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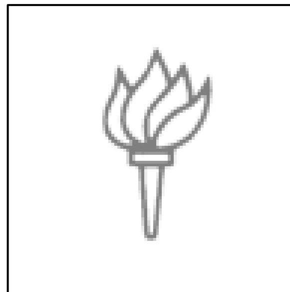

All Stick and No Carrot? Reforming Public Offerings

Stephen J. Choi and Adam C. Pritchard

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Abstract: The SEC heavily regulates the traditional initial public offering. Those regulatory burdens fuel interest in alternative paths for private companies to go public, "regulatory arbitrage." The SEC's response to the emergence of alternatives, most recently SPACs and direct listings, has been to suppress them by imposing heightened liability under Section 11 of the Securities Act. The SEC's treatment of the traditional IPO regulatory process as a one-size-fits-all regime ignores the weaknesses of this process, in particular the informational inefficiency of the book-building process. In this essay we argue that the agency's focus in regulating issuers going public should be on promoting market pricing driven by sophisticated investors with access to credible disclosure. We propose an alternative approach that provides issuers with a clear choice in going public: 1) provide disclosures for a seasoning period prior to listing their securities for public trading, with corresponding reductions in regulatory requirements for going public (the "carrot"); or 2) impose heightened liability on company's going public without a seasoning period, not only for registration statements, but also for the company's periodic disclosures released during a post-offering seasoning period (the "stick"). We argue that such a regime would push issuers to maximize the joint welfare of both issuers and investors.

Why do companies go public? The standard answer is to raise capital. Companies also go public, however, for reasons other than raising money, most importantly to create a liquid secondary market for their shares. Spotify, for example, went public through a direct listing onto the New York Stock Exchange and raised nothing. A liquid secondary market like the New York Stock Exchange allows insiders and other early-stage investors to sell shares, rewarding them for their efforts in building a company. Having liquid securities also facilitates a company's use of its shares as consideration to acquire other companies. Public company status may also raise a company's public profile and enhance its credibility with customers and suppliers. Thus, the path to public status is important regardless of whether the company needs to raise capital.

Why do investors buy shares in initial public offerings? The standard answer is that they seek a vehicle providing returns in the form of dividends and capital gains. Those returns can be used for future consumption. But the evidence is substantial that investing in IPOs—at least after the shares begin trading in the secondary market—is a money-losing proposition on average, at least when compared with investing in a broad-based market portfolio.[1] The motivation for investing in IPO stocks, therefore, cannot be explained as an effort to maximize returns. The most plausible explanation is that investors are looking not simply to keep pace with the market, but rather, an investment opportunity with the potential for lottery-ticket type returns.[2] Risk and return are inevitably linked, however, so for every IPO stock

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[1] See Honghui Chen, Minrong Zheng, IPO underperformance and the idiosyncratic risk puzzle, 131 Journal of Banking and Finance 1, 1-2 (2021); Jay Ritter, The Long-Run Performance of Initial Public Offerings, 46 Journal of Finance 3, 4 (1991).

[2] See Chen and Zheng, supra note 1, at 2 (providing evidence of "investors' preferences for stocks with lottery features" in an initial public offering).

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generating supra-normal returns, there will be a substantial number that disappoint. Those inevitable disappointments are a key driver of efforts to regulate the process of going public. Investor protection is an uphill effort when investors refuse to protect themselves through low-cost diversification.

How do companies go public? The securities laws provide a limited range of choices. The traditional IPO was once the dominant path to raising capital for a growing company, but challengers to that dominance have emerged in today's securities markets. Issuers may go public through a reverse merger with a pre-existing public company, or a variant of the reverse merger involving a special purpose acquisition company (SPAC) offering securities in a public offering followed by a "de-SPAC" merger with a private company. Issuers may also go public by directly listing onto a securities exchange like Spotify did. The direct listing allows investors to sell securities previously sold by the issuer through a private placement. Indeed, (some) investors can trade privately placed securities in off-exchange secondary markets even without a direct listing, after sufficient time has passed since the initial private placement. The creation of private markets for institutional traders has the potential to erode some of the liquidity advantages of the exchanges, but trading in those venues remains limited at best. A direct listing on an exchange still offers far greater liquidity than private markets.

How should we assess the going public choices available to private issuers under the federal securities laws? We argue that the regulation of public offerings should seek to facilitate the transition from private company to public company – including the use of alternatives to traditional IPOs – when this transition maximizes the joint welfare of investors and the issuer.[3] Although the SEC frequently invokes investor protection as the goal of securities regulation, investors bear the cost of regulation too – investors do not benefit from regulation that is excessive or inefficient. Securities regulation that leads to more accurate prices and more robust capital markets benefits investors, but also others, including employees, competitors, and the overall economy, so there are clearly externalities.[4] Nonetheless, focusing on the joint welfare of issuers and investors allows the identification of going public alternatives that, because they are likely to maximize this joint welfare, have the potential to also maximize social welfare. Alternatives to the traditional IPO that do not maximize even the joint welfare of issuers and investors – the parties to the bargain – are unlikely to maximize social welfare. Identifying situations in which market forces may fail to maximize joint welfare will help guide the SEC in reserving heavy-handed regulatory protections for those contexts.

A lighter regulatory touch may be appropriate if markets have efficient price discovery. Efficient pricing gives some assurance that the choice of a going public alternative benefits both issuers and investors. To identify efficient pricing, we start with the end: the public company. What attributes of a public company promote investor protection? Shares of a public company listed on a national exchange with sufficient market capitalization and trading volume attract the attention of institutional investors and analysts. That is the paradigm for informationally-efficient securities markets, fueled by both mandatory disclosures filed with the SEC pursuant to the Securities Exchange Act of 1934 (Exchange Act) and voluntary disclosures made by companies seeking to bolster the liquidity of their shares. Those markets are dominated by sophisticated investors who rapidly incorporate new information into market prices,

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[3] Others have taken this approach in assessing the value of securities regulatory protections. See Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2366-67 (1998) ("Regulatory competition is desirable because when the choice of investments includes variation in legal regimes, promoters of firms will find that they can obtain a lower cost of capital by choosing the regime that investors prefer.… Promoters thus will bear the cost of operating under a legal regime inimical to investor interests, and they will therefore select the regime that maximizes the joint welfare of promoters and investors.").

[4] See Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment, 85 Va. L. Rev. 1335, 1345-46 (1999).

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hoping to profit by trading in volume in response to the flow of information. Issuers benefit from these informationally efficient markets in the form of a reduced cost of capital. Retail investors benefit by free-riding on the efforts of the sophisticated investors who are setting the market price for the stock of publicly-traded companies.

The argument for choice is strongest when markets are informationally efficient. Issuers that eschew regulatory protections that benefit investors more than they cost issuers will face a higher cost of capital. Issuers that seek to maximize the price they obtain in an offering will thus have an incentive to adopt value-increasing regulatory protections. Institutional investors will price those protections into their valuations. An informationally-efficient secondary trading market is the closest we can come to a free lunch in the field of investor protection, particularly for retail investors. But getting there is tricky.

Consider a private company, selling securities in private placements which subsequently trade in private markets. Private markets suffer from thin trading, and thin trading discourages the production of useful information. Individual investors are generally excluded from such markets in the name of investor protection, and many institutional investors are wary of them as well, deterred by the poor information environment. Private issuers that choose not to adopt value-increasing regulatory protections in such a market may receive a pricing penalty, but it will be a fuzzy signal at best, given the overall lack of information about the issuer. Giving such a private company a free pass to becoming a public company by listing its stock for trading on a national securities exchange, without any regulatory requirements, may expose investors to unwarranted risk. The concern is that less sophisticated investors may dominate trading after listing. Their valuations may reflect a lottery mentality, rather than the rigorous analysis we associate with professional investors.

The traditional IPO attempts to bridge the gap between private and public with a heavy dose of regulation. The SEC tightly controls this process with a focus on investor protection. In a traditional IPO, a private company sells shares following a restrictive “gun-jumping” process under the Securities Act of 1933 (Securities Act) that includes a quiet period prohibiting – absent an exemption – communications which may “condition the market” for the company’s securities. The company drafts a mandatory disclosure document, the registration statement, providing audited financials, a description of its business, executive compensation disclosures and much more. The SEC will review the IPO registration statements and provide comments. If the company refuses to cooperate, the SEC can terminate the effectiveness of a registration statement with a stop order if it contains a material misstatement or omission. For misstatements that get past the SEC, heightened liability under Section 11 awaits the company and its officers and directors. Liability also extends to the professionals who assist the company, including underwriters.

Some issuers may find the traditional IPO too slow or costly. Heightened liability under Section 11 may lead to more nuisance suits against issuers, underwriters, and others involved in the offering. The value for investors of the traditional IPO regulatory scheme is also questionable in modern markets. It is unclear why the SEC needs to mandate a quiet period if most investors in an IPO are institutional investors, which was not the case in 1933.[5]

This heavy-handed regulation, all done in the name of investor protection, produces a market that seems rigged to benefit investment banks and their institutional investor clients. Investment banks extract a healthy commission ranging up to 7% of the IPO offering amount for their services shepherding

[5] Indeed, over the past two decades, the SEC through rulemaking has reduced quiet period restrictions on disclosure. Under Rule 163B promulgated in 2019, for example, an issuer may condition the market in communications with qualified institutional buyers and institutional accredited investors during the public offering process. See Rule 163B, Securities Act.

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companies through the going public process.[6] In exchange, the investment banks act as gatekeepers to the public markets, serving the merit-regulation role denied to the SEC by Congress when it adopted the Securities Act. The underwriters allocate the offered shares mainly to institutional investors, who benefit from the traditional underpricing of shares.[7] Issuers pay the cost of this underpricing, "leaving money on the table." The fact that underpricing is well-known, but still recurring, calls into question the informational efficiency of the book-building process for IPOs.[8] Retail investors are generally relegated to buying newly-listed shares in the frothy secondary market, where the long-term returns are typically disappointing.[9] So even the heavy-handed regulation of the traditional IPO does not prevent retail investors from getting the short end of the stick.

Given these limitations of the traditional IPO model, we believe there is room for innovation in the process of going public. Providing alternative paths to public status may allow more issuers to raise funds at a lower cost or with greater speed, potentially spurring economic growth. The SEC worries, however, that issuers going public through a non-traditional alternative may increase the risk to investors. An issuer may avoid a traditional IPO to evade the scrutiny of the SEC and underwriters. Opportunistic issuers may misrepresent the value of their securities to investors. These problems are exacerbated if institutional investors are reluctant to participate in alternative paths to public company status. The SEC focuses on these downsides, making the agency less than enthusiastic about incursions into the traditional IPO's market dominance. The SEC dictates the complicated regulatory regime governing traditional public offerings. Naturally, the agency views that paradigm as the gold standard.[10] The agency's default response has been to increase liability and other regulatory requirements to bring regulatory equivalence for alternatives and the traditional IPO.[11] From an investor protection perspective, there are legitimate concerns that opportunistic issuers with thinly traded securities can take advantage of less sophisticated investors. In that scenario, choice for issuers can harm investors and the capital markets. But the

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[6] Walid Y. Bushab & Felipe Restrepo, The "7%" solution" and IPO (under)pricing, 144 J. Fin. Econ. 953, 952 (2022) (finding that 94% of IPO issuers in their sample from 1996 to 2018 paid underwriters a 7% commission); Hsuan-Chi Chen & Jay R. Ritter, The Seven Percent Solution, 55 J. FIN. 1105, 1108-12, 1130 (2000) (finding that IPO underwriting commissions concentrated around 7% of deal value may reflect implicit collusion). Very large companies (over $500 million) going public have been able to negotiate a lower rate. See, e.g., Allistair Barre & Alexei Oreshovic, Facebook underwriters to get 1.1 percent fee: source, Reuters (March 19, 2012).

[7] Underpricing is defined as the percent difference between the secondary market price of a company at the close on the first day of trading after an IPO and the IPO price. See Jay R. Ritter & Ivo Welch, A Review of IPO Activity, Pricing, and Allocations, 57 Journal of Finance 1795, 1796-97 (2002) (reporting that IPOs between 1999 and 2000 were underpriced by 65%).

[8] Underpricing may still be optimal for the issuer and underwriter. For example, the issuer may accept underpricing to reduce the exposure to Section 11 liability. That may be benefit the issuer overall, but it comes at the expense of distorted pricing.

[9] See Jay R. Ritter, The Long-Run Performance of Initial Public Offerings, 46 Journal of Finance 3.

[10] For example, when the SEC proposed new rules to increase the level of regulatory protections for IPOs conducted by SPACs, Gary Gensler, the SEC Chair, stated that: "Functionally, the SPAC target IPO is being used as an alternative means to conduct an IPO. Thus, investors deserve the protections they receive from traditional IPOs, with respect to information asymmetries, fraud, and conflicts, and when it comes to disclosure, marketing practices, gatekeepers, and issuers." See SEC Press Release 2022-56, March 30, 2022 (available at https://www.sec.gov/news/press-release/2022-56).

