, *supra* note 70, at 15.

197 *See* Krause, *supra* note 193 (discussing the 144A market's lack of appeal to small companies); Wahba, *supra* note 194 (same).

198 *See generally* Smaller Reporting Company, Regulatory Relief and Simplification, Securities Act Release No. 33-8876, 73 Fed. Reg. 934 (Jan. 4, 2008) (codified at 17 CFR pts. 210, 228, 229, 230, 239, 240, 249, 260, 269) [hereinafter Smaller Reporting Company Release].

is a relatively recent innovation, an analysis of the new framework, as well as early evidence, suggests that going public as an SRC is not an attractive alternative to the conventional path.

This template, which came into existence in early 2008, is best understood against the backdrop of what it replaced.[199] Starting in 1992, smaller companies had their own reporting regimen, which was outlined for them under Regulation S-B.[200] Under this regulation, "small business issuers," which were defined as those with less than $25 million in revenues and less than $25 million in publicly-held stock outstanding, received two primary benefits.[201] First, they could go public using form SB-1 or SB-2.[202] Second, once public, rather than filing the traditional Exchange Act reports (10-Qs and 10-Ks) they were permitted to file versions specifically suited for small businesses (10-QSBs and 10-KSBs).[203] All of these forms mandated less information than that required of other companies and were therefore cheaper to complete.[204]

The SEC did little of substance to change this framework when it adopted the SRC regime. Essentially, what it did was merge Regulation S-B into Regulation S-K.[205] Now all companies must fill out the same registration statement (Form S-1).[206] But those qualifying as SRCs (firms with a common public equity float of less than $75 million or those without a public float and annual revenues of less than $50 million) are only required to comply with a subset of the disclosure items; this subset essentially corresponds to what was previously required of small business issuers.[207] This reporting paradigm continues once the firms are public. Instead of filling out 10-QSBs or 10-KSBs, these firms complete a subset of the requirements for 10-Qs and 10-Ks.[208]

The superficial changes, while they may make the regulatory apparatus a bit cleaner, do nothing to make IPOs any more attractive. IPOs declined for a long while in spite of the small-business-issuer regime, suggesting that the regulatory compromises it offered were insufficient to entice firms onto the public market. If this template did

199 *See id.*

200 17 C.F.R. §§ 228.10–.703 (2007) (rescinded 2008).

201 *See id.* at § 228.10(a); Smaller Reporting Company Release, *supra* note 198, at 936.

202 *See* 17 C.F.R. §§ 239.9, 239.10; Debra J. MacLaughlin & Wendy Hambleton, *Securities and Exchange Commission Reporting Requirements*, *in* 1 ACCOUNTANT'S HANDBOOK 3.1, 3.24–.25 (D.R. Carmichael et al., 11th ed., 2007).

203 *See* 17 C.F.R. § 228.10(a)(2); MacLaughlin & Hambleton, *supra* note 202, at 3.24–.25.

204 *See* MacLaughlin & Hambleton, *supra* note 202, at 3.24–.25 exhibit 3.1.

205 *See* Smaller Reporting Company Release, *supra* note 198, at 937.

206 *Id.*

207 *See id.* at 935–36. In addition, SRCs are free to comply with additional disclosure items if they choose. *See id.*

208 *See* SEC. & EXCH. COMM'N, CHANGEOVER TO THE SEC'S NEW SMALLER REPORTING COMPANY SYSTEM BY SMALL BUSINESS AND NON-ACCELERATED FILER COMPANIES: A SMALL ENTITY COMPLIANCE GUIDE 5–6 (2008), *available at* http://www.sec.gov/info/smallbus/secg/smrepcosysguid.pdf.

not convince firms to go public, the prospects for the all-too-similar SRC regime appear bleak.[209]

But there is one change that appears promising. Because the definition of an SRC noted above is substantially broader than the definition of a small business issuer,[210] larger firms can take advantage of this lighter reporting template. Broadening access could theoretically attract more firms onto the public markets. In practice, though, it does not look like the change has had an impact. Despite its enactment in 2008, there has been no appreciable bump in IPO activity over the last few years.[211] In fact, the years following the rule change all had lower IPO figures than 2007, the year before the SRC regime took effect. It is impossible to know what the number of IPOs would have been in recent years had these reforms not been enacted, which means that an unassailable conclusion as to the impact of the SRC regime is out of reach. With this caveat in mind, however, these statistics certainly suggest that the changes were ineffectual.

Although the revised reporting regime is ill-suited to rejuvenate the IPO market, the experience with Regulation S-B carries an important lesson for reform: to make the public markets attractive again, the SEC and Congress must do more than tinker with disclosure obligations.

b. Regulation A

Regulation A[212] is similar to the SRC regime in that it allows firms to access the public markets without complying with all of the usual requirements.[213] The availability of this avenue, however, is tied to the size of the offering rather than the size of the company. Up to $5 million of securities may be sold pursuant to Regulation A, $1.5 million of which may be sold by existing shareholders.[214]

Under this rule, firms must provide information that is less than, but analogous to, that provided in a traditional registration statement and prospectus.[215] The main differences are that firms need provide less

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209 In fact, the SRC regime actually requires additional financial information, so it increases the costs on firms. *See* Smaller Reporting Company Release, *supra* note 198, at 936.

210 *See supra* note 207 and accompanying text.

211 *See* Gao, *supra* note 65, at 46 fig.1 (showing very few IPOs among both small and large firms from 2008–2009 and a modest uptick in 2010 and 2011).

212 17 C.F.R §§ 230.251–.263 (2011).

213 *See* Rutheford B. Campbell, Jr., *Regulation A: Small Businesses' Search for "A Moderate Capital"*, 31 DEL. J. CORP. L. 77, 80 (2006).

214 17 C.F.R. § 230.251(b). Public companies may not use Regulation A to raise capital. *Id.* § 230.251(a).

215 *See* Campbell, *supra* note 213, at 104–06 (2006) (discussing the Regulation A disclosure requirements).

financial information,[216] and that, while financial statements must be in conformity with Generally Accepted Accounting Principles, they usually need not be audited.[217] Unlike the filing of a registration statement, going public pursuant to Regulation A does not automatically trigger ongoing reporting obligations under the Exchange Act.[218] But section 12(g) again comes into play. Firms that cross the dollar-amount and shareholder-number thresholds in this provision are required to file such reports.[219]

Regulation A's effort to accommodate issuers seeking to raise small amounts of capital, while it may be well-intentioned, goes virtually unused.[220] In its current form, the regulation is regulatory surplusage. There are several likely explanations for why it has proven unattractive to issuers. First, $5 million is a relatively paltry sum in comparison with the efforts a company must go through to qualify for the rule.[221] The federal requirements, though reduced, are still significant.[222] Second, Regulation A offerings are not blue-sky exempt, which raises the costs considerably. As Professor Campbell has argued, "a Regulation A offering of $5 million in twenty-five states would likely present problems with state securities laws so overwhelmingly complex that they would swamp any benefit from reduced [federal] disclosure costs."[223] Finally, Regulation A is not designed to provide entry onto the premier exchanges. As just noted, the rule permits firms to raise money from the public, but does not obligate them to make ongoing reports. If a firm does not make ongoing reports, however, it cannot be listed on the top-tier exchanges.[224] Thus, shares in firms making use of Regulation A would trade on the OTC markets, which, as discussed below, are far inferior.[225] Regulation A, therefore, may decrease the costs of going

216 *See id.* at 105 & n.145.

217 *See* Form 1-A, OMB No.: 3235-0286, at Part F/S, *available at* http://www.sec.gov/about/forms/form1-a.pdf; Campbell, *supra* note 213, at 105.

218 *See* 1 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 7:48 (2011).

219 *See supra* note 159 and accompanying text. After going public via Regulation A, firms would likely seek to qualify for the SRC reporting regime. *See* 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 6:27 (2d ed. 2011).

220 Campbell, *supra* note 213, at 82–83; *see also* DAVID N. FELDMAN, REVERSE MERGERS AND OTHER ALTERNATIVES TO TRADITIONAL IPOS 200 (2d ed. 2009) ("Most securities lawyers cannot remember the last time someone they know has used Regulation A . . . ."); Coffee, *supra* note 108, at 5 (noting that only seven Regulation A offerings took place in 2010).

221 *See* Richard A. Mann et al., *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 833 (2004).

222 *See supra* notes 215–217 and accompanying text.

223 Campbell, *supra* note 213, at 111.

224 *See* Securities Exchange Act of 1934 § 12(a), 15 U.S.C. § 78*l*(a) (2006) (requiring a registration statement for trading on a national securities exchange); *id.* § 78m(a) (requiring all registered companies to file Exchange Act reports).

225 *See* 1B BLOOMENTHAL & WOLFF, *supra* note 129, § 12:111 (2011); Alix Stuart, *Is Going Public Going out of Style?*, CFO MAG., May 2011, *available at* http://www.cfo.com/article.cfm/14570187/2/c_14570395.

public, but the benefits are severely decreased as well. This combination of drawbacks is likely what dooms this rule to near irrelevance.[226]

c. Reverse Mergers

Reverse mergers are yet another way to go public without conducting a traditional IPO. As firms began to balk at IPO costs, these transactions inspired a cottage industry that extolled their virtues as a cheaper alternative.[227] Enthusiasm for reverse mergers is shortsighted, however, and in any case, because of new regulations, their salad days are likely past.

A reverse merger is a transaction in which a private company goes public by merging into a public one.[228] The public company used for this purpose is a shell entity, meaning it has no ongoing operations.[229] As a result of the reverse merger, the private company gains the public-company status of the shell.[230]

But that is all it gains. Unlike in a traditional IPO, where the company issuing shares is launched onto a national exchange like the NYSE or NASDAQ, a company that completes a reverse merger trades on the less-desirable OTC market.[231] While transition to the premier markets is possible, most reverse-merger companies are ill-positioned to meet their quantitative and qualitative standards.[232]

With these markets mostly out of reach, the key benefit firms typically get from reverse mergers is that they become public companies

226 The JOBS Act adds section 3(b)(2), among other related provisions, to the Securities Act. *See* JOBS Act, Pub. L. No. 112-106, § 401, 126 Stat. 306, 323–25 (2012). The new rules give the SEC the authority to add a new registration exemption similar to Regulation A, but with a $50 million offering cap. *See id.* Like Regulation A, this new exemption will not provide a safe-harbor from state blue-sky laws. *See id.*; *see also* DAVID M. LYNN & ANNA T. PINEDO, MORRISON FOERSTER, THE JOBS ACT 15 (2012), *available at* http://www.mofo.com/files/Uploads/Images/JOBS_Act_Summary_A3b2.pdf (summarizing Regulation A and section 3(b)(2)). There is reason, therefore, to be skeptical about whether firms will make use of this alternative. *See* Coffee, *supra* note 108, at 5–6. In addition, the JOBS Act instructs the Comptroller General to study the effect of blue-sky laws on Regulation-A offerings. *See* JOBS Act § 402.

227 *See* FELDMAN, *supra* note 220, at 27–34; William K. Sjostrom, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J. 743, 748 & n.45 (2008). The number of reverse mergers appears to have climbed from 2004–2008, but declined since then. *See* FELDMAN, *supra* note 220, at 3 fig.1.1; PUB. CO. ACCOUNTING OVERSIGHT BD., ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES FROM THE CHINA REGION: JANUARY 1, 2007 THROUGH MARCH 31, at 3 tbl.1 (2010), *available at* http://pcaobus.org/Research/Documents/Chinese_Reverse_Merger_Research_Note.pdf.

228 FELDMAN, *supra* note 220, at 3–4. *See generally* SEC, INVESTOR BULLETIN REVERSE MERGERS (2011), *available at* http://www.sec.gov/investor/alerts/reversemergers.pdf.

229 FELDMAN, *supra* note 220, at 3–4.

230 *Id.*

231 *Id.* at 25, 91; Sjostrom, *supra* note 227, at 749.

232 *See* FELDMAN, *supra* note 220, at 98.

without filing a costly registration statement. Allowing them to skip this step, though, comes at the expense of investor protection. It was at the registration stage where, as mentioned earlier, accounting gimmicks at Groupon and Zynga were uncovered.[233] Also, numerous accounting problems have been discovered at China-based firms that utilized the reverse-merger process as a way to go public in the U.S.[234] If these firms had been required to file a registration statement, perhaps these issues would have been caught earlier.

Reverse mergers are also inconsistent with the remainder of the regulatory framework. The SRC regime, for instance, pins lower regulatory requirements on smaller size. This makes sense because, as discussed above, smaller firms have more difficulty paying compliance expenses.[235] Reverse mergers, on the other hand, are simply a form of regulatory arbitrage. They are a way to access the public markets without going through the ordinary process; but this deviation is not justified on policy grounds. Rather, these transactions are merely the product of lawyerly sleight of hand.

