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DEMOCRATIZING STARTUPS

*Seth C. Oranburg**

Abstract

President Obama signed the Jumpstart Our Business Startups ("JOBS Act") of 2012 into law to "help entrepreneurs raise the capital they need to put Americans back to work and create an economy that's built to last." The goal is to "democratize startups" by making capital available to diverse entrepreneurs in new geographies. Yet the net effect of securities regulations and market conditions is the opposite. Startup companies are encouraged to stay private so capital is consolidating in large, mature firms instead of recycling into new startups. Evidence of consolidation is that once-rare "Unicorns" (billion-dollar startups) now number at least 170. More money is going into huge private companies, yet total venture capital investment is flat, so less is going to new startups. This could stall out the innovation economy.

Democratizing startups requires safe-harbor exemptions from securities regulations for both original issuance and resale of stock, but securities regulations do not permit resale on exchanges. This Article proposes "Rule 144B," a regulatory provision that could be enacted without an act of Congress, to permit transparent web-based venture exchanges with fraud-prevention intermediaries termed "independent analysts." This Article answers the SEC's call for rulemaking comments and informs Congress's new work on JOBS Act 2.0.

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INTRODUCTION

"Startup America" is the initiative by President Obama to create strong startup ecosystems in every state.[1] The initiative is supported by recent legislation, the Jumpstart Our Business Startups Act of 2012 ("JOBS Act"),[2] which passed quickly with wide bipartisan support for its goal to "allow Main Street small businesses and high-growth enterprises to raise capital from investors more efficiently, allowing small and young firms across the country to grow and hire faster."[3] Americans overwhelmingly support the policy goal of democratizing startups, which means providing more capital to diverse entrepreneurs—including women and minorities in novel geographies outside of Silicon Valley—for new business projects beyond high technology. But Silicon Valley—and the entire startup economy—cannot diversify under current securities regulations and market conditions. In addition to allowing startups to sell stock through crowdfunding and mini-IPOs, securities regulations must also allow investors to *resell* that stock. This Article provides a novel and feasible regulatory solution to facilitate resale exchanges.

1. *Fact Sheet: White House Launches "Startup America" Initiative*, WHITE HOUSE, https://www.whitehouse.gov/startup-america-fact-sheet [http://perma.cc/9JAZ-6KNN] (last visited Mar. 26, 2016).

2. Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

3. Office of the Press Sec'y, *President Obama to Sign Jumpstart Our Business Startups (JOBS) Act*, WHITE HOUSE (Apr. 5, 2012), https://www.whitehouse.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act [http://perma.cc/Z5GZ-9L2J].

The JOBS Act's goal of democratizing startups is stymied by other securities regulations working at cross-purposes. Securities regulations have three goals, as stated by the Securities and Exchange Commission (the "SEC")—the agency created to carry out these goals: protecting investors, maintaining orderly capital markets, and facilitating efficient capital formation.[4] The JOBS Act prioritizes capital formation, but other laws prioritize protecting investors through safeguards and mandatory disclosures, which can make capital formation less efficient.[5] The net impact of these securities regulations and capital markets is to encourage startups to stay private instead of going public. This trend of startups staying private leads to consolidation of capital in a few large startups instead of recycling it into many smaller startups across the country.[6]

Staying private limits liquidity and undermines democratizing startups in three ways. First, the new, smaller investors that the JOBS Act hopes to attract will be discouraged by the inability to resell their stock, especially because the established, larger investors have better access to off-exchange resale markets.[7] Second, mainly young companies create jobs, but staying private means capital is consolidated in more mature companies instead of recycled into young organizations. Moreover, startup employees paid in stock options find themselves with a de facto non-compete until the company goes public, which distorts labor markets in unexpected ways.[8] Third, wealthy and influential investors who need to resell large blocks of stock can do so only in secret trading environments, which, like "dark pools,"[9] promote opportunism

4. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about/whatwedo.shtml [http://perma.cc/HV7J-RRFA] (last modified June 10, 2013).

5. *See, e.g.*, Stuart R. Cohn*, The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1439–44 (2012).

6. For a discussion of how and why startups are staying private, see *infra* Part II. Staying private—which the JOBS Act encourages—undermines the stated purposes of the JOBS Act in the following way: (1) small investors are disadvantaged; (2) stock options are devalued; and (3) "dark pools" persist. See *infra* note 9 for a discussion of "dark pools."

7. *See infra* Part II.A.

8. *See infra* Part II.B.

9. Dark pools are trading markets available and known to very few investors. Brian G. Cartwright, General Counsel, U.S. Sec. & Exch. Comm'n, Speech by SEC Staff: The Future of Securities Regulation (Oct. 24, 2007), https://www.sec.gov/news/speech/2007/spch102407bgc.htm. Common traders cannot get liquidity in dark pools—only big banks and hardcore analysisists know they exist. *Id.* ("The second form of deretailization I want to discuss is the development and growth over the last several decades of important new trading markets that are entirely closed to retail investors. The 'dark pools' of liquidity that have garnered some press of late are one example, but perhaps the most familiar is

and fraud while providing none of the virtues of public exchanges like price discovery.[10] Without liquidity, startup capital cannot be recycled.

Today's private stock markets have not developed exchanges—markets for the easy resale of standardized units of private-company stock—because such exchanges would almost certainly be unlawful under current securities regulations. Without secondary markets, private-company stock is hard to resell, or is "illiquid," which creates a number of problems discussed in detail in this Article. SharesPost appears to interpret SEC no-action letters to prohibit it from making offers to buy or sell securities because its own guidelines, promulgated after the SEC guidance was issued, explain that SharesPost refrains from this behavior.[11] FundersClub obtained a no-action letter from the SEC that permits it to solicit investment in select private companies only if it does not receive any transaction-based compensation.[12] AngelList received a no-action letter permitting it to aggregate investors only if it will not handle any customer funds or securities.[13] SecondMarket stopped operating its resale auction and has shut out retail investors completely.[14] Firms will not develop a private-stock exchange unless there is a clear legal way to operate it.

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the 144A debt market. Promulgated by the SEC in 1990, Rule 144A removed most of the regulatory impediments to secondary market transactions between large institutions that qualify as 'QIBs.' 'QIB' or 'Q-I-B' is the acronym for 'qualified institutional buyer,' a term defined in Rule 144A generally to mean institutions that have at least $100 million invested in securities.").

10. *See infra* Part II.C.

11. *See* SHARESPOST FIN. CORP., A SHARESPOST PRIMER ON SECONDARY MARKET SECURITIES LAW (2012), https://sharespost.com/site/assets/files/3063/primer_on_secondary_market_securities_law.pdf [http://perma.cc/SEX4-8LLA] ("Furthermore, in a series of no-action letters, the SEC has indicated that a private offering distributed electronically is not a general solicitation so long as the following circumstances apply: The postings are made on a password-protected web page that cannot be accessed by the general public. The password-protected web page is available to a particular investor only after a determination is made that the investor is accredited. The questionnaires or forms by which accredited investors are qualified do not reference any specific transaction posted or to be posted to the site. A potential investor can purchase securities only in transactions that are posted after the investor's qualification.").

12. FundersClub Inc. & FundersClub Mgmt. LLC, SEC No-Action Letter, 2013 WL 1229456, at *3 (Mar. 26, 2013) ("The officers, directors and employees of FundersClub and FC Inc. and FC Management personally do not receive transaction-based compensation for their efforts in raising investments for the investment funds.").

13. AngelList LLC, SEC No-Action Letter, 2013 WL 1279194, at *4 (Mar. 28, 2013) ("Neither AngelList Advisors nor any Lead Angel will handle any customer funds or securities.").

14. Jen Wieczner, *Investing in Private Startups Is a Hot Trend. But, Sorry, You're Not Invited*, FORTUNE (Aug. 14, 2014, 7:36 AM), http://fortune.com/2014/08/14/private-equity-retail-investors-buy-private-company-shares/ ("While the old model allowed shareholders

SEC Commissioner Luis A. Aguilar recently asked for "any and all viable suggestions as to how to improve the secondary [resale] trading environment for shares of small business securities."[15] Meanwhile, Congress is working on JOBS Act 2.0.[16] This Article addresses the concerns of both regulators and legislators by providing the regulatory solution that follows from its theoretical analysis: the SEC should institute a safe-harbor exemption that allows public venture stock exchanges to facilitate web-based transactions.[17] To prevent fraud and solve rational apathy and information asymmetry problems, this Article proposes a new "Rule 144B" safe harbor that requires exchanges employ "independent analysts."[18] This hybridized public stock analyst and venture capital manager fills a new role for this new type of stock market. The 144B exchange provides liquidity and investor protections that are necessary for efficient capital markets.

This Article proceeds as follows. Part I explores securities regulation in a novel light, with an emphasis on how the normative goals of the JOBS Act are unique among securities regulation statutes. Part II contributes a new analysis of the phenomenon of staying private, which demonstrates how this growing trend frustrates democratizing startups. Part III argues that securities regulations can achieve the goal of democratizing startups while protecting investors through a new regulatory solution that the SEC can implement without an act of Congress. This Article concludes with brief insights about the future of securities regulations.

PART I. SECURITIES REGULATION

Securities regulation has three goals: protecting investors, maintaining orderly capital markets, and facilitating efficient capital

to auction their stakes to any willing buyer, sometimes independent of the company's approval, SecondMarket today only works with the private companies themselves to host official secondary transactions where the companies set the price of their own shares and choose the buyers.").

15. Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Public Statement, The Need for Greater Secondary Market Liquidity for Small Businesses (Mar. 4, 2015), http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html.

16. Sarah N. Lynch, *U.S. House Republicans Prepare a Second JOBS Act Bill; Critics See Dangers*, THOMSON REUTERS (Apr. 9, 2014, 2:41 PM), http://www.reuters.com/article/2014/04/09/house-sec-bills-idUSL2N0N10ZJ20140409 [http://perma.cc/E69H-HJZN] (statement of Representative Scott Garrett, R-NJ) ("The costs to these companies of going and staying public remains [sic] unacceptably high.").

17. *See infra* Part III.A.

18. *See infra* Part III.B.

formation.[19] These goals are often in tension, and this Part will explain how the normative goals of securities regulation have conflicted over time by situating their legislative history in their historical and academic contexts.

The very brief history is that Congress enacted disclosure rules in response to scandals and economic pessimism, and Congress exacted exemptive rules in response to optimism and economic growth. Section A explains that the U.S. government inaugurated the federal securities laws and created new securities regulations in this context of economic catastrophes and anti-Wall Street sentiments to protect investors through mandatory disclosures. Section B describes exemptions to those disclosure rules that the SEC created to balance investor protection with the need for capital formation. Section C introduces the JOBS Act, the most remarkably deregulatory securities law statute, which created new exemptions from disclosures for entrepreneurs to facilitate startup capital formation and thereby create jobs. This Part reveals how federal securities laws work at cross-purposes, which frustrates the goals of the JOBS Act.

A. Sunlight and Disclosures

The initial federal securities laws developed in response to economic catastrophe. In the so-called "Roaring Twenties," post-World War I America experienced incredible economic growth. "[A]pproximately $50 billion of new securities were sold in the United States" that decade.[20] This bull market collapsed on the infamous Black Thursday, October 24, 1929.[21] By the following Tuesday, the stock market lost thirty billion dollars.[22] From September 1, 1929 to July 1, 1932, the NYSE fell eighty-three percent.[23] This crash affected the entire nation.

19. *See, e.g.*, *SEC Budget Hearing Before the Subcomm. on Fin. Servs. & Gen. Gov't of the S. Comm. on Appropriations*, 113th Cong. (2013) (testimony of Mary Jo White, Chair, U.S. Securities and Exchange Commission) (remarking on the SEC's "three-part mission: to protect investors, maintain . . . efficient markets, and facilitate capital formation").

20. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 1 (rev. ed. 1995).

21. *Id.* at 2–3.

22. *Timeline: Timeline of the Great Depression*, PBS, http://www.pbs.org/wgbh/americanexperience/features/timeline/rails-timeline/ [http://perma.cc/X9H3-2BTZ] (last visited Mar. 27, 2016).

23. SELIGMAN, *supra* note 20, at 1; *see also* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1223 (1999).

Unemployment skyrocketed from 1.5 million in 1929 to twelve million in 1932.[24]

When President Franklin Roosevelt was elected in 1932, America was locked in the grip of the Great Depression. The public outcry against Wall Street led the Senate Committee on Banking and Currency to hold the Pecora hearings, which examined securities dealings and stock exchange practices.[25] These hearings found evidence of extensive problems in securities markets.[26]

The U.S. Congress introduced federal securities laws in the 1930s to restore investor confidence, which was destroyed by the Great Depression and the scandals that led up to that economic disaster. At the time, scholars, legislators, and judges seemed to agree with Supreme Court Justice Louis D. Brandeis's 1914 observation about financial markets: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[27] The Securities Act of 1933 embodies Brandeis's "sunlight" policy by creating a comprehensive disclosure regime that requires companies to produce public information before selling stock in public capital markets.[28]

Professor Felix Frankfurter, who assembled the drafting team for the Securities Act, explained that the primary goal of early federal securities disclosure rules was to illuminate corporate activity of securities issuers: "The information that must be furnished in the registration statement is intended to reveal facts essential to a fair judgment upon the security offered."[29] Congress was also explicit about using mandatory disclosure requirements to make corporations more

24. LEONARD BAKER, BRANDEIS AND FRANKFURTER: A DUAL BIOGRAPHY 275 (1984).

25. Williams, *supra* note 23, at 1223–24.

26. *Id.* at 1224. The Pecora hearings found evidence of "unsound credit practices leading to excess speculation"; "manipulative devices . . . [that] produced a false impression of market activity and/or manipulated or depressed the prices of the securities" (such as wash sales, matched orders, and short sales); "unfair or manipulative market activities by insiders and directors"; "deceptive and manipulative devices" by underwriters; "monopolistic practices by investment banks"; and "unfair practices, such as the use of 'preferred lists' for distributing securities." *Id.* at 1224–26.

27. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

28. Williams, *supra* note 23, at 1212–13 ("Brandeis had a great deal of influence on President Roosevelt's thinking about disclosure as the proper approach to securities regulation (Roosevelt had asked to be introduced to Brandeis soon after Roosevelt's election). Brandeis also strongly influenced the thinking of Felix Frankfurter, who oversaw the writing of the Securities Act and its passage through Congress." (footnote omitted)).

29. Felix Frankfurter, *The Federal Securities Act: II*, FORTUNE, Aug. 1933, at 55.

accountable to the public.[30] This was specifically designed to change corporate behavior by interfering with business activity.[31]

The normative goal of protecting investors, and thereby the whole economy, was so strong that corporate governance discussion shifted from free market to interventionist theories. Influential scholars Adolf A. Berle and Gardiner C. Means encouraged the federal government to directly regulate corporate affairs by preempting state incorporation laws by a federal incorporation regime.[32] Although Congress expressly agreed with Berle and Means that a key feature of a modern corporation is the separation of ownership (by stockholders) and control (by managers),[33] which creates agency problems that cannot be solved by contractual bargaining or private ordering,[34] Congress never enacted a federal incorporation statute because that was deemed to unduly hinder business formation and development.[35] This inconsistency reflects the consistent tension in securities laws between its competing goals of protecting investors, maintaining orderly capital markets, and facilitating capital formation.

Congress continued to advance the sunlight-on-securities agenda with the Exchange Act of 1934, which created the SEC. SEC Director Annette L. Nazareth recently issued a 2003 press release restating the goals of the SEC:

> The SEC is a "full disclosure" agency, and one of its primary missions is to strive to close information asymmetries that may exist among market participants. In the words of Justice

30. Williams, *supra* note 23, at 1227 ("The legislative history of the Securities Act is quite explicit about the use of disclosure (supported by broad liability provisions for inaccurate and incomplete disclosure) as a regulatory means to foster greater public accountability in the corporate enterprise.").