[11] Others also take the goal of regulatory equivalence as their paradigm, deeming the regulatory protections in a traditional IPO as the standard and then assessing other types of offerings in comparison with this standard. See, e.g., Andrew F. Tuch & Joel Seligman, The Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers, and Direct Listing, 108 Iowa L. Rev. 303 (2023) (assessing regulatory protections for investors, including Section 11 liability, in SPACs and direct listings in comparison with traditional IPOs as the standard).

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traditional IPO is not great for retail investors, and it has its own deficiencies in promoting accurate pricing, which we discuss in greater detail below.

In this essay, we take a fresh approach.[12] Rather than attempting to assess directly the costs and benefits to issuers and investors of alternative methods of going public, we analyze whether issuers internalize those costs and benefits. An alternative that reduces the regulatory protections in the traditional IPO may still be efficient if the issuer internalizes potential benefits and costs to investors, that is, maximizes joint welfare. Informational efficiency is the key driver here. If investors are rational and informed, they will pay more for securities to reflect the value of applicable protections. Issuers maximizing proceeds will internalize this value to investors because they can charge more for securities. In contrast, if less sophisticated investors in the market bear the risk and costs because the market is not informationally efficient, issuers will not internalize those risks and costs. In that scenario, there is no assurance that the alternative path to going public improves the joint welfare of issuers and investors or overall social welfare. Issuers may choose alternative methods of going public because unsophisticated investors are unable to price protections – or the absence thereof – and implicitly subsidize the issuers' choice. Thus, the presence of institutional investors helps ensure that the transition from public to private maximizes joint investor and issuer welfare.

We proceed as follows. In Part I, we evaluate the strengths and weaknesses of the existing regulatory approach. Part II lays out a framework for evaluating different paths to public company status. Part III looks at the alternatives to the traditional IPO that have recently arisen and the SEC's responses to "regulatory arbitrage."[13] In Part IV, we outline an alternative regulatory approach focused on minimizing the costs of transition from public to private. Issuer choice plays a role in our proposed alternative, but our proposal harnesses that choice to promote investor protection and capital formation.

I. Regulatory Structure

One could imagine a regulatory regime that required companies going public to do so only through a traditional IPO. But this is not the regime we have today. Instead, the Securities Act takes a transaction-specific approach to regulation. That approach, in conjunction with alternative paths to public company status under the Exchange Act, gives issuers a degree of choice in how to go from private to public. The choice in how to go public is more an artifact of the focus in the securities laws on transactions rather than a deliberate method to maximize issuer and investor welfare.

Enacted in response to perceived abuses by issuers and promoters that preceded the Great Depression, the Securities Act focuses on offers and sales of securities by issuers, referred to as primary market transactions. The focus on primary market transactions is embodied in Section 5 of the Securities Act, which prohibits sales of securities by "any person" unless a registration statement is in effect. The phrase "any person" includes the issuer. Section 5's prohibition is the foundation for the regulatory requirements imposed on a traditional IPO. Section 5 requires that the issuer file a registration statement with the SEC, as well as comply with process rules, including the quiet period, before offering securities.

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[12] Others have argued against the SEC's strategy of imposing traditional IPO-style regulations on alternatives to the traditional IPO. See Usha R. Rodrigues and Michael Stegemoller, Why SPACs: An Apologia (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4072834) ("SPACs thus offer a new opportunity to interrogate a basic presumption underpinning the IPO process—namely, that to protect retail investors we need an underwriter, to which we assign strict liability under Section 11 of the 1933 Securities Act.")

[13] See, e.g., SEC Rel. 34-96443, at 32 (Dec. 2, 2022) (expressing concern about "regulatory arbitrage" for direct listings done without an underwriter).

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Sales may take place only after the SEC declares the registration statement effective.[14] Heightened liability for material misstatements and omissions in the registration statement and prospectus apply pursuant to Sections 11 and 12(a)(2) of the Securities Act, but these apply only in connection with public offerings.[15]

The flipside of the Securities Act's focus on the issuer's primary market transaction is that the statute's regulatory reach largely ends after that market transaction is complete, whether through a traditional IPO or an exempt offering. Investors trading the securities in the secondary market are only lightly regulated. The treatment of secondary market transaction results from the interaction between the universal prohibition of Section 5 and the nearly as broad exemption provided by Section 4(a)(1) of the Securities Act. Section 5's requirement of an effective registration statement for a sale of securities applies to "any person," including investors selling in the secondary market. For an investor unable to obtain the issuer's cooperation, the investor is unlikely to have the resources or access to information necessary to create a registration statement, making the resale unlawful under Section 5. Section 5 – on its face – effectively prohibits secondary market resales. Section 4(a)(1), however, negates that broad reach by exempting transactions that do not involve an "issuer, underwriter, or dealer" from Section 5. The key to Section 4(a)(1)'s application is whether the transaction is separate from the issuer's transaction. So long as a secondary market trade is separate from the issuer's initial primary market transaction, and does not involve a person in a control relationship with the issuer (an "affiliate"), Section 4(a)(1)'s exemption allows the seller to avoid Section 5's implicit prohibition against resales. For example, any resales that occur after the initial distribution in a registered public offering are deemed separate from the issuer's public offering transaction.[16]

The connection between Section 4(a)(1) and the freedom of investors to sell in the secondary market is not affirmatively stated in the language of Section 4(a)(1). Section 4(a)(1) exempts resales from Section 5's prohibition if there is no issuer, underwriter, or dealer participating in a resale. The negative implication is that others, exempted from Section 5's *prohibition*, are *affirmatively allowed* to resell. An unquestioned premise within the securities laws is that if a resale is not prohibited under Section 5, then unrestricted resales are allowed. The upshot is that the SEC's regulatory leverage is maximized at the point when the agency controls access to the primary markets through the prohibition of Section 5. After the securities have made their way to public trading, the SEC's authority is much reduced. This creates an incentive for the SEC to make the most of the regulatory leverage afforded by Section 5.

That premise of free resale in the secondary markets is reinforced by the sequential adoption of the principal securities laws. Congress followed the Securities Act with the Exchange Act a year later. The Exchange Act deals explicitly with the secondary markets. Absent some now discarded constitutional limitations, Congress could have used the Exchange Act to address the question of when resales should be allowed in the secondary market. But the Exchange Act is silent on the topic of resales, absent fraud or manipulation. Instead, the Exchange Act focuses on identifying "public" companies, referred to as Exchange Act reporting issuers or simply "reporting issuers," based on three standards: 1) a prior public offering through an effective registration statement,[17] 2) passing certain minimum thresholds for total assets and number of shareholder,[18] and 3) listing on a national securities exchange.[19] (Companies doing an IPO typically trigger all three.) The Exchange Act imposes periodic disclosure requirements on reporting

[14] See Section 8(a), Securities Act; Rule 473, Securities Act.
[15] Gustafson v. Alloyd Co., Inc., 513 U.S. 561 (1995) (holding that § 12(a)(2) applies only to public offerings). Section 11 only applies to misstatements in a registration statement, which is only required for public offerings.
[16] See Stephen J. Choi and A.C. Pritchard, Securities Regulation: Cases and Analysis 775 (5th Ed. 2019).
[17] Exchange Act § 15(d).
[18] Exchange Act § 12(g).
[19] Exchange Act § 12(a), (b).

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issuers, applying largely uniform disclosures for most public companies.[20] For a U.S. domestic issuer, this includes annual Form 10-K and quarterly Form 10-Q filings. In addition, issuers must file Form 8-K disclosures upon certain specified events, such as a change in control. To ensure accuracy of disclosures, the Exchange Act also applies antifraud liability under Rule 10b-5 to all companies for material misstatements and omissions in connection with the purchase or sale of securities. Rules 10b-5's prohibition of materially misleading statements is enforced by both the SEC and private securities fraud class actions. Over time, the SEC has come to recognize that the information provided in the Exchange Act's periodic filings is the equivalent to that found in a registration statement. That recognition has been followed by a great relaxation of disclosure requirements for seasoned issuers through "incorporation by reference." If Exchange Act disclosures already inform the market, the disclosure mandated by the Securities Act offer little marginal benefit.

The Exchange Act's three standards for a public company, combined with the transaction-based regime under the Securities Act, corresponds with three choices available to issuers in how to go public.

1. An issuer can go public through a traditional IPO with an effective registration statement, complying with the regulatory requirements of Section 5 of the Securities Act.
2. An issuer can go public indirectly through a private placement – exemptions under Section 4(a)(2) of the Securities Act and Regulation D[21] – followed by secondary market resales to the general public, after sufficient passage of time to deem the resales as separate transactions.
3. A direct listing of securities, with early investors selling previously privately placed securities onto a national securities exchange such as the New York Stock Exchange or Nasdaq.

These three routes track the standards for public company status under the Exchange Act. Regardless of the route taken, once a company is public, the securities laws take a largely one-size fits all approach, applying the same mandatory disclosures and antifraud liability under Rule 10b-5 to most public companies.[22]

The transaction-based regime also allows issuers – with some creative corporate lawyering – to go public through a fourth method involving a merger. Suppose Company A sells shares through a traditional IPO. Thereafter, Company A's shares are freely tradeable in the public secondary market. Company B, a private company, can then go public by simply merging into Company A, leaving Company A as the public surviving company with the business of Company B now part of Company A. If Company A is a shell company, post-merger the business of Company A consists entirely the business of Company B. This path to going public is called a "reverse merger." If Company A is a Special Purpose Acquisition Company (or SPAC) and contains funds that will benefit the target company post-merger then this way of going public is called a "de-SPAC merger." In both cases, investors who purchase shares of Company A, either prior to or after the merger, end up holding securities after the merger that depend on the assets and operations of the former private Company B. The freely tradeable securities of Company A now depend on the underlying cash flows generated by Company B.

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[20] Exchange Act § 13(a).

[21] Other exemptions under Section 4 include crowdfunding offerings under Section 4(a)(6) of the Securities Act and the SEC's Regulation Crowdfunding. Section 3 of the Securities Act provides for exempt securities and gives the SEC authority to establish through rulemaking exempting small issues.

[22] Congress has lightened the burden for "emerging growth companies," and the SEC makes some accommodation for foreign issuers and smaller companies. Of course, these companies arguably pose a higher risk of fraud as they are apt to have less robust control systems.

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II. A Framework for Analysis

To assess the various ways to go public, let's start with the traditional IPO pursuant to Section 5 of the Securities Act as our benchmark. The traditional IPO typically takes place through a firm commitment offering with several Wall Street investment banks act as underwriters. These banks take on the risk of the offering because they are purchasing directly from the issuer before reselling to investors. By putting their own money at risk in the offering, underwriters certify that the offering is of sufficient quality that the underwriters are willing to take title to the securities during the offering.[23] The underwriters minimize that risk, however, by assembling a "book" of investors to whom the underwriters immediately resell the offered securities. In addition, to obtain a due diligence defense to possible Section 11 liability for material misstatements or omissions in the registration statement, investment banks acting as underwriters, and associated entities including auditors and attorneys, will investigate the issuer and the accuracy of its disclosures prior to the public offering going effective.[24]

The goal of the procedures used in the traditional IPO is to protect investors, particularly the unsophisticated. The concern leading to the enactment of the Securities Act was that investors, eager for the prospect of quick gains after an IPO, may go into a speculative frenzy, ignoring disclosures and making ill-advised investment decisions.[25] By making issuers go public through a process that limits disclosures that condition the market, the public offering process may encourage investors to focus on the mandatory disclosures in the registration statement. With the benefit of mandatory disclosure, investors may then make reasoned investment decisions, discouraging speculative frenzies. The certification from underwriters in a firm commitment offering may provide further assurance for investors that IPOs are

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[23] *See* William K. Sjostrom, Jr., Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?, 53 Fla. L. Rev. 529, 581 (2001) ("A key role served by an underwriter in a traditional IPO is that of certification intermediary."). But see Iris Tan, Disintermediation of the IPO Industry: The Viability of Auctioned IPO as an Alternative Under the Changing Underwriting Paradigm, 15 Va. L. & Bus. Rev. 271, 308 (2021) (arguing that: "The recent decline of the underwriting practice and the shattered reputation mechanism make the signaling mechanism much less effective than before. It is not rare that many IPO regulatory incompliances by issuers were aided and abetted, or directly caused, by agents who were supposed to keep the gate of the IPO market.").

[24] For a discussion of Section 11's due diligence defense and how the defense encourages investigation by the underwriters, auditors, and attorneys in a traditional IPO, see Tuch and Seligman, supra note __, at p. 13-14 ("Section 11 nonetheless assures that the expertise of multiple gatekeepers is brought to bear in the cause of deterring corporate misconduct.").