In light of the public-policy concerns, in November 2011 the SEC approved rules requiring that newly-minted public companies that achieved this status through a reverse merger must trade for at least a year on an alternate platform, such as the OTC market, before joining the major exchanges.[236] The new rules also require that, among other things, before listing on the national exchanges, a company must file at least one annual report—a document that includes audited financial statements.[237] These rules are likely a step forward in that they provide additional protection for NYSE and NASDAQ investors. The key limitation, however, is that the OTC market is left outside the regulatory sphere. Investors on these platforms are left with the status quo.

Even though the new rules are not full-proof, the increased compliance requirements will likely temper the reverse-merger fad.[238] This is a good thing. A true low-cost alternative to traditional IPOs should not only offer liquidity and investor protection, but be justified on policy grounds and make sense within the larger regulatory

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233 *See supra* note 163 and accompanying text.

234 *See* Azam Ahmed, *Chinese Reverse-Merger Companies Draw Lawsuits,* N.Y. TIMES DEALBOOK, (July 26, 2011, 2:35 PM), http://dealbook.nytimes.com/2011/07/26/chinese-reverse-merger-companies-draw-lawsuits/.

235 *See supra* notes 88–89 and accompanying text.

236 Press Release, SEC, SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies (Nov. 9, 2011), *available at* http://www.sec.gov/news/press/2011/2011-235.htm.

237 *See* NASDAQ OMX GROUP, INC., NASDAQ STOCK MARKET RULES § 5110(c)(2)(A) (2012) [hereinafter NASDAQ MARKET RULES]; NYSE, INC., LISTED COMPANY MANUAL § 102.01F(3) (2012) [hereinafter NYSE LISTED COMPANY MANUAL].

238 *See* Karina Frayter, *Dismal Outlook for Reverse Mergers*, CNBC (Dec. 14, 2011, 10:17 AM), http://www.cnbc.com/id/45658983/Dismal_Outlook_for_Reverse_Mergers.

apparatus. Reverse mergers satisfy none of these criteria.

2. Alternative Public Equity Markets

As mentioned above, Regulation-A issuances and reverse mergers lead to the OTC market. It is also possible for companies to conduct nontraditional public offerings in this marketplace or register their existing shares for OTC trading.[239] Up until very recently, engaging in such transactions meant a company's shares would trade on the OTC Bulletin Board or the Pink Sheets—platforms with a history of illiquidity and fraud.[240] As the IPO market has cooled, however, the landscape for alternative public equity markets has transformed. Now, if a company falls short of or is disenchanted with the NYSE or NASDAQ, it can choose to trade on one of three OTC market tiers—OTCQX, the OTCQB, or OTCPink[241]and soon, such firms will be able to list on the NASDAQ BX Venture Market (BX Market), which is currently under development.[242] All of these could theoretically serve as havens of equity liquidity for emerging firms. In this Section, I survey this transformation in the alternative equity markets and conclude that, while the launch of these new platforms is an improvement over the status quo, all of them have significant shortcomings.

a. The OTC Market

i. Decline of the OTC Bulletin Board

The OTC Bulletin Board is fading fast. But it is still worth a brief mention because its shrinking footprint is a key development in the changing landscape of the OTC market. Unlike the NYSE or NASDAQ, the OTC Bulletin Board has no qualitative or quantitative listing standards.[243] In the past, this market also used to be distinguishable from the top exchanges because of an absence of regulation. This changed in 1999, however, when, partly out of fraud concerns, FINRA

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239 *See* FELDMAN, *supra* note 220, at 183–99 (discussing the option of "self-filing" an S-1 registration statement). Technically, a company wishing to trade on the OTC market cannot list its shares itself; rather, it needs to coordinate with a broker to do so on its behalf. *See id.* at 196.

240 *See* J. WILLIAM HICKS, INTERNATIONAL DIMENSIONS OF U.S. SECURITIES LAW § 2:24 (2011); Molitor, *supra* note 91, at 330 n.123; Michael Schroeder et al., *Penny-Stock Fraud Is Again on a Resurgence, Bolstered by Loopholes and New Technology*, WALL ST. J., Sept. 4, 1997, at A12.

241 *About OTC Markets Group*, OTCMARKETS, http://www.otcmarkets.com/about/overview (last visited Dec. 28, 2011).

242 *FAQ*, BX VENTURE MARKET, http://www.bxventure.com/faq (last visited Dec. 28, 2011).

243 Molitor, *supra* note 91, at 327–28.

mandated that firms on this platform file Exchange Act reports.[244]

So began the market's steep decline. Although some OTC Bulletin Board firms were already filing such reports, many were not. Of the latter group, 76% moved from the OTC Bulletin Board to the more lightly regulated Pink Sheets rather than comply.[245] The market continued to limp along until 2011. In this year, over 600 firms were removed because of anemic trading activity, essentially ending the OTC Bulletin Board's existence as an active market.[246] Today, only about 30 firms are solely quoted on this venue.[247] Because the OTC Bulletin Board is headed for extinction, it is not a destination entrepreneurial firms would consider when looking to list their shares.

ii. The Transformation of the Pink Sheets

The Pink Sheets has rebranded and reorganized into three tiers under the umbrella of the OTC Markets Group.[248] While its changes are for the better, the new-look Pink Sheets still hold little appeal for domestic companies seeking a healthy venue for secondary-market trading.

The Pink Sheets were traditionally the venue of last resort. Listing requirements on this platform were non-existent and regulation was lax. Like the OTC Bulletin Board, the Pink Sheets had no quantitative or qualitative listing requirements.[249] Unlike the OTC Bulletin Board, Pink-Sheet companies were never required to file Exchange Act reports.[250]

In lieu of the ongoing disclosure regime, these companies were bound only by a few federal rules—the same rules that govern companies trading on OTC Markets Group platforms today. The first is the general prohibition against fraud to which all companies issuing securities are subject.[251] The second is section 12(g), which, as mentioned earlier, requires that all companies with greater than $10 million in assets and more than a certain number of shareholders register their shares and file ongoing reports.[252] The third is rule 15c2-

244 *See* Bushee & Leuz, *supra* note 20, at 239.
245 *Id.* at 235, 243.
246 *See* 24 WILLIAM M. PRIFTI, SEC. PUB. & PRIVATE OFFERINGS § 9:23.05 (2011).
247 *Learn—OTC Market Tiers*, OTCMARKETS, http://www.otcmarkets.com/otc-101/otc-market-tiers (last visited, Jan. 20, 2012).
248 *See* PRIFTI, *supra* note 246, at § 9:23.05.
249 Molitor, *supra* note 91, at 330–32.
250 *Id.* at 332.
251 *See* Joseph I. Goldstein et al., *An Investment Masquerade: A Descriptive Overview of Penny Stock Fraud and the Federal Securities Laws*, 47 BUS. LAW. 773, 809–10 & n.184 (1992).
252 *See supra* note 159; Molitor, *supra* note 91, at 314–16.

11.[253] Under this rule, before a broker-dealer may list a company's shares for trading, it must compile information about the company's business and products, as well as two years of financial statements.[254] This information must then be made available to potential purchasers upon request.[255]

This regulatory regime has remained static as the Pink Sheets has transformed itself into the three-tiered OTC Markets Group.[256] Under the new setup, what was traditionally simply known as the Pink Sheets has essentially been reincarnated as the lowest listing tier and renamed OTCPink.[257] Like its predecessor, this market has no listing requirements and is simply governed by the federal regulations listed above.[258] Because OTCPink is merely the Pink Sheets with a new name, it will likely suffer from the same issues that plagued the original. In particular, the Pink Sheets had a reputation for illiquidity[259] and as the home of shoddy companies, many of which had been delisted from higher-tier markets.[260] Few legitimate emerging firms would relish the

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253 17 C.F.R. § 240.15c2-11 (2011).

254 *See id.* § 240.15c2-11(a); *see also* Molitor, *supra* note 91, at 335–38 (describing rule 15c2-11 in depth).

255 17 C.F.R. § 240.15c2-11(a)4, 5. The penny stock rules, which generally apply to trades in OTC shares priced at under $5.00, are also relevant. *See* Molitor, *supra* note 91, at 328 n.114. But these rules, which, among other things, require that selling brokers disclose the risks of trading in penny stocks, are more aimed at disrupting high-pressure sales and boiler-room tactics, than at providing investors with information about the issuer. *See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 686–88 (1996). Transfers on the OTC markets are generally exempt from registration under Section 4(1). *See* HAZEN, *supra* note 117. They are also generally exempt from registration under state blue-sky laws. *See* ROBERT BARTLETT, SCALING MANDATORY DISCLOSURE IN BOTH "PUBLIC" AND "PRIVATE" SECURITIES MARKETS 11-12 (2012), *available at* http://www.sec.gov/info/smallbus/acsec/acsec-backgroundmaterials-090712-bartlett-article.pdf (presented at the Sept. 7, 2012 Meeting of the SEC Advisory Committee on Small and Emerging Companies).

256 *See* About OTC Markets Group, *supra* note 241.

257 *See OTC Pink Marketplace—Speculative Trading Marketplace*, OTCMARKETS, http://www.otcmarkets.com/otc-pink/home (last visited Dec. 28, 2011); *Learn—OTC 101 FAQs*, OTCMARKETS, http://www.otcmarkets.com/otc-101/otc101-faq (last visited Dec. 28, 2011) (referring to OTCPink as synonymous with the Pink Sheets).

258 *Cf. Learn—OTC Market Tiers*, *supra* note 247 (noting that OTCPink lists dormant companies, as well as those that provide no information).

259 *See* ADVISORY COMM. REPORT, *supra* note 87, at F-1 n.2 (noting the infrequency of trading in many Pink-Sheets companies); Davidoff, *supra* note 58, at 134–35 (criticizing the Pink Sheets for, among other things, lack of liquidity); Sjostrom, *supra* note 227, at 749 & n.51; Jeffrey H. Harris et al., *Off but Not Gone: A Study of Nasdaq Delistings* 3 (Dice Ctr. Working Paper No. 2008-06, 2008) (finding a 60% drop in volume when firms move from NASDAQ to the Pink Sheets); *OTC Markets Group Inc. (formerly known as Pink OTC Markets, Inc.)*, SEC. & EXCH. COMM'N, http://www.sec.gov/answers/pink.htm (last visited Dec. 28, 2011) (describing Pink-Sheets stocks as thinly traded).

260 *See* Jonathan Macey et al., *Down and Out in the Stock Market: The Law and Economics of the Delisting Process*, 51 J.L. & ECON. 683, 684 (2008) (describing the Pink Sheets as a landing spot for delisted NYSE firms); *See* Molitor, *supra* note 91, at 331 n.123 (2006) (describing the range of companies trading on the Pink Sheets).

opportunity to sign up for a platform laden with such baggage.

On top of this, the regulatory regime that applies to OTCPink raises severe investor-protection concerns. Thanks to 15c2-11, this market is not a total informational vacuum. At the same time, however, the transparency mandated by the rule is quite limited. Although financial statements must be disclosed to prospective investors, they are only required to be "reasonably current."[261] This standard is met even if a firm's balance sheet, for instance, is over one-year old.[262] Thus, information can be stale even when it is first provided. And the problem worsens over time. These disclosures are only required when the firm's shares are first quoted on the market and are only filed with the original broker.[263] Because of this, after a firm begins trading, its publicly-available information can quickly become dated and difficult to find.

In addition, 15c2-11 disclosures only need to be furnished if the potential investor asks for them.[264] But unsophisticated investors may not know to do so. This is particularly problematic because unsophisticated individual investors make up a large portion of OTC-market participants.[265] Indeed, many institutional investors are contractually bound to stay away.[266]

Making matters worse is the potential for stock-price manipulation. This is easiest to do when prices are low and trades infrequent.[267] Because this is the case in the OTC market, it has always been marred by these practices.[268] When this unfortunate reality is added to the list of other investor-protection concerns, it becomes apparent that OTCPink represents a gaping hole in the regulatory fabric. It is a place where unsophisticated investors can invest in questionable companies without access to current information and in an environment conducive to fraud.

This lack of regulation is not only problematic on its face; it is also inconsistent with the remainder of the regulatory structure. It is difficult to reconcile the high-level commitment to investor protection reflected

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261 17 C.F.R. § 240.15c2-11(a)(5) (2012).

262 *Id.* § 240.15c2-11(g)(1).

263 This is as a result of the rule's piggyback provision. *See id.* § 240.15c2-11(f)(3); Molitor, *supra* note 91, at 365.

264 17 C.F.R. § 240.15c2-11(a)(4), (5).

265 Langevoort, *supra* note 255, at 686.

266 Self-Regulatory Organizations; NASDAQ OMX BX, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto to Create a Listing Market on the Exchange, SEC Release No. 34-64437, 76 Fed. Reg. 27,710, 27,712 n.22 (May 6, 2011) [hereinafter BX Market Approval].

267 *See* Langevoort, *supra* note 255, at 686. *See generally* Goldstein, *supra* note 251, at 773.