31. 77 CONG. REC. 2951 (1933) (statement of Rep. Reilly) ("Yes; the bill is intended to interfere with business—that is, a certain kind of undesirable business—that has fleeced the American investors out of billions of dollars in the past decade.").

32. Letter from William O. Douglas to Adolf A. Berle, Jr. (Jan. 3, 1943) (on file with the Library of Congress).

33. 77 CONG. REC. 2917–18 (1933) (statement of Rep. Rayburn) ("[T]oday the owner of shares in a corporation possesses a mere symbol of ownership, while the power, the responsibility, and the substance which have characterized ownership in the past have been transferred to a separate group which holds control.").

34. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (describing corporations as entities that separate ownership and control and identifying problems that arise from this dynamic).

35. *See* Williams, *supra* note 23, at 1220 ("Adolf Berle had suggested more direct approaches to President Roosevelt for ensuring corporate accountability, including federal incorporation, but Roosevelt rejected federal incorporation in favor of a disclosure-based approach drawn from Brandeis's and Frankfurter's ideas." (footnote omitted)).

> Brandeis, "Sunshine is the best disinfectant." Only through the steady flow of timely, comprehensive and accurate information can people make sound investment decisions.[36]

In modern times, economic crisis has also compelled Congress to enact new federal securities disclosure regulations. Starting in the fall of 2001, one huge public corporation after another became embroiled in massive scandals.[37] First Enron, which purported to be the seventh largest corporation in the world,[38] and then WorldCom, which acquired sixty telecommunications firms in the prior fifteen years,[39] turned out to be mere paper tigers ensconced by "accounting irregularities" that were perpetuated by management.[40] Other major firms like Tyco,[41]

36. Annette L. Nazareth, Dir., Div. of Mkt. Regulation, U.S. Sec. & Exch. Comm'n, Remarks Before the Brown University Commencement Forum: Come with Me to the SEC (May 24, 2003), http://www.sec.gov/news/speech/spch052403aln.htm [http://perma.cc/9Y5M-LWHQ].

37. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 2–3 (2002) ("These firms' managers have become poster boys for the problems of separation of ownership and control.").

38. Dan Ackman, *Enron the Incredible*, FORBES (Jan. 15, 2002, 12:00 PM), http://www.forbes.com/2002/01/15/0115enron.html ("[F]ew investors—and few Wall Street analysts—understood how Enron was booking revenue, even though the distorting technique is what allowed Enron to be billed as the 'seventh-largest company in America.'").

39. Kurt Eichenwald, *For WorldCom, Acquisitions Were Behinds Its Rise and Fall*, N.Y. TIMES (Aug. 8, 2002), http://www.nytimes.com/2002/08/08/business/for-worldcom-acquisitions-were-behind-its-rise-and-fall.html?pagewanted=all ("Mr. Ebbers talked of how his company had grown enormously through no fewer than 65 mergers, capped by the granddaddy of them all, its acquisition of MCI.").

40. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1572 (2006) ("The persons most responsible for the accounting irregularities at Enron, WorldCom, and a host of other companies were managers who, beginning in the 1990s, began to be primarily compensated with equity compensation and so had a strong incentive to recognize income prematurely in order to inflate reported income.").

41. Press Release, U.S. Sec. & Exch. Comm'n, SEC Sues Former Tyco CEO Kozlowski, Two Others for Fraud (Sept. 12, 2002), https://www.sec.gov/news/press/2002-135.htm. The CEO and CFO of Tyco were sentenced to eight to twenty-five years in prison for stealing $150 million from the corporate funds and inflating income by $500 million. Catherine Fredenburgh, *Ex-Tyco CEO Demands Insurer Foot $17.8M Legal Bill*, LAW360, http://www.law360.com/articles/6835/ex-tyco-ceo-demands-insurer-foot-17-8m-legal-bill (last visited May 7, 2016) ("Tyco was accused by the SEC of inflating its operating income by at least $500 million through improper accounting practices related to some of the hundreds of corporate acquisitions that Tyco engaged in as part of a massive expansion that began in 1991."); Shayna Jacobs & Corinne Lestch, *Ex-Tyco CEO, Convicted of Stealing $150M from Company, Set for Release on Parole in January*, DAILY NEWS (Dec. 4, 2013, 1:36 AM), http://www.nydailynews.com/new-york/nyc-crime/tyco-ceo-convicted-stealing-150m-free-article-1.1536865 ("A disgraced former Tyco CEO is expected to be

HealthSouth,[42] Freddie Mac,[43] American Insurance Group,[44] Lehman Brothers,[45] and others followed in scandalous suit. The massive public outcry against financial manipulation galvanized Congress to pass sweeping regulations governing corporate behavior, including the Sarbanes-Oxley Act of 2002 ("SOX").[46]

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paroled next month on his sentence for pilfering $150 million from the company, state officials said.").

42. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges HealthSouth Corp. CEO Richard Scrushy with $1.4 Billion Accounting Fraud (Mar. 19, 2003), https://www.sec.gov/news/press/2003-34.htm. The CEO of HealthSouth was indicted for thirty-six counts of accounting fraud for allegedly inflating earnings by $1.4 billion and convicted of bribing the Governor of Alabama. *Id.*; Krysten Crawford, *Ex-HealthSouth CEO Scrushy Walks*, CNN MONEY (June 28, 2005, 4:37 PM), http://money.cnn.com/2005/06/28/news/ news makers/scrushy_outcome/ ("The 52-year-old founder and ex-CEO of HealthSouth faced 36 counts, including fraud, money laundering and conspiracy charges."); Carrie Johnson, *Jury Convicts HealthSouth Founder in Bribery Trial*, WASH. POST (June 30, 2006), http://www.washingtonpost.com/wp-dyn/content/article/2006/06/29/AR2006062901912.html ("An Alabama jury yesterday convicted HealthSouth Corp. founder Richard M. Scrushy—acquitted last year of federal accounting-fraud charges—of paying half a million dollars in bribes to former governor Don Siegelman in exchange for a seat on a state health-care board. . . . [T]he jury convicted [HealthSouth CEO] Scrushy of all six bribery, mail fraud and conspiracy charges.").

43. Press Release, U.S. Sec. & Exch. Comm'n, Freddie Mac, Four Former Executives Settle SEC Action Relating to Multi-Billion Dollar Accounting Fraud (Sept. 27, 2007), https://www.sec.gov/news/press/2007/2007-205.htm. CEO, COO, and former senior management of Freddie Mac misstated $5 billion in earnings and were fined $125 million by the SEC, plus $50 million to settle federal charges. *Freddie Mac Pays $50M to Settle Fraud Charges*, ABC NEWS, http://abcnews.go.com/Business/story?id=3664473&page=1 (last visited May 7, 2016) ("Mortgage finance company Freddie Mac FRE will pay $50 million to settle federal charges that it fraudulently misstated earnings over a four-year period. . . . Freddie paid a then-record $125 million civil fine in 2003 in a settlement with the Office of Federal Housing Enterprise Oversight . . . ."); Jonathan D. Glater, *Freddie Mac Understated Its Earnings by $5 Billion*, N.Y. TIMES (Nov. 22, 2003), http://www.nytimes.com/2003/11/22/business/freddie-mac-understated-its-earnings-by-5-billion.html ("Freddie Mac said yesterday that it had understated its earnings by nearly $5 billion over more than three years.").

44. Erik Holm, *AIG, Other Insurers Settle Suit over Bid-Rigging*, WALL ST. J. (Mar. 21, 2011, 7:25 PM), http://www.wsj.com/articles/SB10001424052748703858404576214972 845965148. The CEO of American International Group settled with multiple plaintiffs for over $2 billion for allegations of bid-ridding and stock-price manipulation and $3.9 billion for fraud. *Id.*; *see also Case Summary: American International Group, Inc. (AIG) Securities Litigation*, STAN L. SCH., http://securities.stanford.edu/filings-case.html?id= 103311 (last visited May 7, 2006) (reviewing the entire history of AIG's settlement, showing a total of more than $2 billion in settlement).

45. Michael J. de la Merced & Andrew Ross Sorkin, *Report Details How Lehman Hid Its Woes*, N.Y. TIMES (Mar. 11, 2010), http://www.nytimes.com/2010/03/12/business/12 lehman.html?pagewanted=all&_r=0. Lehman executives and its accountants at Ernst & Young allegedly hid fifty billion dollars in loans disguised as sales. *Id.*

46. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, 29 U.S.C.).

At the time of its promulgation, SOX was called "the most important securities legislation since the original Federal securities laws of the 1930's."[47]

> SOX creat[ed] the Public Company Accounting Oversight Board; . . . enhanc[ed] the independence of public company auditors; regulat[ed] corporate governance and responsibility; enhanc[ed] financial disclosure; regulat[ed] securities analyst conflicts of interest; . . . add[ed] several new substantive crimes under the securities laws and enhanc[ed] penalties for violations of the securities and other laws[;] . . . provided for additional funding of the SEC and enhancement of the SEC's regulatory authority[;] commissioned several studies that required reports back to Congress[;] and contained an editorial comment on corporate tax returns.[48]

Despite SOX's disclosure requirements, another financial crisis occurred soon after its enactment. The Great Recession started in 2007 with the subprime mortgage crisis and quickly expanded into a global financial crisis in which the global stock market dropped over fifty percent.[49] National securities experts worried the Great Recession could destabilize the entire geo-political economy.[50] Once again, Congress advanced the "sunlight" policy of securities regulation to advance the normative goals of protecting investors and stabilizing markets by passing the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").[51] Dodd-Frank further increases the

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47. *Implementation of the Sarbanes-Oxley Act of 2002: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 108th Cong. 6 (2003) (statement of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission).

48. Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1154 (2004) (footnotes omitted).

49. Sher Verick & Iyanatul Islam, The Great Recession of 2008–2009: Causes, Consequences and Policy Responses 23 (May 2010) (unpublished manuscript), http://ftp.iza.org/dp4934.pdf [http://perma.cc/C6E2-PMFX]; *see also* Barry Eichengreen & Kevin Hjortshoj O'Rourke*, What Do* [sic] *the New Data Tell Us?*, VOX (Mar. 8, 2016), http://voxeu.org/article/tale-two-depressions-what-do-new-data-tell-us-february-2010-up date ("At their trough [world equity markets] were 50% below peak.").

50. *See, e.g.*, Tom Gjelten, *Economic Crisis Poses Threat to Global Stability*, NAT'L PUB. RADIO (Feb. 18, 2009, 12:07 AM), http://www.npr.org/templates/story/story.php?story Id=100781975.

51. Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended in scattered sections of 112 U.S.C.).

demands on public companies and requires them to make disclosures with six provisions that pertain to corporate governance.[52]

These "sunlight" policies may protect investors and prevent systemic economic failure,[53] but they are not free. They make it very expensive, difficult, and time-consuming to be a public company. Cumulatively, the Securities Act, the Exchange Act, SOX, Dodd-Frank, and other securities regulations force an average company to incur about $5.7 million in one-time costs to "go public" in an initial public offering ("IPO")—which allows it to raise money in the public capital market—plus about five to seven percent of gross proceeds raised in the IPO and another $1.5 million in annual recurring costs as a result of being public.[54] In addition, public-company managers have to spend time and effort on regulatory compliance instead of running and growing the business.

B. Regulatory Exemptions

Periodically, the SEC has recognized that sunlight policies and disclosure regimes frustrate the goal of capital formation. This administrative agency has broad rulemaking power, which it has

52. The six provisions of Dodd-Frank that pertain to corporate governance are: requiring periodic shareholder advisory votes on executive compensation (the "say-on-pay" mandate); mandating fully independent compensation committees for reporting companies with specified oversight responsibilities; requiring companies to provide additional disclosures with respect to executive compensation; expanding SOX's rules regarding clawbacks of executive compensation; affirming SEC authority to allow shareholders to use the company's proxy statement to nominate candidates to the board of directors (the "shareholder access rule"); and requiring companies to disclose whether the same person holds both the CEO and chairman of the board positions and why they either do or do not do so. *Id.*

53. However, many scholars argue that the sunlight policies are ineffective in that they do not actually protect investors or prevent system failure. *See, e.g.*, Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1821 (2011) ("Like their predecessors in SOX, the six key corporate governance provisions of Dodd-Frank satisfy the key criteria of quack corporate governance."); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1602 (2005) ("An extensive empirical literature suggests that those mandates were seriously misconceived, because they are not likely to improve audit quality or otherwise enhance firm performance and thereby benefit investors as Congress intended.").

54. PRICEWATERHOUSECOOPER, CONSIDERING AN IPO?: THE COSTS OF GOING AND BEING PUBLIC MAY SURPRISE YOU 1 fig.1 (2012), http://www.pwc.com/en_us/us/transaction-services/publications/assets/pwc-cost-of-ipo.pdf [http://perma.cc/CNX5-9VZL] (providing that there are $3.7 million directly attributable costs, plus $1 million other incremental costs, plus $1 million to convert to a public company, equaling $5.7 million). Additionally $1.5 million are incurred per year to stay public. *Id.*

exercised to create exemptions to federal securities regulations that it deems necessary for efficient capital formation. This Subpart discusses the most important regulatory exemptions created by the SEC: Regulation D,[55] Rule 144,[56] and Rule 144A.[57] The next Subpart discusses the new statutory exemption created by Congress.

The SEC promulgated Regulation D in 1982 specifically to facilitate capital formation.[58] Section 5 of the Securities Act requires all offers to sell securities in interstate commerce to be registered with the SEC or exempted from registration.[59] Regulation D provides three exemptions from registration requirements—Rules 504, 505, and 506—for the original issuance of securities.[60] Rule 504 allows issuers to sell up to one million dollars in securities in any twelve-month period to anyone.[61] Rule 505 allows sales of up to five million dollars to unlimited "accredited investors" ("AIs")[62] and up to thirty-five other non-accredited investors.[63] Rule 506 allows unlimited sales to AIs.[64]

It is critical to note that Regulation D pertains only to original issuances (first offers or sales) of stock.[65] Regulation D is not a resale exemption. Stock sold under Regulation D cannot be resold unless the

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55. 17 C.F.R. § 230.501–.508 (2015).

56. *Id.* § 230.144.

57. *Id.* § 230.144A.

58. Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225, 227 (1990) ("The SEC promulgated Regulation D in 1982 as part of a major effort to reduce regulatory constraints on capital formation—particularly by small business—to the greatest extent compatible with investor protection.").

59. 15 U.S.C. § 77e (2012).

60. *Regulation D Offerings*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/answers/regd.htm (last visited Apr. 4, 2016).

61. *Rule 504 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/answers/rule504.htm (last visited Apr. 4, 2016); *see also* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251, 11,257–58 (Mar. 8, 1982).

62. An "accredited investor" is an individual with at least $200,000 in annual income or $1 million in net wealth, or a married couple with at least $300,000 in annual income. 17 C.F.R. § 230.501(a)(5)–(6) ("Accredited investor shall mean . . . [a]ny natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000 . . . [or] [a]ny natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.").

63. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. at 11,252.

64. *Id.*

65. 17 C.F.R. § 230.500(d).

stock is registered with the SEC or meets an exemption.[66] The main resale exemptions are Rule 144 and Rule 144A.[67]

Rule 144 was originally adopted in 1972 to permit resale of unregistered securities, but its ability to provide liquidity is substantially limited by holding-period and selling-volume restrictions.[68] To benefit from this non-exclusive safe harbor, resellers originally had to hold the securities for at least two years prior to resale, but in 1997 the SEC shortened the holding period to one year.[69] The holding period begins when the purchase price of the shares are fully paid,[70] which means that stock options must be exercised and then held for one year before they can be resold under Rule 144.[71] After the holding period is met, sellers can only sell up to one percent of the company's outstanding shares of that class of stock, or the average reported weekly trading volume of the four preceding calendar weeks.[72] Scholars have recognized that Rule 144 can only provide limited liquidity because of its holding-period and selling-volume restrictions.[73] Critically for present purposes, Rule 144's holding period only permits tacking between holders so long as sales are made privately,[74] so this rule is virtually useless for public-exchange transactions.