[25] Felix Frankfurter, The Federal Securities Act: II, Fortune, Aug. 1933, at 53, 54 ("During the height of the greatest speculative carnival in the world's history, billions of new securities were floated, of which a large part had no relation to the country's need and which inevitably became worthless; worthless not merely for millions who had sought speculative gains, but for those other millions who sought to conserve the savings of a lifetime. By all the subtle and mesmerizing arts of modern salesmanship, the sellers of securities had so extended the field of security buyers that 55 per cent of all savings ... went into publicly marketed securities."). See Bloomberg News, A Speculative Frenzy is Sweeping Wall Street and World Markets, Bloomberg December 19, 2020 ("Animal Spirits are famously running wild across Wall Street, but crunch the numbers and this bull market is even crazier than it seems.") (available at https://www.bloomberg.com/news/articles/2020-12-19/a-speculative-frenzy-is-sweeping-wall-street-and-world-markets#xj4y7vzkg). One could also argue that the run up in crypto currency during the COVID pandemic was due to a speculative frenzy. See Yakob Peterseil and Joanna Ossinger, Speculative Frenzy Spills into Crypto as Bitcoin Tests Highs, Bloomberg, January 28, 2021 (available at https://www.bloomberg.com/news/articles/2021-01-28/bitcoin-s-wild-ride-accelerates-with-push-back-above-33-000#xj4y7vzkg). Often, speculative frenzies do not end well for investors. See Clem Chambers, Bitcoin to $0? Crypto Crash of 2022, Forbes, June 23, 2022 (available at https://www.forbes.com/sites/investor/2022/06/23/bitcoin-to-0-crypto-crash-of-2022/?sh=5138512e7873).

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priced fairly. This falls short of direct merit regulation of offerings by the SEC, but it does put a heavy regulatory thumb on the scale.

Are the protections afforded investors through a traditional IPO worth the cost? Issuers may take several months to go through a traditional IPO. Most investors in a traditional IPO today are institutional investors, who were not a significant presence in the 1920s market. Mutual funds and other institutions are not generally associated with speculative frenzies. Why should we limit disclosure in a quiet period if the "smart money" establishes the market price?[26] Moreover, heightened liability under Section 11 may not be necessary to protect institutional investors who can: 1) assess the accuracy of disclosure, and 2) punish underwriters who sponsor fraudulent companies by refusing to invest in future offerings. In this case, the cost to the issuer of heightened liability, including the possibility of nuisance litigation, may outweigh the benefit to investors. The delay imposed on issuers, the prospect of increased legal liability, and the costs of an underwritten offering may cause some issuers to avoid the traditional IPO.

The principal benefit today of the regulatory approach for the traditional IPO may be the de facto exclusion of individual investors from the pricing process. Markets dominated by individual rather than institutional investors suffer from informational inefficiency. For example, individual investors dominate trading in "penny stocks," defined by their small market capitalization. These shares trade in the over-the-counter market rather than a national exchange. Those markets, ignored by institutional investors, are notorious for their vulnerability to fraud and manipulation. The SEC, along with FINRA, spends considerable enforcement resources chasing after the pump-and-dump schemes that recur in the market for penny stocks. Allowing retail investors to dominate the IPO process would raise similar investor protection concerns. Retail investors – the "dumb money" – may distort pricing for public offerings. Of course, the de facto exclusion of retail investors from IPO allocations, while perhaps promoting more efficient price discovery, means that there will be pent-up retail demand when the secondary trading market opens. That demand potentially fuels the large increases in share prices after the IPO. This creates an opportunity for a different type of distortion – issuers leaving "money on the table" – and a systematic wealth transfer from retail investors, buying potentially overvalued shares, to institutional investors, "flipping" the shares into the secondary market.[27]

Ultimately, how we view alternatives to the traditional IPO turns on the value of giving issuers choice in how they go public. The choice we have today is not the product of a careful balancing of the pros and cons of choice but instead is the happenstance product of our transaction-focused regime devised in 1933. Choice in such circumstances can certainly decrease the joint welfare of issuers and investors. Not all issuers have value-increasing projects. Opportunistic issuers may misrepresent the value of their projects, defrauding unsuspecting investors. Those unsuspecting investors may well be retail, rather than institutional. The risk of opportunism gives the SEC political credibility in its efforts to constrain alternatives to the traditional IPO. The SEC's reaction when promoters use this choice is to eliminate choice and impose traditional IPO style protections. That response, however, ignores that choice can sometimes increase the joint welfare of issuers and investors. Choice allows issuers unhappy with the traditional IPO easier access to the U.S. capital markets. Issuers with value-increasing projects who cannot afford the traditional IPO process would benefit from this access. Moreover, the exit option provided by

[26] Indeed, the SEC has recognized the costs of limiting disclosure to institutional investors during the quiet period of an IPO. In 2019, the SEC promulgated Rule 163B that allows an issuer, and those working on the issuer's behalf, to communicate to institutional accredited investors and qualified institutional buyers on a public offering. Such communications are nonetheless subject to heightened liability under Section 12(a)(2) of the Securities Act. See Rule 163B, Securities Act.

[27] Christine Hurt, Moral Hazard and the Initial Public Offering, 26 Cardozo L. Rev. 711, 715-716 (2005).

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IPO alternatives constrains Congress and the SEC from unduly burdening the public offering process with excessive regulation.

We propose a framework to determine when choice is good or bad. In assessing whether issuers should have choice in how to go public, we could try to compare the costs and benefits to issuers and investors for the traditional IPO against alternatives. Such a comparison, however, is no easy task. It might be easier to ask a related question—do we have confidence that the market interactions of the issuer, investors, and other market participants will result in the issuer internalizing the costs and benefits of regulatory protections for investors? In other words, do we think the regulatory protections will be efficiently priced? If so, then if the issuer chooses an alternative to the traditional IPO that reduces investor protections, we can expect that this choice will reflect a calculation that the issuer's costs from the traditional IPO outweigh the benefits to investors. Thus, the alternative would maximize the joint welfare of the issuer and investors. If the issuer does not internalize all the costs and benefits, then we lack confidence that this choice increases the joint welfare of the issuer and investors. Without internalization, an issuer may choose to go public in a non-traditional manner at the expense of investors in the market: a wealth transfer. If such non-wealth generating transactions became the norm, investor participation would likely decline, thereby discouraging capital formation.

The two principal factors affecting whether the issuer will internalize the costs and benefits of protections for investors are: 1) the type of investors purchasing the offering, and 2) the information environment for the issuer. These factors are related. Institutional investors assessing a public offering have the financial sophistication to assess the value of regulatory protections and will – through their analysis, information sharing, and trades – generate a robust information environment. Such investors will discount the securities of issuers that do not provide adequate protections, thereby causing issuers to internalize the loss to investors from inadequate protections.

The presence of an existing information environment that incorporates the value of investor protections into the market price for an issuer's securities will also protect retail investors. Such a "thick" information environment typically follows when many investors own the issuer's shares, analysts follow the company's disclosures, and the public is familiar with the company. In an offering, the issuer may need to sell to institutional investors to raise sufficient capital for its projects; selling only to unsophisticated investors constrains the capital available. The need to sell to institutions will induce the issuer to reflect the available (or absent) regulatory protections in the offering price. Institutional investors will pay less for securities that lack value-increasing protections. That market pricing will cause the issuer to internalize the value of such protections. The thick information environment encourages the issuer to adopt investor protections that the market values more than their cost to the issuer, notwithstanding the presence of unsophisticated investors who may be incapable of accurately pricing those protections. For an issuer in a thick information environment with a liquid secondary market for its securities, omitting regulatory protections will depress the market price for the securities, leaving the issuer with smaller proceeds.

Although sophisticated investors and a thick information environment may lead issuers to internalize the value of investor protections, what happens in a market dominated by unsophisticated investors with little information about the company? In this case, there is no assurance that market forces will lead an issuer to adopt regulatory protections that increase the joint welfare of the issuer and investors. Particularly if unsophisticated investors end up bearing the cost of risky or fraudulent securities, we might worry that issuers do not internalize these costs. Issuers might pursue a going public transaction that lacks the protections of the traditional IPO as a wealth transfer. In that scenario, the unsophisticated investors in effect subsidize the issuer's savings from avoiding the costly regulations of the traditional IPO.

With this framework in hand, let's assess the alternatives to the traditional IPO in today's capital markets and how the SEC has responded to those alternatives.

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Part III. Alternatives to IPOs

A. Private Placements and Direct Listings

From the beginning, the federal securities laws provided issuers a choice between a traditional IPO and a private placement exempt under Section 4(a)(2) of the Securities Act. How do we assess the choice between traditional IPOs and private placements? Rather than impose mandatory disclosure, process rules, and heightened liability provisions, private placements rely instead on investors who can "fend for themselves." In *Ralston Purina*, the Supreme Court justified the focus on whether investors can fend for themselves, writing that "exempt transactions are those as to which 'there is no practical need for . . . [the bill's] application'."[28] If investors can fend for themselves, they should have the financial sophistication to price the value of regulatory protections, including disclosure, just as they price expected future cash flows. Issuers, in turn, will internalize both the costs and benefits of regulatory protections and voluntarily adopt measures, such as disclosure, that investors value more than the cost to the issuer, thereby maximizing the joint welfare of the issuer and the investors. The private placement, at least in theory, places choice in the hands of issuers that, because of internalization, will have incentives to maximize the joint welfare of the issuer and investors.

The key to this happy scenario is identifying investors who can "fend for themselves." That is no small task. Does sophistication turn on education, work experience, investment experience, investment success, or some combination of these factors? Through rulemaking, the SEC has provided a safe harbor for private placements in Regulation D. Ostensibly implementing *Ralston Purina*'s "fend for themselves" formulation, Regulation D focuses on whether an investor is an "accredited" investor. Issuers are allowed to sell securities to an accredited investor under Rule 506 of Regulation D without an individual assessment of the investors' knowledge and experience in investing. For non-accredited investors, in contrast, the issuer must assess investment ability individually.[29]

Accredited investors include a variety of entities including various institutional investors such as mutual and pension funds. Accredited investors also include certain individuals for whom sophistication is more questionable. For purposes of this essay, however, we assume (like the SEC) that accredited investors are in fact sophisticated. If the initial sophisticated investors in a private placement hold onto their shares indefinitely, then we could stop our analysis here. The private placement would result in shares in the hands of (hopefully) sophisticated investors and the company would not have used the private placement to go public indirectly. But the initial investors will not want to hold their share indefinitely. Indeed, a permanent ban on resales by the initial investors would result in few willing investors to purchase in a private placement in the first place. Securities are a store of value, not a trophy.

With respect to resales, issuers again have a choice. An issuer can register resales by the initial investors as a secondary public offering pursuant to Section 5 of the Securities Act, thereby allowing unrestricted resales to the public. Some investors in private placements negotiate for registration rights that require the issuer to register resales. In a registered secondary public offering, an issuer must comply with similar regulatory requirements as in a traditional IPO.

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[28] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

[29] There is no limit on dollar amount or limit on the number of accredited investors to which an issuer may sell in a Rule 506 private placement. No mandatory disclosure exists for accredited investors. Moreover, if all purchasers in an offering are verified to be accredited then the issuer may engage in general advertising and solicitation in reaching such investors. See Securities Act Rule 506(c).

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The transaction focus of the Securities Act gives issuers another option for initial investors in a private placement to resell into the public secondary markets. Initial investors, other than affiliates of the issuer, may resell in the secondary market freely without registration using Section 4(a)(1)'s exemption from Section 5. The only precondition is that the resale transaction must be separate from the issuer's private placement. Whether a resale transaction is separate turns on the status of the initial investor. If the initial investor is deemed to be an underwriter, then the investor will be considered a "conduit" and the resale transaction will be part of the issuer's private placement. If the initial investor is not an underwriter, then the resale transaction is separate from the private placement. Therefore, the initial investor can use the Section 4(a)(1) exemption from Section 5.[30] The SEC provides a safe harbor from underwriter status in Rule 144. The safe harbor turns, in part, on the amount of time that has passed from the initial sale of securities by the issue to the investor's resale transaction. Applying Rule 144 to avoid underwriter status, the investor can then use Section 4(a)(1) to exempt the resale from Section 5. Thus, investors can simply wait for resales to eventually become permissible. Note that the information environment is relevant to the holding period – only six months for reporting companies, a year for non-reporting – but not dispositive. After a year, securities sold by *any* issuer can be freely resold.

Investors' ability to eventually resell privately-placed shares is limited not by the securities laws but instead by market demand. For a small, private issuer, there may not be much interest among investors in purchasing the issuer's securities in the secondary market. The rise of off-exchange platforms for trading privately-placed securities ameliorates this lack of liquidity. Nonetheless, liquidity for resales of privately placed securities is far less than for those traded on a national securities exchange. The transition to exchange trading thus provides both essential liquidity and public company status, each essential to an informed investing market.