268 *See* Rajesh K. Aggarwal & Guojun Wu, *Stock Market Manipulations*, 79 J. BUS. 1915, 1917 (2006) ("Our analysis shows that most manipulation cases happen in relatively inefficient markets, such as the OTC Bulletin Board and the Pink Sheets, that are small and illiquid."); *supra* note 267 and accompanying text.

in the regulation of the premier markets with the near indifference towards the goal in this arena. In addition, the absence of oversight contravenes the complementary notion that runs through much of securities regulation, in particular rule 144A, which is that less-regulated securities are only suitable for sophisticated purchasers. Here, we have unsophisticated investors exposed to the most dangerous securities. A comprehensive regulatory structure needs a market where struggling firms can go, but OTCPink lacks the minimal safeguards that one should possess.

The next-higher tier is the OTCQB.[269] This market raises many of the same concerns as OTCPink, but to a lesser degree. The OTCQB replicates the structure of the OTC Bulletin Board, and it is where Bulletin-Board companies migrated to as that platform disintegrated.[270] Like the OTC Bulletin Board, it only lists firms that are current in their reporting obligations, but otherwise has no qualitative or quantitative requirements.[271]

While companies traded on the OTCQB are likely a step-up from those trading on OTCPink, they are not the type that emerging young companies would wish to be associated with. Like the Pink Sheets, the OTC Bulletin Board was traditionally a home for firms that had been delisted from the major exchanges.[272] Now these firms trade on the OTCQB. At best, delisted companies house an honest, yet struggling, business; at worst, there is some sort of illicit behavior. If an emerging firm were to list alongside these companies, it would surely have to discount its shares to compensate investors skeptical about the prospects of any young firm choosing to do so.

The story is similar with respect to liquidity. Since the market just launched in 2010, its trading activity has been little studied. But the market's behavior is likely similar to that of the OTC Bulletin Board, which was studied while it was still an important platform. When compared to the Pink Sheets, the OTC Bulletin Board had greater liquidity.[273] When compared to the premier exchanges, however, its liquidity was paltry.[274] Assuming this is likewise the case at the OTCQB, this middling status would make the market unappealing. If an emerging firm chose to go public on the OTCQB, it would bear the cost

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269 *OTCQB Market Tier*, OTCMARKETS, http://www.otcmarkets.com/otcqb/home (last visited Jan. 16, 2012).

270 *See* PRIFTI, *supra* note 246, at § 1:10; *OTCQB Market Fact Sheet*, OTCMARKETS, http://www.otcmarkets.com/content/doc/ps/OTCQBfactsheet.pdf (last visited Jan. 16, 2012).

271 *OTCQB Market Tier*, *supra* note 269.

272 *See* Macey et al., *supra* note 260, at 689.

273 *See* Harris, *supra* note 259, at 3.

274 *See* Aggarwal & Wu, *supra* note 268, at 1917; Harris, *supra* note 259, at 3 (noting the decline in share volume when firms fall to the OTC Bulletin Board from NASDAQ); Phyllis Plitch & Michael Rapoport, *NASD Tacks up Strong New Rules on Bulletin Board*, WALL ST. J., June 22, 2000, at C1 (noting that OTC Bulletin Board stocks are thinly traded).

of securities-law compliance, but would not receive the benefit of liquidity.

The highest platform of the OTC Markets Group, OTCQX, has the most to offer. Unlike the others, this one is "quality controlled."[275] Like more well-respected exchanges, firms seeking to list on it must meet certain quantitative requirements. Listing here, for example, requires at least $2 million in assets.[276] OTCQX also has an ongoing disclosure requirement. Firms must either be reporting companies under the Exchange Act or they must comply with the platform's disclosure guidelines.[277] Another rule is that companies must have a Designated Advisor for Disclosure (DAD).[278] The DAD, which can be a qualified investment bank or attorney,[279] serves the company as a "cautious and conscientious advisor."[280] They also play an oversight role: DADs are relied on to prevent "companies with inadequate or questionable . . . disclosure from joining OTCQX."[281]

Unlike the other tiers, this one seems to have potential as an alternative listing venue for startup companies. It gives them a platform that is subject to less regulation than the premier exchanges, but is exclusive enough to eliminate dubious firms. The venue, however, has not caught on. Although it was launched in March 2007, at last count, it only lists 30 U.S. firms.[282] Moreover, rather than drawing new firms to the public markets, it appears that the OTCQX is serving as a home for firms looking to relocate: the vast majority came from other OTC markets or landed on the OTCQX after being delisted from a premier exchange.[283]

We can only speculate as to why new firms have been unimpressed. But one problem may be perception. The OTC Markets Group is still thought of as the Pink Sheets, a market synonymous with trading in dubious and delisted companies.[284] Firms, therefore, may view even its highest tier with skepticism. OTCQX is not helped in this regard by its inclusion of delisted firms. While they may meet the requirements of

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275 *OTCQX Overview*, OTCMARKETS, http://www.otcqx.com/qx/otcqx/overview (last visited Sept. 30, 2012).

276 *OTCQX Requirements & Fees*, OTCMARKETS, http://www.otcqx.com/qx/otcqx/requirements (last visited Dec. 28, 2011).

277 OTCQ MARKETS GROUP, INC., OTCQX RULES FOR U.S. COMPANIES § 3.1(r)(i)(ii) (2011), *available at* http://www.otcqx.com/content/doc/qx/Rules/OTCQX.pdf.

278 *Id.* § 4.1.

279 *Id.*

280 *Id.* § 4.2(b).

281 *Id.* § 4.2.

282 *See List of OTCQX Securities*, OTCQX, http://www.otcqx.com/qx/market/otcqxList (last visited Jan. 16, 2012).

283 A list of the U.S. firms trading on the OTCQX as of September 22, 2011, as well as information about their listing histories is on file with the author.

284 *See* 1 BLOOMENTHAL & WOLFF, *supra* note 129, at § 2:17.30 (positing that the negative image of the Pink Sheets is inhibiting the success of the OTCQX market).

this platform, they still carry the stigma of delisting, which likely chills the platform's acceptance as a legitimate alternative for new companies. Also, going public on a platform like this sends an unwanted signal to investors—that the company is not good enough for the premier markets.[285] While a firm may have a perfectly good reason to choose OTCQX, it would likely have to discount its shares to compensate investors for the perceived risk. Finally, this platform may lack liquidity. There have been no formal studies of this market, but an informal review of its activity reveals that many of the firms are thinly traded. On a given day, more than 45% of the companies on the market do not trade.[286] Some go without trading for weeks or more.[287] It is too early to tell, but a lack of liquidity may be one reason this platform has failed to attract emerging firms.

From an investor-protection standpoint, this marketplace has much to like. The inclusion of DADs is a nice touch, as are the quantitative standards. But this template does come with a big drawback—it is an exercise in purely self-regulation. The OTC Markets Group polices OTCQX compliance and there is no accountability for effective enforcement.[288] Without SEC oversight, there is the potential for this organization to bend its rules or look the other way so as to maintain listings. Indeed, the failure of the NYSE to police its own rules was a key reason for the enactment of the federal securities laws in the first place.[289] Thus, while OTCQX may have a reasonable template, it would be better if it were integrated into the larger securities-law framework.

In providing liquidity for shareholders in delisted firms, the OTC market plays a seldom-acknowledged yet crucial role in U.S. equity markets more broadly. Notwithstanding their contribution, however, the lack of regulation poses investor-protection concerns that are worthy of attention. Moreover, the chilly reception among new ventures to the launch of OTCQX suggests that the OTC market will remain a place for castoffs rather than hopeful emerging companies.

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285 *See* Macey & Kanda, *supra* note 17, at 1023–24 (discussing the signaling role played by exchanges).

286 This figure is based on observation of approximately one month of market data (on file with author). Market activity can be viewed at *Market Activity: Current Market*, OTCQX, http://www.otcqx.com/qx/market/current (last visited Feb. 10, 2012).

287 Firm-level trading data can be viewed at Current OTCQC Market Statistics, *supra* note 286.

288 *See* 3D BLOOMENTHAL & WOLFF, *supra* note 219, at § 23:39.95.

289 *See* 1 LOUIS LOSS ET AL., SECURITIES REGULATION 321 (4th ed. 2006).

b. The NASDAQ BX Venture Market

Once the NASDAQ BX Venture Market opens, it will create another alternate listing venue.[290] Unlike the OTC market, which has a feeble regulatory backbone, this market will share the regulatory structure underpinning the premier exchanges. Companies on this exchange will be subject to all of the reporting obligations under the Exchange Act, as well as Sarbanes-Oxley.[291] The difference between this exchange and the NYSE and NASDAQ will be its listing standards. First, its quantitative requirements will be lower. On the premier exchanges, firms must meet a series of hurdles in terms of assets, share price, and float.[292] This market, however, will only require that firms have been in operation for at least one year and have at least $1 million in equity or $5 million in assets.[293] Second, not all of the qualitative listing standards of the premier exchanges will apply to this platform. The biggest difference will be that, unlike aspirants to a NYSE or NASDAQ listing, firms seeking to trade on the BX Market will not need to have a majority independent board.[294]

This venue will have certain advantages over other alternative equity markets, but ultimately it too will likely fall short. Unlike the private markets, firms on this exchange will not need to worry about having too many shareholders. In addition, there will be no limitation on who can participate. Both of these factors open the door for broader liquidity. The BX Market will also have a leg-up on the OTC Markets Group. Its stronger regulatory backbone and association with NASDAQ rather than the Pink Sheets puts it on sounder footing. What will likely hold this platform back, however, is that it does not do enough to reduce costs.

When compared to the top-tier exchanges, there will likely be some savings because firms will not be required to meet all of the corporate-governance requirements. But the key securities-law compliance burdens will remain. At the same time, the future of the exchange is uncertain, as is the liquidity it will offer. This combination of costly regulation and questionable prospects will likely make this venue unappealing to emerging firms. As a result, the market may evolve into a soft-landing venue rather than a true equity alternative. In other

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290 *See FAQ*, *supra* note 242; *see also* BX Market Approval, *supra* note 266, *passim* (approving of this new platform).

291 *See FAQ*, *supra* note 242.

292 *See* Molitor, *supra* note 91, at 332–33 (describing listing standards for NYSE and NASDAQ).

293 *Companies*, BX VENTURE MARKET, http://www.bxventure.com/companies/ (last visited, Jan. 20, 2012).

294 *See* NASDAQ MARKET RULES, *supra* note 237, at § 5605(b)(1); NYSE LISTED COMPANY MANUAL, *supra* note 237, at § 303(A).01; *FAQ*, *supra* note 242.

words, firms that can no longer comply with the numerical listing standards of the premier exchanges may fall to the BX Market, as opposed to the OTC market, when delisted. This is good for these companies, but if this starts to happen, it would further dampen the appeal of the BX Market for true emerging firms.

In the end, this effort to create a junior equity market appears half-hearted. The visions of bold reform that the market's name inspires never actually materialize. While the addition of this platform may be an improvement over the status quo, it looks ill-positioned to remedy the troubled relationship between entrepreneurial firms and the U.S. equity markets.

C. *Summary of Analysis*

I argued in Part I that falling IPOs were a negative signal about the state of entrepreneurship and equity markets, but that without surveying liquidity alternatives we could not know for sure whether the statistics were sounding a false alarm. If there were other comparable ways of accessing equity liquidity, then maybe the crucial relationship between equity markets and entrepreneurs was maturing as opposed to atrophying.

This Section has surveyed the possible alternatives and found them to be inadequate. In the process, it has also provided an overview of secondary-market regulation. What this has revealed is a regulatory structure that consists of a series of ill-fit and seemingly ad hoc regulations, rather than one based on a cohesive unifying theory.

The lack of attractive alternatives means that the dearth of IPOs should be taken seriously. It is not the case that emerging firms are finding suitable liquidity elsewhere in U.S. equity markets. Rather, if they are providing their employees and investors with any opportunity to resell their equity, it is on markets that are far inferior. In this new reality, shares in emerging firms are less valuable. As discussed in Part I, less valuable shares translate to a weakened entrepreneurial ecosystem—a consequence with deleterious reverberations throughout the economy.[295]

[295] This conclusion is consistent with a recent poll of venture capitalists, a majority of whom called the industry broken, and 92.7% of whom were worried or very worried about exit markets. *See* Scott Austin, *Majority of VCs in Survey Call Industry 'Broken'*, WALL ST. J. VENTURE CAPITAL DISPATCH (June 29, 2009, 4:38 PM), http://blogs.wsj.com/venturecapital/2009/06/29/majority-of-vcs-in-survey-call-industry-broken/. The conclusion is also in harmony with evidence that entrepreneurial activity and fund-raising have been flat or declining over the past six to twelve years. *See* ABDUL ALI ET AL., GLOBAL ENTREPRENEURSHIP MONITOR: NATIONAL ENTREPRENEURIAL ASSESSMENT FOR THE UNITED STATES OF AMERICA 53–54 & fig.36 (2010), *available at* http://www.gemconsortium.org/docs/download/667 (discussing and showing flat and declining entrepreneurship since 2000); *id.* at 58 & tbl.22 (discussing and

All of this points towards the need for reform. An improved equity-market structure would provide a suitable listing alternative for emerging firms and fill the gaps in the existing desultory framework.

