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Revisiting *"Truth in Securities" Revisited*: Abolishing IPOs and Harnessing Private Markets in the Public Good

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I. INTRODUCTION

Milton Cohen, in his seminal article, *"Truth in Securities" Revisited*,[1] was the first to highlight the awkwardness created by the enactment of the Securities Act of 1933[2] before the enactment of the Securities Exchange Act of 1934.[3] Cohen pointed out that if the Securities Act, which regulates public offerings of securities, had been adopted subsequent to or simultaneously with the Exchange Act, which regulates the disclosure obligations of public companies, then public-offering disclosure obligations would naturally piggyback on the periodic disclosure obligations mandated for public companies.[4] Franklin Delano Roosevelt's political calculation, however, ensured that the bills would be separate and that the Exchange Act would come second.[5] That accident of history meant that the two statutes would develop separate disclosure obligations. That separate development ignored the economic reality that investors would seek largely the same information in valuing securities, regardless of

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Special thanks go to Don Langevoort and Bob Thompson. I was asked to comment on their article, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. (forthcoming 2013), which was the inspiration for this project. Their article provides a much more comprehensive discussion of the background issues raised here; we disagree on the best way forward, but I have benefitted from a number of helpful conversations with them on this topic. I am grateful to the Cook Fund of the University of Michigan Law School for support for this project.

1. Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966).
2. Pub. L. No. 73-38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a–aa).
3. Pub. L. No. 73-404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–pp).
4. Cohen, *supra* note 1, at 1341–42.
5. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 51–53 (3d ed. 2003).

whether they were purchasing from an issuer in a primary transaction or another investor in a secondary transaction.

Companies' public-offering and secondary-market disclosure obligations have gradually converged since Cohen wrote in the 1960s. The rise of integrated disclosure obligations for the two Acts in the 1980s[6] is generally considered a way station along the path to full-blown company registration.[7] Company registration would allow a company to register as a public company just once; thereafter, the company could offer and sell securities whenever it wanted, without the need to register the securities themselves.[8] The move toward company registration began with shelf registration under Rule 415,[9] which allows for considerable incorporation by reference of prior public disclosure in registration statements for offerings by public companies. That movement culminated in the SEC's 2005 offering reforms, which streamlined shelf registration.[10] Now, the largest public issuers operate under the functional equivalent of company registration. The advantages of company registration are available, however, only for a subset of the companies that have previously transitioned from private- to public-company status. Initial public offerings (IPOs), the customary path for attaining public-company status, are not included in shelf registration. Instead, IPOs are still subject to the traditional regulatory regime, with its "gun-jumping" restrictions on voluntary disclosures and offers made before the SEC's approval of a company's registration statement. The gun-jumping rules are intended to quell speculative fervor by forcing disclosure into the SEC's mandatory format.

The separate enactment of the Securities Act and the Exchange Act also influenced the development of the distinction between public and private under those two statutes. Both the Securities Act and the Exchange Act reflect a public–private divide, but they take very different approaches to drawing that line. The Securities Act draws the line be-

6. *See* Adoption of Integrated Disclosure System, Securities Act Release No. 33-6383, 47 Fed. Reg. 11380-01 (Mar. 16, 1982).

7. *See* Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567 (1997).

8. Company registration is the organizing principle underlying the American Law Institute's proposed codification of federal securities law. *See* FED. SEC. CODE (1980). In 1996, the SEC's Advisory Committee on the Capital Formation and Regulatory Processes issued a report outlining a voluntary pilot program for company registration. SEC. & EXCH. COMM'N, REPORT OF THE ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES (1996), *available at* http://www.sec.gov/news/studies/capform.htm.

9. Shelf Registration, Securities Act Release No. 33-6499, 29 SEC Docket 138 (Nov. 17, 1983).

10. Securities Offering Reform, Securities Act Release No. 33-8591, 85 SEC Docket 2871 (Aug. 3, 2005).

tween public and private in a manner that focuses explicitly on investor protection. The dividing line under the Exchange Act, by contrast, is a compromise—reflecting not only investor protection, but also interests in capital formation and practical ease of application. I argue here that the resulting mismatch between the public–private dividing lines under the two Acts means that the transition from private to public will inevitably be awkward, abrupt, and fraught with problems for issuers, investors, and regulators. Can we reconcile the two dividing lines so that companies can navigate this passage from private to public more smoothly?

Congress has partially addressed this problem with its recent adoption of the Jumpstart Our Business Startups Act (JOBS Act). Unhappy with the SEC's somewhat tepid efforts to facilitate capital raising by smaller companies, Congress gave the SEC new authority to exempt offerings from the requirements for registered offerings. Along with that exemptive authority, Congress authorized the SEC to adopt less demanding periodic disclosure requirements for companies who avail themselves of this new offering exemption. These disclosure requirements would presumably only apply until a company triggered the standards for full-fledged public-company status. Those public-company standards are also newly raised by the JOBS Act. The JOBS Act reforms have the potential to create a lower tier of public companies, thus blurring the line between public and private. Advocates for investor protection have roundly criticized these changes, asserting that it opens the door for fraud and manipulation.[11] Such criticisms carry some weight, given the abuses that repeatedly occur in the penny stock market.

My thesis is that the transition between private- and public-company status could be less bumpy if we unify the public–private dividing line under the Securities Act and Exchange Act. The insight builds on Cohen's thought experiment where Congress first enacted the Exchange Act. My proposed public–private standard would take the company-registration model to its logical conclusion. The customary path to public-company status is through an IPO, typically with simultaneous listing of the shares on an exchange. There is nothing about public offerings, however, that makes them inherently antecedent to public-company status. What if companies became public, with required periodic disclosures to a secondary market, *before* they were allowed to make public offerings?

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11. Andrew Ackerman, *Scrap Over Easing IPO Rules*, WALL ST. J., Mar. 16, 2012, at C3 ("Former Securities and Exchange Commission Chairman Arthur Levitt called it 'the most investor-unfriendly bill that I have experienced in the past two decades.'").

I propose a two-tier market for both primary and secondary transactions keyed to investor sophistication. The private market would be limited to accredited investors, while the public market would be accessible to all. An easily measured quantitative benchmark—market capitalization or trading volume—would trigger the transition between public and private markets, allowing companies to elect public status after reaching that threshold. Once a company opts for public status, that newly public company would have a seasoning period during which periodic disclosures would be required. Only after the seasoning period could newly minted public companies sell shares to the public at large. Such a regime would substantially enhance the information available to the primary market once a company makes a public offering. More importantly, it would allow the secondary market to process that information before any public offerings. This regulatory framework would go a long way toward both promoting efficient capital formation and eliminating the waste currently associated with IPOs. A happy byproduct would be more vigorous protection for unsophisticated investors.

I proceed as follows. Part II outlines the current public–private dividing lines under the Securities Act and the Exchange Act. This part also explores Facebook's recent transition from private to public status under that framework, as well as Congress's recent intervention in the field with the JOBS Act. Part III explores the problems of making the transition from private to public, focusing on IPOs and their role in capital allocation. This part uses Facebook's IPO as both an illustration and as a cautionary tale. Part IV sketches an alternative to the current regulatory framework based on the two-tier-market proposal summarized above. Part V concludes.

II. PUBLIC VERSUS PRIVATE

The distinction between public and private companies is an important triggering mechanism under both the Securities Act and the Exchange Act. As noted above, the two statutes' differing demarcations between public and private date back to their original enactment during the New Deal. Common to both are the significant regulatory consequences that flow from public designation. Consequently, companies and their lawyers spend considerable energy avoiding public status. This regulatory arbitrage has induced the SEC to spend like effort in curtailing those attempted evasions of public status. The SEC has erected fences around private companies and private offerings that result in markets facing an informational void when a company is ready to make the transition from private to public. Facebook's recent IPO and preceding developments illustrate the problems created by the transition. Those developments helped spark the tweaks that Congress made to the public–private dividing line in the JOBS Act.