Both the NYSE and Nasdaq allow issuers to list their stock for trading on the exchange through a direct listing. The SEC, however, rebuffed the efforts of the NYSE to allow listing without an offering.[31] When Spotify sought to do its direct listing, that listing could have been accomplished with an Exchange Act registration, but the SEC insisted on a registration statement under the Securities Act.[32] The SEC's director of Corporate Finance took the position that the company's intention to inform the investing public about its business and prospects looked like an offer – even though Spotify was not planning to sell securities. The NYSE also acquiesced to the SEC's demand that the exchange require a Securities Act registration statement when it proposed a rule to facilitate direct listings.[33] Currently, both the NYSE and Nasdaq require a registered offering under the Securities Act – with the potential threat of Section 11

[30] If an affiliate attempts to resell then those who offer on behalf of the affiliate or purchase from the affiliate with a view to the distribution of the securities may be deemed an underwriter under Section 2(a)(11) of the Securities Act. Once an underwriter is present in the transaction then the affiliate will be unable to use the Section 4(a)(1) exemption from Section 5.

[31] Notice of Filing of Proposed Rule Change to Amend Section 102.01B, Exchange Act Rel. No. 34-80313, 82 Fed. Reg. 16082, 16082 (Mar. 31, 2017) (proposing changes to § 102.01B of the NYSE Listed Company Manual); Order Granting Accelerated Approval of Proposed Rule Change Relating to Listing of Companies, Exchange Act Release No 34-82627, 83 Fed. Reg. 5650, 5651 (Feb. 2, 2018) (approving changes to § 102.01B of the Listed Company Manual).

[32] Dakin Campbell, Going Public 127 (2022)

[33] Brent J. Horton, Direct Listings and the Weakening of Investor Protection, 50 Fla. St. U. L. Rev. at 9 (forthcoming 2022)

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liability – as a threshold requirement for direct listing.[34] When in doubt, the SEC's default is to impose liability by requiring registration under the Securities Act.[35]

If the issuer seeks only to direct list previously sold shares held by early investors, the direct listing is called a Selling Shareholder Direct Listing.[36] If the issuer sells securities for its own account, the direct listing is called a Primary Direct Floor Listing.[37] (To date no company that has raised capital through a primary direct floor listing.)[38] Either way, as part of the registered offering, the NYSE and Nasdaq require that a company have an effective registration statement under the Securities Act that covers some, but not all, of the shares that will be listed for trading.[39] An issuer, for example, can file a registration statement covering the resales of shares only by its affiliates in a Selling Shareholder Direct Listing. The purpose of the registered sale from the exchanges' perspective is to ensure that there will be a liquid trading market. The NYSE, for example, requires that a company has at least 1.1 million publicly held shares, 400 round lot holders (i.e., holders of 100 shares), a price per share of $4.00 or more, and a market capitalization of at least $100 million (excluding affiliates and 10% shareholders).[40] In contrast to a traditional IPO, however, management and significant shareholders typically do not have to agree to a lock-up agreement restricting resales after the direct listing. Consequently, non-affiliates holding shares purchased in a prior private placement who have held their shares for a year are now eligible for the Rule 144 safe harbor; they can resell immediately into the NYSE or Nasdaq. Once the listing requirements are met, the issuer will have gone public with a public secondary market for its shares on the NYSE or Nasdaq.

The SEC, for its part, was focused on the disclosure requirements of the Securities Act in requiring registration of shares sold by existing shareholders in a direct listing. Also relevant were the Act's stringent liability provisions. In 2018 Spotify used a direct listing of its existing common stock on the NYSE to go public without any sales by Spotify itself. Instead, in the direct listing, Spotify's registration statement covered sales by employees and early-stage investors. Spotify succeeded in its effort only after a year

[34] See Exchange Act Release No. 34-90768 (Dec. 22, 2020); File No. SR-NYSE-2019-67. There is alternative path if the company has established the requisite market capitalization as reflected in trading in private markets, but the limited appeal of private markets apparently makes this currently a non-starter.

[35] One liability difference is that issuers doing direct listings can avail themselves of the safe harbor for forward-looking projections. Issuers use this freedom to conduct an earnings call with future earnings projections at the time the company's shares begin trading. Tuch and Seligman, supra note -- at 67.

[36] Relatively few companies have taken the direct listing route to going public. In 2021, 942 companies went public. Only 7 of the 942 companies used a direct listing to go public (none of which raised capital for the companies). See Luisa Beltran Direct Listings Jump. Why the Path to Going Public is Getting Noticed, Barrons, Dec. 1, 2021 (available at https://www.barrons.com/articles/direct-listings-vs-ipo-paths-to-going-public-51638305261).

[37] In 2020 and 2021 respectively, the SEC approved NYSE and NASDAQ rule changes that allowed companies to raise capital through a primary offering in a direct listing of equity. The NYSE refers to a direct listing that also raises capital for the company as a "primary direct floor listing." NASDAQ refers to such a direct listing as a "Direct Listing with a Capital Raise."

[38] There is some concern that without no-action relief from the SEC the primary direct listing would violate Regulation M's anti-manipulation provisions, despite the SEC's approval of the NYSE's direct listing rule. David Lopez et al., Direct Listings 2.0-Primary Direct Listings, Harv. L. School Forum on Corp. Gov., (Sept. 20, 2020), https://corpgov.law.harvard.edu/2020/09/20/direct-listings-2-0-primary-direct-listings/.

[39] See NYSE Quantitative Initial Listing Standards (Section 1).

[40] The NYSE also requires that a company selling through a primary direct floor listing must either (1) sell at least $100 million in shares in the opening auction on the first day of trading or (2) have an aggregate market valuation of newly issued and pre-existing publicly held shares of at least $250 million at the time of listing.

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spent dealing with the SEC's concerns. [41] That regulatory delay is an implicit tax on innovation in capital raising.

Direct listings have several advantages relative to a traditional IPO.[42] Direct listings allow for market-based pricing of offered securities, which may result in more accurate and transparent pricing relative to book-built offerings. The lack of lock-up agreements provides insiders and large shareholders immediate liquidity with the direct listing. In a traditional IPO, institutional investors dominate purchasing in the initial distribution. By contrast, with a direct listing, any investor can purchase immediately. This makes it less likely that there will be a big run-up in the price on the first day of trading. Issuers in a direct listing have more flexibility in communicating with investors compared with a traditional IPO. Direct listings typically feature investor day presentations over the internet. Finally, because no underwriters participate in a direct listing with selling shareholders, the issuer pays no underwriter fees. Instead, the issuer pays advisory fees to investment banks assisting in the offering. Those fees average around $28 million.[43] According to PWC, underwriter fees in a traditional firm commitment IPO averaged 5.4% for IPOs selling $500 million to $1 billion, and 3.5% for IPOs over $1 billion.[44] Of course, these fees are not directly comparable, as no issuer has sold shares in a primary direct listing to date. Spotify, one of the larger companies to do direct listing, paid $45 million for its direct listing, but likely would have paid around $130 million if it had done an IPO.[45] Given that direct listings are still a nascent path to going public, there may be room for these advisory fees to go lower still—unless liability concerns change the calculus.

So what is the downside? Compared with the traditional IPO, direct listings provide investors with potentially reduced protections.[46] First, the Wall Street investment banks participating in a selling shareholder direct listing may not be underwriters.[47] Much turns on underwriter status: If an investment bank is not an underwriter in a direct listing, the investment bank does not face Section 11 liability and therefore has no need for a due diligence defense. Without that liability risk, investment banks may have less incentive to investigate the veracity of the issuer's disclosures.[48] In a traditional IPO sold through a firm commitment, Wall Street investment banks will purchase from the issuer with a view to the distribution of the securities to the public and will thus be deem underwriters. In a direct listing, there are no Wall Street investment banks purchasing from the issuer with a view to the distribution of securities to the public. Instead, the NYSE and Nasdaq each require that issuers conducting a direct listing employ a financial advisor to provide an independent valuation of the issuer's publicly held shares.[49] Absent a role in the direct distribution of securities, financial advisors in a direct listing may still be underwriters if they are deemed to offer to investors on behalf of the issuer as part of a distribution of securities.

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[41] Going Public at 181.

[42] See Rand Hawk, IPOhub, IPO Alternative – Direct Listing (February 6, 2019) available at https://www.ipohub.org/ipo-alternative-direct-listing/#:~:text=%20Advantages%20%201%20No%20Dilution%20of%20Ownership.,liquidity%20by%20allowing%20shares%20of%20the...%20More%20; Gibson Dunn, A Current Guide to Direct Listings (January 8, 2021) available at https://www.gibsondunn.com/a-current-guide-to-direct-listings/.

[43] Horton, supra note at 13. But see Tuch and Seligman, supra note __, at 67-68 (questioning the magnitude of the cost savings to the issuer of going public through a direct listing compared with a traditional IPO).

[44] PWC, Considering an IPO? First, Understand the Costs, https://www.pwc.com/us/en/services/consulting/deals/library/cost-of-an-ipo.html.

[45] Horton, supra note at __, 200.

[46] See also Tuch and Seligman, supra note __, at 368-69 (discussing the reduced application of Section 11 in direct listings).

[47] Taylor Wilson, Note, Risk and Reputation, 121 Mich. L. Rev. 461 (2022).

[48] See Tuch and Seligman, supra note __, at 69.

[49] See Gibson Dunn, Current Guide to Direct Listings (January 8, 2021).

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Consequently, financial advisors may structure their involvement in a direct listing to avoid direct contact with investors, such as in investor days, thereby escaping underwriter status, absent a regulatory mandate. Indeed, the SEC staff has stated in a no comment letter that investment banks may not assist the issuer with its communications in investor meetings without running the risk of being considered an underwriter.[50] The threat of Section 11 liability together with the risk associated with purchasing IPO securities in a firm commitment traditional IPO for resale gives Wall Street investment banks an incentive to investigate the accuracy of disclosures and the overall quality of an offering. The presence of investment banks acts to certify the traditional IPO to investors. Correspondingly, the lack of Section 11 liability and the lack of risk bearing leads to less (if any) certification from the participation of investment banks in a direct listing. The SEC has cut off that possibility in approving recent rule changes for primary direct listings, but it remains for selling shareholder direct listings.

Second, even for the issuer and selling shareholders, Section 11 liability has limited applicability for direct listings. Liability under Section 11 applies only to the specific shares registered in the registration statement and thus excludes private placement shares resold through Rule 144 into the NYSE or Nasdaq. Moreover, even for the specific shares registered, plaintiffs face a tracing issue. Most courts require that plaintiffs show that their specific shares are traceable to the registration statement with a misleading statement or omission. However, because Rule 144 resales typically occur concurrently with resales under a registration statement in a direct listing, there will be a mixture of Rule 144 and registered shares traded, making tracing difficult if not impossible for many investors. This concern was raised by the Council of Institutional Investors in opposing the NYSE's direct listing proposal.[51] The Ninth Circuit recently allowed for tracing in this scenario, but the Supreme Court has granted certiorari and is expected to address the issue this term.[52]

To date no issuer has taken advantage of the SEC's December 2020 approval of rule changes allowing for primary direct listing offerings. One stated concern is that the SEC requires that primary direct listings set a price range in the effective registration statement (the "Pricing Range Limitation") within which the price determine at the opening auction must fall. Even if there is large investor interest in the offering, an issuer may not increase the price above the top end of the Pricing Range Limitation, leading the issuer to have to either accept a lower price than warranted in the market or to cancel or delay the offering. The SEC in December 2022 responded to this difficulty by approving NYSE and Nasdaq rule changes that allow the auction price to fall within a "modified" pricing range that goes from 20% below the low price in the Pricing Range Limitation and 80% above the high price in the Pricing Range Limitation in a primary direct listing offering.[53] That should reduce the chances of a failed offering.

The SEC demanded a price, however, for loosening up the difficulties created by its Pricing Range Limitation. The quid pro quo extracted by the SEC was that the rule changes also require issuers in primary

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[50] See Spotify Technology S.A., SEC No Action Letter (Mar. 23, 2018) (recommending that the SEC not take enforcement action under Rule 101 and 102 of Regulation M based on the representation, among others, that the "Financial Advisors will not further assist the Company in the planning of, or actively participate in, investor meetings.").

[51] Jeffrey P. Mahoney, Re: File Numbers R-NYSE-2019-67, Council of Institutional Investors letter to SEC (Jan. 16, 2020). The Council's members are the principal beneficiary of the allocation scheme for traditional IPOs.

[52] Pirini v. Slack Technologies, Inc., 13 F.4th 940, 947 (2021) (holding that unregistered shares sold pursuant to a direct listing may be traced to the registration statement used in the direct listing because "this case involves only one registration statement … [a]ll of Slack's shares sold in this direct listing, whether labeled as registered or unregistered, can be traced to that one registration."), petition for certiorari granted, 22-200 (Dec. 12, 2022).

[53] See https://www.davispolk.com/insights/client-update/sec-relaxes-nyse-pricing-restrictions-primary-direct-listings.

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direct listing to retain an underwriter and name the underwriter in the registration statement, exposing the investment bank agreeing to the underwriter role to Section 11 liability and bringing primary direct listings closer to the regulation of traditional IPOs.[54] The lack of an underwriter remains a possibility for secondary direct listings. The rule changes also require that the underwriter have the ability to impose lock-up arrangements, limiting the ability of insiders and others to resell their shares during the issuer's sale.[55] While lock-up arrangements are in place, the initial purchasers in a primary direct listing would face fewer (if any) tracing issues that may otherwise impede their ability to utilize Section 11 liability. When in doubt, the SEC's response is to suppress "regulatory arbitrage" by bringing alternatives in line with traditional IPO regulation.