Resale exemptions achieved their goal of reducing compliance costs and making capital formation more efficient.[75] Regulation D and Rule

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66. *Id.*

67. Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 638–39 (1997).

68. *See* Notice of Adoption of Rule 144, Securities Act Release No. 5223, 37 Fed. Reg. 591 (Jan. 11, 1972).

69. Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 7390, 62 Fed. Reg. 9242, 9242 (Feb. 28, 1997) (codified at 17 C.F.R. pt. 230) ("Today, for the first time since the adoption of Rule 144 in 1972, the Commission is adopting amendments to shorten the holding period that must be satisfied before limited resales of restricted securities may be made by affiliates and non-affiliates in reliance upon the rule." (footnote omitted)).

70. 17 C.F.R. § 230.144(d)(1).

71. Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 40 (2012) ("Rule 144 does not count the length of time that a stock option is held; rather, the holding period begins when the option is actually exercised. Consequently, Rule 144 is not available to resell recently exercised stock options." (footnote omitted)).

72. 17 C.F.R. § 230.144(e)(1)(i)–(iii).

73. *E.g.*, Mira Ganor, Note, *Improving the Legal Environment for Start-up Financing by Rationalizing Rule 144*, 33 WM. MITCHELL L. REV. 1447, 1451 (2007) ("Both the holding-period restriction and the selling-volume restriction impair investor liquidity.").

74. *See* 17 C.F.R. § 230.144(d)(1).

75. Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 7390, 62 Fed. Reg. 9242, 9243 (Feb. 28, 1997) (codified at 17 C.F.R. pt. 230) ("The Commission believes, and the public comments support the view, that reduction in the Rule 144 holding periods will reduce compliance burdens and costs without significant

144A proved to encourage venture capital formation. Prior to the Regulation D safe-harbor exemption, investment in private stock totaled $18 billion in 1981.[76] These "private placements" quickly increased under Regulation D "to $139 billion in 1987 and then to $202 billion in 1988."[77] This success led the SEC to promulgate an additional safe-harbor exemption, Rule 144A, which allows resale without any holding period to a qualified institutional buyer ("QIB").[78] This resale rule accelerated private placements, which exceeded $1.3 trillion in 2012.[79] The dramatic increase in private-company investment following each successive exemption for private-stock resale highlights the importance of a resale exemption—not just an original sale exemption—to facilitate formation of venture capital funds and their investment into startups.

These "exemptive" policies have proven that both original issuance and resale safe harbors are necessary for private placements and, therefore, critical for startups and the entire venture capital industry. But exempting companies from making disclosures for the sake of capital formation is clearly at odds with the "sunlight" policies and their goal of protecting investors by making information available to them. The Supreme Court attempted to resolve this seemingly schizophrenic approach to securities regulations in the seminal 1953 case *SEC v. Ralston Purina Co.*, which held that only sales to sophisticated investors are not public offerings and therefore do not require

impact on investor protection. The Commission also believes that the action being taken will promote market efficiency, investment and capital formation by reducing the liquidity costs of holding restricted securities and reducing issuers' cost of raising capital through the sale of restricted securities.").

76. Roberta S. Karmel, *Regulation by Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L.J. 681, 689 (2008) ("After Regulation D was passed, the total amount of securities sold in private placements increased from $18 billion in 1981 to $139 billion in 1987 and then to $202 billion in 1988.").

77. *Id.*

78. 17 C.F.R. § 230.144A(d). A QIB is an institution that has at least $100 million in net investments. *Id.* § 230.144A(a)(1)(i) ("For purposes of this section, qualified institutional buyer shall mean . . . [a]ny of the following entities, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity.").

79. Cheryl Conner, *A Trillion Dollar Source of New Funding? The SEC's New 'Reg D,'* FORBES (July 13, 2013, 11:28 AM), http://www.forbes.com/sites/cherylsnappconner/2013/07/13/a-trillion-dollar-source-of-new-funding-the-secs-new-reg-d/#774ed1071fdd ("The existing 'Reg D' program exemption has already been responsible for more than $1.3 trillion in funding in 2012, and more than 37,000 Regulation D offerings have been executed since 2009.").

mandatory public disclosures.[80] SEC exemptions follow the *Ralston Purina* doctrine and permit only certain investors to participate in private stock markets.

The issuance exemptions in Regulation D and the resale exemption in Rules 144 and 144A enabled modern venture capital financing.[81] Venture capital is where institutional investors make passive investments in venture capital funds, which are run by venture capital managers who make active investments in new business ventures.[82] The venture capital market is often regarded as the "crown jewel" of the American economy.[83] These new business ventures are colloquially called "startups," which generally refers to high-growth, high-risk, early-stage businesses that are backed by venture capital financing.[84] Startups have historically developed in the Silicon Valley region of California and focused on high-tech projects. These regulations achieved their purpose of exempting venture capital financing from securities regulations.

Venture capital financing exemptions are based on the AI concept as proxy for sophistication. The AI concept assumes that wealthier investors have the knowledge and bargaining power to guarantee access to appropriate information through contracting. Alternatively, the SEC assumes that AIs can afford to lose their investment. An AI is an

80. 346 U.S. 119, 125 (1953) ("[T]he applicability of § 4(1) should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

81. *See* JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS § 14.12, at 342–49 (2d ed. 1995); Karmel, *supra* note 76, at 689 ("As a result of Regulation D and Rule 144, the private placement market in the United States grew quickly."); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 90 n.250, 135 ("Easing the restrictions on secondary distributions should have a beneficial effect on primary offerings, particularly to venture capitalists who will want to sell after a public offering.").

82. Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070 (2003) ("The typical transactional pattern in the U.S. venture capital market is for institutional investors—pension funds, banks, insurance companies, and endowments and foundations—to invest through intermediaries, venture capital limited partnerships usually called 'venture capital funds,' in which the investors are passive limited partners.").

83. *Id.* at 1068 ("The venture capital market and firms whose creation and early stages were financed by venture capital are among the crown jewels of the American economy.").

84. Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1411–12 (2008) ("Start-ups have little or no operating history or tangible assets with which to predict future performance, and scientific or technological novelty like that found in the typical Silicon Valley start-up adds another layer of uncertainty.").

individual with more than $1 million in net worth (excluding primary residence) or more than $200,000 in annual income ($300,000 for married couples).[85] This was a high threshold when the rule was promulgated in 1982, but it has never been adjusted for inflation, so the threshold has much less significance now. There were 9.63 million households in America in 2013 with a net worth of $1 million or more.[86] Consequently, the AI concept has come under scrutiny recently for failing to be a valid proxy for sophistication of investors.[87]

Rule 144 and 144A are not up to the task of facilitating smaller resale transactions for retail investors. Rule 144 and 144A transactions must be private, which requires the services of an investment banker, lawyer, and/or registered broker-dealer. The transaction costs of Rule 144 and 144A transactions make small resale transactions unaffordable. That means securities regulations may be encouraging smaller investors to purchase stock from original issuers, yet it is locking them out of opportunities to resell those securities.

C. The JOBS Act

Congress recently passed groundbreaking legislation that is designed to make it much easier for the general public to invest in private companies. Title III of the JOBS Act amended the Securities Act to allow a company to offer and sell up to one million dollars worth of equity securities (stock) in a twelve-month period to the general public without registering the securities with the SEC.[88] This new exemption to registration under the Securities Act is called "crowdfunding."[89]

President Barack Obama made the normative goals of the JOBS Act quite clear. At the bill's signing, the President said: "These proposals

85. *See supra* note 62.

86. Emily Jane Fox, *Number of U.S. Millionaires Hits New High*, CNN MONEY (Mar. 14, 2014, 10:55 AM), http://money.cnn.com/2014/03/14/news/economy/us-millionaires-households/ [http://perma.cc/53Y9-8XGW].

87. Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 766 (2009) ("Recent proposed revisions to the current accredited investor definition for natural persons and the exponential growth of the hedge fund industry make it clear that a review of the accredited investor definition for natural persons is relevant and that adjustments are necessary.").

88. Pub. L. No. 112-106, § 302, 126 Stat. 306, 315 (2012) (codified as amended in scattered sections of 15 U.S.C.).

89. *See, e.g.*, *Jumpstart Our Business Startups Act: Frequently Asked Questions About Crowdfunding Intermediaries: Division of Trading and Markets*, U.S. SEC. & EXCHANGE COMMISSION (May 7, 2012), http://www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediariesfaq.htm [http:// perma.cc/TS3J-QUTY].

will help entrepreneurs raise the capital they need to put Americans back to work and create an economy that's built to last."[90] The associated White House press release elaborated: "The JOBS Act will allow Main Street small businesses and high-growth enterprises to raise capital from investors more efficiently, allowing small and young firms across the country to grow and hire faster."[91]

The JOBS Act stands in stark contrast to the Securities Act, the Exchange Act, SOX, and Dodd-Frank because the JOBS Act is the only securities statute to emphasize efficient capital formation above investor protections. In fact, critics of the law point out that the legislative history of the JOBS Act "is bereft of any evidence of serious consideration of investor protection concerns."[92] As Professor Robert Thompson joked: "The JOBS Act is the biggest deregulatory statute in the history of American securities regulation. That's not a high barrier to cross."[93]

The JOBS Act implicitly recognizes that sunlight, like many disinfectants, can kill desirable activity as well as undesirable activity. Startups grow quickly in part because they are able to take risks that public companies cannot take. Quarterly disclosures and annual shareholder meetings give shareholders the incentive and the opportunity to fire managers that do not turn a quarterly profit,[94] but startups can focus on a long-term plan that may pay greater dividends overall. Young startups often operate in "stealth mode" because it can be difficult for young firms to protect their intellectual property.[95] In fact, the JOBS Act expressly makes it much easier for startups to stay private longer by raising the maximum private-company record-shareholder limit from 500 to 2000.[96]

90. Office of the Press Sec'y, *supra* note 3.

91. *Id.*

92. Michael D. Guttentag, *Protection from What? Investor Protection and the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 207, 253 (2013).

93. *Deregulating the Markets: The JOBS Act*, 38 DEL. J. CORP. L. 476, 488 (2013) (statement of Robert B. Thompson, Professor of Business Law, Georgetown University Law Center).

94. *See, e.g.*, Richi Jennings, *Twitter Boss Costolo Says He Wasn't Fired (but, Yeah, He Was)*, COMPUTERWORLD (June 12, 2015, 3:25 AM), http://www.computerworld.com/article/2934788/social-media/twitter-ceo-costolo-fired-itbwcw.html ("Last week, one of the company's biggest shareholders and cheerleaders, Chris Sacca, publicly called for change.").

95. Matt Villano, *Why Startups Launch in 'Stealth Mode' and Others Don't*, ENTREPRENEUR (Oct. 17, 2013), http://www.entrepreneur.com/article/229461 ("Operating in stealth mode also can help protect intellectual property until launch.").

96. *Jumpstart Our Business Startups Act Frequently Asked Questions: Changes to the Requirements for Exchange Act Registration and Deregistration*, U.S. SEC. & EXCHANGE

Much has already been said about whether the JOBS Act mandates sufficient "sunshine" disclosures to protect investors from fraud.[97] Even the SEC is concerned about whether it can provide sufficient investor protections while complying with its congressional mandate to implement the JOBS Act.[98] This Article does not opine on whether the JOBS Act, as it has been passed into law, should have prioritized investor protections over capital formation.

Rather, this Article considers whether the JOBS Act can actually achieve its purported goals: (1) democratizing access to capital for new entrepreneurs in new geographies outside of Silicon Valley and democratizing access to startup investments for new investors; (2) creating jobs; and (3) growing the innovation economy.[99] Part II next discusses how the JOBS Act is likely to fail in these goals because it does not account for unintended consequences of the staying private trend.

PART II. PRIVATE PROBLEMS

The private/public dichotomy is a hallmark of securities regulation. Securities regulations categorize a company as private if it has not registered its stock with the SEC.[100] Registration brings the obligation

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COMMISSION (Apr. 11, 2012), https://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-12g.htm ("Title V and Title VI of the JOBS Act amend Section 12(g) and Section 15(d) of the Exchange Act as follows: The holders of record threshold for triggering Section 12(g) registration for issuers (other than banks and bank holding companies) has been raised from 500 or more persons to either (1) 2000 or more persons or (2) 500 or more persons who are not accredited investors."). Many have speculated that exceeding the 500 shareholder limit is the reason Facebook went public. *See, e.g.*, Steven Davidoff Solomon, *Facebook and the 500-Person Threshold*, N.Y. TIMES: DEALBOOK (Jan. 3, 2011, 4:03 PM), http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/?_r=2.

97. *See, e.g.*, Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1739 (2012) ("This Article discusses the importance of disclosure in any crowdfunding exemption and concludes that with the new exemption, Congress has given the SEC the tools to implement a viable exemption without unduly sacrificing investor protection.").

98. *See* Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Public Statement, Investor Protection Is Needed for True Capital Formation: Views on the JOBS Act (Mar. 16, 2012), http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171490120 ("This bill seems to impose tremendous costs and potential harm on investors with little to no corresponding benefit.").

99. *See* Office of the Press Sec'y, *supra* note 3.

100. Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 846 n.101 (1981) ("Where the transaction involves the issuance of the offeror's securities, the offer must be registered with the Securities and Exchange Commission pursuant to the Securities Act of 1933

to make periodic disclosures to the public and the opportunity to raise money by selling stock in public markets. Startups traditionally sought to "go public" by registering and having an initial public offering within about seven years of formation because the venture capital funds that finance startups are established with a ten-year term. The invested money needs to be returned to the fund investors when the term expires.[101] The ideal way for this money to be returned is when a startup has an IPO, which is regarded as the "gold standard" in venture capital success.[102] The ten-year term limit on venture capital funds drove startups to go public within that time frame.

The IPO was the crowning event at the culmination of a process known as the startup financing cycle.[103] This cycle begins with incorporation and initial capitalization.[104] Friends and family provide a small amount of initial funding. Angel investors provide most of the initial capital.[105] The startup begins operating at a loss. About half of the startups fail to earn profits; they go broke and liquidate.[106] The other half manage to either generate revenues that cover costs[107] or secure venture capital financing in an investment called the "Series A."[108] Venture capital investors reinvest in the startup in later staged investments called Series B, C, D, and so on.[109] These investments are illiquid. They are locked up in the startup until the startup exits the private market ideally through an IPO (or sub-optimally through a mergers and acquisitions ("M&A") event) that allows the investors to divest their investment.[110]

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unless an exemption from registration is available."). *See generally* R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS 464–95 (4th ed. 1977).

101. Susan Pulliam & Jean Eaglesham, *Investor Hazard: 'Zombie Funds,'* WALL ST. J. (May 31, 2012, 10:09 PM), http://www.wsj.com/articles/SB10001424052702304444604577339843949806370.

102. Ibrahim, *supra* note 71, at 11.

103. DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 5 (2d ed. 2014).

104. *Id.*

105. Andrew Wong, Mihir Bhatia & Zachary Freeman, *Angel Finance: The Other Venture Capital*, 18 STRATEGIC CHANGE 221, 221–22 (2009). *But see* Laura Entis, *Where Startup Funding Really Comes From (Infographic)*, ENTREPRENEUR (Nov. 20, 2013), http://www.entrepreneur.com/article/230011 ("[P]ersonal loans and credit—along with investments from friends and family—make up the lion's share of funding for startups in the U.S.").