III. A LIFECYCLE MODEL OF SECONDARY-MARKET REGULATION

The original securities laws failed to comprehensively regulate the secondary market for securities. The rules set out a full and rich regulatory structure governing the trading of publicly-listed firms on national exchanges, but said little about trading in companies that remain private or that are delisted.[296] While the SEC has enacted regulations pertaining to these benighted areas of the law, its efforts have been unconfident and contradictory.[297] As a result, we still have an out-of-balance and uneven regulatory framework that fails to suitably account for the entirety of secondary-market trading and lacks a satisfactory underlying theory. For a great while, a vibrant IPO market hid the inadequacy of the framework as a whole and dulled the need for reform. But the tide has now receded. As the traditional public listing has become less desirable, it has become apparent that the regulatory structure fails to accommodate alternatives that offer both liquidity and investor protection.

I recommend a lifecycle model of secondary-market regulation to comprehensively respond not only to the lack of a suitable listing venue for entrepreneurial firms, but also to the overarching failure of the regulatory framework to sensibly regulate the secondary market as a whole. Under the lifecycle model, there would be a market expressly for young firms, markets that accommodate mature firms, markets for companies nearing insolvency or showing other signs of unhealthiness, and finally markets for firms that have chosen to stay private. Each of these markets would have a regulatory framework narrowly-tailored to suit the firms that trade there. This template has the potential to rejuvenate the IPO market and harmonize the remainder of the regulatory structure.

The lifecycle approach is based on a dynamic form of cost-benefits analysis.[298] The idea of fitting regulation to firms as they age is founded

showing flat and declining U.S. "dynamism" —a measure of entrepreneurship—since 2001); *id.* at 57 & fig.39 (discussing and showing poll results indicating declining funding availability since 2006). While broadly supportive, this evidence has its limitations. First, other causes may be the explanation for this state of affairs. Second, a weak state of entrepreneurship may be causing the decrease in IPOs, rather than the other way around. This possibility seems remote, however. Even if their numbers are reduced, there are still many start-ups. The problem is that they are not going public. *See* Ibrahim, *supra* note 25, at 12–13 & n.42; Lucchetti, *supra* note 26.

296 *See supra* Part I.

297 *See id.*

298 Much has been written about cost-benefits analysis. For a comprehensive discussion, see

on the observation that the social costs and benefits of regulation change as firms mature, and that a regulatory structure that reflects this shifting social calculus would be attractive to new firms, protect investors, and be internally consistent. Generally speaking, under this approach, regulation would increase as firms age and become larger, but then decrease as they shrink and approach insolvency.

The primary reason for this bell-curved regulatory structure is that both young firms and old ones are more sensitive to costs than firms in between. First consider young firms. For them, costs loom large in absolute terms (because compliance is most expensive in the beginning, when a firm is figuring out how to conform), in relative terms (because young firms are usually small, compliance costs them more as a percentage of revenue), and in opportunity-cost terms (these are the companies most likely to have otherwise spent the money on innovation and growth).[299] Firms on the decline are likewise sensitive to costs. They are likely to be small, raising relative costs, and have high opportunity costs (these firms are not focused on hiring and growth, but compliance expenses may force a firm to prematurely close its doors or layoff staff). Regulations that appreciate these circumstances would create a better environment for young and old firms.

Nor are the benefits of regulation constant. As discussed further below, large mature companies have an outsized impact on society. Regulating these companies more stringently may, therefore, be justified because it comes with benefits beyond investor protection.[300]

By taking all of this into account, the shape of the regulatory structure begins to come into focus. But the outline remains hazy. The best way to render the concept more tangible is to give a concrete example of what a regulatory and market structure based on it might look like. What follows, therefore, is an outline of a potential multi-tiered lifecycle market structure. The goal is to present a defensible and reasonable template. While a more rigorous and technical analysis of the optimal structure would be a logical additional step, doing so is beyond the scope of this Article.

A. *Emerging-Firm Market*

The lynchpin of the lifecycle model is a new market specifically designed for entrepreneurial firms. We can refer to it as the emerging-firm market or the EF Market for short. The goal in designing such a

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MATTHEW D. ADLER & ERIC E. POSNER, NEW FOUNDATIONS OF COST-BENEFIT ANALYSIS (2006).

299 *See supra* note 34 and accompanying text.

300 *See infra* notes 367–371 and accompanying text.

market is to provide the suitable listing venue for emerging firms that we lack today.

The essential feature of such a market would be an intermediate regulatory template. Part II of this Article showed that there is a vast regulatory gulf between the traditional public markets on the one hand and the public and private alternatives on the other. The EF Market would fill this space.

If a middle ground were offered, there is good reason to think that emerging firms would find it appealing. This is because such an offering would be responsive to the factors thought to have contributed to the recent decline in IPOs. Both academics and entrepreneurs have made a strong case that rising regulatory costs on the traditional public markets are a key explanation for the diminishing number of public offerings.[301] If they are right, then providing a lower tier of regulation should help make going public attractive again. Further, even if factors other than regulation are more important, rolling back regulatory costs would still prove helpful. If we look at the decision to go public as being the result of a cost-benefits analysis conducted by each firm, we can explain diminishing IPOs as a case where costs are rising as benefits are shrinking, at least for many companies. Since regulation is one such cost, bringing these down would shift the entire calculus, and therefore restore their appeal.[302] For example, let us assume that declining liquidity for smaller firms is the largest factor chilling the IPO market. If this is true, the issue warrants direct attention, but can also be addressed indirectly by easing regulatory burdens. If liquidity has decreased, it means the benefits of being public have been reduced; if costs are reduced commensurately, going public remains a viable alternative.[303]

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301 *See supra* Part I.C.

302 But any reduction in regulation to reduce costs needs to be approached with care. When regulation is reduced, investors may respond by discounting the shares of firms in the market to account for the loss in protection. If this discount offsets the cost-savings, then nothing has been gained. The goal, therefore, is to achieve an efficient level of regulation—the amount that maximizes the benefit of the regulatory scheme as reflected in more valuable shareholder equity relative to the cost in terms of firm compliance outlays. Thus, the way to improve matters is to scour the current regulatory framework for efficiency gains—the task implicitly undertaken in Parts III.A.1–2. *Cf. Examining Investor Risks*, *supra* note 108, at 1–3 (noting the tension between the cost of capital-raising and the cost of capital).

303 Decreased regulatory costs are also beneficial if the cause of the decline in IPOs has to do with the two explanations discussed *supra* note 108. One theory pointed to the lack of interest among institutional investors, which are playing an increasingly pronounced role in securities markets, and which are looking for investments that are more liquid than small-company stock. This boils down to an argument about price. Institutions may prefer liquidity, but they purchase illiquid assets all of the time. If they are uninterested in small-company stock because of its illiquidity, it means that firms are demanding a price that institutions are unwilling to pay given the discount they apply to illiquid securities. The price firms demand, however, is at least partially driven by the costs of going public. If costs were lower, firms would be more willing to issue shares for a lower price—one which institutional investors may be willing to pay. More generally, this explanation for declining IPOs can be looked at as an argument that there is

In designing an intermediate regulatory template, the key question is how much breathing room to grant emerging firms. On the one hand, regulatory forgiveness needs to be substantial enough to actually have an impact. Our experience with Regulation S-B and the SRC regime illustrates that more than tiered disclosure is necessary to make listing an attractive option.

On the other hand, there does not appear to be good reason to shatter the public-market template. The inability of alternative U.S. equity markets to generate liquidity shows that too little regulation can be as problematic as too much. Moreover, in Europe and the United Kingdom, there has been a great deal of experimentation with lower-tier markets. But results have been mixed.[304] The most successful platform, the UK's AIM Market, has had great success attracting listings, but has been unable to generate much liquidity for its participants.[305] This evidence suggests that patterning the new market on these would be a mistake.

It would be better, instead, to make this new market a less-regulated version of today's premier exchanges. After all, the public market was successful in attracting IPOs through the 1980s and 1990s with a relatively high level of regulation. It was when compliance obligations were ratcheted up a notch that problems began to emerge. In addition, empirical evidence has shown that mandated disclosure—the hallmark of the public markets—is associated with stronger securities markets and more IPOs.[306] The regulatory structure for the EF Market should, therefore, stay true to the fundamentals of public-market regulation yet contain cuts that are meaningful enough to garner renewed interest.

Going down this path involves an investor-protection tradeoff. Regulatory cuts would potentially lead to more firms in the marketplace, but reductions would also potentially expose investors to greater risk. The justification for making this tradeoff is not based on a quantification of the exact costs and benefits involved in such a

softer demand for IPO shares. Softer demand means lower prices, but if costs are brought down as well, going public remains viable. Similarly, lowering regulatory costs would prove beneficial even if Professor Xiaohui Gao and his colleagues are correct that part of the decline in IPOs has to do with technological trends making it increasingly profitable to merge rather than remain independent. A lower regulatory burden would shift this calculation. While there may never be as many IPOs as there were in the past, if there is an attractive platform, it makes staying independent, which is arguably a more socially-beneficial path, more attractive and thus more likely.

304 *See* Gao et al., *supra* note 65, at 2–3; Mendoza, *supra* note 94, at 291–92 & tbl.2.

305 Gao et al., *supra* note 65, at 20; Mendoza, *supra* note 94, at 298; *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Committee on Banking, Housing, and Urban Affairs*, 112th Cong. 5 (2012) (statement of Jay R. Ritter, Cordell Professor of Finance, University of Florida).

306 *See* Rafael La Porta et al., *What Works in Securities Law?*, 61 J. FIN. 1, 19 & tbl.III (2006).

compromise—indeed, doing so would be quite a challenge given that quantifying the benefits of investor protection is notoriously slippery. Rather it is based on an intuitive weighing of the broad and tangible economic benefits of increased entrepreneurship against the more restricted and abstract benefits that flow from nonessential investor protections (i.e., those above and beyond the central regulatory mandates regarding fraud liability and the ongoing disclosure of key items).[307]

This thinking is also based on the idea that the substantive reforms that are likely necessary to make the public markets attractive again, when carefully targeted, can lead to significant cost savings without significant investor-protection losses. Based on this mindset, in the EF Market I propose, I focus on reforming or eliminating (i) particularly costly and controversial regulations; (ii) those that are an ill-fit to entrepreneurial firms; and (iii) those that are the source of increased compliance expense and litigation risk over the past fifteen years.

1. Reduced Compliance Obligations on the EF Market

As discussed above, the adoption of Sarbanes-Oxley in 2002 was the key regulatory change enacted during the period of IPO declines.[308] It jumps out, therefore, as the most obvious candidate for reform. Although potentially controversial, it may be advisable to completely exempt firms on the EF Market from this statute. This would significantly reduce costs for such firms. It would also do so at a crucial time. Sarbanes-Oxley compliance is particularly expensive when a firm initially ramps up.[309] This is right when a young company could be expending funds on hiring and growth.[310] In addition, freeing emerging firms from this statute would remove a layer of regulation that is largely inapt. For example, the most expensive and maligned provision, section 404, is focused on ensuring that firms have a robust system of internal controls.[311] This is perhaps an appropriate concern with respect to mature companies. But requiring this of entrepreneurial firms—where the business models themselves are still taking shape—appears

[307] *See* John D. Graham, *Savings Lives Through Administrative Law & Economics*, 157 U. PA. L. REV. 395, 447–48 (2008) (discussing intuitive cost-benefits analysis). Professors Langevoort and Thompson draw a similar distinction, differentiating between core and noncore aspects of securities regulation. *See* Donald C. Langevoort & Robert B. Thompson, *'Publicness' in Contemporary Securities Regulation After the JOBS Act* 39 (Georgetown Public Law & Legal Theory Research Paper No. 12-004, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1984686.

[308] *See supra* notes 83–88 and accompanying text.

[309] *See* Bainbridge, *supra* note 94, at 1781; *supra* note 88 and accompanying text.

[310] *See supra* note 50 and accompanying text.

[311] *See* 15 U.S.C. § 7262 (2006).

premature. From society's perspective, it is likely better that these companies devote this money to their nascent enterprises rather than to meticulously-crafted internal reporting structures.

Empirical evidence also supports Sarbanes-Oxley relief. Specifically, questions have been raised about its purported investor-protection benefits. In the most poignant and well-known empirical critique, Professor Romano condemned key corporate-governance provisions of the statute—those mandating management certification of financial statements, limiting corporate purchases of investment banking and other non-audit services from the corporation's auditors, outlawing corporate loans to officers, and calling for independent audit committees.[312] While there are limits on the extent to which empirical analysis can capture the benefits of the statute,[313] and there are studies that reveal positive aspects,[314] if we are looking to reduce compliance expenses in order to attract listings, a costly act with weak empirical support is a sensible target.

In the same vein, it is also likely wise to exempt firms on this venue from the new Dodd-Frank requirements. While securities regulation was not the focus of Dodd-Frank, this statute did contain a number of provisions on the topic. These provisions focus on executive compensation, with substantive rules requiring, among other things, that shareholders get a vote on such matters,[315] and that corporations have independent compensation committees.[316] The statute also calls for increased compensation-related disclosure.[317] Rather than telling investors more about the content of management's pay packages, this disclosure mandate forces firms to discuss how executive compensation relates to its financial performance and how it compares to that of rank-and-file employees.[318]

While the exponential growth of executive compensation may be a valid cause for concern, it is not one that directly relates to investor protection. That being the case, to avoid further increasing compliance costs and dampening the appeal of going public, young firms could be

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312 *See generally* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

313 *See* BUTLER & RIBSTEIN, *supra* note 94, at 26 (quoting Congressman Michael Oxley defending Sarbanes-Oxley); Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1845 (2007).