Whether the issuer's choice of a private placement followed by resales into the public secondary market improves on the joint welfare of the issuer and investors relative to a traditional IPO turns on the issuer's internalization of those costs and benefits. If the investors in the public secondary market price the reduction in traditional IPO protections, then they will be willing to pay less for the securities in the secondary market. Consequently, the initial investors who are reselling to the public with the direct listing, anticipating that discount, will adjust the price they are willing to pay to the issuer at the time of the private placement. Issuers choosing to sell securities through a private placement that expect that the securities will eventually enter the public secondary market will thus internalize both the costs and benefits – lower cost and less liability exposure – of going public in this manner. The choice by such an issuer to sell through a private placement that leads to a direct listing instead of a traditional IPO will maximize the joint welfare of the issuer and investors.

Can we be confident in the efficiency of that pricing mechanism? The ability of investors purchasing in the secondary market to price regulatory protections turns on the information environment for the issuer and the financial sophistication of the investors. Some pre-IPO issuers have a thick information environment because their businesses are relatively mature. This thick information environment potentially will generate a price in the secondary market that reflects the choice to go public with fewer regulatory protections than in a traditional IPO. For example, prior to Spotify's direct listing, the company received media attention focused on Spotify's size and use of a direct listing to go public.[56] Spotify's market capitalization after the close of its first day of trading on the NYSE was $26.5 billion.[57] The media attention and the anticipated large market capitalization after the direct listing, point toward outsized investor interest. A company the size of Spotify warrants inclusion in the portfolios of many institutional investors. More than 30 million shares changed hands on Spotify's first day of trading, roughly 17% of Spotify's outstanding stock.[58] With that kind of trading volume, a well-known company such as Spotify may draw sufficient analyst coverage to incorporate the reduced regulatory protections into the market's view of the company. By the time of Spotify's first earnings release after its IPO, the company

[54] See https://www.davispolk.com/insights/client-update/sec-relaxes-nyse-pricing-restrictions-primary-direct-listings.

[55] See https://www.davispolk.com/insights/client-update/sec-relaxes-nyse-pricing-restrictions-primary-direct-listings.

[56] See Spotify becomes first major company to file for direct listing of up to $1 billion, Washington Post, February 28, 2018 (available at https://www.washingtonpost.com/business/economy/spotify-becomes-first-major-company-to-file-for-a-direct-listing-of-up-to-1-billion/2018/02/28/1b3a725a-1cbe-11e8-b2d9-08e748f892c0_story.html); Seth Fiegerman, Spotify plans to go public on April 3, CNN Business, March 15, 2018 (available at https://money.cnn.com/2018/03/15/technology/spotify-ipo-investor-day/index.html).

[57] Spotify's common stock price at the close of trading on April 3, 2018 was $149.00999 and Spotify had 178.1 million shares outstanding on that same date, giving Spotify a market capitalization of $26.5 billion. See Center for Research in Security Prices.

[58] Going Public at 141.

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had at least seven analysts covering it.[59] The assessment of institutional investors and analysts will be reflected in the market price for a company like Spotify's shares at the time of the direct listing.

Most private companies that sell securities through private placements, however, have little or no analyst coverage and illiquid secondary markets prior to their public listing. Even a relatively established company like Slack, which went public in a direct listing onto the NYSE in 2019, had concerns about liquidity when it did its direct listing.[60] Lesser-known companies are more of a challenge for direct listing. The SEC currently requires an issuer doing a direct listing to file a registration statement covering at least a portion of the private placement shares to be resold in the public market. For an issuer lacking analyst coverage and institutional investor owners, it is unclear whether the reduced regulatory protections for a direct listing compared to a traditional IPO—a lack of underwriter certification and reduced liability exposure—will be priced correctly at the opening. Whose demand will set that price: retail or institutional investors?

The worry is that an opportunistic issuer may seek to take advantage of unsophisticated investors through a direct listing, even when not raising any capital directly, to benefit the initial private placement investors. The initial private placement investors, who may expect to profit at the expense of the unsophisticated investors in the secondary market, will in turn be willing to pay more for their shares to the issuer in the private placement. Even if the initial private placement investors do not fully anticipate such later opportunistic behavior on the part of the issuer (and thus do not increase their willingness to pay at the private placement stage), the issuer may still attempt to take advantage of unsophisticated investors in a later direct listing to benefit sellers who are affiliates of the issuer.

The potential for opportunism is exacerbated by the absence of prior Exchange Act filings. Because shares are sold directly into the market rather than through a book-building process, retail investors may dominate the buy-side of the initial public market in a direct listing, particularly if the company operates in a hot sector. Unlike an IPO there is no way to exclude the demand of individual investors from this initial pricing. Unsophisticated retail investors may struggle to account for the reduced protections properly. Will institutional investors enter the market promptly? Short selling may help bring prices into line, but that depends on the availability of shares for short sellers to borrow. This increases the risk that the investors in a direct listing will not adjust their willingness to pay for securities from the issuer at the time of the direct listing to account for departures from traditional IPO protections.

The SEC's investor protection concern is not much different, however, from the exploitation of retail investors by institutional investors who flip their shares in secondary trading after a traditional IPO. Indeed, although issuers may have an incentive to take advantage of unsophisticated investors in the public market in a direct listing (for example, to benefit affiliates engaged in resales in the direct listing), we believe that the incentive for opportunism is, if anything, less than in a traditional IPO—the principal justification for the heavy regulatory burden imposed by the Securities Act. From the issuer's perspective, the goal of the direct listing is to provide liquidity to its early backers and employees; the company has satisfied its capital needs elsewhere. All else equal, higher is better, but the stock price at the listing will have minimal effect on the company's long-term prospects. The company's ability to raise capital going forward instead will be determined by its performance after it goes public. That performance will be transparent in the company's Exchange Act filings as digested by analysts and institutional investors.

The critical question relating to informational efficiency is whether the listing standards imposed by the exchanges correlate with the likelihood of analyst coverage and active trading. The NYSE's current

[59] See New Constructs, Sell Side's Defense of Certain Underwriting Clients Reeks of Conflict, May 7, 2018, at p. 3 ("In the week leading up to the earnings release, seven different analysts initiated Buy ratings on Spotify.).
[60] Going Public at 152.

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standards require a minimum $100 million market capitalization. For companies just meeting this threshold, this is small-cap territory for publicly-traded issuers. Institutional investors and analysts are unlikely to take an interest in such companies, which means that retail investors will tend to dominate trading. For these companies, a lock-up provision for at least some of the affiliate shares would provide some assurance against inflated pricing at the open. If the affiliates are retaining a portion of their shares, they may be more concerned with attracting institutional investors to support the eventual trading price. That price will reflect the fundamental value of the issuer, rather than the potentially mispriced opening price. Affiliates, as a result, may have an incentive to limit inflated projections at the time of the direct listing. Presently, however, no lock-up provisions are required for direct listing public offerings.

For larger companies, in contrast, direct listings may quickly draw institutional investors into the market on the first day of trading. "Cross-over" investors who participate in both private and public markets are increasingly the norm.[61] Analysts and short sellers will quickly follow. Spotify's large initial post-IPO market capitalization of $26.5 billion is well within the range of companies that attract the attention of institutional investors. The market reality of institutional investors' focus on larger issuers may explain the dearth of direct listings so far. Of the eight direct listings on the NYSE through 2021, the smallest pre-listing valuation was $1.5 billion, with the majority valued in excess of $10 billion. Few companies are as well-known and as large as Spotify at the time of their IPO. For smaller companies, direct listings are risky for individual investors unable to free ride on the analysis of institutional investors that drive the pricing of traditional IPOs. On the other hand, it is worth noting that retail investors are generally unable to buy at the price set in the traditional IPO; they are relegated to buying at the inflated price in the secondary market.

The upshot: there is an inherent tradeoff between encouraging smaller companies to go public through a direct listing, with weaker market forces to price regulatory protections, and restricting direct listings to larger companies. The latter may offer more accurate pricing due to the presence of institutional investors that will cause issuers to internalize the value of regulatory protections for investors. As usual, there is no free lunch. But there is minimal policy justification for requiring a large well-known company like Spotify to register shares for sale under the Securities Act when doing a direct listing. Similarly, it is unclear what protection simply having the issuer file a registration statement with the SEC will provide retail investors purchasing in a thin secondary market following the direct listing of a smaller, less well-known company.

B. Reverse Mergers and SPACs

In a reverse merger, a private company merges with an existing public shell company. In the merger, the public shell corporation survives, absorbing the business of the private company. Typically, the public shell corporation will issue shares to the shareholders of the private company and the private company's shares will be extinguished. If the private company's assets are greater than those of the public shell corporation, as is typical, the shareholders of the private company will own most of the shares of the surviving public company after the merger. Consequently, the shareholders of the private company will control the public company post-merger. The managers of the target company will also typically take control of the public company's board of directors and management. If the former target company shareholders sell their shares into the secondary market, the purchasers of such shares effectively become public shareholders of an entity (the post-merger company) whose performance depends on the business of the pre-merger target company.

[61] Going Public at 164.

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In the mid-2000s, a technique for a private company to go public relying on a prior initial public offering by *another* company became popular—commonly referred to as a "reverse" merger.[62] By the early 2010s, however, interest in reverse mergers had dwindled. The diminishing popularity of reverse mergers coincided with increasing public reports of fraud involving reverse merger issuers. The SEC responded, not with rulemaking to deal with abuses, but rather, by suspending trading in several post-merger public companies.[63] This regulatory option allowed the agency to avoid the burdens of the Administrative Procedure Act, but did nothing to recover the losses of investors who had already invested in companies only to see their trading price eviscerated – or prevent it from happening again. It was a band-aid, not a fix for the problem.

The lack of a real fix became apparent when a variant of the reverse merger grew in popularity. Rather than using an existing public shell company, this variant involves creating a new public company vehicle known as a Special Purpose Acquisition Company or SPAC. The importance of SPACs as a means of going public increased exponentially. In 2020, SPAC IPOs accounted for more than half of total IPOs.[64] By 2022, however, SPACs had virtually disappeared. Why did the novel transactional form fly so high, so quickly and fall so fast?

A SPAC involves two transactions, each of which might be characterized as the "going public" event: 1) the initial public offering of the SPAC itself, in which the SPAC sells shares to the public; and 2) the reverse merger of the SPAC with a private company target, effectively taking the target company public through a merger into the SPAC (referred to as a "de-SPAC" merger). Sponsors of a SPAC will typically promise the SPAC IPO investors that the offering proceeds will be used to facilitate a reverse merger or other business combination transaction with a (not yet identified) private company. At the time of the SPAC IPO, the sponsor will take a 20% equity interest in the SPAC, called the sponsor's "promote." The SPAC will issue the remaining 80% of shares together with warrants in the IPO to outside investors.[65] At the time of the SPAC IPO the SPAC has no operations; consequently, there is little to disclose to investors. There is correspondingly little potential for Section 11 liability exposure.[66] SPACs will often list on Nasdaq and the NYSE after the initial IPO to encourage secondary market trading.[67] But, until a merger

[62] See Yawen Li, "The Shell Game": Reverse Merger Companies and the Regulatory Efforts to Curb Reverse Merger Frauds, 15 NYU Journal of Law & Business 153, 162 (2018) (noting that there were only 3 reverse mergers in 1990 but that there were 236 in 2008 and 257 in 2010). Many of the reverse mergers in the late 2000s involved Chinese companies. See id. at 163 ("During the period from January 1, 2007 to March 31, 2010, there were 159 companies from the China region that accessed U.S. capital markets through a reverse merger transaction.").
[63] See SEC, Investor Bulletin: Reverse Mergers, June 1, 2011, at p. 3 (detailing SEC actions that suspending trading in a number of reverse merger entities) (available at https://www.sec.gov/investor/alerts/reversemergers).
[64] See Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACS, 39 Yale J. on Reg. 228 (2022) at p.3 ("In both 2020 and 2021 (through November), SPAC IPOs accounted for more than half of total IPOs, and among firms that went public in those years, SPAC mergers accounted for roughly 22% and 34%, respectively.").
[65] The typical SPAC will sell a unit comprised of a share of stock and a warrant for a fixed price of $10 per unit. See Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACS, 39 Yale J. on Reg. 228 (2022) at p. 11.
[66] See Tuch and Seligman, supra note __, at p. 26 ("[W]ith no operating or financial history, a SPAC has little to disclose other than the obvious risks in such an offering."). See Quinn Emanuel, Litigation Risk in the SPAC World ("Because SPACs are blank-check companies with no operations, the initial IPO registration statement is generally regarded as a straightforward exercise with limited risk.") available at https://www.quinnemanuel.com/the-firm/publications/litigation-risk-in-the-spac-world/. Quinn Emanuel does note that "tricky situations" may arise if the SPAC has identified a potential target before the SPAC IPO—a situation the SPAC may avoid by simply not having such an identified target at the time of the SPAC IPO. See id.
[67] See https://www.nasdaq.com/solutions/spac