106. *See* ROBERT WILTBANK & WARREN BOEKER, RETURNS TO ANGEL INVESTORS IN GROUPS 1 (2007), http://sites.kauffman.org/pdf/angel_groups_111207.pdf.

107. This is called the "break even." CUMMING & JOHAN, *supra* note 103, at 7 fig.1.2.

108. *Id.*

109. *Id.*

110. *Id.* at 592.

It was once very rare for a privately funded startup to be worth more than one billion dollars and rare for a startup to stay private for long after being valued at more than one billion dollars. The startup worth more than one billion dollars was so rare it was called a "Unicorn."[111] Startups, however, are not going public in an IPO or liquidating in an M&A event. Increasingly, they are staying private.[112] As of August 16, 2016, there are at least 170 so-called Unicorns, with a cumulative valuation of over $620 billion.[113] The biggest private companies—like Uber, Airbnb, and Pinterest—are so large they prompted the new coinage "Decacorn," a private startup valued at over $10 billion.[114]

111. Definition of *Unicorn*, INVESTOPEDIA, http://www.investopedia.com/terms/u/unicorn.asp (last visited May 7, 2016).

112. *E.g.*, Yuliya Chernova, *For Billion-Dollar Companies, Venture Deals Outstrip Going Public*, WALL ST. J. (Aug. 19, 2014, 2:40 PM), http://blogs.wsj.com/venturecapital/2014/08/19/for-billion-dollar-companies-venture-deals-outstrip-going-public/.

113. *The Unicorn List: Current Private Companies Valued at $1B and Above*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies (last visited Aug. 17, 2016).

114. Sarah Frier & Eric Newcomer, *The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies*, BLOOMBERG TECH. (Mar. 17, 2015, 9:00 AM), http://www.bloomberg.com/news/articles/2015-03-17/the-fuzzy-insane-math-that-s-creating-so-many-billion-dollar-tech-companies ("But there are more than 50 [Unicorns] now. There's a new buzzword, 'decacorn,' for those over $10 billion, which includes Airbnb, Dropbox, Pinterest, Snapchat, and Uber.").

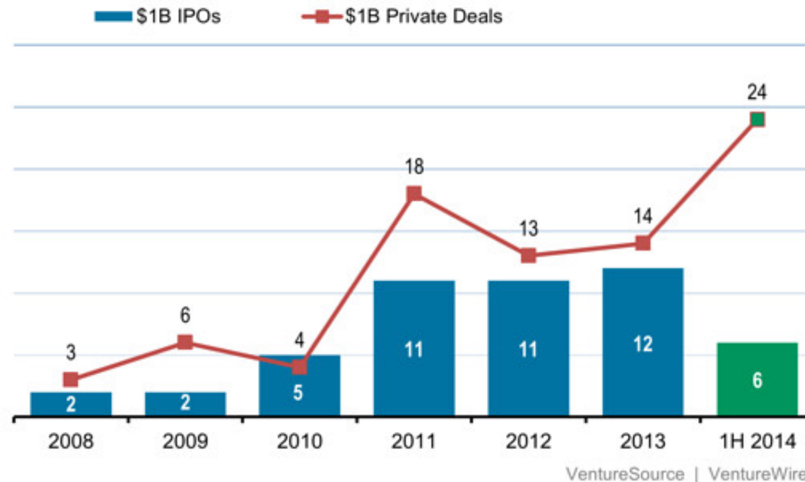
Figure 1

There are more private startup companies valued at over $1 billion ("Unicorns") than elements on the periodic table.[115]

115. *The Periodic Table of Unicorns*, CB INSIGHTS (June 16, 2015), https://www.cbinsights.com/blog/periodic-table-unicorns-list-companies-one-billion/ [https://perma.cc/39ZS-C7NY].

Staying private and growing extremely valuable is a new phenomenon that affects all startup stakeholders, including investors, employees, and society at large. This trend is the unintended consequence of the securities regulations and market factors described in Part I, the result of which is a large and growing gap between large private financing rounds and initial public offerings.[116] In other words, startups are now able to stay private, yet access plenty of capital. Staying private longer undermines many assumptions about private securities.

Figure 2



Gap Between Private Deals and Public Offerings[117]

The causes of the "staying private" trend are attributable to several factors, including the increased expense of going public, the uncertainty of greater regulatory costs in the future for being public, the relatively easy access to capital while staying private, the greater agility for a non-disclosing company, management's preference for staying private, increased public comfort with private corporations, technology that

116. Chernova, *supra* note 112.
117. *Id.*

facilitates investment in private companies, volatility in public markets, access to overseas venture stock exchanges, and other factors. But the effects of staying private are clear. Staying private creates new problems for investors, employees, labor markets, and the economy. In particular, staying private frustrates the fundamental goals of a new law that is designed to "democratize" startup investment and fuel the innovation economy.

This Part will next identify and analyze three problems that confound the JOBS Act's stated goal of democratizing startup investment. The first and foundational problem is the emergence of what this Article terms an "illiquidity discount asymmetry,"[118] which means that startup stock is worth substantially less when held by employees and poorer investors, yet that exact same stock is worth much more in the hands of upper management and the wealthiest investors. This raises obvious fairness concerns. It also frustrates the JOBS Act by chilling venture investment by poorer investors.

Second, the staying private trend creates a de facto non-compete that locks employees to their companies and distorts the labor market. The illiquidity discount asymmetry also devalues stock options, which threatens to destroy the purpose of stock options to incentivize employees to work harder for less salary. Startup culture is fueled by the perception that employees are pari pasu with management in taking on startup risk. The innovation economy is built upon motivating employees this way, and that foundation is threatened by the devaluation of increasingly illiquid stock options. In addition, fairness concerns are even stronger here than with investors because startup employees—who traded off higher salary for more stock options—do not receive the benefit of that bargain when they find that they are holding worthless securities.

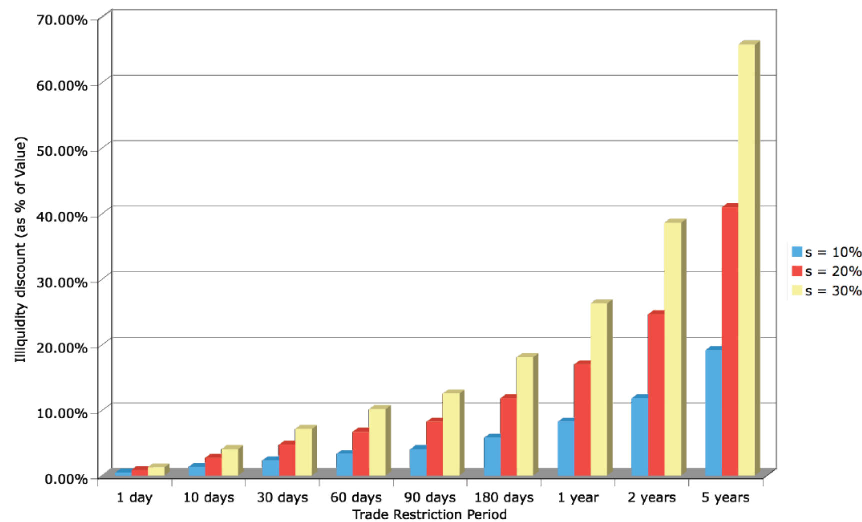
Third, staying private threatens to curtain the innovation economy and disrupt the entire startup financing lifecycle by inhibiting the recycling of early stage investment capital. Additional systemic risks arise where venture capitalists ("VCs") can lawfully access liquidity only in the types of unregulated markets that generally concern scholars and regulators. The staying private trend has driven wealthy investors to seek liquidity in unregulated dark pools where there is documented opportunistic behavior—i.e., pushing domestic stock transactions to offshore stock markets, outside the auspices of SEC regulation.

118. *See infra* Part II.A.

A. Illiquidity Discount Asymmetry

Liquidity refers to the ability to buy or sell something. Something that is hard to resell, or "illiquid," is worth less than a similar thing that is easy to resell because resale of an illiquid thing requires more time, money, and risk. When illiquidity is the result of a trade restriction like securities regulations, the extent of the marketability or illiquidity discount is a function of the trade restriction period. This is true for securities such as stock and stock options, as illustrated in the figure below, which shows that the longer a security must be held, the less that security is worth.[119]

Figure 3



Illiquidity Discount as a Function of Trade Restriction Period[120]

The unfortunate truth of our securities regulations is that they require poorer investors to hold private stock for longer than the wealthiest investors. Laws further restrict poorer investors' access to resale markets. This causes private stock to have a bigger illiquidity

119. ASWATH DAMODARAN, MARKETABILITY AND VALUE: MEASURING THE ILLIQUIDITY DISCOUNT 23 (2005), http://people.stern.nyu.edu/adamodar/pdfiles/papers/liquidity. pdf [http://perma.cc/Q58R-YCUE].

120. *Id.* at 23 fig.3.

discount and thus be less valuable in the hands of poorer investors than in the hands of wealthier ones, who can access the resale market quicker and easier. Ironically, this is the unintended consequence of securities regulations that were designed to protect poorer investors, yet those regulations have the actual effect of creating an illiquidity discount asymmetry favoring wealthier investors over poorer ones.

Securities regulations create the illiquidity discount asymmetry by allowing large banks to host private stock markets for their QIBs, who must have more than $100 million in net investments.[121] Smaller stockholders, and employees with stock options, are systematically disadvantaged by Rule 144A, which creates the QIB restriction on private-stock resale.[122] The lack of an equal-access safe-harbor exemption—such as the new Rule 144B that this Article proposes[123]—harms poorer stockholders and employees disproportionately more than it harms wealthier stockholders and management. And the lack of a general solicitation provision keeps transactions off exchanges, so trading mainly occurs in over-the-counter transactions in private stock markets called "dark pools."[124]

Accordingly, Rule 144A—and the VC secondary exchange that it allows—does not provide a framework for a fair, transparent, and liquid market for companies that are staying private. SEC Commissioner Luis A. Aguilar recently went on record stating that "[v]enture exchanges . . . have fared poorly."[125] The Commissioner explained that venture exchanges suffer from low liquidity and high volatility.[126] In Part III,

121. *See supra* note 78.
122. 17 C.F.R. § 230.144A (2015).
123. *See infra* Part III.
124. *See supra* note 9.
125. Aguilar, *supra* note 15; *see also* Reena Aggarwal & James J. Angel, *The Rise and Fall of the Amex Emerging Company Marketplace*, 53 J. FIN. ECON. 257, 257 (1999).
126. Aguilar, *supra* note 15; *see also* SRIDHAR ARCOT, JULIA BLACK & GEOFFREY OWEN, THE LONDON SCH. OF ECON. & POLITICAL SCI., FROM LOCAL TO GLOBAL: THE RISE OF AIM AS A STOCK MARKET FOR GROWING COMPANIES 7 (2007), http://www.lse.ac.uk/intranet/LSEServices/communications/pressAndInformationOffice/PDF/FULLREPORTAIM.pdf [http://perma.cc/2Y8Y-KX3Q] ("Liquidity among AIM stocks varies widely; stocks with the highest capitalisation and the largest free float show liquidity levels that are comparable to the Main Market, but at the lower end of the market there is a large number of illiquid stocks."); Aggarwal & Angel, *supra* note 125, at 264, 281; Aaron Hoddinott, *TSX Venture Exchange . . . Buy or Sell?*, PINNACLE DIG. (Apr. 29, 2012), http://www.pinnacledigest.com/blog/aaron-hoddinott/tsx-venture-exchangebuy-or-sell [http://perma.cc/596E-92GG] ("[T]he TSX Venture has always been a boom/bust exchange. It's extremely volatile. The exchange has existed for 11 years and during that time, it has gone through 7 bear markets of its own (market downturns of 20% or more)."); Peter Koven, *Can the Once-Mighty TSX Venture Exchange Be Saved?*, FIN. POST (Dec. 27, 2014), http://business.financialpost.com/investing/can-the-once-mighty-tsx-venture-exchange-be-saved?__lsa=

this Article responds to the SEC's request for suggestions on the development of a viable secondary trading environment for restricted securities.[127] This Part of this Article sets the foundation for those suggestions by analyzing why our current securities regulation regime does not provide the necessary liquidity. In short, Rule 144A's safe harbor provides liquidity only for QIBs, who are large institutions that own over $100 million in net investments.[128] It does not provide liquidity to many other startup investors. Angels, who invest about twenty-five billion dollars annually in startups,[129] are generally classified as AIs.[130] They need only have one million dollars in net assets or $200,000 in annual income to purchase private-company equities in the large Regulation D market.[131] Wealthy angels and small venture capital funds may also be classified as qualified purchasers ("QPs"),[132] but even QPs with ninety-nine million dollars in net investments cannot purchase equities on a 144A market.

This disparity in access to a resale market means that AIs and QPs have an "illiquidity discount"[133] on their shares, while QIBs enjoy the

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2516-3866 [http://perma.cc/8G7E-M7XR] ("Liquidity on most [TSX Venture] stocks is very poor, which makes it difficult for them to be bid anywhere but down.").

127. Aguilar, *supra* note 15 ("Ultimately, the goal is to develop a viable secondary trading environment that promotes a fair, transparent, and liquid market for the securities of small businesses—a market in which investors can have confidence that they are being treated fairly. There is no better way to protect investors' interests, while promoting the successful expansion of small businesses. I look forward to a robust discussion on any and all viable suggestions as to how to improve the secondary trading environment for shares of small business securities.").

128. *See supra* note 78.

129. JEFFREY SOHL, CTR. FOR VENTURE RES., THE ANGEL INVESTOR MARKET IN 2014: A MARKET CORRECTION IN DEAL SIZE (2015), https://paulcollege.unh.edu/sites/paulcollege.unh.edu/files/webform/2014%20Analysis%20Report.pdf [https://perma.cc/2TCE-JM62] ("Total investments in 2014 were $24.1 billion, a decrease of 2.8% over 2013 . . . .").

130. *See supra* note 62.

131. *See supra* note 62; *see also* VLADIMIR IVANOV & SCOTT BAUGUESS, U.S. SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009–2012 (2013), https://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf ("Capital raised through Regulation D offerings continues to be large—$863 billion reported in 2011 and $903 billion in 2012.").

132. 15 U.S.C. § 80a-2(51)(A) (2012) ("'Qualified purchaser' means (i) any natural person . . . who owns not less than $5,000,000 in investments[;] . . . (ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related[;] . . . (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments.").

133. Spencer P. Patton, Note, *Archangel Problems: The SEC and Corporate Liability*, 92 TEX. L. REV. 1717, 1732 n.89 (2014) ("An illiquidity discount is a reduction in the price of a security that must be made in order for the price to reflect the fact that the security

full value of their shares. In other words, the 144A regime makes private-company stock most valuable to the wealthiest class of investor and least valuable to the poorest class of investor. This problem will be exacerbated when crowdfunding allows all people, even those who do not qualify as AIs, to invest in startups.