A. The Public Trigger

1. The Securities Act

Under the Securities Act, public offerings are open to any and all comers. Accordingly, public offerings are subject not only to extensive disclosure requirements, but also to a byzantine array of gun-jumping rules limiting voluntary disclosure intended to curb speculative frenzies for newly issued securities.[12] Private offerings are exempt from registration and the gun-jumping rules under § 4(a)(2) of the Securities Act. The Supreme Court has interpreted § 4(a)(2) in *SEC v. Ralston Purina Co.*[13] as permitting private offerings only to investors who can "fend for themselves," and therefore do not need the protections afforded by registration under the Securities Act. Because they are limited to sophisticated investors, private offerings are subject to considerably less onerous disclosure requirements than public offerings.[14] But private offerings are subject to a number of procedures designed to prevent end runs around the public-offering process—in other words, nominally private offerings that are funneled through intermediaries to the public at large: "distributions."[15]

The SEC has provided a safe harbor for § 4(a)(2) under Rule 506 of Regulation D.[16] Rule 506 offerings are limited to investors with the requisite sophistication to evaluate the investment.[17] This requirement is diluted somewhat, however, by Regulation D's conclusive presumption that accredited investors, which include individuals with annual income of $200,000 or assets of $1 million, are deemed to have the requisite investment sophistication.[18] This presumption, although somewhat difficult to square with *Ralston Purina* (and reality, for that matter), encourages many companies to limit their offerings to accredited investors exclusively. The regulatory presumption is that wealthy investors are capable of assessing the merits of an investment on their own, without the disclo-

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12. Those rules are accompanied by an equally byzantine array of exemptions to make the whole scheme viable, if expensive. For a comprehensive summary, see STEPHEN J. CHOI & A. C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 404–51 (3d ed. 2011).
13. 346 U.S. 119, 125 (1953).
14. 17 C.F.R. § 230.502 (2012).
15. *See* United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968).
16. 17 C.F.R. § 230.506 (2012).
17. *Id.* § 230.506(b)(2)(ii).
18. *Id.* §§ 230.501(a)(5)–(6).

sure mandated pursuant to the Securities Act. Market demands, however, dictate that some disclosure, comparable to the core mandatory disclosure requirements, will be forthcoming. Query how accurate that disclosure will be without the sanction of the Securities Act's liability provisions.

2. The Exchange Act

The Exchange Act also has a public–private dividing line, but it is framed very differently than the Securities Act. The Exchange Act's history has shaped its dividing line. When the Securities Exchange Act was enacted in 1934, there were two types of trading venues: stock exchanges—the New York Stock Exchange being the most dominant—and the over-the-counter (OTC) market.

At first, Congress chose to require disclosure only from exchange-listed companies.[19] In 1936, Congress added companies making a public offering to the list of public companies; periodic disclosures would be required after the IPO.[20] Both of these categories could be avoided; issuers that did not list on an exchange and did not make a public offering would not be burdened by disclosure requirements, albeit at the cost of less liquidity and less access to capital. It was not until 1964 that Congress added companies trading in the OTC market to the list,[21] closing a loophole long disliked by both the SEC and the exchanges.[22] Even then, not all OTC companies were brought within the rubric of public status; only companies with 500 or more "record" shareholders that were also above a certain minimum asset size (currently set at $10 million) were included.[23] Smaller companies, for which the opportunities for fraud and manipulation were most prevalent, remained largely unregulated. If anything, the 500-shareholder limit disguised the substantial space left for smaller companies to remain private. The 500 number tallied record ownership rather than beneficial ownership. So, if broker-dealers held the shares on the company's record books as nominees for their customers, companies could have thousands of beneficial owners hidden beneath a record shareholder number that remained under 500.

Why the numerical trigger? Joel Seligman suggests the number reflects a political compromise, with Congress splitting the difference be-

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19. Pub. L. No. 73-404, § 12(a)-(b), 48 Stat. 881 (1934) (codified at 15 U.S.C. § 78l(a)-(b) (2012)).

20. Pub. L. No. 75-462, § 3, 49 Stat. 1375 (1936) (codified at 15 U.S.C. § 78o(d) (2012)).

21. Pub. L. No. 88-467, § 3(c), 78 Stat. 565 (1964) (codified at 15 U.S.C. § 78l(g) (2012)).

22. SELIGMAN, *supra* note 5, at 312.

23. *See* 17 C.F.R. § 240.12g-1.

tween the regulators and the securities industry.[24] The numerical criterion has a certain logic. Investor protection may be more important for larger companies because they have more investors, but capital formation for larger companies is potentially more significant. Bigger companies, because of the wider scope of their operations, might have greater influence on the efficiency of capital allocation in the overall economy.[25] (Of course, smaller companies might be more significant to capital formation at the margin because they have greater potential for growth.) Whatever the motivation, the numerical trigger adopted in 1964 extended the earlier pattern of forcing disclosure from companies "presumed to be the subject of active investor interest."[26] The 1964 Act excluded companies with fewer investors for reasons of "practicality," despite the SEC's recommendation of a broader reach in its Special Study of the Securities Markets.[27] Giving the SEC the greater regulatory reach that it sought would have maximized investor protection. Even while greatly expanding the scope of regulation, however, politicians were concerned by the negative effects that might arise if small companies were roped into the burdens of public-company status. Investor protection would have to be balanced against the need to foster capital formation.

Notably absent from these criteria for public-company status under the Exchange Act was any consideration of the character of the investors. The Act treated sophisticated institutions and small retail investors alike for purposes of the tally to 500 that triggered public-company status. Issuers could not avoid public-company status by limiting their investor base to accredited investors. Such a limitation could be achieved through the imposition of transfer restrictions by the issuer, but it would not avoid public status if the 500-shareholder limit was passed. Regardless of the sophistication of those 500 investors, the company had no choice but to comply with the periodic disclosure requirements of the Exchange Act upon reaching the threshold.

B. Facebook

Facebook's recent transition from a private company to a public one illustrates the problems created by the differing private–public divid-

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24. SELIGMAN, *supra* note 5, at 315.

25. *See, e.g.*, Gil Sadka, *The Economic Consequences of Accounting Fraud in Product Markets: Theory and a Case from the U.S. Telecommunications Industry (WorldCom)*, 8 AM. L. & ECON. REV. 439 (2006) (demonstrating market distortions created by massive fraud at WorldCom).

26. Cohen, *supra* note 1, at 1341.

27. *Id.* at 1368. The SEC's recommendation is found in REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt.3, at 62–64 (1963).

ing lines under the two Acts. The Exchange Act's numerical trigger for public-company status recently emerged from technical obscurity as Facebook inched toward becoming a public company. In late 2010, Goldman Sachs proposed selling a significant block of Facebook shares.[28] The transaction drew attention because Facebook, at that time, was a private company, and it was planning to maintain that status. Goldman planned to preserve Facebook's private status by selling the company's shares to institutional and other sophisticated investors via a trust that would bundle their interests into a single investment vehicle.[29] The bundling was the unusual feature of the transaction. It was designed to keep the number of record Facebook investors under the 500-shareholder filing threshold of the Exchange Act.[30]

Whether this bundling approach was a viable strategy is open to debate. Rule 12g5-1(a) of the Exchange Act allows shares held of record by a legal entity to count as one person. Rule 12g5-1(b), however, stipulates that "[i]f the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent" the filing requirement, "the beneficial owners of such securities shall be deemed to be the record owners thereof." In other words, subsection (b) suggests that the SEC would look past the legal entity to the actual owners, *if* the issuer knows that the entity is being used to avoid public-company filing.