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is announced, there is little information generated that might create trading opportunities, so trading in the post-IPO secondary market is typically light.[68]

The SPAC will typically set a two-year period after the IPO to find an operating company with which to conduct a reverse merger.[69] The SPAC IPO proceeds are put in escrow, invested in treasury bonds, until the merger. If the sponsor does not identify an acquisition target in the two-year period, the typical SPAC agreement requires the SPAC to liquidate and distribute the net offering proceeds back to the SPAC shareholders. The time limit imposed by the SPAC agreement results in the sponsor having an incentive to make a deal with some target firm in the two-year window or else walk away with nothing.[70] Once the SPAC identifies a private company target, the SPAC will either merge with the private company or combine through another form of business combination. Shareholders will sometimes vote on the acquisition, particularly if the SPAC merges with the target company. If there is a merger vote, SPAC shareholders can sue for material misstatements or omissions in the proxy statement under Section 14(a) of the Exchange Act.[71]

After the SPAC shareholders vote to approve a de-SPAC merger, SPACs typically provide the shareholders the option to redeem their shares for the IPO purchase price plus interest accumulated on the SPAC funds while in escrow. That is a modest return, but redeeming shareholders retain their warrants, giving them the right to purchase shares in the post-merger entity at a specified strike price. In practice, most of the initial investors in a SPAC IPO will either sell their shares in the secondary market prior to a merger or redeem their shares at the time of the merger.[72] Consequently, shareholders that remain with the post-merger company usually purchased their shares in the secondary market rather than the SPAC IPO. There may be additional investors who purchased SPAC shares through a private placement after the SPAC IPO (a “PIPE” transaction). The SPAC uses that capital to make up for cash used to fund redemptions and meet minimum cash requirements for the merger with the target company.

Like a reverse merger, merging with a SPAC allows a private company to go public without going through the traditional IPO process.[73] Unlike a reverse merger, the private company may also receive funds from the SPAC as part of the de-SPAC merger. In a typical de-SPAC merger, the shareholders of the target private company typically receive either cash or shares in the SPAC as consideration for the merger.

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[68] Usha Rodrigues & Michael Stegemoller, SPACs: Insider IPOs, University of Georgia School of Law Res. Paper No. 2021-09, at 52 (finding for a sample of pre-acquisition SPACs an average of 37 trades a day).
[69] See Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACS Ohlrogge, and Emily Ruan, A Sober Look at SPACS, 39 Yale J. on Reg. -- (2022) at p. 11. .
[70] Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACS, Ohlrogge, and Emily Ruan, A Sober Look at SPACS, 39 Yale J. on Reg. 228 (2022) at p. 23. The SEC’s 2022 proposed rules would expand disclosures related to the SPAC sponsor’s conflicts of interest as well as the dilution to SPAC investors from the sponsor’s promote among other things.
[71] See Emily Strauss, Suing SPACS, 96 So. Cal. L. Rev. (forthcoming 2023) (presenting empirical study of lawsuits involving SPACs); Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACS, 39 Yale J. on Reg. 228 (2022) at p. 74 (“SPACs’ proxy statements routinely make qualitative statements about sponsors and SPAC management having conflicting interests with shareholders. They vary, however, in the transparency of the specifics. Some SPACs are opaque with respect to such matters as the sponsor’s relationship with affiliates that make PIPE investments,135 ownership interests in the sponsor, and how the sponsor divides the promote among different individuals and institutions.”).
[72] Usha Rodrigues & Michael Stegemoller, SPACs: Insider IPOs, University of Georgia School of Law Res. Paper No. 2021-09, at 55 (finding that 54% of shareholders voting on acquisitions redeem their shares).
[73] See Tuch and Seligman, supra note __, at p. 22 (“[A] SPAC merger serves the functions of a traditional IPO—providing cash for growth, Exchange Act-registered securities, opportunities for exit, and significant publicity.”).

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If the SPAC issues new shares to the target company shareholders, the SPAC will often register these shares on a Form S-4 registration statement.

For shares issued under a registration statement related to the de-SPAC merger, the SPAC faces potential Section 11 liability for misstatements and omissions in the registration statement.[74] Traditionally, however, SPAC shareholders are not treated as purchasers in the de-SPAC merger if the SPAC issues new shares only to the target company shareholders and not the pre-merger SPAC investors. The pre-merger SPAC shareholders therefore do not have standing to sue under Section 11.

In early 2022, the SEC proposed rules to combat abuses in SPAC offerings and de-SPAC mergers. The SEC's proposed rules would deem both the SPAC and the target company as "issuers" in the de-SPAC merger even if only the SPAC is actually issuing shares in the merger.[75] The proposed rules also would treat SPAC shareholders as buyers of shares in a de-SPAC merger even if the SPAC shareholders' shares are not exchanged for new shares in the merger.[76] Under the 2022 proposed rules, SPAC shareholders could potentially bring a Section 11 suit against the SPAC and the target company, as well as other Section 11 defendants, as a "purchaser" if there is a material misstatement or omission in the Form S-4 registration statement for the de-SPAC merger.

Importantly, although the investment banks that acted as underwriters in the initial SPAC IPO often act as advisors in the de-SPAC merger, the investment banks will avoid selling efforts in connection with the merger to avoid underwriter status under Section 11.[77] Escaping the reach of Section 11 reduces the incentive of the investment banks to perform due diligence compared with a traditional IPO.[78,] In the SEC's proposed rules, underwriters at the time of the SPAC IPO that act as advisors in the de-SPAC merger may be deemed underwriters in the de-SPAC merger under certain circumstances.[79] For example,

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[74] The SEC's 2022 proposed rules require the target company to sign as a co-registrant for the de-SPAC merger related registration statements.

[75] See SEC, Securities Act Release No. 33-11048 at p. 75.

[76] See SEC, Securities Act Release No. 33-11048 at p. 101 ("[W]e are proposing new Rule 145a under the Securities Act that would deem such business combination transactions to involve a sale of securities to a reporting shell company's shareholders.")

[77] See Tuch and Seligman, supra note __, at p 32 ("In SPAC mergers, investment banks routinely act as M&A advisors to SPACs or target companies and as placement agents in PIPE transactions. In acting as M&A advisors or placement agents, investment banks will rarely perform any of the specified functions for underwriter status; in fact, they try to deliberately avoid performing any of those functions, wary of the potential for Section 11 liability if they do."). See Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACS, Ohlrogge, and Emily Ruan, A Sober Look at SPACS, 39 Yale J. on Reg. 228 (2022)("whereas an IPO exposes the underwriter to litigation risk under Section 11, there is no underwriting of shares in a SPAC merger. Consequently, even where shareholders have a valid Section 11 claim against the SPAC and its management, they do not have a claim against an underwriter."). Even where Section 11 may apply, investors may face a tracing issue where target shareholders resell their SPAC shares into the secondary market and such shares become "mixed" with existing SPAC shares in the secondary market. See Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACS, Ohlrogge, and Emily Ruan, A Sober Look at SPACS, 39 Yale J. on Reg. 228 (2022).

[78] See Tuch and Seligman, supra note __, at p. 32. Discussing the lack of Section 11 liability on investment banks in mergers, Tuch and Seligman remark: "In mergers, neither an investment bank nor any other transaction participant requires comfort letters or negative-assurance letters attesting to the accuracy of corporate disclosures—a basic difference from the verification process in traditional IPOs." Id. at 35.

[79] See SEC, Securities Act Release No. 33-11048 at p. 96 ("Proposed Rule 140a would clarify that a person who has acted as an underwriter in a SPAC initial public offering ('SPAC IPO underwriter') and participates in the distribution by taking steps to facilitate the de-SPAC transaction, or any related financing transaction,200 or otherwise participates (directly or indirectly) in the de-SPAC transaction will be deemed to be engaged in the

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investment banks that act as underwriters in the SPAC IPO whose compensation depends on the successful completion of a later de-SPAC merger may be deemed as underwriters for the de-SPAC merger if they act as financial advisors in the merger and assist in completing the de-SPAC merger.[80] To avoid that outcome, SPAC sponsors may simply select other investment banks not associated with the SPAC IPO to act as advisors in the de-SPAC merger.

Going public through a de-SPAC merger provides potential benefits compared with a traditional IPO. A de-SPAC merger may offer a quicker alternative for a target company seeking to go public while still allowing the target company to raise capital.[81] A de-SPAC merger may offer more certainty and lower out-of-pocket fees and costs for a target company compared with the traditional IPO.[82] SPAC sponsors may also provide advice to private companies seeking to go public through a de-SPAC merger.[83]

Assessing the costs of a SPAC relative to a traditional IPO is complicated because there are distinct groups of investors. There are the initial investors in the SPAC IPO, most of which are institutional investors. Because the initial investors either resell their shares or redeem and benefit from the warrants they receive at the time of the IPO, they almost always receive a positive return on their investment.[84] The second group consists of the shareholders of the target company – typically founders and early-stage investors who exchange their target shares in return for shares of the SPAC post-merger. The shareholders of the target company on average experience positive returns from the merger.[85] The real risks of a SPAC appear to fall on those investors – primarily retail – who purchase the SPAC shares in the secondary market prior to the merger with a private company. Economically, purchasers of SPAC shares in effect invest in the business of the target company after the de-SPAC merger. Their returns will depend on the performance of this business. But at the time these shareholders purchased, there would typically be little or no information available regarding the private company target. Mandatory disclosure – and liability – do little work in these circumstances. And the promoter is taking twenty percent off the top.

How should we weigh the costs and benefits of going public through a de-SPAC merger? As before, the answer lies with whether the decisionmaker, in this case the SPAC sponsor and the target company,

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distribution of the securities of the surviving public entity in a de-SPAC transaction within the meaning of Section 2(a)(11) of the Securities Act.").

[80] See id at p. 97 (noting that "it is common for a SPAC IPO underwriter (or its affiliates) to participate in the de-SPAC transaction as a financial advisor to the SPAC, and engage in activities necessary to the completion of the de-SPAC distribution such as assisting in identifying potential target companies, negotiating merger terms, or finding investors for and negotiating PIPE investments.")

[81] See Gahng et al., supra note __, at 12 ("[I]t is frequently stated that the time it takes for an operating company to negotiate a merger with a SPAC and win shareholder approval is less than that of a traditional bookbuilt IPO."); Max H. Bazerman and Paresh Patel, SPACs: What You Need to Know, Harvard Business Review (July-August 2021) (" For targets, the entire SPAC process can take as little as three to five months, with the valuation set within the first month, whereas traditional IPOs often take nine to 12 months, with little certainty about the valuation and the amount of capital raised until the end of the process."); John Lambert, KPMG Advisory, Why so many compares are choosing SPACs over IPOs ("A SPAC merger doesn't need to generate interest from investors in public exchanges with an extensive roadshow (although raising PIPE involves targeted roadshows)."), available at https://advisory.kpmg.us/articles/2021/why-choosing-spac-over-ipo.html.

[82] See Gahng et al., supra note __, at 13; Max H. Bazerman and Paresh Patel, SPACs: What You Need to Know, Harvard Business Review (July-August 2021).

[83] See Gahng et al., supra note __, at 12.

[84] See Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACS, 39 Yale J. on Reg. 228 (2022)) at p. 6, 12, 17-22.

[85] See Klausner et al., supra note __, at p. 7-8, 41. Other research however has found that the target company's shareholders bear at least some of the costs of a de-SPAC merger. See Gahng et al., supra note __, at 6–15.

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internalizes fully the costs and benefits of reducing regulatory protections relative to a traditional IPO. If the investors purchasing SPAC shares prior to the de-SPAC merger in the secondary market are sophisticated and can assess issuer disclosures, or alternatively, the SPAC trades in a thick information environment in which the risks and returns of the SPAC are reflected in the market price, then the SPAC and target company would internalize the costs and benefits of reduced protections relative to a traditional IPO. If the protections of a traditional IPO add more costs to the offering than benefits to the investors in the secondary market, then target companies could obtain greater net offering proceeds through a de-SPAC merger compared with a traditional IPO. The choice of the target company to go public through the de-SPAC merger would maximize the joint welfare of the issuer and investors. Indeed, in this case, one can wonder whether the market should have even greater flexibility to reduce the regulatory protections compared with a traditional IPO for issuers going public through a de-SPAC merger, such as doing away with (or making optional) Section 11 liability for both the SPAC IPO and any registered offering in the de-SPAC merger.[86]

If investors in the post-SPAC IPO secondary market lack sophistication and the information environment for the SPAC and target company is poor, the de-SPAC merger may harm the joint welfare of the issuer and investors. The beneficiaries will be the SPAC initial investors, the SPAC sponsor, and the target company and target shareholders. Opportunistic market participants will not internalize all the costs of a SPAC offering and subsequent de-SPAC merger, which will typically be borne by unsophisticated investors buying SPAC shares in the secondary market. Thus, SPAC sponsors will have an incentive to go public to extract wealth from those unsophisticated investors. If the costs of the de-SPAC merger fall on target shareholders, instead of, or in addition to, the SPAC secondary market investors, we can ask the similar question: Do the SPAC sponsor and the target company internalize these costs? If the target company's management is sophisticated and realizes this cost but nonetheless go forward with the de-SPAC merger then we can infer that the de-SPAC merger is value-increasing for the target shareholders despite these costs. The exception would be if agency costs cause the target company management's interests to diverge from its shareholders.