B. De Facto Non-Competes

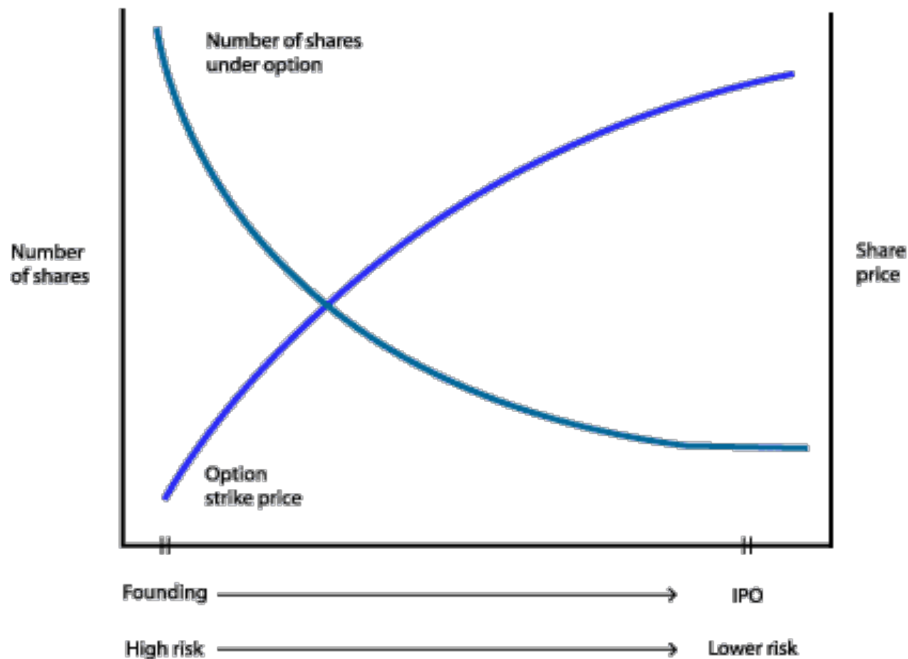
Stock options are a popular way for private startup companies to pay employees. Employees generally have to work for a startup for four years to be able to exercise all their stock options, whose value increases if the company does well.[134] This may align the interests of employees, management, and investors, who otherwise would suffer from agency problems. Plus, this allows the cash-strapped startup to use its capital for other purposes. Stock options are risky because a private company (or its employee) may fail (or be terminated) in the four years before the options "vest" and can be exercised. Even when the vested shares are exercised, the resulting shares have an illiquidity discount because they generally cannot be resold until the company goes public. The number of options that an employee receives is inversely related to salary, and, as the figure below illustrates, the risk of these options is inversely related to the proximity to the IPO.[135]

cannot be sold as easily as other securities.").

134. "The cheap common stock purchased by the founders and management is often subject to an ownership vesting arrangement with the company. Typically, the stock vests evenly over four or five years." Duncan M. Davidson, *Common Law: Uncommon Software*, 47 U. PITT. L. REV. 1037, 1049 (1986). "The evidence is that the managers often exercise their options as soon as they vest[—]if they are in the money . . . ; that the typical period over which options vest is two to four years; and that companies frequently grant additional, later-vesting options during the original vesting period." Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1130 (2003). Typically, the stock is restricted and vests over a four-year period. Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60, 72 (2011).

135. Johanna Schlegel, *Understanding Your Options*, SALARY.COM, http://www.salary.com/advice/layouthtmls/advl_display_nocat_Ser56_Par123.html (last visited Apr. 6, 2016).

Figure 4



Inverse Relationship of Proximity to Going Public and Option Risk[136]

As companies stay private longer, the employees' option shares get riskier as their illiquidity discount grows. In other words, stock options become worthless as the startup stays private longer. Meanwhile, management and VC investors do not suffer from this problem because they have other liquidity options. Staying private therefore disrupts the alignment between labor and management because management can liquidate its investment through a 144A transaction on a VC secondary market, while labor cannot. Labor may be forced to hold their equity indefinitely. This threatens to undermine the value of stock options, which have been called the "central pillar of innovation."[137]

136. *Option Grant Practices in High-Tech Companies*, PHOTONICS MEDIA, http://www.photonics.com/Article.aspx?AID=28203 (last visited Apr. 6, 2016).

137. Thomas A. Smith, *The Zynga Clawback: Shoring Up the Central Pillar of Innovation*, 53 SANTA CLARA L. REV. 577, 581 (2013) ("A central pillar of Silicon Valley business culture . . . is that 'start-ups with limited cash and a risk of failure dangle the

This problem came to light when frustrated Facebook employees tried to sell their stock options on a new market called SharesPost.[138] Unfortunately, the employees were bamboozled by unscrupulous traders, and the SEC shut down SharesPost.[139] The alleged fraud occurred precisely because SharesPost was not an exchange that executed transactions. To comply with securities regulations, SharesPost functioned like a bulletin board that connected buyers and sellers who would then transact privately off the exchange.[140] Mazzola allegedly took advantage of the off-exchange transactions by elevating the Facebook stock price to include a five percent secret commission and falsely claimed to hold positions in other startup stock to attract investors to their fund.[141] Facebook employees would not have been so exposed to these fraudsters if their stock was trading on an exchange that provided transparency, price discovery, and oversight.

Without a secondary market like SharesPost on which to sell their equity, labor has to wait until management elects to do an IPO or M&A, which they may choose to never do because management has a third option for liquidation through a VC secondary market. In other words, employees who traded higher salaries for stock options on the premise that "we're all in this together"[142] were misled, which is simply unfair. A 2013 survey realized that seventy-one percent of employee stock options become liquid only at a value-realizing event (like an IPO or M&A).[143]

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possibility of stock riches in order to lure talent.'").

138. It is understandable that the ordinary people who work at successful startup companies like Facebook (as opposed to venture capital fund managers) want their fair share of the company's success, and ordinary people cannot always afford to wait until a company goes public to get the cash they need to buy a house, send a child to college, or pay off credit card bills.

139. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares (Mar. 14, 2012), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171487740.

140. *SecondMarket and SharesPost: The New Market*, ECONINTERSECT.COM (Jan. 23, 2011), http://econintersect.com/b2evolution/blog1.php/2011/01/23/secondmarket-and-sharespost-the-new-market ("SharesPost operates under a different business model as a 'passive bulletin board' within the meaning established by the SEC in certain No-Action letters.").

141. Complaint ¶¶ 1, 19, SEC v. Mazzola, No. CV-12-1258 (N.D. Cal. Mar. 14, 2012), 2012 WL 836186, at *1, *6.

142. PAUL OYER, STAN. INST. ECON. POL'Y RES., STOCK OPTIONS—IT'S NOT JUST ABOUT MOTIVATION (2002), http://web.stanford.edu/group/siepr/cgi-bin/siepr/?q=system/files/shared/pubs/papers/briefs/policybrief_oct02.pdf.

143. WORLDATWORK & VIVIENT CONSULTING, INCENTIVE PAY PRACTICES SURVEY: PRIVATELY HELD COMPANIES 10 (2014), http://www.worldatwork.org/waw/adimLink?id=74765.

But management and VC investors can, and do, obtain liquidity much earlier.

This is not just a huge burden for individual employees. It also distorts the labor market by tying employees to their employers beyond what they bargained for. Startup employees understand that they forfeit their stock options if they quit before the stock vests. But tax law mandates that employees must purchase their stock options within ninety days of leaving their employer.[144] Private-company employees do not always have the cash to exercise their options, and it is hard to borrow cash to exercise shares that cannot be resold or used as collateral. Therefore, employees who quit without the cash to buy out the stock options in a private company forfeit their equity position, which means they have worked for below-market cash compensation.[145] Management, which has access to other liquidity options on the VC secondary markets, can effectively claw back the option grants to labor through attrition. This incentivizes employees to stay with firms longer than they otherwise would and, therefore, may be the source of a labor-market distortion.[146]

The labor-market distortion cannot be solved by private ordering because stock option contracts are, like all complex contracts, incomplete.[147] Common stock contracts are deliberately incomplete: it is

144. I.R.C. § 422 (2012). The ninety-day rule is one of several features a stock option must have to qualify as an incentive stock option ("ISO"), and "the ISO rules provide additional employee-level benefits." David I. Walker, *Is Equity Compensation Tax Advantaged?*, 84 B.U. L. REV. 695, 712 (2004).

145. While it is commonly understood that employees will forfeit their stock options if they quit before the options vest, this Article goes further and suggests that employees forfeit even vested stock options if they lack the cash to exercise them upon their termination. For the conventional understanding of how stock options are designed to encourage employees to share risk with the firm, see Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 887 (1997) ("Because the stock options vest over time, if key employees are terminated or quit, they will have worked for below-market monetary compensation while forfeiting their equity stake in the venture.") and William A. Sahlman, *Insights from the Venture Capital Model of Project Governance*, 29 BUS. ECON. 35, 36 (1994) ("The vesting requirement means that if employees are terminated, they will likely lose their stock. In most cases, they will have worked for below-market cash compensation, and they will forfeit their equity position.").

146. *See* BRUCE BRUMBERG, THE STOCK OPTION TAX DILEMMA FACED BY PRE-IPO COMPANY EMPLOYEES (2012), https://sharespost.com/site/assets/files/3071/the_stock_option_tax_dilemma_faced_by_pre-ipo_company_employeess.pdf [https://perma.cc/NXH2-UFUK].

147. There is a robust discussion in the literature about incomplete common stock contracts. *See, e.g.*, William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1839 (2013) ("Since stockholder interests are so broad as to be non-contractible, incomplete transactions are inevitable, and therefore make fiduciary

more efficient to deal with certain issues only when they arise because the huge set of possible contingencies for residual claimants "make[s] ex ante contractual specification unfeasible."[148] To the extent that common stock contracts are incomplete, stock option contracts are even more incomplete because they introduce the additional layer of an option contract on top of the common stock contract. Incomplete stock option contracts do not necessarily account for the possibility that the interests of management and option-holders diverge on whether to have a liquidity event, and there is no corporate law backdrop to address this problem with default rules.

C. Systemic Risks

Staying private creates three substantial and systemic risks. First, an IPO or other liquidity event liberates capital to be deployed in new ventures. While VCs are able to obtain some liquidity in today's secondary markets, many VC investments cannot be completely or even partially cashed out without a liquidity event.[149] Without cashing out, VCs therefore cannot reinvest in new companies, and the startup financing cycle shuts down. Second, without IPOs or a robust and liquid stock exchange on which to trade, VCs must sell these stocks in off-exchange environments similar to so-called "dark pools." These low-information environments create opportunity for bad behavior and preferential treatment, which have been the subject of recent SEC indictments.[150] Third, startups that need greater liquidity for their shareholders than SharesPost-style secondary markets or dark pools can list their stock on foreign "venture exchanges" in Canada, Europe, and South America.[151] American investors in these foreign-listed

protection necessary.").

148. *Id.* ("Protecting that reliance with fiduciary principles is thought to be more efficient than forcing common stock investors to specify their rights ex ante. Indeed, the set of possible contingencies for the common is so large as to make ex ante contractual specification unfeasible." (footnote omitted)).

149. *See* sources cited *supra* note 126; *see also* Aggarwal & Angel, *supra* note 125, at 281 (noting that European venture exchanges "suffered from severe illiquidity").

150. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges New York-Based Dark Pool Operator with Failing to Safeguard Confidential Trading Information (June 6, 2014), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542011574 ("The Securities and Exchange Commission today charged a New York-based brokerage firm that operates a dark pool alternative trading system with improperly using subscribers' confidential trading information in marketing its services.").

151. John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 673 (1999) ("[F]irms seeking any of a variety of goals—to raise equity capital, to increase share value, or to

startups, and domestic employees who received stock options in lieu of salary, cannot be effectively protected by domestic regulators like the SEC and the Department of Justice. This is particularly disconcerting because many of these foreign exchanges have been described as the "Wild West," and they are prone to spectacular failure.[152]

1. Breaking the Startup Financing Cycle

Staying private threatens to disrupt the entire startup financing lifecycle by inhibiting the recycling of early stage investment capital into new venture. Professor Jeff Schwartz explained in his article, *The Twilight of Equity Liquidity*, that the failure of U.S. equity markets to offer a stock exchange for young companies manifests in "a less robust entrepreneurial ecosystem and weaker equity markets."[153] He recognized that the innovation economy relies on a steady flow of capital that VCs provide by exiting successful older startups and investing in younger ones.[154] Furthermore, IPOs are the gold standard in startup exits for VC liquidity.[155] M&A events (which Schwartz calls "trade sales")[156] do not offer complete liquidity because a company's acquisitions are often paid for with a mix of cash and stock.[157] If the acquirer is also a private company, then the target company's stockholders end up still holding restricted private stock.[158] From a broader economic perspective, M&A exits may be inferior to IPO exits because acquisitions may destroy jobs, whereas IPOs create jobs.[159]

make acquisitions for stock—may decide to list on a foreign stock exchange and thereby opt into foreign governance standards.").

152. Aggarwal & Angel, *supra* note 125, at 258 (noting the "many failed attempts to launch public equity markets for small stocks in the US and Europe").

153. Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 533 (2012).

154. *Id.* at 541 ("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.").

155. Ibrahim, *supra* note 71, at 11.

156. Schwartz, *supra* note 153, at 541–42.

157. *See, e.g.*, Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 123 n.11 (1992) ("[W]hen a bidder thinks its stock is overvalued, it uses stock rather than cash for the acquisition . . . .").

158. Schwartz, *supra* note 153, at 541–42; *see also* JOHN HAWKEY, EXIT STRATEGY PLANNING: GROOMING YOUR BUSINESS FOR SALE OR SUCCESSION 171–82 (2002) (discussing trade sales).

159. Schwartz, *supra* note 153, at 542 ("In addition, a trade-sale undermines job-

In other words, Professor Schwartz analyzed alternative sources of liquidity and found that the markets for private shares "have little to offer."[160] Secondary markets built on section 4(1½) of the Securities Act,[161] Rule 144,[162] and Rule 144A[163] do not provide the certainty, flexibility, and reliability that markets need to function properly. In fact, 92.7% of VCs polled in 2009 were either "worried" or "most worried" about the uncertain state of exit markets.[164] Without well-functioning exit markets, the VC funds that have been fueling the innovation economy will eventually dry up.

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.").

160. *Id.* at 551.

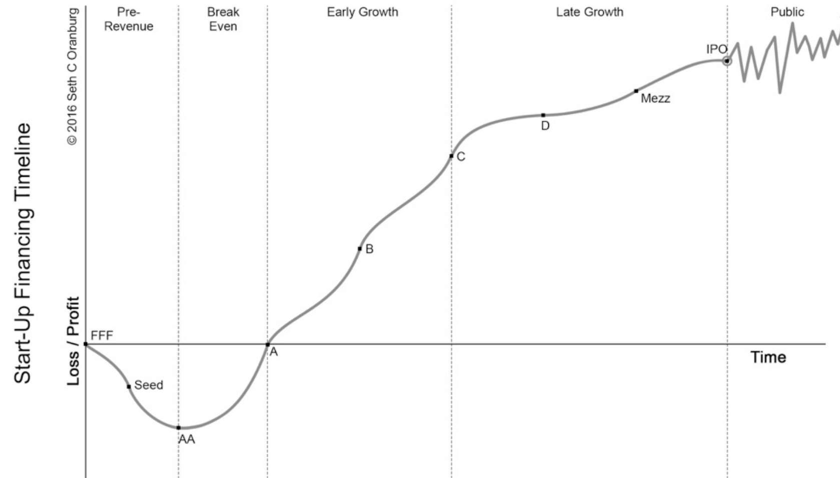
161. *Id.* at 553 ("Essentially, the rule for section 4(1½) is that a resale to a limited number of sophisticated and informed investors, with whom the seller has a preexisting relationship, who themselves do not intend to flip the stock, is permissible, so long as the seller held the shares for a sufficient amount of time. As the ambiguity of the language suggests, the boundaries of these criteria are hazy. Such haziness means that this rule is ill-suited to serve as the foundation for a liquid market." (footnotes omitted)).

162. *Id.* at 555 ("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. 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." (footnote omitted)).

163. *Id.* at 561–62 ("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. This changed with the launch of several new trading venues a few years ago, but these platforms have met with little success." (footnote omitted)).