The proposed transaction attracted considerable media attention, which led to the offering's eventual demise. Concerns that the media attention looked like a "general solicitation," which would cause the offer to become "public" and conflict with the Securities Act of 1933, killed the deal.[31] Goldman instead placed the shares in an offshore transaction.[32] Subsequently, Facebook has transitioned to a public company; its initial public offering is discussed in detail below.[33]

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28. Evan Weinberger, *Goldman's Facebook Stake May Force SEC's Hand*, LAW 360 (Jan. 4, 2011, 6:00 PM), http://www.law360.com/articles/217826/goldman-s-facebook-stake-may-force-sec-s-hand.

29. *Id*.

30. Facebook's assets were already well in excess of $10 million. *See* Kevin Kelleher, *Facebook is Worth $52 Billion, and That's Not a Good Thing*, REUTERS (Dec. 13, 2010), http://blogs.reuters.com/mediafile/2010/12/14/facebook-is-worth-52-billion-and-thats-not-a-good-thing/.

31. 17 C.F.R. § 230.502(c) (2012) (prohibiting general solicitations in connection with private placements under Rule 506).

32. Liz Rappaport, Aaron Lucchetti & Geoffrey A. Fowler, *Goldman Limits Facebook Offering*, WALL ST. J. (Jan. 18, 2011), http://online.wsj.com/article/SB10001424052748703396604576087941210274036.html ("Goldman Sachs Group Inc. slammed the door on U.S. clients hoping to invest in a private offering of shares in Facebook Inc., because it said the intense media spotlight left the deal in danger of violating U.S. securities laws.").

33. *See infra* text accompanying notes 74–83.

Facebook's interaction with the private–public divide was also highlighted in another story that surfaced around the same time. Word leaked that the SEC was investigating secondary trading markets for violations relating to the resale of securities issued by private companies.[34] Facebook was among the more notable companies traded on one of these venues, SecondMarket.

These markets cater mainly to current and former employees of private companies, but also to some early-round investors. They have experienced strong growth in recent years. According to the *New York Times*, "[i]n 2009, SecondMarket completed $100 million worth of transactions in private shares. Last year, its volume was nearly six times that amount, with Facebook trades making up the bulk. Its rival SharesPost logged $625 million in transactions last year, more than double its total from 2010."[35] The SEC's investigation threatened this growth.

The SEC later announced that it had reached a settlement of an enforcement action with SharesPost. The agency's complaint alleged that the trading venue had been operating as an unlicensed broker-dealer.[36] At the same time, the SEC announced an enforcement action against Felix Investments. The SEC's complaint alleged that Felix took secret commissions from the sellers of private shares, in addition to the fees paid by purchasers. The agency also alleged that Felix had misled investors in connection with the sale of Facebook shares. The SharesPost enforcement action is a mere regulatory violation; the Felix action, however, is a reminder of the vulnerability of thinly traded markets to manipulation.[37]

Despite the growth of private markets, these trading venues are still dwarfed by the trading of public-company shares on registered exchanges. The current structure of these private markets substantially limits their trade volume. SecondMarket and similar venues do not provide the liquidity afforded by an exchange, as they lack specialists and market

34. Peter Lattman, *Stock Trading in Private Companies Draws S.E.C. Scrutiny*, N.Y. TIMES DEALBOOK (Dec. 27, 2010), http://dealbook.nytimes.com/2010/12/27/stock-trading-in-private-companies-draws-scrutiny/.

35. Evelyn M. Rusli & Peter Lattman, *Losing a Goose That Laid the Golden Egg*, N.Y. TIMES DEALBOOK (Feb. 2, 2012), http://dealbook.nytimes.com/2012/02/02/losing-the-goose-that-laid-the-golden-egg/.

36. Evelyn M. Rusli, *Charges Filed Against Brokerage Firms That Trade Private Shares*, N.Y. TIMES DEALBOOK (Mar. 14, 2012), http://dealbook.nytimes.com/2012/03/14/charges-filed-against-brokerage-firms-that-trade-private-shares/.

37. Facebook's initial registration statement for its IPO disclosed that it had been contacted by SEC staff in connection with its investigation into alternative trading venues. Alison Frankel, *What Everyone Missed in Facebook's IPO Filing*, REUTERS (Feb. 2, 2012), http://in.reuters.com/article/2012/02/03/frankel-facebook-idINDEE81205H20120203. No enforcement action, however, was filed against Facebook.

makers. Instead, they provide the more limited liquidity service of matching buyers and sellers in a central, virtual location.[38] These trading venues are limited to accredited investors, and the venues screen prospective investors to ensure that they qualify as accredited.[39] These precautions help ensure that the shares are not being "distributed" to the public, which could render the trading venue an underwriter for purposes of the Securities Act.[40] The Exchange Act's numerical shareholder limit for private companies is an additional obstacle to private-market growth. Notwithstanding these limitations under current regulation, the growth of these venues suggests clear potential for expansion if the regulatory scheme would accommodate it. The SEC's investigation, however, casts a shadow over the future of private markets.

C. The JOBS Act

The fallout from Goldman's failed private offering of Facebook shares triggered a rather dramatic legislative response. Congress seized upon the salient occasion to attack the SEC for blocking capital formation.[41] The SEC responded in timeworn fashion, promising a review of its regulations to assess their effect on U.S. capital markets.[42] But the SEC's delay tactic failed; the Republican House of Representatives saw a wedge issue that could make the Democrats look bad in an election year and pushed forward with legislation. That bill would ultimately become the JOBS Act. President Barack Obama, anxious to portray himself as "pro-growth," while facing an economy still plagued by high levels of

38. 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.

39. *Id*.

40. *See* Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959) (interpreting the definition of an "underwriter" in § 2(a)(11) of the Securities Act).

41. Letter from Rep. Darrell Issa, Chairman, House Oversight Committee, to Mary Schapiro, Chairman, Sec. & Exch. Comm'n (Mar. 22, 2011), *available at* http://www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf.

42. Letter from Mary Schapiro, Chairman, Sec. & Exch. Comm'n, to Rep. Darrell Issa, Chairman, House Oversight Committee (Apr. 6, 2011), *available at* http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

unemployment, signed the JOBS Act into law.[43] The SEC's opposition to the bill[44] carried little weight in the face of those electoral imperatives.

1. Exchange Act Reforms

The JOBS Act makes it easier to remain a private company. The 500-shareholder limit for triggering public-company status under the Exchange Act is now gone. The JOBS Act raises that number to 500 persons who are not accredited investors, and more critically, 2,000 investors overall.[45] Excluded from both numbers are shareholders who received the securities through an employee compensation plan exempted from registration.[46] This latter provision promises to delay the point at which a growing company would be forced to make the periodic disclosures required of public companies. I question whether this is an important constraint for companies smaller than Facebook that are striving to maintain their private status. Data on this issue are simply not available.

A key goal of the JOBS Act was to jump-start the market for IPOs by easing the burden of public-company status on newly public companies. The JOBS Act eliminated a substantial expense for post-IPO companies by exempting them from § 404 of the Sarbanes-Oxley Act, which required auditor assessment of a company's internal controls.[47] The JOBS Act also reduced the audited-financial-statement requirement for IPOs to only two years.[48] These regulatory relaxations last for five years from a company's IPO or until the company reaches $1 billion in annual revenue, whichever is sooner.[49]

43. Jonathan Weisman, *Final Approval by House Sends Jobs Bill to President for Signature*, N.Y. TIMES (Mar. 27, 2012), http://www.nytimes.com/2012/03/28/us/politics/final-approval-by-house-sends-jobs-bill-to-president-for-signature.html.

44. David S. Hilzenrath, *Jobs Act Could Remove Investor Protections, SEC Chair Mary Schapiro Warns*, WASH. POST (Mar. 14, 2012), http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html ("'Too often, investors are the target of fraudulent schemes disguised as investment opportunities,' Schapiro wrote. 'As you know, if the balance is tipped to the point where investors are not confident that there are appropriate protections, investors will lose confidence in our markets, and capital formation will ultimately be made more difficult and expensive.'"). State securities regulators also voiced their opposition. *The JOBS Act an Investor Protection Disaster Waiting to Happen*, N. AM. SEC. ADMINISTRATORS ASS'N (Mar. 22, 2012), http://www.nasaa.org/11548/nasaa-the-jobs-act-an-investor-protection-disaster-waiting-to-happen/.