The need for regulatory protection for SPAC IPOs and de-SPAC mergers thus turns on whether the harms from the lack of regulatory protections are internalized by the SPAC issuer, or alternatively, the target company in the SPAC merger. Whether internalization occurs depends on the specific information environment surrounding a SPAC (or the target company). But the current approach is one-size-fits all, making no distinctions based on the information environment. The transaction focus of the Securities Act treats investors who purchase SPAC shares in the secondary market prior to the de-SPAC merger the same as other secondary market transactions despite what may be a substantial information void. The investors

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[86] Rodrigues and Stegemoller (2022) note that after a SPAC announces an acquisition target, the stock price of the SPAC may potentially reflect the market's assessment of the target. For a SPAC with sufficient trading volume and investor interest, this post-announcement market has the potential to incorporate information on the de-SPAC merger efficiently into the SPAC market price. See Usha R. Rodrigues and Michael Stegemoller, Why SPACs: An Apologia (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4072834) ("This, then, is the truly revolutionary aspect of the SPAC: it creates a market in the value of still-private companies.). Rodrigues and Stegemoller give the example of Digital World Acquisition Corporation's (DWAC) announcement of its plans to merger with Trump Media/Technology Group and how the market price for DWAC's shares responded rapidly to information on the merger after the announcement. See id. Rodrigues and Stegemoller nonetheless report from an empirical study of SPACs from 2010 to 2019 that negative information is less likely to be impounded in the SPAC share price prior to the de-SPAC merger. They write: "[T]here is no significant change in the informativeness of prices until after the de-SPAC. That is, prices do not reflect the change in liquidity, for an obvious reason: the redemption right provides an implicit floor and bolsters the stock price to secure it at around the $10 level." Id.

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who purchase SPAC shares in the secondary market receive the same periodic disclosures under the Exchange Act as other reporting issuers, but this will be of little use prior to the acquisition of an operating company. The primary antifraud provision is Rule 10b-5, the same as for other secondary market transactions, but again, a SPAC with no operations has little to potentially misstate. At the time of the de-SPAC merger, SPAC shareholders may bring a Section 14(a) action for misstatements or omissions in the proxy statement if there is a merger vote. Section 14(a), however, typically does not result in liability for investment banks advising in the merger.[87] Section 11 liability is possible for registration statements filed as part of the de-SPAC merger, but as discussed above, investment bank advisors are typically not treated as underwriters under Section 11. Lastly, the limits on publicity for a traditional IPO do not apply to the de-SPAC merger for the SPAC investors, allowing for earlier publicity of the de-SPAC merger prior to the filing of the registration statement. With no "quiet" period, there is a greater risk of a "speculative" frenzy luring in retail investors.[88]

The SEC's proposed regulatory protections for de-SPAC mergers bring them closer to a traditional IPO, but the proposals make no distinction based on the information environment for the SPAC or the target company. For the unsophisticated investors in low information environment companies, the SEC's proposed tightening of SPAC regulations make sense. Indeed, if unsophisticated investors predominate in this situation, the SEC might well have gone further and imposed the full array of protections governing a traditional IPO, including Section 11 liability for all investment bank advisors and greater limitations on publicity of the de-SPAC merger prior to the filing of the registration statement.

A cost of the SEC's one-size-fits-all approach, however, is that in some cases the SPAC secondary market prior to a de-SPAC merger may in fact be thick. In those cases, investors in the post-SPAC IPO secondary market may be able to rely on the market price to reflect investor protections. With investor protections reflected in the market price, issuers will internalize the benefits of such protections when they initially offer the SPAC to the public, giving the issuers strong incentives to maximize the joint welfare of investors and issuers. As with direct listings, the SEC reverted to its default regulatory approach, which is more liability regardless of the information environment. If issuers already seek to maximize the joint welfare of investors and issuers, imposing Section 11 liability on investment banks acting as advisors in a de-SPAC merger and giving Section 11 standing to SPAC shareholders who did not actually purchase any shares in a de-SPAC merger may not provide sufficient value to justify the costs associated with such heightened liability.

The current pattern of lawsuits against SPAC promoters does not give much comfort. In a recent study, Emily Strauss found that the "probability that a deSPAC transaction will generate a lawsuit appears to be unrelated to the returns on the deal, the size of the merger, the industry of the target, and various proxies for SPAC quality." Moreover, she found a negative association between such suits and redemption, suggesting that lawyers were targeting deals most favored by investors.[89] The fact that plaintiffs' lawyers are targeting the deals that investors apparently consider the best should give the SEC pause. Ex post liability is no substitute for an ex ante robust information environment. Lawyers benefit from more lawsuits, but investors typically receive pennies on the dollar.

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[87] See Tuch and Seligman, supra note __, at p. 33-34 (noting that "investment banks have rarely faced liability under Section 14(a) of the Securities Exchange Act and only then for fairness opinions shown to be objectively and subjectively false.").

[88] See Tuch and Seligman, supra note __, at p. 39, 42-43 ("SPAC mergers do not face the same restrictions on publicity as traditional IPOs, with the result that SPAC investors may make investment decisions on information that is more weakly-vetted than information available to their counterparts in traditional IPOs.").

[89] Strauss, supra note .

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The SEC's proposed rules seem to have contributed to a steep decline in the market for SPACs, which dwindled to a trickle in 2022.[90] Perhaps confirming that the decline was not expected to be temporary, Goldman Sachs, previously a major player in SPAC deals, announced in May 2022 it was exiting the field.[91] Another important advisor in the field announced that it was opening a liquidation business to help failed SPACs shut down.[92] In July of 2022, there were no new SPACs, for the first time in five years.[93] A month later, two ETFs focused on SPACs shut down.[94]

The SEC has also brought enforcement resources to bear against SPACs. One very high-profile SPAC, Digital World Acquisition Corporation, has repeatedly delayed its proposed merger with Trump Media & Technology Group, the social media company backed by former President Donald Trump.[95] The delays are apparently in a response to an investigation by the SEC into the possibility that Digital World may have been in discussions with Trump Media about a deal prior to Digital World's initial offering, which would have required disclosure. Digital Media and Trump have launched a campaign to bring shareholder pressure on the SEC to terminate the investigation, but most commentators consider that unlikely.[96]

It remains to be seen whether the SEC will tweak its proposed rules in response to their apparent chilling effect. Of course, getting rid of SPACs may have been the SEC's intended—if undisclosed—purpose. As Commissioner Hester Peirce put it in her dissent to the rule proposal:[97] "The proposal—rather than simply mandating sensible disclosures around SPACs and de-SPACs, something I would have supported—seems designed to stop SPACs in their tracks." And so it has.[98]

IV. An Alternative Regulatory Approach

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[90] Sara B. Potter, U.S. IPO Activity Drops Dramatically in the First Half of 2022, Factset Insights (July 14, 2022), available at: https://insight.factset.com/u.s.-ipo-activity-drops-dramatically-in-the-first-half-of-2022.
It probably did not help that a high percentage of post-acquisition SPACs were issuing going concern warnings at the same time. Eliot Brown, Shakeout Threatens SPACs, Wall St. J. (May 28, 2022) (reporting that 10% of post-SPAC merger companies that merged in 2020 and 2021 had issued going concern warnings, roughly double rate of IPO issuers from the same period).

[91] Sridhar Natarajan and Ruth David, Goldman Is Pulling Out of Most SPACs Over Threat of Liability, Bloomberg (May 9, 2022).

[92] Bailey Lipschultz, SPAC Winter is So Bad One Adviser Opened a Liquidation Business, Bloomberg Law News (Aug. 24, 2022); see also Bailey Lipschultz, Dozens of De-SPACs Flag Severe Cash Problems as Economy Weakens, Bloomber Law News (Oct. 5, 2022).

[93] Aziz Sunderji & Amrith Ramkumar, Activity in SPACs Reaches Lowest Level in Five Years as Boom Fades Quickly, Wall St. J. B1 (Aug. 18, 2022).

[94] Emily Graffeo, Two SPAC ETS Wiped Out in One Month Signal Boom Is Truly Over, Bloomberg Law News (Sept. 7, 2022).

[95] Will Feuer, SPAC Again Puts Off Vote on Trump Merger, Wall St. J. B3 (Oct. 11, 2022).

[96] Matthew Goldstein, 'Defund the SEC' Is Now Rallying Cry on Trump Site, N.Y. Times (Oct. 6, 2022).

[97] Commissioner Hester M. Peirce, Damning and Deeming: Dissenting Statement on Shell Companies, Projections, and SPACs Proposal (March 30, 2022).

[98] As noted by Rodrigues and Stogemoller, the end of SPACs may lead some companies disfavored by Wall Street investment banks unable to raise capital. See Usha R. Rodrigues and Michael Stegemoller, Why SPACs: An Apologia (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4072834) ("One vaunted advantage that SPACs offer is their ability to circumvent this gatekeeper and raise money in the capital markets even if they are disfavored by banks because of their large capital needs and limited prospects for short- term revenue.").

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The transaction-based regime under the Securities Act gives issuers a degree of choice in how to go public. This choice, however, is not the product of an assessment of what options maximize the joint welfare of issuer and investors, or more generally social welfare. Instead, the existing choice is simply an artifact of the transaction-focus of the Securities Act dating back to 1933. Moreover, the SEC has managed the going public choice in a heavy-handed way. The agency's responses to direct listings and SPACs demonstrate that the SEC views alternatives to the traditional IPO as "regulatory arbitrage" that needs to be brought in line with the traditional IPO by imposing similar regulatory protections—one size fits all. But the traditional IPO has its own weaknesses. Traditional IPOs are a lucrative business for institutional investors and investment banks, but far from favorable for retail investors, and expensive for capital formation.

It is undeniable that issuers can take advantage of the choice afforded by the Securities Act to engineer transactions that utilize sales to unsophisticated investors in the secondary markets as an alternative means to go public. If issuers do not internalize the costs and benefits from these reduced regulatory protections relative to a traditional IPO, they are unlikely to choose an alternative to the traditional IPO that maximizes the joint welfare of the issuer and investors. This creates the possibility that a company with little existing public information that poses heightened risks for investors would avoid going public through a traditional IPO (which may highlight such risks to the market) but instead choose to sell through a private placement or a SPAC. The securities sold could then make their way to retail investors through unrestricted resales. To the extent either the initial investors in the private placement or the investors who purchase through resales in the secondary market do not price the regulatory benefits they otherwise would have received from a traditional IPO, the high-risk issuer will not internalize these benefits when selling through the private placement or a SPAC.

Taking advantage of the limited choice afforded under the transaction-based regime may also impose additional costs. Issuers and their advisors will expend resources seeking ways to exploit the transaction-based regime to go public without a traditional IPO. Compared with a full choice regime, which would allow issuers to simply choose which investor protections to apply,[99] the limited choice may cause issuers to take actions that decrease the overall welfare of the issuer and investors solely to avoid classification as a traditional IPO. Issuers may engage in artificial and costly steps, such as identifying and merging with a shell company in a reverse merger with a SPAC, to avoid the rules associated with a traditional IPO. Issuers may also avoid relying on certain value-increasing regulatory protections out of a fear that the use of these protections will bring with them the full range of traditional IPO regulations (and their expense), in particular the draconian liability provisions of Section 11. For example, issuers in a de-SPAC merger may eschew using investment banks as more than advisors so the investment banks avoid becoming underwriters in the merger transaction. If the threat of underwriter status, with its exposure to legal liability, could be taken off the table, the issuer and investment banks could negotiate for the investment banks to play a greater marketing and certification role in the de-SPAC merger. A greater certification role for the investment banks might benefit the SPAC investors. The SEC instead insists on imposing Section 11 liability on every innovation, regardless of the potential benefits for investors. All stick, no carrot.

How should we reform the choice embedded in the Securities Act for companies to go public to reflect new market realities? One could target the definition of transaction in the Securities Act. For example, the scope of transactions for which the requirements of a traditional IPO apply could be expanded. With respect to SPACs, some have argued that the de-SPAC merger itself should be

[99] For articles proposing choice in securities regulation see Stephen J. Choi and Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 Southern Cal. L. Rev. 903 (1998); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359 (1998).