314 *See* BUTLER & RIBSTEIN, *supra* note 94, at 83 (citing studies showing positive effects); Luigi Zingales, *Is the U.S. Capital Market Losing Its Competitive Edge?* 17–18 (The Initiative on Global Markets, The Univ. of Chicago Graduate Sch. of Bus., Working Paper No. 1, 2006) (comparing costs and benefits of Sarbanes-Oxley).

315 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010).

316 *See id.* § 952.

317 *See id.* § 953.

318 *See id.*

exempted. Dodd-Frank contains other substantive and disclosure provisions related to securities law as well.[319] But like the executive compensation provisions listed above, they too have only a tenuous connection to investor protection.[320] As such, little would likely be lost by exempting emerging firms.

One notable feature of both of the above statutes is that even though entrepreneurial firms were not involved with the scandals that led to the financial reforms, they were captured in the broad regulatory responses that followed. As discussed in Part I, the tendency for such firms to be uncritically swept into round after round of increasing regulations likely gives entrepreneurs pause.[321] To protect companies in this market from being indiscriminately included in the next regulatory overhaul, listed companies could be exempted from new regulations, unless specifically included. Moreover, if the SEC is contemplating new regulations for this marketplace, it could be required to break out its analysis and specify why it is appropriate for such companies.

These changes would do much to lower the actual and potential regulatory burdens that firms face when they go public. At the same time, the impact on investor protection would likely be minimal. The Sarbanes-Oxley reforms, while perhaps attractive in the abstract, only have mixed empirical support; the Dodd-Frank reforms are more targeted at social issues. In any event, even if there would be some difficult-to-measure decrease in investor protection stemming from this regulatory peel-back, the tradeoff would be worthwhile if it means rejuvenating the IPO market.

Several other reforms should also be considered to make the disclosures that remain less costly and more approachable. The eased disclosure obligations that currently apply to smaller reporting companies could be made available to firms on the EF Market.[322] We could also go further. Both the Management Discussion & Analysis (MD&A) section[323] of the securities disclosures and the executive compensation section[324] employ a belt-and-suspenders approach. They

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319 *See, e.g.*, *id.* § 972 (calling for disclosure pertaining to whether the CEO is the same person as the chairman of the board of the directors); *id.* § 954 (calling for clawbacks of incentive-based compensation in cases of accounting restatements); *id.* § 1502 (conflict-mineral disclosures); *id.* § 1503 (mine-safety disclosures); *id.* § 1504 (resource-extraction disclosures).

320 *See* Bainbridge, *supra* note 94, at 1796–1815 (critiquing the corporate-governance-related provisions of the act). *See generally* David M. Lynn, *The Dodd-Frank Act's Specialized Corporate Disclosure: Using the Securities Laws to Address Public Policy Issues*, 6 J. BUS. & TECH. L. 327 (2011) (discussing the conflict-mineral, mine-safety, and resource-extraction disclosures).

321 *See supra* note 97 and accompanying text.

322 *See supra* Part II.B.1.b.

323 Item 303 of Regulation S-K, 17 C.F.R. § 229.303 (2011). *See generally* LOSS & SELIGMAN, *supra* note 77, at 175–80.

324 Item 402 of Regulation S-K, 17 C.F.R. §228.402.

are both rules-based and principles-based, requiring disclosure of discrete topics in specified ways, while at the same time including open-ended requirements that firms describe other material information.[325] This comprehensive approach increases costs and leads to legalistic jargon-filled prose.[326] Instead of this template, perhaps the rules should move towards a principles-based approach. For MD&As, the rules could require, for instance, that management provide a plain-English description of their views on the current state of the firm, including a discussion of its financial statements, as well as their views of the future prospects and challenges facing the company. For executive compensation, the rules could require that the firm describe its material aspects.[327]

These changes would not only reduce compliance burdens, but would also have the potential to increase liquidity. If disclosures were more approachable, individual investors might be more inclined to read them themselves, and thus be more willing to invest without an analyst recommendation. Since there is a dearth of analyst coverage for smaller firms, reducing investor dependence on them could help invigorate this area of the market.[328]

Along these lines, it would also be helpful if individual investors could easily access a summary of a firm's disclosures. The ability to view a several-page description of the firm and its finances would again incentivize participation without an analyst's prodding. Even though the public markets have become increasingly institutionalized, the participation of individual investors is important in connection with

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325 *See* Bainbridge, *supra* note 85, at 14–16 (discussing the distinction between rules and principles).

326 *See* Kenneth R. Davis, *Taking Stock—Salary and Options Too: The Looting of Corporate America*, 69 MD. L. REV. 419, 445–46 (2010) (discussing the daunting length of executive-compensation disclosures); GUY P. LANDER, 14A U.S. SEC. LAW FOR FINANCIAL TRANS. § 7:253 (2d ed. 2011) (discussing the length and complexity of MD&A disclosures).

327 SEC rules currently give smaller companies some relief from the executive-compensation and MD&A disclosures. *See* Executive Compensation and Related Person Disclosure, SEC Release No. 33-8732A, 71 FED REG. 53158, 53192 (Sept. 8, 2006); 17 C.F.R. § 229.303 (Instruction 1 to 303(a)),(d).

328 In an influential paper on declining IPOs, David Weild and Edward Kim (members of the accounting and advisory firm, Grant Thornton) suggested, among other things, that to increase liquidity for small-company stock, regulators should mandate minimum bid-ask spreads with respect to certain trades. They argue that doing so would help provide financing for analyst coverage for small companies, which would boost coverage and liquidity. WEILD & KIM, *supra* note 70, at 19. While this step may be advisable, it seems that it would be better, as discussed above, to first attempt to decrease reliance on analyst coverage rather than fix prices in the hope that the increased profits will be channeled in the direction we want. The JOBS Act instructed the SEC to study issues related to this proposal and authorized the agency to implement certain changes based on its analysis. *See* JOBS Act, Pub. L. No. 112-106, § 106(b), 126 Stat. 306, 312 (2012). This study has been conducted and the SEC chose not to proceed with rulemaking. *See generally* SEC. & EXCH. COMM'N, REPORT TO CONGRESS ON DECIMALIZATION (2012), *available at* http://www.sec.gov/news/studies/2012/decimalization-072012.pdf.

smaller IPOs and smaller companies, which are areas of particular concern.[329] Rather than having firms put these summaries together themselves, however, which would increase firm costs, the SEC could do it. Firms could submit their information in electronic form, and the SEC could use an algorithm to create summary financial statements and other pertinent information, which could be accessed on its website.[330]

The SEC could also help in other ways. First, it could waive filing fees for IPOs for firms with under a certain amount of assets and have reduced filing fees for ongoing reports while firms are listed on this market. At the same time, the SEC could increase the amount of staff devoted to reviewing IPO documents so that the going-public process, which can drag on for a lengthy amount of time, moves more quickly.[331] These final steps would essentially be a subsidy for entrepreneurial firms. But given their import to society, this is a defensible use of government funds.

2. Decreasing Litigation-Related Expenses on the EF Market

In the 2000s, litigation expenses increased as well.[332] Again, one reason was likely Sarbanes-Oxley. Not only did the statute set out harsher penalties for misconduct; it also broadened the scope of culpable behavior.[333] Professor Ribstein has argued that section 404, for instance, expanded liability risk because "a clever trial lawyer might be able to trace virtually any business problem, in hindsight, to a failure to implement some internal control."[334] A testament to the heightened liability exposure brought about by the statute is that after its passage the cost of directors-and-officers liability insurance doubled.[335] Given the above, freeing entrepreneurial firms from Sarbanes-Oxley should not only reduce the compliance burden, but also decrease litigation

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329 *See* Donald C. Langevoort, *Global Securities Regulation After the Financial Crisis*, 13 J. INT'L ECON. L. 799, 806 (2010) (discussing the role of retail (i.e., individual) investors in smaller markets); Lucchetti, *supra* note 26.

330 *Cf.* Paredes, *supra* note 102, at 478–79 (discussing the possibility of tiered disclosure).

331 *See* RICHTER, *supra* note 76, § 3.27 (stating that SEC review can take forty to fifty days). Today, the SEC may lack the resources to take this step. *See* William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 111 (2011); *Examining Investor Risks*, *supra* note 108, at 4 & n.4. This proposal, therefore, would be aided by increased funding to the agency—something Congress has recently resisted. *See* James B. Stewart, *As a Watchdog Starves, Wall Street Is Tossed a Bone*, N.Y. TIMES, July 16, 2011, at A1.

332 *See supra* note 102 and accompanying text.

333 *See supra* note 102 and accompanying text.

334 Larry E. Ribstein, *Sarbanes-Oxley After Three Years* 10 (U. Illinois Law & Econ. Research Paper No. LE-05-016, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=746884.

335 James S. Linck et al., *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors*, 22 REV. FIN. STUD. 3287, 3287 (2009).

exposure.

But Sarbanes-Oxley is not to blame for much of the recent increase in litigation. Rather it is attributable to more aggressive uses of existing legal remedies.[336] To further reduce costs, then, we must look at altering the liability exposure that such firms have to traditional causes of action.

One doctrine that could be scaled back is section 11 of the Securities Act.[337] This provision allows shareholders to sue for material misstatements in connection with a registration statement without having to prove scienter or causation.[338] The provision appears to be motivated by the notion that new firms, because of their limited track record, pose a particularly great risk of fraud.[339] To deter fraudsters, the rule provides for broad liability.[340] But this additional deterrence comes at a cost. Because the liability potential is so great, there is risk that legitimate firms are undertaking costly diligence measures to avoid liability or are deterred from entering the market altogether.[341]

We cannot know for certain whether the increased fraud deterrence justifies these drawbacks. But since we are particularly concerned with a lack of IPOs, and we already have SEC review of IPO documents and 10b-5 liability attached to registration statements, it appears that section 11 is an investor-protection luxury rather than a necessity. One alternative would be to repeal the section. Short of that, the SEC could be permitted to sue based upon it, but not private plaintiffs.

For firms trading on the EF Market, we could also trim 10b-5 liability for secondary-market transactions. Under 10b-5, a person involved in a secondary-market transaction with another party can sue the corporation for material misstatements in its public disclosures even

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336 *See supra* notes 99–101 and accompanying text.

337 15 U.S.C. § 77k (20).

338 *See* LOSS & SELIGMAN, *supra* note 78, at 1228–29 & n.85. Section 12(a)2, 15 U.S.C. § 77l(a)(2), offers a theory of liability that is similar to section 11. While the latter is tied to misstatements in registration statements, the former is tied to misstatements in connection with prospectuses and oral communications. *See id.* Like section 11, section 12(a)2 has been held to only apply to public companies. *See* Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995). That being the case, it poses an additional cost to going public. While the case could be made that it too should therefore be looked at as a candidate for reform, section 12(a)2 is more limited than section 11 in that, among other things, it requires negligence on the part of the defendants. *See* Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act*, 75 WASH. L. REV. 429, 437–39, 469 (2000). Since it is not a strict-liability offense, it poses a lesser threat to emerging firms.

339 *See* Sale, *supra* note 338, at 434.

340 *See id.*

341 *See* 3B BLOOMENTHAL & WOLFF, *supra* note 219, at § 12:26 ("Section 11 . . . now stalks the securities world deterring an terrorizing issuers, underwriters, their key personnel, securities lawyers, and the accounting profession."); Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 45–46 (2000).

though the firm was not directly involved in the purchase or sale.[342] The doctrine is rendered particularly powerful because of the "fraud on the market" theory, which allows any trader to sue the firm even if that person did not directly rely on the misstatement.[343] 10b-5 coupled with the fraud on the market theory is the basis of the paradigmatic securities class action.[344]

This doctrine as applied to secondary-market transactions is a good candidate for reform because the exposure is highly costly for firms[345] and the rule's investor-protection bona fides are debatable. Litigation awards are traditionally justified from a compensation perspective—that is, they provide compensation to the victims of the misdeed—or from a deterrence perspective. Both are suspect in this case. The main problem is that shareholders are essentially suing themselves. As the residual owners of defendant firms, they end up paying these damage awards to other shareholders. What makes this particularly problematic is that shareholders frequently own a diversified portfolio.[346] Diversified shareholders will sometimes be in the plaintiff class and sometimes be owners of defendant firms. The net effect is that these shareholders do not gain anything from these lawsuits. In fact, as Professor Coffee has argued, because attorneys take a large chunk of the damage awards, "from a compensatory perspective, the odds are high that shareholders are made systematically worse off by securities class actions."[347] The deterrence function of the rule can also be questioned. Because of corporate indemnification and directors-and-officers insurance, the executives responsible for the misconduct are rarely personally liable.[348] Deterrence is thereby muted.[349]

While this critique carries much truth, it is not fully convincing. True, many shareholders are diversified, but some are not.[350] Victims of securities fraud who are undiversified do receive a net compensation benefit when awarded damages for securities fraud. Also, while management may dodge personal liability, the rule still serves a deterrence function. Managers that invite fraud liability upon their firm

342 *See generally* LOSS & SELIGMAN, *supra* note 77, at 1273–1301.