45. Jumpstart Our Business Startups Act § 501, 15 U.S.C. § 78l(g)(1)(A) (2012).

46. *Id.* § 502, 15 U.S.C. § 78l(g)(5)(A).

47. *Id.* § 103, 15 U.S.C. § 7262(b).

48. *Id.* § 102, 15 U.S.C. § 77g(2)(A).

49. *Id.* § 101(a)–(b), 15 U.S.C. §§ 77b(a)(19), 78c(a)(80).

2. Securities Act Reforms

The JOBS Act also loosens the gun-jumping rules. The JOBS Act authorizes issuers to "test the waters" with qualified institutional buyers and accredited investors before filing a registration statement.[50] The goal is to assess whether there is demand for the company's shares, allowing the company to avoid the expense of the registration process if interest is lacking. In addition, the law frees analysts to issue research reports for new issuers during the offering process.[51] The goal of this provision is to promote demand for the company's shares. The combination of these two provisions suggests that Congress sees the gun-jumping rules as hopelessly outdated.

Especially relevant to the Facebook affair, the JOBS Act also targeted the SEC's ban on general solicitation in private placements. In fact, the JOBS Act repealed the prohibition outright.[52] Under the JOBS Act, the media attention that Goldman's proposed offering drew would not have jeopardized the § 4(a)(2) exemption as long as actual sales were made only to accredited investors.

Another provision of the JOBS Act has the potential to blur the distinction between private and public in a much more profound way. Congress opened the door for public offerings by smaller companies with substantially fewer restrictions. It did so by increasing the SEC's authority to exempt offerings from registration under § 5, raising the offering limit under § 3(b) tenfold from $5 million to $50 million.[53] The gun-jumping rules are put aside altogether, as companies are allowed to "test the waters" prior to filing a registration statement.[54] Moreover, Congress also stipulated that the securities sold be unrestricted, meaning they could be freely resold to retail investors.[55] In a somewhat unusual move, Congress mandated the adoption of a new exemption by the SEC pursuant to this authority, perhaps recognizing that the SEC would simply ignore it otherwise. In a concession to investor protection, however, Congress did allow the agency to require periodic disclosures by companies that avail themselves of this new exemption.[56] It also made offering dis-

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50. *Id.* § 105(c), 15 U.S.C. § 77e(d).

51. *Id.* § 105(a), 15 U.S.C. § 77b(a)(3) (2012).

52. *Id.* § 201(a)(1) (codified at § 4(b) of the Securities Act). Congress also authorized an exemption for "crowd-funding." *Id.* §§ 301–05, 15 U.S.C. §§ 77d, 77d-1, 78l(g), 78c, 77r, 78o.

53. *Id.* § 401(a)(2), 15 U.S.C. § 77c(b)(2).

54. *Id.* § 401(a)(2), 15 U.S.C. § 77c(b)(2)(E).

55. *Id.* § 401(a)(2), 15 U.S.C. § 77c(b)(2)(B).

56. *Id.* § 401(a)(2), 15 U.S.C. § 77c(b)(4).

closures subject to § 12(a)(2) liability under the Securities Act, but not, conspicuously, § 11's strict liability regime.[57]

3. Implications for the Private–Public Dividing Line

At first glance, the JOBS Act is a direct shot across the SEC's bow, moving the line between public and private markets to afford private markets considerably more space. For the SEC, preservation of public markets—populated by a sizable contingent of retail investors (voters)—is an existential task. The agency, after all, wraps itself in the mantle of "the investor's advocate," and its political support is inextricably connected to its regulation of those public markets. If the public markets ceased to exist, Congress would have little interest in funding the agency.

From another perspective, however, these provisions of the JOBS Act are far from revolutionary. Congress raised the number of investors for triggering public-company status, but left intact the basic architecture of the securities markets—both primary and secondary—as reflected in the Securities Act of 1933 and the Securities Exchange Act of 1934. Raising the threshold for filing under the Exchange Act does not challenge the notion that there should be a numerical dividing line between public and private; it simply reflects a policy disagreement between the SEC and Congress over where that line should be drawn.

Where does the private–public dividing line stand after the enactment of the JOBS Act? Overall, the JOBS Act gives private companies more latitude to remain private and eases the initial cost of transitioning to public status. Under the Exchange Act, the JOBS Act raises the threshold for triggering public-company status. For companies that choose to seek public status, the periodic disclosures required for the first five years should be less expensive without the requirement of auditor certification of internal controls. For the Securities Act, the JOBS Act makes it easier to raise capital while staying private by opening the private placement process by permitting general solicitations. Finally, and potentially the most radical change, the SEC's new authority to exempt offerings up to $50 million carries the intriguing possibility that the SEC will create a junior-varsity level of public companies.

At this point, the creation of a public-company incubation pool is only a possibility, as it is easy to see the SEC dragging its heels in implementing this exemption, and Congress has not mandated a date for its adoption. Certainly nothing will happen at the SEC anytime soon. The agency is still struggling to get out from under a rulemaking backlog cre-

57. *Id.* § 401(a)(2), 15 U.S.C. § 77c(b)(2)(D).

ated by the Dodd-Frank Act. After the 2012 election, perhaps with a less glaring spotlight from Capitol Hill,[58] the SEC may feel that it has a freer hand in imposing substantial requirements on the exemption that it will eventually promulgate. If it does so, the SEC may strangle the JOBS Act offering exemption in its crib.

III. MEDIATING THE TRANSITION FROM PRIVATE TO PUBLIC

Milton Cohen's central insight was that the disclosure needs of investors were the same in the primary and secondary markets for securities.[59] Since Cohen wrote his article in the mid-1960s, the acceptance of the "efficient capital market hypothesis" by both regulators and courts has reinforced his insight. Cohen's argument was simply the commonsense notion that disclosure obligations should be made consistent for the two markets. The implication of the efficient capital market hypothesis, however, is that disclosure particular to securities offerings might be largely redundant. If the market has the information prior to the issue of the securities, investors already have the tools that they need to assess the value of the new issue. Moreover, retail investors can free ride on the efforts of institutional investors when purchasing if they are all participating in the same market, buying from the same fungible pool of securities. If the efficient capital market hypothesis captures the reality of public offerings, the pricing decisions of the institutional investors will determine the market price, thereby providing some assurance that retail investors are getting a fair deal.

More fundamentally, with the advent of the efficient capital market hypothesis and its acceptance by the SEC, the regulatory focus of the Exchange Act has shifted. Although the Exchange Act may have been originally about investor protection, the development of the efficient capital market hypothesis has pushed the goal of the Exchange Act toward accurate pricing.[60] Investor protection is simply a happy byproduct of efficient pricing. If markets are fully informed, the theory goes, risks will be accurately priced. If the goal is accuracy, rather than paternalism, reflecting risks in the market price is good enough. Unfortunately, there are substantial reasons to doubt the efficiency of the market for IPOs.

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58. *See* Mary L. Schapiro, Chair, Sec. & Exch. Comm'n, *Testimony Concerning the "JOBS Act in Action Part II: Overseeing Effective Implementation of the JOBS Act at the SEC*,*"* SEC. & EXCH. COMM'N (June 28, 2012), http://www.sec.gov/news/testimony/2012/ts062812mls.htm (announcing that the SEC would not meet deadlines imposed in the JOBS Act).

59. *See* Cohen, *supra* note 1.

60. Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1415 (1999).