164. Scott Austin, *Majority of VCs in Survey Call Industry 'Broken,'* WALL ST. J. (June 29, 2009, 4:38 PM), http://blogs.wsj.com/venturecapital/2009/06/29/majority-of-vcs-in-survey-call-industry-broken/.

Figure 5



The Start-Up Financing Timeline illustrates the path venture-funding startups traditionally took from initial private financing to initial public offering.

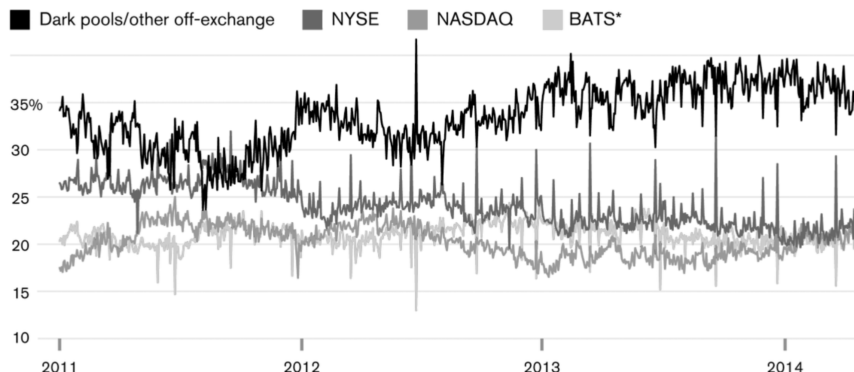
2. Trading in Unregulated Dark Pools

This Subpart explains how the problems with trading public-company stock in private dark-pool markets also apply to private-company stock that is traded in similarly "dark" markets. Dark pools are private stock markets that are not accessible by the general investing public.[165] In fact, dark pools are designed so institutions can hide their orders from the marketplace.[166] Many scholars have expressed serious concerns that this "shadow banking system" creates dangerous systemic risks.[167] Dark pool transactions are secret, one-off,

165. *See supra* note 9.
166. BRIAN R. BROWN, CHASING THE SAME SIGNALS: HOW BLACK-BOX TRADING INFLUENCES STOCK MARKETS FROM WALL STREET TO SHANGHAI 116 (2010).
167. *See, e.g.*, Frank Pasquale, *Restoring Transparency to Automated Authority*, 9 J. ON TELECOMM. & HIGH TECH. L. 235, 252 (2011) ("Though the rise of the 'shadow banking system' and 'dark pools' may make its spread inevitable, trade secrecy appears inappropriate when a Gordian knot of gambles can put the entire global financial system at risk.").

idiosyncratic deals that do not reveal a market price.[168] They reduce liquidity in exchanges, making retail investment less efficient,[169] and raise transparency concerns.[170] The use of dark pools to trade public-company stock is growing rapidly.[171]

Figure 6



More transactions are happening off exchanges, in dark pools housed inside big banks.[172]

168. Robert Hatch, *Reforming the Murky Depths of Wall Street: Putting the Spotlight on the Security and Exchange Commission's Regulatory Proposal Concerning Dark Pools of Liquidity*, 78 GEO. WASH. L. REV. 1032, 1039 (2010) ("[C]ritics worried that by hiding information from the public at large, the activity in dark pools would harm the validity of public price quotes by making it difficult for investors to know if they were getting either the best price or the appropriate price for their transactions.").

169. *Id.* ("[C]ritics worried that the lure of higher prices in dark pools would suck liquidity out of conventional exchanges, making it harder and more expensive for retail investors to conduct trades.").

170. Michael C. Schouten, *The Case for Mandatory Ownership Disclosure*, 15 STAN. J.L. BUS. & FIN. 127, 142 n.64 (2009) ("Not surprisingly, dark pools are increasingly raising transparency concerns.").

171. William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 68 (2013) ("There is a growing phenomenon of securities being traded in so-called dark pools.").

172. Sam Mamudi, *Dark Pools: Private Stock Trading vs. Public Exchanges*, BLOOMBERG QUICKTAKE, http://www.bloombergview.com/quicktake/dark-pools (last updated Feb. 1, 2016).

The private stock market is fragmented into approximately fifty individual marketplaces, commonly called "dark pools," that are owned and operated by the world's largest banks.[173] The percentage of stock trades that happen in private dark pools, not on public stock markets, is rising sharply, as the figure above illustrates.[174] Critics argue that higher dark-pool trading results in lower market quality, including more volatility, lower liquidity, and rampant opportunism.[175] Wrongdoing is clearly occurring in dark pools. Despite difficulty policing these secret trading environments, SEC investigations have found massive banks like UBS privileging certain market participants over others.[176]

The Rule 144A venture stock resale market is really just a series of transactions in small, fragmented markets which are very similar to what are traditionally referred to as dark pools. These 144A resales are virtually invisible to regulators like the SEC.[177] Market participants cannot learn the price of securities traded in dark pools because there is no price disclosure mechanism. The price disclosure problem is more pronounced in private-stock markets because there is no public-exchange price to help determine the private-market price. This is particularly harmful to employees and smaller investors who have less access to private bankers, valuation firms, or other sources of information that can help value private securities.

Dark pools and other over-the-counter (off-market) transactions are a predictable consequence of inadequate markets. Even though these markets have high transaction fees, limited ability to provide price discovery, hard-to-detect opportunism, and other disadvantages,[178] they

173. Robert Lenzner, *Dark Pools Fragment the Stock Market into 50 Private Stock Markets*, FORBES: INV. (June 27, 2014, 12:08 PM), http://www.forbes.com/sites/robertlenzner/2014/06/27/dark-pools-fragment-the-stock-market-into-50-private-stock-markets/.

174. Mamudi, *supra* note 172.

175. *See, e.g.*, Memorandum from Cristie L. March, Senior Adviser, Office of the Chairman to File No. S7-02-10 (Apr. 10, 2013), http://www.sec.gov/comments/s7-02-10/s70210-396.pdf [http://perma.cc/GR33-L7W3].

176. Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges UBS Subsidiary with Disclosure Violations and Other Regulatory Failures in Operating Dark Pool (Jan. 15, 2015), http://www.sec.gov/news/pressrelease/2015-7.html ("An SEC examination and investigation of UBS revealed that the firm failed to properly disclose to all subscribers the existence of an order type that it pitched almost exclusively to market makers and high-frequency trading firms.").

177. BROWN, *supra* note 166, at 116 ("A dark pool is an anonymous crossing network that allows institutions to hide their orders from the marketplace.").

178. The Congressional Research Service's report, *Dark Pools in Equity Trading*, lists five regulatory concerns: market fragmentation, fairness and access, price manipulation,

are growing because they remain better than any available alternatives.

3. Trading in Offshore Stock Markets

If they do not want to transact in dark pools, QIBs can convince management to list their stock on a foreign "venture exchange," such as the Alternative Investment Market ("AIM") in London. When stock is traded offshore, the SEC cannot protect American investors. These venture exchanges have been described as "a market for lemons"[179] and the "Wild West"[180] by scholars and regulators. This sort of international "regulatory dualism"[181] or "regulatory arbitrage"[182] diminishes the effectiveness of any domestic regime. Moreover, empirical studies have shown that listing outside the United States diminishes shareholder value.[183] This is particularly problematic here, where the largest and wealthiest investors can obtain liquidity by listing outside the United States at the expense of smaller and poorer investors and employees

improper trade, and lack of price discovery. GARY SHORTER & RENA S. MILLER, CONG. RESEARCH SERV., R43739, DARK POOLS IN EQUITY TRADING: POLICY CONCERNS AND RECENT DEVELOPMENTS 6–8 (2014), https://www.fas.org/sgp/crs/misc/R43739.pdf.

179. Cécile Carpentier & Jean-Marc Suret, *Entrepreneurial Equity Financing and Securities Regulation: An Empirical Analysis*, 30 INT'L SMALL BUS. J. 41, 41 (2010) ("The quality of firms, their post-listing operating performance and strategy, and their fate largely support the opinion that strong listing requirements are essential to prevent the emergence of a lemon market.").

180. Aguilar, *supra* note 15 ("Scandals involving some ECM companies only cemented the exchange's reputation as a lawless Wild West.").

181. Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475, 478 (2011) ("Regulatory dualism seeks to avoid, or at least mitigate, the Olson problem by permitting the existing business elite to be governed by the prereform regime, while pursuing development by allowing other businesses to be governed by a reformed regime. Put in terms of capital market and shareholder protection, regulatory dualism establishes a new and more rigorous shareholder protection regime, operating parallel to the existing one, that is open to any new or existing firm that wishes to make use of it.").

182. Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563, 567 (1998) ("Regulatory arbitrage traditionally indicates a phenomenon whereby regulated entities migrate to jurisdictions imposing lower regulatory burdens. By doing so they exert a downward pressure on those jurisdictions that want to retain the regulated activity within their borders.").

183. *Id.* at 634 ("Notwithstanding the above, a certain amount of support may be found in the results of expected returns tests of foreign listings incoming to the United States versus those outgoing from the United States. As a broad generalization, the former systematically tend to increase shareholder value whereas the latter tend to do the opposite and exhibit negative abnormal returns.").

who cannot access those markets and whose shares also have an illiquidity discount.[184]

Listing on offshore stock markets also creates a number of problems for the issuing company. The most significant problem is the massive transaction costs that a U.S. company will spend to list on a foreign stock exchange in order to understand and comply with foreign regulatory regimes.[185] Furthermore, this solution exacerbates the illiquidity discount asymmetry problem because it is more difficult for smaller stockholders to find an international broker willing to sell just a few shares on a foreign stock exchange than it is for a larger stockholder to find a broker willing to make a large block sale.[186]

PART III. DEMOCRATIZING PRIVATE STOCK EXCHANGES

New securities regulations unintentionally encourage startups to stay private. Staying private creates a number of problems that hurt smaller investors, devalue employee stock options, create systemic risks, and threaten to break the startup financing cycle. One solution could be to reverse these new securities regulations. Many scholars have advanced the position that SOX and Dodd-Frank are bad laws,[187] but as one of SOX's most fervent critics points out, "[c]ongressional repeal of SOX's corporate governance mandates is not on the near-term political horizon."[188]

Moreover, SOX and Dodd-Frank are not the only reasons why companies are staying private. Even before SOX and Dodd-Frank, going

184. *See* Schwartz, *supra* note 153, at 543 ("[F]orcing U.S. investors to look abroad for U.S. companies undermines investor protection.").

185. *Id.* at 542 ("The key issue is that going overseas involves significant transaction costs.").

186. Steven M. Davidoff, *Regulating Listings in a Global Market*, 86 N.C. L. REV. 89, 136–37 (2007).

187. *See, e.g.*, Bainbridge, *supra* note 53, at 1821 ("Like their predecessors in SOX, the six key corporate governance provisions of Dodd-Frank satisfy the key criteria of quack corporate governance."); Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 242 (2011) ("[T]he Dodd-Frank Act leaves much to be desired."); Ribstein, *supra* note 37, at 3 ("Post-Enron reforms, including Sarbanes-Oxley, rely on increased monitoring by independent directors, auditors, and regulators who have both weak incentives and low-level access to information. This monitoring has not been, and cannot be, an effective way to deal with fraud by highly motivated insiders. Moreover, the laws are likely to have significant costs . . . ."); Romano, *supra* note 53, at 1602 ("An extensive empirical literature suggests that those mandates were seriously misconceived, because they are not likely to improve audit quality or otherwise enhance firm performance and thereby benefit investors as Congress intended.").

188. Romano, *supra* note 53, at 1602.

public was expensive not just once but on an on-going basis to comply with the Securities Act and the Exchange Act. In addition to the cost of complying with those laws, going public also risks subjecting the company and its management to whatever additional regulations Congress demands after the next crisis. Staying private also offers many benefits. Private-company managers have more freedom and less liability.[189] VCs get protected access to a rare and valuable class of assets. Private startups have more flexibility with pricing their employee stock options. And there is a certain allure to being private that is ameliorated when securities regulations require a public company to "open the kimono" at least every three months.

This Article therefore does not recommend a reactionary response to securities laws. Indeed, in other work I argue that crowdfunding is inherently different from traditional fundraising, and so it requires progressive new approaches.[190] Rather, this Part proposes a new safe-harbor exemption that allows for domestic private stock exchanges to facilitate transactions of private-company stock. Such a rule would have three primary benefits. First, it would give employees access to a domestic venture exchange that is transparent, liquid, and fair. Second, it would encourage QIBs to transact on venture exchanges instead of in unregulated dark pools. Third, it would move transactions from offshore locations to American soil, where the lemons and Wild West problems can be mitigated by SEC oversight.

This Article also acknowledges that a domestic "venture exchange" could be problematic by creating an environment where investors can trade stock about which they have no good information. This problem is exacerbated where investors only have a small stake in each company and therefore are "rationally apathetic" about monitoring their investment. Fortunately, this problem can be addressed. In public markets, rational apathy is countered somewhat by analysts whose profession is to monitor and report on public companies. This distributes the cost of monitoring across all investors who purchase the report. The problem in venture exchanges—and in small-cap public-company stocks—is the lack of analyst coverage on listed companies.

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189. Consider, for example, how Twitter CEO Dick Costolo was forced to retire by shareholders who were upset that Twitter was not growing revenue fast enough. Erin Griffith, *Where Did Dick Costolo Go Wrong?*, FORTUNE (June 12, 2015, 6:44 AM), http://fortune.com/2015/06/12/twitter-ceo-dick-costolo-resigns/. When the company was private, Costolo was subject only to scrutiny by a few VCs and founder Jack Dorsey. *Id.*

190. *See generally* Seth C. Oranburg, *A Place of Their Own: Crowds in the New Market for Equity Crowdfunding*, 100 MINN. L. REV. HEADNOTES 147 (2016), http://www.minnesotalawreview.org/wp-content/uploads/2016/08/Oranburg-FINAL.pdf.

This Article's proposed Rule 144B addresses that problem by instituting a private independent analyst ("PIA") who must monitor and report to shareholders on each company listed on a 144B domestic venture exchange.

This Part explains how the 144B market will be defined by two characteristics. First, Rule 144B would allow for the development of stock exchanges—unlike Rule 144A which only allows for stock markets—that do not restrict access to the stock exchange based on wealth. This "equal access" principle is necessary to reduce or remove the illiquidity discount asymmetry. Second, all companies listed on a 144B exchange must have a PIA. The PIA shall have access to board meetings and books and records, much like a VC would, but unlike a VC the PIA cannot have any interest in the stock price. This Part will discuss criticism and limitations of a 144B market.

A. Venture Exchanges

This Article recommends a new securities regulation fostering a domestic venture exchange. To be clear, there already exists a domestic venture market for the resale of startup stock that is legal under current regulations. But the existing "Rule 144A Market" is merely an informal market, not a structured exchange. A market is any sort of system, institution, process, relationship, or infrastructure where market participants can trade goods, services, or information for money or other goods, services, or information.[191] Market participants consist of buyers and sellers who set prices based on supply and demand.[192] The price reflects the true value of the thing that is traded only when the market is efficient and perfectly competitive.[193] Market inefficiencies include time-inconsistent preferences,[194] information

191. *See* JEFFREY M. PERLOFF, MICROECONOMICS 3 (Donna Battista et al. eds., 5th ed. 2009).

192. *Id.* at 11–26.

193. This is called the efficient-market hypothesis, a theory in financial economics which states that the price reflects all the available information about a stock. Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics* 3 (Princeton Univ., CEPS Working Paper No. 91, 2003), https://www.princeton.edu/ceps/workingpapers/91malkiel.pdf. No real-world markets are perfectly efficient, however, and the price only reflects the value to the extent that markets are efficient. *Id.* at 3–4.