343 *See* Bratton & Wachter, *supra* note 331, at 82–83.

344 *See* Amanda Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1302, 1313 (2008).

345 *See* A.C. Pritchard, *Markets As Monitors: A Proposal to Replace Securities Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 928 (1999).

346 *See* Coffee, *supra* note 101, at 1558.

347 *See* John C. Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 228, 304 (2007).

348 *See* Coffee, *supra* note 101, at 1567–70; Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 654 (1996).

349 *See* Coffee, *supra* note 347, at 304.

350 *See* Schwartz, *supra* note 59, at 61.

likely will not last long there.[351] The point here, however, is not to fully engage in what is a long-standing and nuanced debate about the merits of securities class actions,[352] but rather to point out that if regulators were to limit the rule's application to entrepreneurial firms, they would be scaling back a remedy that is highly controversial in its own right. In seeking to balance the costs and benefits of regulation, this cause of action, therefore, stands out as a good place for reform.

One option would be to limit damages from 10b-5 suits arising out of secondary-market transactions. Professor Langevoort, for instance, has tentatively suggested capping damages at $10 million for large companies.[353] Whatever the figure, a cap on damage awards is likely a good compromise. Victims would still be able to seek compensation for malfeasance and management would still be chastened, at least somewhat, by the threat of liability stemming from their actions.[354] Defendant parties, however, would only be subject to manageable monetary penalties.

3. Listing Requirements

The shape of the EF Market comes into greater focus when we turn to its potential listing requirements. In considering regulatory reform, the main task was to lower costs without overly compromising investor protection. Devising listing requirements requires a similar balancing act. In this case, the goal is to structure the market to target successful entrepreneurial firms. Listing standards should be set high enough to eliminate companies that lack legitimate operations and some track record of sustained operations. They should also be low enough so that entrepreneurs can conduct public fundraising relatively early in their company's development and so that early-stage employees and investors do not have to wait too long for liquidity.

Thoughtful listing requirements benefit both investors and those firms that make the cut. With minimum standards in place, companies are not forced to expend resources attempting to stand out from a mass of unstable and potentially dishonest companies and investors do not

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351 *See* Bratton & Wachter, *supra* note 331, at 111–12 & n.153. Also, deliberately dishonest conduct is normally outside the scope of directors and officer's insurance. *See* Langevoort, *supra* note 348, at 657.

352 For the latest round, see generally James D. Cox, *Securities Class Actions as Public Law*, 160 U. PA. L. REV. PENNUMBRA 73 (2011), responding to Bratton & Wachter, *supra* note 331.

353 Langevoort, *supra* note 348, at 661.

354 This change may not significantly reduce the threat of litigation posed to companies with smaller market capitalizations. This is because the high cost of bringing securities class actions makes them an unattractive target already. *See* Stephen J. Choi, *The Evidence of Securities Class Actions*, 57 VAND. L. REV. 1465, 1473 (2004); Coffee, *supra* note 101, at 1543–44 & n.29.

have to expend resources seeking to avoid non-meritorious firms.[355] These transaction-cost savings should make the market more attractive to both groups, which would improve its liquidity and make it more viable.

Reasonable minds can differ as to where quantitative requirements should be set. One defensible approach would be to limit this platform to firms with at least two years of operations, at least $10 million in assets, and a projected equity float with a valuation of over $2 million.[356] These criteria are not overly onerous, but firms without a genuine business would have difficulty meeting them.

Along the same lines, the market should also be limited to new ventures. Firms listed on other platforms or that have been delisted should be denied eligibility. One reason for this is to send a clear signal to investors.[357] If such firms were allowed to join, the EF Market would no longer be truly a venture market. This would make it less attractive to potential investors, because they would no longer be assured—without additional investigation—that companies on the market are promising emerging firms.

Another reason to restrict access is that this market represents a choice to provide special treatment to a group of companies because of their unique circumstances. It would defeat the point to allow companies outside this group to take advantage of regulatory compromises designed to suit others.

In the same vein, firms should not be allowed to trade on this platform forever. The market is designed to supplement the traditional stock market, not supplant it over time. But if firms could stay here indefinitely, that would be the eventual result. Therefore, after a certain number of years, firms should be forced to move on.[358] Changing platforms should not involve a great deal of expense, but firms would need to adjust to a regulatory template designed for mature companies.

A strong case can also be made that, even if still relatively young, companies should be forced to change platforms once they reach a certain size.[359] The growth rate at these larger firms will likely be on the decline and they can afford greater regulation; thus, the rationale for reducing costs is weaker. Moreover, as discussed below, larger firms

355 *See* Macey & Kanda, *supra* note 17, at 1023.

356 For comparison to the BX Market, see *Companies*, *supra* note 293.

357 *See* Macey & Kanda, *supra* note 17, at 1023–24 (discussing stock exchanges as signaling mechanisms).

358 Ten years is likely a reasonable time limit. After this time period, emerging firms show no increased job creation vis-à-vis older firms. Haltiwanger et al., *supra* note 44, at 2. Providing such firms with favorable regulations for ten years after going public should allow them plenty of time for growth. In addition, this time frame would allow them to adjust to the rigors of being public.

359 The size criteria can be set to align with the requirements for the large-company mature-firm market described *infra* Part III.B.

pose unique risks to society; thus, the case for increased regulation is stronger.[360]

Participation in the EF Market could be further limited by qualitative standards. The premier exchanges require certain corporate-governance practices, in large part focused on director independence.[361] Should EF firms be subject to the same mandate? While such measures have intuitive appeal, the empirical support for them is mixed.[362] Also, while it is reasonable to expect well-established firms to observe such practices, growing young firms might be forgiven for having not yet developed them. Thus, while it may be worthwhile to require disclosure of corporate-governance matters,[363] a structural mandate appears unnecessary.

The changes listed above should do much to resuscitate the IPO market. Entrepreneurial firms should no longer shun the public markets when entry would be through a platform that is reserved for qualified young companies and is subject to reduced compliance obligations. The development of such a market is only part of the solution, however. As discussed below, a regulatory and market structure that adjusts to firms as they progress would also make being public more attractive.

B. *Mature Company Equity Markets*

After a certain length of time, firms would be forced to move onto a market designed for mature companies. The regulatory template for this market should be sensitive to the social costs and benefits of regulating firms at this point in their existence. It should also be sensitive to how mature firms are different from each other. While companies differ across a number of dimensions, the most salient in this context is size. As discussed below, large firms justify a much more stringent regulatory structure. A reasonable approach for dealing with the different concerns raised by larger versus smaller firms is to divide the mature-company marketplace into two platforms: one for the largest firms, another for mid-sized and smaller ones.[364]

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360 By this same logic, firms that are already large prior to their IPO should not be allowed onto the EF Market.

361 *See, e.g.*, NYSE LISTED COMPANY MANUAL, *supra* note 237, §§ 303A.01, .04–.06; *see also* Sjostrom, *supra* note 27, at 439.

362 *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 26–29; Romano, *supra* note 312, at 1530, 1532; Prentice & Spence, *supra* note 313, at 1864–69.

363 *See, e.g.*, 17 C.F.R. § 229.407 (2012).

364 Professors Langevoort and Thompson also advocate for imposing lighter regulations on smaller companies. *See* Langevoort & Thompson, *supra* note 307, at 6. Similarly, in a forthcoming article, Professor Guttentag argues for, among other things, exempting firms under a certain size from federal disclosure requirements. *See generally* Guttentag, *supra*

Larger mature firms should be subject to higher regulatory scrutiny than either emerging ones or smaller ones of a similar age. This is because the social costs of regulating large firms are lower and the social benefits are higher. Compliance expenses are less worrisome for larger firms because they have a less significant impact on their budgets and bottom lines.[365] Moreover, money that large firms divert towards compliance carries lower opportunity costs—at least when compared to emerging firms. Since they are not the drivers of innovation and economic growth that emerging firms are, the regulation expenses they incur are more defensible.[366]

At the same time, the case for regulation is stronger. The actions of these companies not only impact shareholders, but also large numbers of employees and customers, and even communities, cities and nations.[367] The widespread economic injuries caused by Enron's fraud show the danger such firms present.[368] That the federal government rescued auto-industry firms for fear that their failure would further weaken an already struggling national economy is additional proof.

The scope and concentration of power in large companies, in fact, makes them start to resemble governmental entities. Along these lines, Professor Langevoort has argued that the evolving purpose of securities regulation is not confined to "shareholder or investor welfare per se, and instead relates to the desire to impose norms that we associate with public governmental responsibility—accountability, transparency, openness, and deliberation—on nongovernmental institutions that have comparable power and impact on society."[369]

Professor Coglianese has made a similar point. He argues that power and legitimacy are connected: because the government is so powerful, the public has always demanded legitimacy from it; because corporations have power akin to governments, there is this same demand.[370] Just as public law's manifold checks and balances give the government legitimacy, Sarbanes-Oxley's focus on improving corporate governance, as well as other recent measures, can be conceptualized as

note 160.

365 *See* Bainbridge, *supra* note 85, at 24 (discussing outsized impact of regulatory costs on small firms).

366 *See supra* Part I.B.

367 *See* Cary Coglianese, *Legitimacy and Corporate Governance*, 32 DEL. J. CORP. L. 159, 160 (2007).

368 *See* Kathleen F. Brickey, *From Enron to Worldcom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 377 n.86 (2003) (discussing Enron losses); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1066 (2009).

369 Langevoort, *supra* note 368, at 1066 (2009); *see also* Langevoort & Thompson, *supra* note 307, at 47–48 (extending on this argument).

370 *See* Coglianese, *supra* note 367, at 159–61.

ways to legitimate private institutions with government-like power.[371] While Professor Coglianese is mainly concerned with presenting a descriptive argument, the normative implications are also compelling.[372] The ability of securities law to satisfy these broader social goals provides an additional basis for it—at least as it pertains to the largest firms. It is these firms that have come to possess public-like features, and it is therefore these firms that demand public-like scrutiny.

Taking all of this into account, one potential way to regulate the large-firm marketplace would be to retain the status quo. Even if the empirical case for Sarbanes-Oxley is uncertain and Dodd-Frank tackles largely social issues, the chance that they both do some good may be worth taking when applied to companies that can afford compliance and wield a great deal of societal influence. Similarly, although there is a strong case that securities class actions are flawed, the argument for a cap on damages is less compelling in this context. One reason is that once firms reach this size, they can better afford the increased insurance premiums and other costs that come with exposure to such suits. Another is that the SEC is not a reliable enforcer of securities laws when it comes to corporate titans. The agency tends to focus on small companies,[373] leaving securities class actions as the primary mechanism for holding large firms accountable. Finally, although reform may be desirable, for larger firms it appears more apt to focus such efforts on increasing the personal liability exposure of management rather than on decreasing firm-level expenses.[374]

Further analysis would be necessary to define exact parameters for what qualifies as a "large firm." But given the rationale for the regulatory template for this venue and the expense associated with the regulations envisioned, restricting this market to the 500 or so largest firms seems reasonable.[375]

Remaining firms should not be subject to such rigorous oversight. This is because mid-size and smaller companies cannot so easily afford such comprehensive regulations. Nor do they wield such impact on society. At the same time, however, they are no longer growth-stage firms, which means that they no longer need as much money to fund development and that they have had more time to install mature

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371 *See id.* at 162–66.

372 *Id.* at 167.

373 *See* Cox, *supra* note 352, at 80 & n.22.

374 *See generally* Coffee, *supra* note 101.

375 The number of companies covered by these regulations would be small as a percentage of all companies, but large when looked at in market-capitalization terms. The large-cap equity index, the S&P 500, for instance, covers 80% of the value of U.S. equities. *See S&P 500*, S&P, http://us.spindices.com/indices/equity/sp-500 (last visited Oct. 3, 2012); Allan Roth, *2010 Stock Market Return—The Numbers*, CBS MONEYWATCH (Dec. 31, 2010, 5:15 PM), http://www.cbsnews.com/8301-505123_162-37742478/2010-stock-market-returns-the-numbers/.

corporate-governance procedures. Given these contrasting considerations, this market should be subject to regulations that are higher than the EF Market and lower than those pertaining to the market for large companies described above.

Though the exact contours of the regulatory framework warrant further study, a possible approach would be to adopt a scheme that is only minimally more invasive than the one adopted for the EF Market. Regulators could, for instance, exempt firms trading on this platform from Dodd-Frank; allow them to provide principles-based MD&A and executive-compensation disclosure; and cap 10b-5 damages awarded in connection with secondary-market transactions.[376] Moreover, in an effort to make firm disclosures more accessible to individual investors—the ones who drive liquidity for smaller firms—the SEC could, as in the EF Market, make summary disclosure information available on its website. Finally, in the one major change from the EF Market, regulators could require that these firms generally comply with Sarbanes-Oxley, but exempt them from its most expensive provision, section 404.[377] This seems reasonable given that these firms will have had more time to develop mature operating and governance practices.