A. IPOs: Bad Deals

The shift in the focus of the Exchange Act toward accuracy has implications for the transition from private to public. Faith in the power of efficient capital markets to protect investors rests, however, on the efficiency of the underlying market. The comfort to both accurate pricing and investor protection provided by the efficient capital markets hypothesis falls apart with the IPO. No one believes that IPOs reflect an efficient capital market. In fact, the evidence is fairly strong that IPOs are inefficient. IPOs are bad deals. The puzzle is why IPOs persist, despite that inefficiency.

IPOs are bad for companies, bad for insiders, and bad for retail investors. The few parties that do clearly benefit from these deals are the individuals who service them: accountants, lawyers, and underwriters. Underwriters, who take a standard commission of 7% of the offering in the overwhelming majority of IPOs, certainly reap a substantial gain from IPOs.[61] In economic jargon, these professionals are termed "transactions costs." Although not intended as a compliment, the term is undoubtedly less tendentious than "blood-sucking parasite," which is the term that more than one entrepreneur might use, pained by giving away such a substantial slice of their growing business to a mere salesman.[62]

It is possible, however, that underwriters are paid for more than simply marketing the offering. Underwriters typically provide market-making services for IPO companies to support the secondary market following the IPO. This commitment is not a contractual obligation, but instead is a customary understanding. If the market-making, standing alone, is not profitable for broker-dealers, then the underwriter's discount may be, in part, compensation for those efforts.

Why are IPOs bad for companies? Apart from the substantial sums paid to the blood-sucking parasites, IPOs suffer from the well-known phenomenon of underpricing. Underpricing is the tendency for the price of stocks to rise significantly above the offering price on the first day of

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61. Hsuan-Chi Chen & Jay R. Ritter, *The Seven-Percent Solution*, 55 J. FIN. 1105, 1105 (2000) (finding that underwriters invariably charge a 7% commission for IPOs between $20 million and $80 million).

62. To be fair to the blood-sucking parasites, the price of the offering may be much smaller if the company is only selling a small percentage of its shares—say 10%—as is typical. The fact that companies sell only a small percentage, however, only reinforces the inefficiency of IPOs. If the terms were better, companies would presumably sell a greater percentage. Under the current regime, IPOs are generally a prelude to a more substantial seasoned offering.

secondary-market trading.[63] From the perspective of the issuer, the gap between the secondary-market price and the offering price reflects unexploited market demand for the company's shares. The explanations offered for underpricing are varied, including insurance against the risk of liability[64] and compensation to institutional investors for the cost of collecting information about the issuer.[65] Another theory is that underpricing encourages institutional owners to retain the shares at least until the lock-up period expires, typically six months after the offering, when the insiders will be free to sell their shares.

These factors may play a role, but there is also the intriguing possibility that the run-up in the secondary market reflects speculative frenzy among retail investors. This speculative frenzy cannot be captured by the issuer because the run-up is driven, at least in part, by the run-up itself—momentum trading on steroids, if you will. The role of speculation appears to be part of the story of why book-built offerings continue to dominate auctions as a means of selling securities.[66] According to this account, auctions have failed to attract a market following because they offer no way of excluding the "dumb money."[67] If retail investors are allowed to dominate the pricing of shares, institutional investors, wary of the "winner's curse," will avoid the offering. If institutional investors refuse to participate, the prospects for a complete unraveling become all too real. Underpricing is simply the byproduct of the need to exclude the undesirables from the initial pricing process. Once the "dumb money" piles into the secondary market, all bets are off.

Whatever the cause of underpricing, companies accept it as the cost of entry into the public markets. IPOs are less capital raisers than they

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63. Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1797 tbl.1 (2002) (finding that between 1980 and 2001, IPOs were underpriced by 22% on average); *see* Roger G. Ibbotson & Jeffrey F. Jaffe, *"Hot Issue" Markets*, 30 J. FIN. 1027 (1975); Jay R. Ritter, *The "Hot Issue" Market of 1980*, 57 J. BUS. 215 (1984); *see also* Judith S. Ruud, *Underwriter Price Support and the IPO Underpricing Puzzle*, 34 J. FIN. ECON. 135 (1993).

64. *See, e.g.*, Philip D. Drake & Michael R. Vetsuypens, *IPO Underpricing and Insurance Against Legal Liability*, 22 FIN. MGMT. 64 (1993); Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789 (1988). *But see* Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. REV. 17 (1993).

65. Ravi Jagannathan & Ann E. Sherman, *Reforming the Bookbuilding Process for IPOs*, 17 J. APPLIED CORP. FIN. 67, 67 (2005).

66. Ravi Jagannathan et al., *Why Don't Issuers Choose IPO Auctions? The Complexity of Indirect Mechanisms* (Nat'l Bureau Econ. Research, Working Paper No. 16214, 2010).

67. William Vickrey, *Counterspeculation, Auctions, and Competitive Sealed Tenders*, 16 J. FIN. 8, 20 (1961) ("[W]here there is much variation in the state of information or the generally expected intensity of desire of the various players for the object, or where the bidders are insufficiently sophisticated to discern the equilibrium point strategy . . . the Dutch auction is likely to prove relatively inefficient . . . .").

are debutante balls. Like wearing a fabulous gown to a ball, newly public companies jostle for a bump in first-day trading in order to be noticed and attract trading volume. The media treat a sharp rise in the after-market price as a reflection of the offer's "success," often ignoring the money the issuer has left on the table during the book-building process.

Why are IPOs bad for insiders? Primarily because insiders suffer substantial dilution of their interests in the company as a result of the IPO. This helps explain why IPOs are generally limited to a small percentage of the company's equity. For companies with the best prospects, the information asymmetry between the insiders and outside investors means that investors are likely to substantially discount the amount they are willing to pay for the company's shares. That discounting will be mitigated, but not eliminated, by mandatory and voluntary disclosures. Antifraud enforcement operates substantially below 100% accuracy, meaning some stretching of the truth will slip through unsanctioned. Moreover, complete disclosure is a practical impossibility even for companies anxious to be forthcoming. Worse yet, disclosure will sometimes be bad for business, as it conveys useful information to a firm's competitors.[68] Given these limitations on disclosure, companies with below-average prospects will be able to hide themselves in the pool of all IPO firms. The inclusion of "bad" firms in the IPO pool means that better-than-average firms will suffer from discounting—a partial lemons effect.[69] Notwithstanding these dilution costs, the benefit to insiders is that they will eventually enjoy a liquid market for their shares after the lock-up expires. For some companies, the costs are worth it. Other companies choose to stay private.

Why are IPOs bad for retail investors? Despite the underpricing that manifests itself in the secondary market on the day that the company goes public, the long-term performance of IPO stocks trails the risk-adjusted returns available from holding the market portfolio.[70] Given that this underperformance is both long-standing and well documented, why do investors continue to invest in IPOs? One answer is that they are lured into foolish purchases by crafty Wall Street salespeople. It is a Wall

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68. *See* Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 151 (2004) (noting greater disclosure in private deals relative to disclosures made by public companies).

69. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

70. Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965, 970 (1995); Terzah Ewing, *Burnt Offerings? Street Debuts Are Fizzling After Pop*, WALL ST. J., Apr. 26, 2000, at C1.

Street truism that "new issues are sold, not bought."[71] This proposition is somewhat difficult to square with the prevalence of institutional investors among the lucky recipients in IPO allocations.[72] But those institutional investors may be counting on the ability to flip the shares to retail investors in the secondary market.[73] Lurking in the background here, especially when combined with the underpricing phenomenon, is the worry that secondary-market prices may be driven by a lottery mentality, at least in the near term. In other words, the institutional investors who receive allocations in the IPO expect to make a profit due to the initial underpricing. The retail investors who purchase their shares in the secondary market, however, are prone to irrational exuberance. Retail investors may be willing to tolerate market-lagging returns overall in exchange for the possibility that one of their purchases may turn out to be the next Apple or Microsoft. This lottery-ticket mentality is not likely to lead to accurate pricing of a company's future cash flows.[74]

B. Facebook Again

Facebook's eventual IPO provided a high profile example of how IPOs can go badly wrong. Running contrary to the typical pattern of underpricing in IPOs, Facebook's secondary-market price quickly took a steep plunge, dropping in its first week of trading from the $38 offer price to less than $32.[75] Within a few months, the price dropped below $20.[76] Not surprisingly, a good deal of finger pointing followed. A variety of factors were identified as the culprit, the most straightforward being the company's decision to issue 25% more shares than originally con-

71. Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979, 998 (1989).