194. *See* Manual A. Utset, *Corporate Actors, Corporate Crimes and Time-Inconsistent Preferences*, 1 VA. J. CRIM. L. 265, 276–77 (2013) ("It turns out that individuals become increasingly impatient the closer that they get to immediate payoffs; or, equivalently, from a short-term perspective they discount immediate payoffs by a greater amount than they did when those payoffs were all still in the future. It is this asymmetry between long-term and short-term impatience that leads people to procrastinate and overconsume."

asymmetries,[195] principal-agent problems,[196] externalities,[197] or public goods.[198] Perfect competition requires a large number of buyers and sellers.[199] Without efficiency and competition, the market price is distorted.

A financial market is a market for trading of securities (like stock and bonds), currencies, fungible commodities, derivatives, futures, insurance, and other financial products. Financial market transactions can occur either on or off an exchange. An off-exchange, or over-the-counter ("OTC") transaction, is done directly between two parties.[200] In

(footnote omitted)).

195. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 102 n.68 (1989) ("In the economics literature several articles examine situations in which asymmetric information induces inefficient contracting.").

196. Robert Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1040 (2011) ("[A]n agency problem arises whenever one person, the *principal*, engages another person, the *agent*, to undertake imperfectly observable discretionary actions that affect the wealth of the principal. The concern is that in exercising this unobservable discretionary authority, the agent will favor the agent's interests when the agent's interests diverge from those of the principal." (footnote omitted)).

197. Externalities are costs or benefits conferred upon others that are not taken into account by the person taking the action. *See generally* A. C. PIGOU, THE ECONOMICS OF WELFARE (4th ed. 1932).

198. Wendy J. Gordon, *Fair Use as Market Failure: A Structural and Economic Analysis of the* Betamax *Case and Its Predecessors*, 82 COLUM. L. REV. 1600, 1610–11 (1982) ("A public good is often described as having two defining traits. First, it is virtually inexhaustible once produced, in the sense that supplying additional access to new users would not deplete the supply available to others. Second, and more important for the instant purposes, persons who have not paid for access cannot readily be prevented from using a public good. Because it is difficult or expensive to prevent 'free riders' from using such goods, public goods usually will be under-produced if left to the private market. A familiar example of a public good is national defense." (footnotes omitted)).

199. On the other hand, a market with a single seller is a monopoly, and a market with a single buyer is a monopsony, which "are the polar opposites of perfect competition." ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 349 (7th ed. 2009). Some have even suggested that a market with only a single buyer and a single seller is not a market at all. ARTHUR O'SULLIVAN & STEVEN M. SHEFFRIN, ECONOMICS: PRINCIPLES IN ACTION 28 (2003).

200. *See* Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1458–59, 1464–67 (1993) ("Innovation has been especially striking in the market for over-the-counter (OTC) derivatives, a type of financial contract individually negotiated among major financial institutions and between such institutions and their sophisticated clients." (footnotes omitted)); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 333 n.486 ("Exchange-traded derivatives are standardized contracts, including futures and options based on commodities and stock indexes, that are traded on an organized exchange and are governed by the rules of that exchange. In contrast, OTC derivatives are contracts that are individually negotiated between a 'dealer' (typically a

OTC financial markets, buyers and sellers must incur searching costs and opportunity costs to find each other and then incur transaction costs to complete the trade.[201] OTC market transactions may be private, in which case there is no price discovery process, and again price may be distorted.[202] Venture transactions today occur mainly in OTC markets.

The call for a "144B" venture-exchange safe harbor, in addition to the "144A" venture OTC-market safe harbor, is solidly grounded in legal and economic theories and empirical evidence that exchanges are superior to OTC markets. Exchanges can solve free rider problems and coordination problems that OTC markets cannot.[203] Even if markets can

money center bank, a large securities firm, or a major insurance company) and an 'end-user' (usually a smaller financial institution, business firm, or investor that wishes to buy the derivatives either for speculation or for hedging against risks arising out of its operations or its investment portfolio). Thus, OTC derivatives, such as forwards, options, and swaps, are highly customized instruments and are not traded in any organized secondary market."); *see also* ALFRED STEINHERR, DERIVATIVES: THE WILD BEAST OF FINANCE 170–223, 237–38 (1998); Peter H. Huang, *A Normative Analysis of New Financially Engineered Derivatives*, 73 S. CAL. L. REV. 471, 485 (2000); Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 7–31, 40–51 (1996).

201. Darrell Duffie, Nicolae Garleanu & Lasse Heje Pedersen, *Over-the-Counter Markets*, 71 ECONOMETRICA 1815, 1815 (2005) ("In over-the-counter markets, an investor who wishes to sell must search for a buyer, incurring opportunity or other costs until one is found. Some over-the-counter (OTC) markets therefore have intermediaries. Contact with relevant intermediaries, however, is not immediate. Often, intermediaries must be approached sequentially. Hence, when two counterparties meet, their bilateral relationship is inherently strategic. Prices are set through a bargaining process.").

202. For example, OTC financial markets for credit derivatives, commercial paper, municipal bonds, securitized student loans, and other products became difficult to value in the financial crisis of 2007–2009, which led to a downward spiral of illiquidity, which further inhibit price discovery, which then increased illiquidity, under which entire markets seized up and became dysfunctional. *See* Randall Dodd, *Markets: Exchange or Over-the-Counter*, INT'L MONETARY FUND, http://www.imf.org/external/pubs/ft/fandd/basics/markets.htm (last updated Mar. 28, 2012) ("*Without liquid and orderly markets, there was no price discovery process and in turn no easy and definitive way to value the securities.* The failure of the price discovery process aggravated the problems at banks and other financial firms during the recent crisis by making it more difficult to meet disclosure and reporting requirements on the value of their securities and derivatives positions. Not only were there no efficient direct market prices, there were often no benchmark prices (which are prices of assets similar to the one being valued). As a result, the assets and positions that were once valued at market prices were instead valued through models that sometimes were not adequately informed by benchmark prices. These valuation problems further depressed prices of affected securities.").

203. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2399 (1998) ("Exchanges can solve free rider problems concerning information production encountered by individual firms, as well as coordination problems presented by investors' need for standardized disclosure. Thus

be only relatively and not fully efficient,[204] exchanges are more efficient than OTC markets.[205] The SEC's power to police OTC transactions is more limited than its power to police exchange transactions.[206] Private litigants may be deprived of "fraud-on-the-market" claims in OTC markets.[207] Empirical economic studies strongly support the claim that exchanges like the NYSE are efficient markets.[208] Exchanges produce valuable information as a byproduct of market trading.[209] Exchanges are more resilient and less prone to systemic failure than OTC markets.[210] And exchanges and OTC markets compete with each other, making both function more efficiently.[211]

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exchanges could replace the government as the solution to a securities market failure.").

204. Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 830 (1985) ("If markets are only relatively efficient, as we expect, then it is wrong to regard the search for undervalued securities by institutional investors as irrational behavior.").

205. Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 873 n.70 (1992) ("By hypothesis, the over-the-counter markets are presumed to be less efficient because of the lower levels of liquidity and professional investor/analyst interest.").

206. *See* Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (2012), *amended by* Pub. L. No. 114-94, 129 Stat. 1312 (2015).

207. *See* Bradford Cornell & R. Gregory Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. REV. 883, 918 (1990) (noting that the defendants' argument regarding the fraud-on-the-market theory of reliance was inappropriate because the securities were traded in the over-the-counter market, not on a stock exchange).

208. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 416 (1970) ("In short, the evidence in support of the efficient markets model is extensive, and (somewhat uniquely in economics) contradictory evidence is sparse.").

209. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 609 (1984) ("This [historical price] information is an ordinary byproduct of market trading: the organized securities exchanges produce it as a routine service, and the financial press serves to collectivize its low cost dissemination." (footnote omitted)).

210. *SEC Legislation, 1963: Hearings on S. 1642 Before the Subcomm. of the S. Comm. on Banking & Currency*, 88th Cong. 12 (1963) (statement of William L. Cary, Chairman, U.S. Securities and Exchange Commission) ("It is well known that the over-the-counter market has not shown the same resiliency since that sharp decline as the exchange markets, both in terms of price and of volume.").

211. John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1257 (1984) ("Increasingly, the stock exchanges are in competition with the over-the-counter market, where the emergence of a computerized inter-dealer quotation system gives issuers an inviting alternative to the exchanges."); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1457 (1997) ("As a provider of liquidity, an exchange competes with other exchanges and over-the-counter markets, both to attract companies to list and to induce investors to purchase listed securities.").

Considering the many benefits of exchanges over OTC markets, it is curious that the SEC has not already acted to create a domestic venture exchange. One explanation for the SEC's inaction is regulatory capture of the SEC by the wealthiest firms who benefit from the illiquidity discount asymmetry and profit from the lack of an equal-access venture exchange.[212] Regulatory capture typically results in policies that favor a concentrated and powerful interest group.[213] The lack of a rule like the proposed Rule 144B may simply reflect that such a rule would benefit a diverse, heterogeneous, disempowered group, like startup employees and poorer stockholders.

Another explanation for the lack of an equal-access venture-exchange rule is bounded rationality of regulators.[214] Many legal scholars have pointed out how the bounded rationality of the SEC may inhibit that agency from promulgating forward-looking regulations that help grow the economy (instead of merely preventing the last crisis from occurring again).[215] This line of economic argument has legal implications, such as discouraging the use of regulators to set prices.[216]

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212. For an explanation of regulatory capture in the context of corporate governance regulation, see William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1885–86 (1995) ("Under capture theories of regulation, interest groups and political decision makers enter into jointly maximizing relationships. The simple demand model of capture asserts that lawmaking follows the lawmakers' responses to demand patterns. Particular responses depend on interactions between the lawmakers' risk profiles and the projected benefits of legislative action. The lawmaker, being risk averse, tries to avoid conflicts—given no demand for legislation, nothing is done; given organized demand, the lawmaker attempts to satisfy the interest group making the demand with beneficial legislation. In addition, interest groups desiring to influence legislation encounter collective action problems. Different groups have different abilities to overcome them—the smaller the group and the higher the per capita stake of its members, the greater the likelihood that the members will work out a collective arrangement and enjoy the benefits of governmental influence. This activity results, according to the theorists of the Virginia School, in a social loss from rent-seeking. Legislators create rents for the benefit of successful interest groups, distributing them based on a self-seeking vote calculus." (footnotes omitted)).

213. *See* Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371, 372 (1983) (explaining how regulatory capture influences public policy).

214. Bounded rationality generally means that humans have limited cognitive abilities and therefore must rely or heuristics and other mental shortcuts to make decisions. *See* Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 99 (1955); *see also* Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051, 1069 (2000) ("This 'bounded rationality' results from the high cost of processing information, the cognitive limitations of human beings, or a combination of the two.").

215. *See, e.g.*, Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1057–58 (2000) ("[L]egislators and regulators are no less subject to bounded rationality and other cognitive biases than any other decisionmakers."); Stephen

If the regulatory capture and bounded rationality explanations are true, it may be difficult for the SEC to create a rule like the proposed 144B. But a different explanation may better explain SEC behavior and frame the solution. The SEC may have recognized that investors suffer from cognitive failings.[217] It could be difficult for the SEC to fulfill its mission of "protecting investors" if it were to permit a domestic venture exchange in which investors could employ flawed heuristics to make bad decisions. One must ask whether the SEC is forbidding a venture exchange in order to protect investors from fraud or simply to protect investors from themselves. The former explanation reflects appropriate agency behavior. The latter "smacks of an unthinking paternalism that reveals its own institutional shortcomings."[218]

This Article assumes that the SEC is capable of overcoming regulatory capture and bounded rationality, if any, provided that a proposed rule like 144B has sufficient protections from fraud. The next Subpart analyzes why fraud occurred in other venture exchanges and then proposes employing a PIA as a solution to mitigate fraud and help investors make better decisions in 144B exchange transactions.

B. Private Independent Analysts

The SEC has good reason to be concerned about fraud in secondary private stock marketplaces. SEC Commissioner Aguilar said: "Venture exchanges are hardly a new idea, however, and prior efforts to establish them in this country have fared poorly. Accordingly, we need a thoughtful and prudent approach that carefully examines why the prior attempts failed" because "[t]hose who cannot remember the past are condemned to repeat it."[219] This Subpart will explain why prior

J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 25 (2003) ("Closely related to bounded rationality are the heuristics that regulators use to manage the deluge of information and problems stemming from the financial markets. Like investors, regulators suffer from the availability heuristic, focusing too much attention on recent and immediately available information.").

216. Edward L. Rubin, Commentary, *The New Legal Process, the Synthesis of Discourse, and the Microanalysis of Institutions*, 109 HARV. L. REV. 1393, 1431 (1996) ("Lifeline banking may be a promising idea, but the bounded rationality of banking regulators may render them unable to set prices at the proper level.").

217. Choi & Pritchard, *supra* note 215, at 71 ("The evidence that investors suffer from cognitive failings is impressive.").

218. Richard A. Epstein, *Regulatory Paternalism in the Market for Drugs: Lessons from Vioxx and Celebrex*, 5 YALE J. HEALTH POL'Y L. & ETHICS 741, 748 (2005) ("Protection against fraud is one thing; paternalism, whether or not intended, is quite another.").

219. *Id.*

attempts failed and provide a solution to prevent such failures in the future.

Venture stock exchanges have been failed experiments across the globe. The only domestic venture exchange, the American Stock Exchange Emerging Company Marketplace, launched on March 18, 1992 and closed on May 11, 1995, ending in what can only be described as a "failure."[220] Overseas, the French Nouveau Marché launched in 1996, the German Neuer Markt launched in 1997, and the Italian Nuovo Mercato launched in 1999 "to attract early stage, innovative and high-growth firms that would not have been viable candidates for public equity financing on the main markets of European stock exchanges."[221] Instead, "[i]nsider trading scandals and accounting frauds tarnished the reputation of new markets. As a result, investor confidence quickly disappeared."[222]

The failure of venture exchanges can be attributed to the fact that listed companies have the worst of corporate governance problems of both private corporations and public corporations, with few of the benefits. On the one hand, exchange participants lack the investor protections typically found in VC arrangements, such as active monitoring and restrictive covenants, that protect against information asymmetries and entrepreneurs' opportunism. On the other hand, exchange participants lack the information typically provided by public-company listing requirements. The information problem is compounded by the fact that exchanges may lack incentives to require their listed companies to make disclosures or to police those disclosures for completeness and accuracy.

To frame this argument in more theoretical terms, a VC-funded company allocates a disproportionate amount of control to its VC owners.[223] In addition to these contractual VC control rights, VCs also control their portfolio companies through staged financing.[224] The VC-

220. Aggarwal & Angel, *supra* note 125, at 258.

221. *Preface* to 10 THE RISE AND FALL OF EUROPE'S NEW STOCK MARKETS ix (Giancarlo Giudici & Peter Roosenboom eds., 2004).

222. *Id.*

223. Gilson, *supra* note 82, at 1096 ("In the United States, the venture capital contracting structure turns the Berle-Means problem on its head. Instead of assuming less control than their proportion of equity would dictate, venture capital investors in the United States take greater control positions than their proportion of equity. Not only do they obtain veto rights over major decisions, retain the continuation decision, and often control a majority of the board, but they also retain the right to terminate the entrepreneur.").

224. *Id.* at 1074 ("[S]taged financing in effect delegates to the investors, in the form of the decision whether to provide additional financing, the decision whether to continue the

funded company thus stands in sharp contrast to the Berle-Means corporation, where there is the endemic problem of the separation of ownership and control.[225] The VC-funded company is also different from a nexus-of-contract public company because VCs have the authority and tools to deal with excessive agency costs.[226] The advantages that VC-funded companies have in dealing with agency problems are lost when the VC sells shares on an exchange to third parties that are not in privity with the issuer. Without privity, investors may lack the contractual power to discipline management, the ability to influence management through staged investment, and the tools to monitor management.