This market's listing standards should be similar to the EF Market. Firms that drop below reasonable thresholds linked to share price and market value should be delisted. For instance, the venue could require, among other more technical things, that firms maintain a share price of above $1.00 and a market capitalization above $2 million.[378] In addition, like entrepreneurial firms, companies on this platform should be free from additional qualitative standards. As discussed above, the premier exchanges impose director-independence requirements on their firms. But this mandate is particularly expensive for smaller companies and of arguable investor-protection merit.[379] It seems reasonable therefore to

376 This market would include a wide range of companies. Therefore, it may be advisable to narrowly tailor regulation within it. For example, larger firms could be subjected to higher caps on 10b-5 damage awards and be required to disclose more executive compensation and MD&A information.

377 *See supra* note 86 and accompanying text. Smaller companies have never been subject to section 404(b) of Sarbanes-Oxley—requiring auditor attestation regarding management assessment of internal controls. The exemption was made permanent as part of Dodd-Frank. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989G(a), 124 Stat. 1376, 1948 (2010); Bainbridge, *supra* note 85, at 28; *see also* ADVISORY COMM. REPORT, *supra* note 87, at 35–36 (discussing why section 404 is inapt with respect to smaller companies).

378 For comparison, see NASDAQ OMX GROUP, INC., INITIAL LISTING GUIDE 9 (2012), *available at* https://listingcenter.nasdaqomx.com/assets/initialguide.pdf (describing listing requirements for its current junior market, the NASDAQ Capital Market) [hereinafter NASDAQ Listing Guide], and *Companies*, *supra* note 293 (describing listing standards for the BX Market).

379 *See supra* note 362 and accompanying text; *see generally* Linck et al., *supra* note 335 (discussing the disproportionate expense borne by smaller firms in hiring directors after

abstain from imposing it upon firms in this market.[380]

Allowing mid-sized and smaller firms to graduate from the EF Market onto a venue that maintains relatively low listing and compliance obligations should increase the attractiveness of going public in the first place, particularly for smaller firms. It would give such firms assurance that, if they remain small, their profits would not be swallowed by compliance expenses. These firms would also have the flexibility to move between the upper and lower market tiers as their fortunes crested and fell.

The relationship between these tiers should be relatively fluid. Growing firms should find it easy to move up to the top tier, while shrinking firms should find it easy to move down.[381] Moreover, in accommodating shrinking firms, the lower-tier market would provide a soft landing for large firms on the decline. The symbolism of the move would potentially cause a company's share price to suffer, but the eased regulatory burden would free up money that could be used to shore up the business and halt operating losses.[382]

One issue with this bifurcated approach is the potential for gaming. Firms may want to manage their size so they can avail themselves of one market or the other. While this is a concern, it is probably not overwhelming. One reason is that it is not clear which market firms would prefer. Some may want to subject themselves to high regulations to send a signal to the market that they are prepared to withstand deep scrutiny.[383] Under this logic, certain firms may strive to get into the more regulated market. This type of gaming does not seem overly problematic. It would involve firms doing their utmost to grow, which they are already amply incentivized to do.

The opposite is also possible, however. Firms may wish to take advantage of the lower-tier template as a way to avoid regulation. To do this, a firm would have to find a way to artificially deflate its value. But

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Sarbanes-Oxley and the contemporaneous adoption of director-independence requirements by the national exchanges).

380 Firms would still be subject to the requirement that they have an independent audit committee. While this is technically a listing standard, it was mandated by Sarbanes-Oxley. *See* 15 U.S.C. § 78j-1 (2006).

381 Rules could be put in place to avoid firms with values frequently fluctuating above and below the demarcation between these markets from having to constantly be switching back and forth. *Cf.* Jeff Schwartz, *The Crystallization of Hedge-Fund Regulation*, 2 HARV. BUS. L. REV. ONLINE 73, 77 (2011), http://www.hblr.org/?p=1688 (discussing a mechanism adopted for hedge-fund regulation that accomplishes a similar task).

382 NASDAQ today offers a three-tiered structure: the Global Select Market, the Global Market, and the Capital Market. *See generally* NASDAQ Listing Guide, *supra* note 378. This allows firms in decline to move down-market. Unlike my proposal, however, they would not be subject to lesser regulation as they do so.

383 *See* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 284–90 (2007) (describing the "bonding hypothesis" as an explanation for cross-listing).

this would be difficult. The dividing line between the two markets should be based on market-related measures, such as share price and market capitalization, as well as internal measures, such as gross and net revenues. Such measures would both ensure an accurate picture of firm size and make regulatory arbitrage difficult. Let us say, for instance, that a firm wishes to lower its market capitalization. A company's market value reflects how well it is doing, as well as broader market forces. The latter are outside a company's control and it is hard to imagine a company purposefully taking actions to lower its stock price so as to take advantage of a lower regulatory platform. There are ample countervailing incentives—like the wrath of firm shareholders—that should prevent such action. Companies could perhaps split themselves up to lower their overall market capitalization, but this seems like a rather extreme move to take advantage of a lower regulatory tier. If firms are willing to go to such great lengths, it may be time to reevaluate the value added by the increased regulation of the large-firm market.

C. *Delisted Market*

Firms that fall beneath the minimum numerical thresholds for the small-firm market would be delisted and trade on a market specifically created for them. One challenge of regulating this arena is designing a regulatory template that such companies could afford. If regulations are too expensive, they will not comply, and there will be no market for shares in such companies. This would destroy what little value these securities have. On the other hand, however, too little regulation and the risk of fraud and abuse outweigh the benefit of maintaining a market for these firms.

A skeletal disclosure template would be a reasonable way to strike this balance. When a firm first joins the market, and on a quarterly basis thereafter, it could be required to produce unaudited financial statements, along with a description of the firm's business and management. This information should be easily accessible and publicly available. While these disclosure obligations would impose some expense on firms listed here, it is hard to picture a functioning market without at least this much transparency.[384] At the same time, firms wishing to provide more information to the market would be free to do so, and would likely be rewarded with more activity in connection with their shares.[385] This market would lack any qualitative or quantitative

[384] *See supra* note 127 and accompanying text.

[385] *See* Bushee & Leuz, *supra* note 20, at 236 (finding that OTC Bulletin Board firms that began filing Exchange Act reports experienced significantly increased liquidity); *Learn—Part I—Market Structure*, OTCMARKETS, http://www.otcmarkets.com/otc-101/market-structure

listing standards, but those failing to comply with the minimal regulations would be ineligible for trading.

Since this is a risky marketplace, there is a case to be made for restricting it to those the securities laws deem more sophisticated, i.e., accredited investors or even QIBs. Doing so, however, would dampen liquidity on a venue where it would likely be an issue.[386] To avoid inhibiting this market, instead of limiting participation, the venue could be labeled as highly risky.[387] Investors could even be required to sign a form certifying that they understand the risks of participation. Although there would surely be investors who make bad decisions, this would be better than the current situation where unsophisticated investors are free to make decisions regarding firms that have made little to no information available.

D. *Private Transactions*

One final piece of the puzzle would be a better legal structure to accommodate transactions in companies that never go public. Even if the environment for IPOs were more hospitable, not all firms would wish to avail themselves of the public markets. They might not need the influx of capital from an IPO or have founders and early investors in search of liquidity. Some quite large firms—including Mars and Levis—have famously eschewed the public markets.[388] What if investors in such companies wish to transfer their shares? Today these transactions would be governed by section 4(1½), rule 144, and rule 144A, but, as I have argued above, these rules have manifold flaws.[389]

One option would be to apply a lifecycle model to these private transactions. As with public firms, we could vary the regulatory template to fit firms as they age. Such nuance, though, is unnecessary in this context. The lifecycle model is useful as a way to fine tune a vast regulatory apparatus designed to protect public investors in liquid secondary markets. But private firms stand outside this structure. Since they need not bear the compliance expense associated with public-firm regulation, there is less concern about narrowly tailoring regulations to fit their circumstances. Instead, we can regulate private transactions

(last visited Jan. 16, 2012) ("Liquidity follows transparency. Companies that provide current disclosure either through a regulator or directly to OTC Markets Group experience significantly greater levels of liquidity, improved price discovery, and more efficient trading.").

386 *See supra* note 259 and accompanying text.

387 *Cf.* Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 538–42 (2009) (discussing libertarian paternalism, a regulatory philosophy that emphasizes freedom of choice, as a template for investment-company regulation).

388 *See America's Largest Private Companies*, FORBES, http://www.forbes.com/lists/2011/21/private-companies-11_rank.html (last visited Feb. 2, 2011).

389 *See supra* Part II.A.

with a more simplified approach.

Regulation of this area should prevent the circumvention of the registration requirement, but allow legitimate secondary-market transactions in private shares. The former could be accomplished with a holding-period requirement. Shareholders in private companies could be locked in for a year. The lock-up, however, could permit them to sell their shares back to the company or to other shareholders. After the year, sales to a broader audience could be permitted. These transfers, however, should not go unregulated. As noted above, we only wish to enable legitimate secondary-market transactions. We could effectuate this goal through a two-part approach. The first would permit sales to family members, friends, and affiliates without any type of regulation. This should cover the majority of transfers in such firms: these companies are usually family-owned or owned by a limited constituency,[390] implying that transfers to outsiders are rare.

The second part of the regime would require disclosure in cases where there was solicitation of third-party investors, through a broker or otherwise. The extent of the mandated disclosures could depend on the size of the transaction. For larger sales, firms could be called upon to produce a great deal of information; for smaller ones, less could be required. The regulations could provide, for example, that in connection with transactions under $10,000, only the disclosures required of delisted firms are expected.[391]

Solicited secondary-market transactions would likely prove difficult because firms would not be legally required to provide the information necessary for these transactions to take place. Sellers not in a position of authority with the company and who have not negotiated registration rights (i.e., the ability to force the company to register its shares) might be forced to sell to acquaintances at a discount. But this is the price of staying private. If a firm wishes to provide its shareholders with greater liquidity, it can go public and submit to ongoing disclosures.

This setup closes the loopholes in the current system that allow private-firm shareholders to sell stock without providing any information. That this potentially makes life more difficult for them is

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390 *See* Chenchuramaiah T. Bathala et al., *Sources of Capital and Debt Structures in Small Firms*, 9 J. ENTREPRENEURIAL FIN. 29, 33 (2004) (finding that 92.6% of surveyed private firms were either closely held or held by families); Mukesh Bajaj et al., *Firm Value and Marketability Discounts*, 27 J. CORP. L. 89, 102 (2001).

391 As in the delisted market, the case could be made for limiting potential buyers to QIBs or accredited investors. A full analysis of the costs and benefits of such restrictions is beyond the scope of this paper. Since this market would be no more risky than the delisted market, though, it seems reasonable to treat these markets similarly. As in that market, disclosure regarding risk and investor acknowledgment of such risk could be required. *See supra* note 386 and accompanying text.

by design. Requiring a degree of transparency in private-market transactions assures the internal integrity of the lifecycle model, protects investors, and delivers a boost to the EF Market (because there is no way to skirt disclosure rules, firms will be forced to look more favorably upon it).

E. *Summary*

This Part laid out a framework for reregulating the secondary market for securities around a lifecycle model. Markets and the regulations that underpin them would be designed to suit the circumstances of firms at the various stages of their existence. To allow entrepreneurial firms to use their limited resources to fund growth, they would be subject to a less costly regulatory framework when they enter the public markets. As firms get older, they would progress to different platforms. Mature firms would be subject to regulations based on their size: large firms would bear the highest scrutiny, while those mid-sized and smaller would have a reduced compliance load. Finally, as firms decline, they would move to a market designed for them—one with only bare-bones regulation.

The new structure also reforms the treatment of private firms. Secondary-market transactions in such firms would be permitted, but subject to disclosure regulations designed to protect unwitting buyers. By providing a regulatory and market structure that fits firms as they age, the lifecycle model offers the potential to not only rejuvenate the IPO market, and thereby salvage the vitally-important relationship between equity markets and entrepreneurs, but also to resolve the manifold issues that mar today's regulatory framework.

F. *Implementation Analysis*

In exploring the lifecycle model and its implications, this Section has so far left issues of implementation aside. How the changes could be carried out, however, warrants a brief discussion. Even though this is a new way of looking at secondary-market regulation, bending the current regulatory and market structure to fit it is not overly complex. Congress and the SEC would need to alter the regulatory landscape, and the private entities that provide the equity platforms would need to adjust their listing standards and adapt their market structures.