72. *See* Reena Aggarwal et al., *Institutional Allocation in Initial Public Offerings: Empirical Evidence*, 57 J. FIN. 1421, 1422 (2002) (finding that institutional investors receive approximately 75% of original IPO shares in an average offering).

73. *See* Douglas O. Cook et al., *On the Marketing of IPOs*, 82 J. FIN. ECON. 35 (2006).

74. Bill George, *The Long-Term Value of Internet Companies*, N.Y. TIMES DEALBOOK (Aug. 3, 2012), http://dealbook.nytimes.com/2012/08/03/the-long-term-value-of-internet-companies/ ("[S]peculative traders looking for outsize returns can increase the volatility of company valuations.").

75. Michael J. De La Merced, Evelyn M. Rusli & Susanne Craig, *As Facebook's Stock Struggles, Fingers Start Pointing*, N.Y. TIMES DEALBOOK (May 21, 2012), http://dealbook.nytimes.com/2012/05/21/as-facebooks-stock-struggles-fingers-start-pointing/.

76. Andrew Ross Sorkin, *The Man Behind Facebook's I.P.O. Debacle*, N.Y. TIMES DEALBOOK (Sept. 3, 2012), http://dealbook.nytimes.com/2012/09/03/david-ebersman-the-man-behind-facebook%E2%80%99s-i-p-o-debacle/.

templated.[77] Undoubtedly, that decision played a part in the unusually large allocation of shares to retail investors in the offering.[78] That influx of "dumb money" gave rise to the specter of the "winner's curse."[79] Morgan Stanley, Facebook's underwriter, was faulted for its aggressive pricing of the stock.[80] NASDAQ, the exchange where Facebook listed its shares, had a technological meltdown that caused a substantial number of orders to apparently disappear into the ether on the first day of trading.[81] Most damning, however, was the revelation that analysts at a number of banks, including Morgan Stanley, had revised downward their earnings projections for Facebook based on difficulties the company had disclosed with making money off of users who accessed Facebook through mobile devices. Analysts' revised estimates were shared with the banks' institutional clients, but not with retail investors.[82] Those lowered projections no doubt fueled the interest of those institutional investors in flipping their shares to retail investors as quickly as possible after the IPO. Lawsuits quickly followed,[83] and Congress called hearings to examine the IPO process generally.[84]

C. Why Do IPOs Persist?

If IPOs are such bad deals, why do they persist? Under the current regime, IPOs are a practical necessity. But from the perspective of efficient capital allocation, IPOs have little to commend them. The common

77. Joe Nocera, *Facebook's Brilliant Disaster*, N.Y. TIMES (May 25, 2012), http://www.nytimes.com/2012/05/26/opinion/nocera-facebooks-brilliant-disaster.html?_r=0&gwh=4CDA5EFF05C82939D6E03278C2882A5C.

78. *See* Jacob Bunge, Aaron Lucchetti & Gina Chon, *Investors Pummel Facebook – Stock Falls 11% in First Full Day of Trading; Complaints of Too Many Shares*, WALL ST. J., May 22, 2012, at A1 ("Retail, or individual, investors usually are allocated up to 20% of the total shares allotted in an IPO, but in Facebook's case, retail allocation was around 25% . . . .").

79. *See* Lynn Cowan, *'Oversubscribed' Is a Weak IPO Signal*, WALL ST. J. (June 18, 2012), http://online.wsj.com/article/SB10001424052702303822204577468931105122266.html ("At the heart of the [Facebook offering]'s flop . . . was a very basic problem: Too many shares were sold at too high a price to too many investors who weren't committed to holding it for very long.").

80. De La Merced, Rusli & Craig, *supra* note 75.

81. Chuck Mikolajczak & John McCrank, *Facebook Shares Sink 11 Percent as Reality Overtakes Hype*, REUTERS (May 21, 2012), http://www.reuters.com/article/2012/05/21/us-facebook-struggle-idUSBRE84J0D620120521.

82. Evelyn M. Rusli, Ben Protess & Michael J. De La Merced, *Questions of Fair Play Arise in Facebook's I.P.O. Process*, N.Y. TIMES DEALBOOK (May 23, 2012), http://dealbook.nytimes.com/2012/05/23/regulators-ask-if-all-facebook-investors-were-treated-equally/.

83. Peter J. Henning & Steven M. Davidoff, *The Facebook I.P.O.'s Potential Legal Exposure*, N.Y. TIMES DEALBOOK (May 23, 2012), http://dealbook.nytimes.com/2012/05/23/the-facebook-i-p-o-s-potential-legal-exposure/.

84. Jean Eaglesham & Telis Demos, *Lawmakers Push for Overhaul of IPO Process*, WALL ST. J. (June 22, 2012), http://online.wsj.com/article/SB100014240527023044414045774790242059 61592.html.

theme running through the problems with IPOs for companies, insiders, and investors is information asymmetry. Investors are not fully informed, and it is costly to provide them with credible information. Speculation and irrational exuberance, fueled by Wall Street marketing and media attention, grease the wheels for deals that would not otherwise be attractive. The *raison d'etre* of IPOs seems to be the fact that they are the entrée to the big leagues of public-company status. From the perspective of both capital formation and investor protection, IPOs are a failure. We see similarly poor results for reverse mergers and private investments in public equities (PIPEs), which are alternative—and somewhat dimly lit—avenues for reaching the ultimate goal of public-company status.[85] Like IPOs, these transactions share the expectation that the issued shares will be dumped on public investors after a holding period, perhaps accompanied by aggressive selling efforts. The transition from private to public seems to be a rocky road, whatever the route taken.

In the next section, I outline an alternative to the IPO designed to deal with the problem of inefficiency created by information asymmetry. I argue that my alternative is superior to the existing regime, both from the perspective of efficient capital allocation and the protection of retail investors.

IV. A Two-Tier Alternative

The public–private dividing line is on shaky ground. Congress has pushed back the public line for the Exchange Act with the JOBS Act. For the Securities Act, the SEC's adoption of the effective equivalent of company registration for established companies suggests a loss of faith in the gun-jumping rules. At least for seasoned offerings by the largest public issuers, the SEC no longer believes that the gun-jumping rules are needed to quell speculation. Congress is unlikely to lead a revival; the JOBS Act reflects a further erosion of the gun-jumping rules for IPO issuers. Congress's endorsement of testing the waters in the JOBS Act sends us further along the road toward complete abolition of the gun-jumping rules. This trend appeals to the economically minded. If we have full disclosure, the technology to distribute that information, and an informationally efficient market, do we need the gun-jumping rules of § 5? The gun-jumping rules linger on for IPOs in a diluted form after the JOBS Act. And yet we saw in the last section that the gun-jumping rules leave much to be desired if the goal is efficient capital formation. The rules fall far short of achieving that goal in IPOs, incapable of overcom-

85. *See* Donald C. Langevoort & Robert S. Thompson, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital-Raising*, 97 CORNELL L. REV. (forthcoming 2013).

ing the fundamental inefficiency of those markets. The only possible remaining justification for the gun-jumping rules, if any, is investor protection. And even there, the empirical evidence suggests that the rules are of dubious utility. The inefficiency of the IPO market persists despite the daunting array of legal restrictions.

This shift by Congress in the JOBS Act and the SEC—with its virtual adoption of company registration—raises a number of questions for the dividing line between private and public. In this section, I propose an alternative to the current dividing line. What if all public offerings were seasoned offerings? Seasoned offerings come with a price informed both by full disclosure and a preexisting trading market. Could we achieve more efficient capital formation and better investor protection simultaneously? Would retail investors be harmed if we eliminated IPOs?