Instead of taking on the worst problems of both VC-funded and publicly-traded companies, the 144B exchange could be used to incentivize corporations seeking liquidity to adopt corporate governance that reflects their most successful practices. Therefore, the crux of the 144B exchange must be to return the power of monitoring and disciplining management to the stockholders. This can be accomplished by installing a quasi-VC called the PIA. The PIA would represent the shareholders on the venture exchange much like a VC manager represents the members of its VC fund, except the PIA's compensation is not based on stock performance. Rule 144B could require all companies listed on a 144B exchange to provide contractual control rights to the PIA, similar to those found in VC contracts. For example, the PIA would have the right to attend board meetings, vote on fundamental corporate transactions (including mergers, major acquisitions, and sales of substantially all assets), prevent the company

company's project.").

225. *Id.* at 1073–74 ("In direct contrast to the familiar Berle-Means governance structure of outside investors having disproportionately less control than equity, the governance structure of a venture capital-backed early stage, high technology company allocates to the venture capital investors disproportionately greater control than equity. It is common for venture capital investors to have the right to name a majority of a portfolio company's directors even though their stock represents less than a majority of the portfolio company's voting power. Additionally, the portfolio company will have the benefit of a series of contractual negative covenants that require the venture capital investors' approval before the portfolio company can make important business decisions, such as acquisition or disposition of significant amounts of assets, or a material deviation from the business plan." (footnote omitted)).

226. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1171 (1981) ("The free riding problems that inhibit monitoring by shareholders are aggravated by the difficulty any shareholder would face in doing anything about the firm's managers once he discovered the existence of excessive agency costs. The shareholder who makes the discovery has no authority to compel the firm to change its ways.").

from issuing more stock, prevent the company from taking on a large senior debt, and vote on management salaries.

In addition to contractual control rights that are similar to what a VC would receive, the PIA would also have responsibilities to produce valuable public information. In the public-company context, stock analysts review publicly available information and often have private access to corporate management.[227] The analyst reviews corporate and systemic information and reports whether the company is correctly valued by its stock price. This is a valuable service because it centralizes efforts that would otherwise have to be duplicated by all stockholders. This reduces the cost of monitoring a corporation and reduces shareholders' rational apathy problems. Analyst reports are integral to overcoming corporate governance problems, but it is hard for smaller firms to attract analyst coverage.[228] By requiring 144B exchange-traded companies to produce analyst reports, the micro-cap companies on 144B exchanges could actually have fewer corporate governance problems than small-cap companies on national stock exchanges.

The PIA concept is reinforced by the real-world example of the advisors and brokers (called nominated advisors or "Nomads") that are required by the world's most successful venture exchange, the AIM.[229]

227. One problem public stock analysts face is that their private access may be cut off if they issue negative reports. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 602 (1990) ("Companies often cut off access for stock analysts who issue negative reports."). This is a problem that would be solved in the 144B exchange, where analyst access is a prerequisite for listing.

228. Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1369–70 (2011) ("But when a company falls below the $300 million market cap, it is extremely difficult to attract attention from analysts or investors. These firms are lucky if a single analyst follows them. With so little attention, the market for such companies' shares is far less informationally efficient than for mid-cap or large-cap companies. Similarly, micro-cap companies present distinctive governance challenges." (footnotes omitted)); *see also* Joshua M. Koenig, *A Brief Roadmap to Going Private*, 2004 COLUM. BUS. L. REV. 505, 512 ("In addition, many companies have been hurt by regulatory efforts to separate stock research from investment banking, which has led Wall Street to cut analyst coverage of small-cap stocks.").

229. The AIM lists over 1000 companies that have a combined market value (or total market capitalization) of $115 billion and an average daily trading volume of over $200 million. LONDON STOCK EXCH. GRP., AIM FACTSHEET (2015), http://www.londonstockexchange.com/statistics/historic/aim/aim-statistics-archive-2015/june-15.pdf. To put those figures in context, the NYSE, which is the largest stock exchange in the world, has about 25,000 listed companies with a total market capitalization of $20 trillion and an average daily trading volume of over $3 billion, and NASDAQ has almost 30,000 listings with a total market capitalization of $7 trillion and an average daily trading volume of around $1.7 billion. *Market Data Center*, WALL ST. J., http://online.wsj.com/mdc/public/page/2_3021-tradingdiary2.html (last updated Apr. 8, 2016). But not all stock exchanges are so

Scholars such as Professor William K. Sjostrom, Jr. have explained how this AIM Nomad model has proved quite successful.[230] The Nomad is responsible for guaranteeing the quality of the company to investors, and the broker is tasked with providing liquidity with "bid and ask prices."[231] Nomads include accounting firms and investment banks that must be pre-approved by the London Stock Exchange.[232] A Nomad determines a company's suitability for listing on AIM, manages the offering process, and advises the company on regulatory matters.[233] There is a market for Nomads, where their reputation is their currency, which incentivizes Nomads to perform their role diligently.[234]

large: the NYSE and NASDAQ together are larger than the next ten largest exchanges combined. Andy Kiersz, *The NYSE Makes Stock Exchanges Around the World Look Tiny*, BUS. INSIDER (Nov. 18, 2014, 11:02 AM), http://www.businessinsider.com/global-stock-market-capitalization-chart-2014-11 ("[T]he two U.S. exchanges together have a larger market cap than the next ten exchanges combined."). In fact, the AIM is about the same size as public national stock markets, including the Santiago Stock Exchange ($221 billion), the Tel Aviv Stock Exchange ($223 billion), and the Oslo Børs ($227 billion). *Monthly Reports*, WORLD FED'N OF EXCHANGES, http://www.world-exchanges.org/statistics/monthly-reports (last visited July 30, 2015). In other words, while the AIM is dwarfed by the NYSE and NASDAQ, so are most of the other stock exchanges in the world. The AIM, therefore, is capable of providing a level of liquidity to private stockholders on par with the liquidity available to holders of public stock listed on many other national exchanges. *See AIM*, LONDON STOCK EXCHANGE, http://www.londonstock exchange.com/companies-and-advisors/aim/aim/aim.htm (last visited Apr. 10, 2016).

230. William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 673–74 (2009).

231. Giancarlo Giudici & Peter Roosenboom, *Venture Capital and New Stock Markets in Europe*, *in* 10 THE RISE AND FALL OF EUROPE'S NEW STOCK MARKETS, *supra* note 221, at 16–17; *see also* Hse-Yu Chiu, *Can UK Small Businesses Obtain Growth Capital in the Public Equity Markets?—An Overview of the Shortcomings in UK and European Securities Regulation and Considerations for Reform*, 28 DEL. J. CORP. L. 933, 950 n.87 (2003) ("[T]he Alternative Investment Market run by the London Stock Exchange reduces costs for small business issuers by requiring only a nominated broker and nominated adviser for trading and compliance purposes."); Stéphane Rousseau, *London Calling?: The Experience of the Alternative Investment Market and the Competitiveness of Canadian Stock Exchanges*, 23 BANKING & FIN. L. REV. 51, 60 (2007) ("AIM rules do not establish specific requirements to be met by companies seeking admission. Rather they require that every company seeking admission appoint a nominated advisor ('nomad') and a broker.").

232. LONDON STOCK EXCH., A GUIDE TO AIM 12 (2015), https://www.londonstock exchange.com/companies-and-advisors/aim/publications/ documents/a-guide-to-aim.pdf.

233. LONDON STOCK EXCH., AIM RULES FOR NOMINATED ADVISERS 8–10 (2014), http://www.londonstockexchange.com/companies-and-advisors/aim/publications/aim-rules-for-nominated-advisers.pdf [http://perma.cc/JVQ8-3VUX].

234. Jose Miguel Mendoza, *Securities Regulation in Low-Tier Listing Venues: The Rise of the Alternative Investment Market*, 13 FORDHAM J. CORP. & FIN. L. 257, 295 (2008) ("Specifically, Nomads bear significant damages for tolerating misdemeanors on behalf of their supervised companies, including the loss of 'reputational capital.'").

Applying the PIA model to 144B exchanges potentially solves the most serious problem faced by venture exchanges. Venture exchanges have a "market for lemons"[235] problem because companies typically use the venture exchange as a staging ground. The most successful companies on a venture exchange may transfer to a better-regarded exchange in order to signal that the company is of higher quality. But this also signals that the remaining firms on the exchange are of lower quality, which encourages the next best firms to leave that exchange in order to separate themselves from that pooling equilibrium. This creates a downward spiral that ends with only the lowest quality firms—the lemons—left on the venture exchange.

The PIA model solves the lemons problem by transferring the quality signal from the exchange to the PIA. Having a highly regarded PIA approve a company sends a strong signal about firm quality even if that firm is trading on an exchange of no repute. The firm no longer has to leave the exchange in order to separate itself from low quality exchange participants because the 144B exchange creates a reputation market for PIAs as well as firms.[236]

C. Application

A highlight of this Article's 144B proposal is that this rule can be promulgated by the SEC without an act of Congress. Generally, an agency may implement its delegated authority through rulemaking.[237] When Congress explicitly delegates to an agency rulemaking authority to effectuate a statute, "[s]uch legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute."[238] "[T]he [Exchange] Act conferred [broad,] open-ended rulemaking authority on the SEC."[239] The JOBS Act also granted specific rulemaking authority to the SEC to create new

235. *See generally* Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561 (2015).

236. This is similar to what has occurred in the AIM Nomad model. Mendoza, *supra* note 234, at 295–96 ("Accordingly, AIM can be considered a 'reputational market,' in which investors rely on the standing of Nomads as a proxy for the quality of listed companies, rather than on the market's regulation.").

237. *See* John F. Manning, *Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules*, 96 COLUM. L. REV. 612, 664 (1996).

238. Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 844 (1984).

239. Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 394 (1990) ("The sophisticated, interested participants in the debates, as well as the authors of the [Exchange] Act, understood that the Act conferred open-ended rulemaking authority on the SEC.").

exemptions to securities regulations.[240] General legal principles, rulemaking history, and specific statutory language demonstrate that the SEC is authorized to promulgate Rule 144B.

The SEC has authority to promulgate exemptions to securities regulations. The SEC promulgated the other exemptions to securities regulations—including Regulation D, Rule 144, and Rule 144A—under its rulemaking power.[241] The recent and similar exemption, Rule 144A, was proposed by the SEC and adopted pursuant to the SEC's notice-and-comment process, without any action by Congress.[242] That Rule has never been challenged for improper delegation or abuse of agency power.

It could even be argued that the SEC has an affirmative obligation to promulgate a venture-exchange, safe-harbor exemption. Section 503 of the JOBS Act stipulates that "[t]he Commission shall also adopt safe harbor provisions that issuers can follow when determining whether holders of their securities received the securities pursuant to an employee compensation plan in transactions that were exempt from the registration requirements of section 5 of the Securities Act of 1933."[243] This command seems to direct the SEC to promulgate rulemaking, allowing employees to resell their exercised stock options. The employee-stock resale exemption as mandated by Congress would be

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240. A. C. Pritchard, *Revisiting* "Truth in Securities" Revisited*: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1001 (2013) ("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.").

241. *See* James R. Doty, *Toward a Reg. FCPA: A Modest Proposal for Change in Administering the Foreign Corrupt Practices Act*, 62 BUS. LAW. 1233, 1234–35 (2007) ("Regulation D and Regulation S under the Securities Act of 1933, Rules 144, 144A and 415 thereunder, and Regulation M under the Securities Exchange Act of 1934 are all examples of SEC rulemaking intended to provide clarity and definition in connection with the requirements of the statutory scheme." (footnotes omitted)); *see also* Robert W. Tarun & Peter P. Tomczak, *A Proposal for a United States Department of Justice Foreign Corrupt Practices Act Leniency Policy*, 47 AM. CRIM. L. REV. 153, 170 (2010) ("Modeled after precedent SEC regulation such as Regulation D and Rules 144 and 144A, Reg. FCPA would establish a permissive filing regime, created through SEC rule-making . . . .").

242. Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6862, 46 SEC Docket 26 (Apr. 23, 1990) ("On October 25, 1988, the Commission proposed Rule 144A (the 'Rule') to provide a non-exclusive safe harbor exemption from the registration requirements of the Securities Act of 1933 (the 'Securities Act') for specified resales of restricted securities to institutional investors." (footnote omitted)).

243. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 503, 126 Stat. 306, 326 (2012) (codified as amended in scattered sections of 15 U.S.C.).

achieved by promulgating a rule like 144B. No such affirmative obligation mandated Rule 144A, so the SEC's authority for Rule 144B is even stronger.

CONCLUSION

This Article has explained why staying private is antithetical to democratizing startups. Yet even the law that specifically intends to democratize startups, the JOBS Act, has some provisions that encourage startups to stay private. This may seem schizophrenic, but staying private offers many economic advantages. Moreover, there are market forces beyond securities regulations that also encourage startups to stay private.

The problem is not that startups are staying private; rather, the problem is that securities laws have not adapted to this new reality. Staying private, in itself, is neither good nor bad. It is a trend that needs to be understood by scholars and applied to securities regulations. This trend is readily understandable in an environment where being public is quite expensive and burdensome. The law must produce bright-line solutions for staying private in an evolving economy. Otherwise, companies will find their own solutions in the shadows.

Securities regulations have not produced a coherent solution because there are trade-offs between forming capital, protecting investors, and democratizing startups. Staying private facilitates certain types of capital formation but frustrates the democratizing capability of startups. Enabling startups to stay private encourages concentrated capital formation. The flip side is that it discourages recycling capital in new and diverse enterprises. Capital formation may be enhanced by allowing new investors who are currently not permitted to buy private-company stock to invest in startups, but these investors are also the most susceptible to fraud, rational apathy, bounced rationality, and other cognitive failures. There has not yet been a solution that balances these equities in a resale market for private-company stock.

This Article suggests that a 144B safe-harbor exemption—a rule that the SEC can promulgate without an act of Congress—provides for an "independent analyst" to monitor and safeguard investments and strikes an acceptable balance. Without a resale exemption, small, private-company stockholders face many disadvantages. Yet a resale exemption subjects those same small stockholders to the risk of fraud-on-the-market. One solution is to create a resale exemption that

balances sufficient investor protections with limited disclosure requirements. The development of liquid, transparent, and fair 144B exchanges for the transaction of private-company stock could facilitate recycling of capital and promote democratizing startups.

An exemption like 144B expressly contemplates the development of multiple private-stock exchanges. Exchanges can experiment with various levels of disclosure requirements and investor protections. The result could be a market for stock markets where issuing startups, stockholders, and investors can shop around for the optimal mix of sunlight and efficiency. This flexibility would help to keep securities regulations from becoming quickly outdated as the nature of investment changes. The SEC could retain the right to permit only certain types of investors into certain markets based on risk of the exchange, amount of investment, sophistication of investor, age of the issuing company, or other factors. The concern for the SEC is to avoid creating new financial asymmetries by giving the wealthiest investors exclusive access to the best markets, as it did with Rule 144A.

Modernizing securities regulations to protect investors while capitalizing the future of innovative startups requires a deeper review of the entire body of securities regulation, which is beyond the scope of this Article. For example, the accredited investor standard, which is based solely on wealth, could potentially be replaced by a more nuanced standard of investor sophistication. Modern technology, like online feedback tools and reputation networks, could provide novel solutions to eighty-year-old securities regulation problems.

Promulgation of Rule 144B could signal the beginning of the SEC's recognition of a paradigm shift in business associations. By implementing a rule designed for the continued operation of large, private companies, the academy and the regulators can start to reform the securities regulations to accommodate the modern reality of staying private. More and more companies choose to be large, widely-held organizations that never intend to go public, and our securities regulations need to account for this new reality.