While some might be concerned that reform in this case requires the cooperation of the exchanges, this complication need not give us pause. First, although listing standards are technically put in place by these companies, the SEC has the power to amend, abrogate, and unilaterally change them.[392] The agency, therefore, can simply demand that the exchanges alter their criteria to conform. There is ample recent precedent for such actions.[393] Sarbanes-Oxley, for instance, required that the exchanges only list firms with independent audit committees;[394] similarly, Dodd-Frank called on the SEC to issue rules prohibiting the exchanges from listing firms whose compensation committees lacked independence.[395]

Second, while the SEC cannot force the exchanges to create a market from scratch, it can, as in the case of rule 144A, create the conditions for one to exist. For example, the litany of reforms laid out for the EF Market could be made to only apply to firms trading on a platform that included the mandated listing standards. It would then be up to the market providers to alter existing markets or create new ones that include these requirements. Given that markets like NASDAQ are already moving in this direction, this should not be a concern.

Indeed, NASDAQ is in a good position to adjust to the new rules. It could change the requirements of the BX Market to create the EF Market outlined above. NASDAQ also has multiple market tiers already in place that could be reconfigured to accommodate the dual-tier market structure proposed for mature firms.[396] While the NYSE also has multiple tiers, it has nothing resembling the BX Market, so it would have further to travel.[397]

The shadow markets would also need to adjust. SecondMarket and SharesPost, for instance, could still exist, but they would need to ensure that the transactions they facilitate comply with the new regulatory template for private-share transactions, rather than the rules on which they are currently based. The OTC Markets Group would need to change as well. For instance, even companies listed on the lowest tier, OTCPink, would need to make the required disclosures. In the end, although the lifecycle paradigm may seem quite removed from our current system, market providers could adjust to fit the new regulatory template without uprooting their businesses.

The other aspect of implementation is the political question of whether this proposal stands any chance of garnering support among

392 *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 92–94 (2005).

393 *See id.*

394 Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (2006).

395 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952(a), 124 Stat. 1376, 1900 (2010).

396 *See supra* note 382 and accompanying text.

397 The NYSE's markets include the NYSE, NYSE MKT, and NYSE Arca. *See U.S. Equities Markets*, NYSE EURONEXT, http://usequities.nyx.com/markets (last visited Feb. 11, 2012).

legislators and regulators. In fact, it does. This proposal is centered around cultivating entrepreneurship in order to support, among other things, job growth. This is a goal to which both political parties repeatedly genuflect.[398] It is also reregulation. It trims regulation for entrepreneurial firms, a goal likely to be embraced by conservatives, while bolstering regulation for OTC firms, a goal more associated with liberal policymakers. Its multi-faceted approach should, therefore, have broad appeal.

G. *Potential Misgivings*

I have attempted to address potential misgivings throughout the Article, but two remain that warrant further discussion. The first is that the regulatory cuts pertaining to the EF Market and the small-firm market are unjustified. The argument could be made that, because less is known about smaller and newer firms, these companies actually pose a greater risk to investors than larger and more established ones. That being the case, these firms should have little, if any, regulatory forgiveness.

Several responses are in order. First, the claim of increased riskiness is empirically contestable. While it makes good intuitive sense, it stands on shaky evidence.[399] Second, even if it is correct, the argument is most salient with respect to the newest and smallest firms.[400] But these would not be included in the EF Market or the small-firm market. Stock in these companies would trade privately and, under my proposal, these markets would be more highly regulated than they are today. Third, even if the newish and smallish firms included in the public markets are more risky, the danger to investors should not increase dramatically: the cuts were intentionally drafted to steer clear of the fundamental investor-protection safeguards.

Finally, this argument discounts other factors. Even if newer and smaller firms pose a greater risk, it remains the case that these firms have trouble affording increased regulations and that regulatory forgiveness offers the potential to reinvigorate the IPO market and provide a boost to emerging firms, which are an important part of the economy. Thus, decreased regulation may still be justified.

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398 The quick and bipartisan passage of the JOBS Act is perhaps the best illustration of this. This deregulatory securities-law bill was justified on the basis of job creation. *See* Steven M. Davidoff, *From Congress, a Law Befitting a Sausage Factory*, N.Y. TIMES DEALBOOK (Apr. 3, 2012, 4:18 PM), http://dealbook.nytimes.com/2012/04/03/from-congress-a-law-befitting-a-sausage-factory/.

399 *See Examining Investor Risks*, *supra* note 108, at 24 n.1.

400 The least information is likely to be available about these firms, thereby increasing the risk of fraud, abuse, or mistake.

Taking the broader context into account still allows for an argument that investor-protection concerns were given short shrift. But this is a discussion that can wait. The main argument in this Article is not for the specific regulatory contours set forth. Rather it is for the overarching theory about how to think about regulating the secondary market for securities. The suggested outline is the result of an intuitive weighing of costs and benefits and observation about what has and has not worked in the past. If further research reveals a better regulatory mix—perhaps one with more investor protection—so be it. The different markets and regulations pertaining to them can be adjusted like radio dials to achieve the desired balance.[401]

Another argument against this approach is that it would be better to allow markets to right themselves. More specifically, an alternative would be to stand back and allow private markets to evolve and meet investor liquidity demands. A proponent of this approach could point to SecondMarket and SharesPost as examples of the potential for entrepreneurial ventures to fill market gaps as they emerge. While these venues may be relatively unappealing today, perhaps they or their competitors could evolve into suitable platforms if given time to develop.

This line of thought also has intuitive pull, but there is reason to be skeptical that it would be a better approach. One issue is that private markets are probably not the ideal location for entrepreneurial firms. As discussed in Part II, these markets tend to be limited to accredited investors or QIBs.[402] Such exclusivity shuts out many individual investors and thereby raises concerns about liquidity and fairness. In addition, it is fanciful to expect that those allowed entry will make sound decisions and police themselves on the grounds that they are sophisticated parties. The financial collapse stemmed in part from poor decisions made by sophisticated investors in private securities markets;[403] the original securities laws were put in place because self-regulation was failing;[404] and studies support the role of regulation in

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401 A related argument could be made that no matter how perfectly the regulatory scheme is calibrated, the IPO market would still be tepid. It is possible that the other factors chilling IPOs are so stultifying that improving the regulatory structure would yield a negligible uptick. If this is the case, the cost of rewriting the rules to better fit issuers might outweigh the benefits. This argument is speculative, but has merit because, as discussed *supra* Part I.C., we are not in the position to apportion blame for the IPO collapse among the various posited factors. Its implication, though, is not that the lifecycle model is incorrect. Rather, it is that further research into the costs of reform and into the causes of the decline would be advisable before moving forward. Such steps would be consistent with this Article, which offers a direction for policy, rather than an off-the-shelf solution.

402 *See supra* note 147 and accompanying text.

403 *See* FIN. CRISIS INQUIRY COMM., THE FINANCIAL CRISIS INQUIRY REPORT, xxiv, xxv (2011) (discussing the role of OTC derivatives in the financial crisis).

404 *See* LOSS ET AL., *supra* note 289, at 321.

fomenting robust markets.[405]

Finally, the regulatory structure for private markets is not currently set up for such an experiment to succeed. As I argued earlier, none of the rules governing private-market resales are well-designed to underpin liquid markets. True, these rules could be changed. But this means regulators would be engaged in creating a market for emerging firms, which is exactly the task the hands-off argument deems inadvisable. Rather than live with the current structure or make piecemeal changes that add to the complexity of an already overwrought regulatory framework, the reregulation effort should be motivated by an overarching theory that is designed to address the manifold issues that trouble today's equity markets.

CONCLUSION

IPOs have been declining for over a decade, but there has been little regulatory response. This is likely because no compelling case has been made for more serious reform. This Article seeks to fill this void.

Before undertaking reform, it must be established that there is a meaningful problem that deserves attention. This Article has argued that the problem that must be addressed is that equity markets no longer offer many entrepreneurial firms a satisfactory platform on which to list their shares. Diminishing IPOs illustrate that the traditional public markets are no longer appealing; a review of alternative equity markets reveals that none offer a comparable substitute. The troubling ramifications of this defect are weakened entrepreneurship and languishing equity markets, which together translate to a less sound economy.

Another prerequisite to reform is a viable solution. To this end, this Article offers a lifecycle model of secondary-market regulation. The central idea behind this approach is that regulations should fit firms as they mature. Under this approach, we would have a market regulated specifically to suit emerging firms, as well as markets designed for older companies. The theory is that young firms would be more apt to join public markets regulated in this fashion because, not only would they find the new emerging-firm market appealing, but they would also be attracted to the idea of having their firms mature on markets with narrowly-tailored regulatory structures. Beyond all this, a market and regulatory structure based on the lifecycle model would also clean up the investor-protection loopholes and internal inconsistencies that plague the current ad hoc regulatory approach.

A vibrant IPO market long gave regulators an excuse for ignoring

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405 *See* La Porta et al., *supra* note 306, *passim*.

the inadequate structure of secondary-market regulation. But plunging numbers have raised the real-world stakes of this regulatory failing. Reforming the regulatory structure along the lines proposed herein offers the potential to reverse the decline in IPOs and thereby heal the relationship between entrepreneurs and equity markets.

EPILOGUE

The JOBS Act is brief at only twenty-two pages long.[406] But it makes a number of changes to securities regulation. Some of these changes have been noted in the body of this Article.[407] In this Epilogue, I briefly address Title I of the statute—the so-called IPO On-Ramp—which is one of the bill's most important sections and one which overlaps with the proposal made herein. This portion of the bill consists of a mishmash of regulatory changes designed to make going public more attractive.

One category of reforms eases rules regarding the going-public process. For instance, the Act allows for broader communications between companies going public and certain potential investors.[408] The other category reduces public reporting requirements. Among other things, under the statute, newly-public firms are exempt from section 404(b) of Sarbanes-Oxley,[409] need only submit two years of audited financial statements (rather than the usual three years),[410] and need not comply with Dodd-Frank's mandate that firms compare and report the difference between executive compensation and that of other employees.[411] One key question that arises in the wake of these reforms is whether continued concern regarding the recent lack of IPOs is warranted.

This depends on whether the On-Ramp looks like it will be a success. Time will tell, but at this point there is reason to be skeptical. Problems with the On-Ramp itself, as well as with the broader structure of the Act, will likely limit the statute's efficacy. One issue is that it is questionable whether the On-Ramp does enough to restore the attractiveness of going public. Law firms predict that many of the reforms related to the going-public process will not lead to major changes in practice.[412] Similarly, the rules easing reporting requirements

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406 The statute is available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

407 *See supra* note 160 and accompanying text; *see also* notes 226 and 328.

408 *See* JOBS Act, Pub. L. No. 112-106, § 105, 126 Stat. 306, 310–11 (2012).

409 *See id.* § 103.

410 *See id.* § 102.

411 *See id.*

412 DAVIS POLK & WARDWELL LLP, THE JOBS ACT: IMPLICATIONS FOR CAPITAL

resemble what has already been done under the SRC regime.[413] In addition, the bill does not channel firms onto the public markets; rather, at the same time that it seeks to make the public markets more attractive, it energizes the private markets by raising the section 12(g) shareholder threshold.[414] This may tempt emerging firms to stay private for longer (or even forever) and encourage public firms to reverse course and go private.[415] Because the JOBS Act muddies the path for emerging firms, it is unclear whether it will bring IPOs back.

Also worth noting is that the Act does nothing to address the investor-protection loopholes in the current regulatory framework. In fact, by opening up the private markets to more companies, it exacerbates concerns related to that arena. The statute, therefore, has the potential to be counterproductive—making investing less safe while not succeeding in invigorating the IPO market. These concerns mean that the argument for reform based on the lifecycle model remains salient.

Ultimately, rather than put to rest the issues addressed in this paper, the JOBS Act actually pushes them to the fore. Ideally, laws are enacted after careful study into their costs and benefits and are motivated by the public good. But the JOBS Act was enacted in great haste and has the look of slick politics.[416] The bill's enactment, though, coupled with its dubious craftsmanship, will force scholars, commentators, and policymakers to closely consider the issues the Act leaves unresolved and this paper directly addresses—the case for reform in light of the IPO collapse and the most effective means of responding to this trend. This Article's argument for why reform is advisable and its prescription for improvement should prove valuable in informing this debate.

MARKETS PROFESSIONALS, PRE-IPO COMPANIES AND PRIVATE OFFERINGS 3 (2012), *available at* http://www.davispolk.com/files/Publication/22e9900d-a956-4bee-a0e2-23c0186 b26a6/Presentation/PublicationAttachment/fb84d88e-8221-4153-9611-f232b77e7bc0/032612_ jobs.act.pdf; LATHAM & WATKINS LLP, THE JOBS ACT AFTER TWO WEEKS: THE 50 MOST FREQUENTLY ASKED QUESTIONS 8 (2012), *available at* www.lw.com/thoughtLeadership/JOBS-Act-FAQs.

413 As under the JOBS Act, companies going public under the SRC regime are only required to file two years of audited financial statements. *See* LEE R. PETILLON & ROBERT JOE HULL, REPRESENTING START-UP COMPANIES § 11:89 (2011).

414 *See supra* note 160 and accompanying text.

415 *Cf.* John Coates & Robert Pozen, Editorial, *A Regulatory Bill that Cuts Investor Protections*, WASH. POST, March 14, 2012, at A13 ("More than two-thirds of all public companies would be exempt under the bill's new [section 12(g)] criterion.").

416 *See* Davidoff, *supra* note 398.