My proposal is inspired by a simple sporting analogy: the English Premier League. The Premier League has twenty teams. At the end of each season, the three worst teams are relegated to the Football League Championship, while the top three teams from that division are promoted. My proposal is for a "Premier League" for public companies and a lower tier for private companies, with distinct primary and secondary markets for each.

Under my proposal, companies could move up and down between the markets as warranted. The number of companies in the public market would not be limited, however, as teams are in the Premier League. Any company reaching a certain quantitative bench mark—say $75 million in market capitalization, a threshold currently used by the SEC for shelf registration[86]—would be eligible for elevation to the public market.[87] Issuers would be able to choose their status; companies would not be dragged into the top tier against their will. Once a company opted for public status, however, the company would be obliged to satisfy the periodic reporting obligations of the Exchange Act for as long as they remained public. Relegation to the lower tier would be subject to a shareholder vote. The following section develops how I anticipate the process might work.

A. The Private Market

Issuers below the quantitative benchmark would be limited in their access to both the primary and secondary markets. Their securities could be sold only to accredited investors, pursuant to the standards under

86. 17 C.F.R. § 230.415(a)(1)(x) (2012).

87. I use market capitalization here simply for ease of exposition. The quantitative benchmark might alternatively be based on trading volume. *See* Langevoort & Thompson, *supra* note *.

Regulation D[88] or § 4(a)(2).[89] In contrast to current practice, those securities could not be freely resold after a minimum holding period.[90] Instead, the issuer would be required to limit transfer of those shares to accredited investors prior to becoming a public company.[91] Among accredited investors, however, the securities could be resold without jeopardizing the issuer's exemption.

I anticipate organized markets for private trading along the lines of SecondMarket and SharesPost. The advent of these markets makes my proposal feasible. The proposal here takes advantage of those developments, but it also builds off the success of the Rule 144A market. This market is currently limited to Qualified Institutional Buyers (QIBs), which are institutional investors with more than $100 million under management.[92] The proposal here would extend that existing market for QIBs by including accredited investors. The QIB market is estimated by industry sources to have over 14,000 participants; the number of accredited investors surely dwarfs that by several orders of magnitude. The success of that QIB market suggests that the private market proposed here would have enough liquidity to function effectively.

These private markets would need the issuer's consent for the trading of their shares, thereby creating a form of quasi-listing. The private-trading market would be responsible for screening prospective investors to ensure that they met the SEC's criteria for accredited investors. Only certified accredited investors would be allowed to participate. This category includes mutual funds, so retail investors could access this private market. They could do so, however, only through a diversified vehicle administered by an investment manager, who would be subject to the usual array of regulations.

The question of disclosure in this market poses a challenging issue. It would defeat the market's purpose to require the disclosure expected of a public company. On the other hand, some standardization of disclosure practices would likely benefit both investors and issuers. The size of today's private offerings also raises the possibility of a collective-action problem for investors, thereby making it difficult for them to negotiate

88. 17 C.F.R. §§ 230.500–08.

89. 15 U.S.C. § 77d(a)(2) (2012).

90. That period is currently one year for non-public companies. 17 C.F.R. § 230.144(d) (2012).

91. *See* Choi, *supra* note 7, at 608 ("[A] true company registration system would similarly restrict the trading of securities of lightly followed companies with little public information regardless of the path the securities took to market.").

92. 17 C.F.R. § 230.144A(a) (2012).

for contractual representations and warranties.[93] There are some fundamentals hard to imagine doing without, such as audited financial statements. Beyond that baseline, however, is a range of difficult questions regarding materiality.

One possibility would be to allow private markets to establish disclosure requirements pursuant to their listing agreements, and those listing agreements would be subject to SEC approval.[94] Such an arrangement would allow for some flexibility and responsiveness to market forces while still ensuring that disclosure did not fall below some desired minimum. The SEC could perhaps implement regulatory oversight through an exemption for the trading venues from exchange status by imposing conditions on the exemption. Alternatively, the SEC could rely on its new § 3(b) exemption authority.[95] The SEC could impose periodic disclosure requirements on companies relying on the § 3(b) exemption to sell shares to retail investors. Companies that limited their sales to accredited investors and restricted the transfer of those shares only to other accredited investors could be exempted from those disclosure requirements.

B. The Public Market

Elevation to the public market would be voluntary. Issuers that were not prepared to handle the burden of public-company obligations could limit the transfer of their shares to the private market, which would be accessible only by accredited investors. If a company felt that it could satisfy its capital needs in the private market, the company would be free to remain there.

Companies could graduate to the public market based on market capitalization or trading volume for common equity. These criteria are similar to the Exchange Act's proxies for active investor interest,[96] but they are more readily measured and less vulnerable to manipulation. Once a company elected to become public, it would initiate the process

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93. *See* Langevoort & Thompson, *supra* note *, at 31 ("[I]f we have doubts about collective action as the number of investors grows—even assuming wealth or sophistication—the case for mandatory periodic disclosure strengthens. In the face of dispersion, both shareholders and potential investors have to glean information on their own to compensate for any lack of voluntary disclosure, which produces inefficient duplication of effort.").

94. Mary Kissel, *So Who Needs Wall Street?*, WALL ST. J., Oct. 29, 2011, at A13 ("SecondMarket requires companies to provide 'audited financials and risk factors' to potential investors. 'That's not required under the SEC rules,' [SecondMarket's CEO] says. 'We don't want to see fraudulent companies on SecondMarket. We don't want to see people, you know, making investment decisions without being well-informed. That's bad for us as a marketplace.'").

95. Securities Act of 1933 § 3(b)(2), 15 U.S.C. § 77b(2).

96. *See supra* text accompanying notes 19–27.

of transitioning to trading in the public market by first filing a Form 10-K.[97] A seasoning period would follow, with the filing of requisite 10-Qs,[98] during which the shares would continue to be traded in the private market.[99] The prices in the private market, however, would now be informed by full SEC-mandated disclosure. After the seasoning period, accredited investors would be able to sell their shares in the public market. This opportunity would be available regardless of whether the accredited investor purchased its shares from the company, or the shares were purchased from other accredited investors in the private-trading market. The public market could be an exchange, if the company chose to list, or an over-the-counter market. Either way, the trading price in the public market would be informed by the prior trading in the private market, as well as the new information released in the company's 10-K and 10-Qs.

The private-market seasoning period before public trading raises some difficult questions. It would not be practicable to limit companies from any sales during the seasoning period; capital needs do not go away simply because the company is making the transition to public status. Indeed, the need for capital is presumably pushing the company to bear the burdens of public status. This creates the possibility that companies could use investment banks or other intermediaries, such as hedge funds, as conduits during the seasoning period. The viability of this strategy is limited, however, by the fact that the intermediaries could only sell shares to other accredited investors during the seasoning period. Thus, the risks of an unregistered "distribution" to retail investors are low. Moreover, unless the company has very pressing capital needs, it is unlikely to tolerate much of a liquidity discount for its shares, which it will be able to freely sell after the seasoning period expires. It might, however, be necessary to impose volume limits on sellers in the public markets during a transition period in order to allow the trading market to develop. A quick dump of shares immediately after the seasoning period expired has the potential to reproduce the inefficient pricing and irrational speculation that taints the market for IPOs.

Only after the company graduated to having its shares traded in the public market would the company be free to sell equity to public investors. What form should sales of public equity by the issuer take? The log-

97. 17 C.F.R. § 249.310 (2012).

98. 17 C.F.R. § 249.308a (2012).

99. *Cf.* Self-Regulatory Organizations, Exchange Act Release No. 34-65708, 76 Fed. Reg. 70799 (Nov. 8, 2011) (approving NASDAQ rule change requiring a seasoning period of a year following a reverse merger before a company can be listed).

ic of the proposal, with its preference for the superior informational efficiency of trading markets, suggests that issuers selling equity should be limited to at-the-market (ATM) offerings. Issuers would sell directly into the public-trading market instead of relying on an underwriter to identify (or create?) demand. This approach puts its faith in markets, rather than salesmen, for efficient pricing. Unfortunately, this strategy has its limitations. ATM offerings are a rapidly growing portion of seasoned equity offerings,[100] but they are still dwarfed by traditional book-built offerings. Particularly for larger offerings, the liquidity of the secondary-trading market may be insufficient to absorb such a large number of shares without substantially diluting existing shareholders. To be sure, book-built offerings would be significantly constrained by the existence of a market price. Is it possible to nudge issuers toward ATM offerings without mandating them?

One possibility would be to eliminate § 11 and § 12(a)(2) liability[101] for at-the-market offerings, while retaining this requirement for underwritten offerings. At a minimum, it makes little sense to impose underwriter liability on the broker-dealers hired by issuers to manage ATM offerings. If large volumes need to be "sold, not bought," the opportunities for abuse arise in the selling process. SEC and FINRA enforcement would be needed to ensure that there were no back-door selling efforts to prime the market for an ATM offering. Even for the issuer, the draconian threat of § 11's strict liability seems excessive for an ATM offering. ATM offerings, if genuinely sold into a preexisting market without stimulation, do not require a registration statement or a prospectus. At most, ATM offerings need an 8-K[102] announcing the number of shares to be offered, followed by another 8-K disclosing the number of shares actually sold. Antifraud concerns could be addressed by the less draconian Rule 10b-5.[103]

C. Relegation

If there are private companies wanting to rise to the public level in my scheme, it follows that there are likely to be public companies attracted to the reduced burdens of private status. An important benefit of a

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100. James D. Small III, W. Clayton Johnson & Leslie N. Silverman, *The Resurgence of United States At-The-Market Equity Offerings to Raise Capital in Volatile Equity Markets*, 4 CAPITAL MARKETS L. J. 290, 292 (2009) ("From June 2008 through the end of April 2009, more than 25 issuers registered with the SEC almost $6.9 billion of equity securities for sales under equity distribution programmes (of which more than $3.2 billion was subsequently sold to investors).").

101. Securities Act of 1933 §§ 11 & 12(a)(2), 15 U.S.C. §§ 77k, 77l(a)(2) (2012).

102. 17 C.F.R. § 249.308 (2012).

103. *Id.* § 240.10b-5.

two-tier market is that retail investors would not be completely cut off from liquidity if a company chooses to relegate itself to the private market. There is no reason to preclude retail investors from *selling* their shares in the private market, even if they would be barred from purchasing shares in companies that dropped down to private-company status. Moreover, there is little to be gained by prohibiting companies from exiting the public pool; a restrictive approach will simply discourage companies from pursuing public-company status in the first place. On the other hand, too lenient an approach may put too much stress on the fiduciary duties of directors under state law to prevent abuses. Are there procedures available that can limit the opportunities for abuse?

I propose that a shareholder vote be required before a company would be permitted to drop from public to private status.[104] A vote, with the usual disclosures required by the federal proxy rules, would be a useful check on private-to-public-to-private manipulation schemes. It would not trap companies, however, that have struggled after going public. The company would have to make its case to its shareholders that the benefits of public-company status were no longer worth the candle. Who should be eligible to participate in the voting? It seems prudent to exclude the votes of insiders and controlling shareholders, but should we also sterilize the votes of institutional investors? My instinct is that this additional restriction would not be necessary. The loss of liquidity attendant to relegation to the private market affects non-controlling institutional investors and retail investors in the same way; their interests are aligned. Giving the veto threat to too narrow of a group raises the possibility of holdup.

D. Objections

Won't an expanded private market open the door to fraud and manipulation? The short answer is that as long as people are infected by the love of money, fraud will always be with us. Given that sad fact of human nature, we should funnel transactions to the venues that make it most difficult to get away with fraud. To be sure, the private market proposed here is likely to have a higher incidence of fraud and manipulation than the public market. But the scope of that fraud will necessarily be limited by the smaller size of the private markets relative to their public counterparts. Moreover, the entities sponsoring trading in those private markets will have competitive incentives to take cost-effective measures

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104. *See* Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135 (2009) (advocating that a shareholder vote be required before a firm could cease periodic disclosures).

to discourage fraud.[105] And the SEC and FINRA enforcement would be available to counter the most egregious abuses.

The potential for abuse in the private market has to be weighed against reductions in fraud elsewhere. In particular, my proposed seasoning-period requirement substantially reduces the opportunities for fraud by companies entering the public market. On balance, the overall incidence of fraud may well be reduced. Furthermore, retail investors, who are least able to bear it, will almost certainly be exposed to less fraud. At the same time, capital formation—efficient allocation of capital to cost-justified projects—will be enhanced.

Another potential objection is that liquidity will suffer if the role of underwriters is diminished. One service provided by underwriters is market making immediately following the offering. My proposal anticipates the market coming into existence prior to the public offering. Will broker-dealers step in to provide liquidity in the absence of underwriters? If market making is profitable on its own, the obvious answer is yes. But if market making is not profitable standing alone for smaller issuers, there is no reason that it has to be bundled with underwriting. If some issuers need to subsidize initial trading in their shares, this can be accomplished outside of an underwriting relationship through a direct payment.

Finally, objectors to my proposal should be careful to avoid the nirvana fallacy. The alternative to my two-tier proposal is not the tight regulation of registered offerings that we saw for much of the Securities Act's history; it is the public-company-"lite" status of offerings exempted under the new § 3(b) of the JOBS Act.[106] Is that public-company incubator pool really superior from the perspective of investor protection?

V. CONCLUSION

What if we simply focused on capital formation in drawing the line between private and public markets? A focus on capital formation suggests that we should put an end to IPOs if we can establish a viable alternative. In my view, restrictions on private markets have hindered that viable alternative from emerging. The JOBS Act's increase to 2,000 shareholders for public-company status is a big step toward a greater role for private markets. My proposed alternative to the current IPO regime would bring the company-registration initiative to its logical conclusion. Private companies would be required to go through a seasoning period—

105. *See* A. C. Pritchard, *Markets as Monitors: A Proposal To Replace Class Actions with Exchanges as Securities Fraud Monitors*, 85 VA. L. REV. 925 (1999).

106. Securities Act of 1933 § 3(b)(2), 15 U.S.C. § 77b(2).

with mandatory disclosure—before selling securities to the public. This seasoning period would mark the line between private and public, rather than the current standards of exchange listing, number of shareholders, or the filing of a registration statement for an initial public offering.

The foundation of my proposal rests on two central premises: (1) IPOs are an inefficient means of capital formation; and (2) private markets, with pools of liquidity that are continuing to expand, will be sufficient to satisfy the capital needs of growing companies until they are ready for the burdens that come with public-company status. The evidence for the first proposition is consistent and strong. The second proposition blazes a path into still uncharted territory. The Rule 144A QIB market and the rise of private markets like SecondMarket and SharesPost show the potential of private-trading markets. Until the passage of the JOBS Act, however, those markets have been hamstrung by the 500-shareholder limit triggering public-company status. Raising that limit to 2,000 shareholders of record promises to substantially increase the liquidity of private markets. More time will be needed, however, before we can assess whether this expansion of the private markets gains market acceptance.

The bottom line is that with the passage of the JOBS Act, change is coming to the demarcation between private and public status under the securities laws. The looming question is whether the SEC will attempt to obstruct this change, or embrace it in an effort to promote greater capital formation. My proposal affords the SEC an opportunity to promote capital formation while also enhancing investor protection. The two-tier private–public market scheme outlined here would complete the company-registration model put forward by Milton Cohen nearly a half century ago. We should harness private markets to promote the public good. Private markets may finally allow us to abolish initial public offerings.