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characterized as a primary public offering by the target company to the SPAC shareholders.[100] The SEC's proposed SPAC rules takes a similar approach, deeming both the SPAC and the target company as "issuers" in the de-SPAC merger even if only the SPAC is actually issuing shares in the merger.[101] The SEC's proposed rules also deem SPAC shareholders as buying shares in a de-SPAC merger even if the SPAC investors' shares do not change in the merger.[102] The SEC's one-size-fits-all approach, however, may overshoot the mark, in the case of sophisticated investors or companies in a thick information environment, or too little, in the case of unsophisticated investors investing in a company with minimal public disclosure. The agency's proposed response, discussed above, impose liability rules that discourage innovation with a one-size-fits-all approach, instead of channeling innovation in ways that balance investor protection and capital formation. The SEC's proposals appear to have already chilled the market for SPACs, even prior to adoption.

We think the key to how we provide choice to issuers in going public lies in the informational efficiency for the issuers' securities. Private markets typically lack informational efficiency; they generally do not have a critical mass of sophisticated institutional investors to process the scant information that is available. Reform could target Section 4(a)(1)'s exemption from Section 5 treating transactions separate from the issuer's primary market transaction as unrestricted. Instead, one could regulate trading of securities in the public capital market based on criteria other than "separateness" from the issuer's transaction. Instead of a transaction – the traditional IPO – as the dominant path for making the transition from private to public, we propose that companies could be given two options. Both focus on the quality of the information environment, but they take different approaches based on timing: one focuses ex ante on developing a thick information environment, the other ex post, on strengthening mandatory investor protections until a company develops such a thick information environment.

Option #1 (ex ante): We propose allowing companies with a thick information environment to have securities traded without restriction in the public capital markets.[103] This first option attempts to leverage the most attractive features of direct listing—market-based pricing and lower investment banking fees—in a way that promotes investor protection without creating inordinate liability risks. The goal would be to ensure a thick information environment prior to a company going public.

Such a reform could be implemented by requiring Exchange Act filings for a period before permitting listing on an exchange, thereby allowing market participants to digest the information. To suggest one possibility, companies could opt for a seasoning period with public reporting, including an initial Form 10 and quarterly Form 10-Qs, while remaining a private company. A period of public reporting, perhaps six months to align with the holding period for Rule 144, would be subject to only SEC enforcement for misleading disclosures.[104] The availability of information, along with the assurance of eventual public listing on the NYSE or Nasdaq, would encourage institutional investors to trade in the

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[100] See Harald Halbhuber, An Economic Substance Approach to SPAC Regulation (2022) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4005605).
[101] See SEC, Securities Act Release No. 33-11048 at p. 75.
[102] See SEC, Securities Act Release No. 33-11048 at p. 101 ("[W]e are proposing new Rule 145a under the Securities Act that would deem such business combination transactions to involve a sale of securities to a reporting shell company's shareholders.")
[103] Our first option builds on an earlier proposal by one of us to create tiered secondary markets based on the sophistication of investors in the markets and the nature of the information environment for the traded companies. See A.C. Pritchard, Revisiting "Truth in Securities" Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good, 36 Seattle U. L. Rev. 999 (2013) (proposing to create tiers of firms based on market capitalization, among other factors, an restricting investor access to the securities of lower tier firms).
[104] Companies would want to make voluntary disclosures to enhance the liquidity of these markets. Those voluntary disclosures would need to be exempted from Regulation M by the SEC.

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private markets for these companies. Securities would trade only among accredited investors until the issuer develops an analyst following and an institutional shareholder base. The goal would be to develop an informationally efficient market, with pricing driven by the "smart money," before allowing retail shareholders to participate.

Under this regime, companies would be eligible for public company status and listing on a national securities exchange after the seasoning period without doing a registered offering, either primary or secondary. To the extent a thick information environment exists for an issuer at the time the issuer transitions to having securities trading on a public exchange market, one could imagine allowing companies that seek to list their shares on a national securities exchange (as opposed to raising capital in a primary offering) to do so without requiring underwriters or, most importantly, Section 11 liability. Disclose now, trade later.

Once public, both retail and institutional investors could freely trade the securities of the company. The company could also do subsequent primary offerings under the SEC's relaxed shelf registration standards for seasoned companies and thereby avoid most of the gun-jumping rules. Indeed, one could consider removing or making Section 11 liability optional for shelf registration offerings by large, well-known issuers trading in thick information environments. The pricing of subsequent shelf offerings would be informed by the information environment created during the seasoning period. In our view, that would be a substantial improvement over the imperfect process of book building currently used for private companies going public in a traditional IPO. Moreover, the company would have had an opportunity to establish credibility with analysts and institutional investors with its disclosures made during the seasoning period prior to going public. Under this regime, underwriter fees would likely be dramatically reduced, as shelf registration fees are a fraction of the 7% typically charged for IPOs.

Experimentation may be required to determine the exactly what is needed to ensure a thick information environment. Perhaps the seasoning period should be shorter or longer depending on a company's size. Alternatives could focus on requirements of a minimum market capitalization, trading volume, or analyst following before making the transition to public company status. Our purpose here is not to specify the exact requirements that define a thick information environment. Instead, our purpose is to shift the focus of regulatory attention away from replicating the traditional IPO requirements across all alternatives to the traditional IPO. Instead the SEC should focus on when issuer choice in going public makes sense and the importance of a thick information environment for this consideration.

In theory, private companies can voluntarily undergo a seasoning period similar to what we propose under Option #1. A private company may already voluntarily file periodic disclosures, including annual Form 10-Ks and quarterly Form 10-Qs. A private company may also list on the over-the-counter market (OTC) and then later "uplist" its securities for trading on Nasdaq or the NYSE. Such a company may also qualify for shelf-registration after sufficient time passes under which the company is a reporting issuer and the company meets the requirements of Form S-3 (principally market capitalization). The abuses associated with the OTC market, however, in which trading is dominated by retail investors, appear to have made the uplisting alternative unattractive, at least for companies that are sufficiently large that they anticipate being able to eventually satisfy exchange listing standards.

Our proposal has at least three differences compared with the existing regime. First, even if a pathway to public company status exists today through a voluntary seasoning period, relatively few companies have taken this path, presumably deterred by the difficulty of satisfying the exchange's minimum capitalization requirements. We suspect that if large numbers of companies go public through an uplift onto a national securities exchange, the SEC will follow the same one-size-fits-all approach of imposing traditional IPO regulatory requirements on this pathway, including requiring a registration statement and an underwriter with corresponding Section 11 liability. Second, we have sketched out only

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part of what could be the potential carrot of our proposal. Although a seasoning period as a public reporting company may be sufficient to ensure a thick information environment, other factors may be used to assess the information environment, such as analyst coverage, that may not necessarily track present uplisting requirements, which focus on minimum share price and minimum number of publicly-held shares.[105] Moreover, once a company is in a thick information environment, the market mechanism that results in the market price reflecting regulatory protections potentially allows for more choice in regulations (i.e., a bigger "carrot"), including making Section 11 liability optional for shelf registered offerings among other possibilities. Third, a key part of our proposal is the stick (explained below) imposing additional aftermarket regulatory requirements on companies that do not trade in a thick information environment that choose to go through the traditional IPO. Even if the carrot route already partially exists in the existing regime, our hope is that this stick will channel more issuers toward the seasoning route to public company status.

Option #2 (ex post): We propose that issuers that lack a thick information environment still have the option of going public through a traditional IPO. However, simply filing one registration statement and selling securities once that registration statement is effective may not necessarily lead to a thick information environment. Issuers that go through a traditional IPO but trade in a low information environment, such as the secondary market after most SPAC IPOs or the OTC markets, expose secondary market investors to potential abuses.[106] Investors that buy SPAC shares in the secondary market prior to a de-SPAC merger are offered little protection from a prior registration statement that contained almost no information of substance. Recognition that the lack of a thick information environment may lead issuers not to maximize the joint welfare of issuer and investors, in turn, justifies greater mandatory regulatory intervention.[107]

As with Option #1, we do not specify the exact contours of the heightened regulatory intervention. Our point instead is to frame when greater regulatory intervention is more justified because issuers do not internalize the costs and benefits of regulatory protections for investors. As one possibility, one could subject all company disclosures to heighted Section 11 liability for a period, for example one year (or until the issuer meets certain metrics for a thick information environment based on market capitalization, analyst coverage and other criteria), after going public. If a company chooses this ex post option, the change from the current regime would be that Section 11 liability would extend not only to registration statement disclosures made in connection with the initial offering, but also to SEC periodic disclosures including Form 10-Qs (and possibly Form 10-Ks if the post-IPO seasoning period is longer than one year). These periodic filings would be incorporated into the registration statement as they were filed. Tracing would perhaps need to be modified to allow purchasers during the seasoning period to recover, as there would potentially be a mismatch between the time of purchase and time a misleading statement became part of the registration statement. Post-IPO heightened liability would allow for post-public seasoning without sacrificing investor protection. With this option, heightened liability would compensate for the weaker information environment until the environment becomes stronger over time. Experimentation will guide the SEC to how long a post-IPO seasoning period is required (and whether other criteria should be used to determine the presence of a thick information environment) and whether to mandate other regulatory protections, such as enhanced disclosures and closer monitoring of trades in

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[105] See https://listingcenter.nasdaq.com/assets/initialguide.pdf.

[106] See Drew Singer, Massive Pops in Tiny IPOs Are Turning Into Even Bigger Busts, Bloomberg (Sept. 7, 2022).

[107] Our second option builds on an earlier proposal by one of us. See Stephen J. Choi, Company Registration: Toward a Status-Based Antifraud Regime, 64 U. CHI. L. REV. 567, (1997) (proposing to vary antifraud liability based on the capitalization and market following of the particular issuer).

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the market. Under this regime, a private company would not need to undergo pre-IPO seasoning as in Option #1. Trade now, but face potential liability later for any material misstatements.

Option #1 takes longer to reach the public markets, but it makes private markets more attractive as a steppingstone to an exchange listing. It also comes with significantly reduced liability exposure. For companies that are not desperate for a large infusion of capital, we believe that option #1 clearly dominates. It runs counter to the SEC's habitual response of imposing liability, but it substitutes reliance on a robust information environment and investment sophistication. These factors are more likely to lead to informational efficiency in the capital markets than the haphazard deterrence, diluted by the prospect of frivolous suits, provided by ex post liability imposed without regard to fault.

We could be wrong, however. If the SEC is right that investors really value liability protections, issuers should opt for Option #2, as that will minimize their cost of capital. The point of providing the two options is to generate reliable market feedback on competing regulatory approaches.

The SEC could implement either of our proposals using its authority granted by Congress in the Securities Act. Using the general exemptive authority granted by Congress,[108] the SEC could modify Rule 144, which presently allows resales of unregistered securities after a defined holding period. Instead of allowing the simple passage of time to determine when investors may resell unregistered securities, the SEC could condition public resales under Rule 144 on the issuer meeting pre-public seasoning requirements (Option #1). Alternatively, if the SEC pursues Option #2, the SEC could utilize the leverage over issuers the SEC enjoys from the SEC's ability to accelerate effectiveness of the registration statement. Section 8(a) of the Securities Act requires that 20 days must pass from the filing of the registration statement with the SEC before the effectiveness of the registration statement, when sales may commence. This 20-day period is reset upon the filing of any amendment to the registration statement, including a pricing amendment. The SEC may condition accelerating the effectiveness (so that an issuer does not need to wait 20 calendar days after pricing to commence sales) on the issuer agreeing to an undertaking assuming post-public offering heightened liability. The SEC could also work with the national securities exchanges to allow for the listing of the securities of companies that satisfy either Option #1 or #2. In particular, the exchanges could facilitate direct listings by creating a probationary period of exchange trading in which a company needs to establish the requisite public float and market capitalization.

Conclusion

Regulatory structure matters. The transaction-based structure of our present securities regime allows innovation in the way issuers go public. But this innovation is not necessarily driven by issuers that internalize the full range of costs and benefits from reducing the regulatory protections governing the traditional IPO. Innovations that do away with these protections may therefore not maximize the joint welfare of issuers and investors. These innovations lead the SEC to play catch-up, as they did recently with their proposed SPAC rule changes. The SEC's stated goal is always to protect the unsophisticated investors that are harmed by new ways of going public. The solution invariably is to apply traditional IPO regulatory protections. Rather than playing catch-up within the transaction-based regime, a better approach would be to reconsider the aspects of the IPO regime that create demand for innovation and channel innovations toward maximizing the joint welfare of investors and issuers. The SEC's single-minded habit of treating the traditional IPO regulatory process as a one-size-fits-all regime, with a reflexive resort to heightened liability under Section 11 in response to market innovations, ignores the weaknesses of the traditional

[108] See 15 U.S. Code § 77z–3.

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IPO. Instead, the agency's focus should be on market pricing driven by sophisticated investors with access to credible disclosure. In that context, the SEC can trust market forces to address the needs of issuers and investors.

To achieve this goal, we propose that the transition from private to public company should turn on information efficiency for a company's securities. Issuers in an informationally efficient market will internalize the costs and benefits of regulatory protections; they should have the freedom to innovate to maximize the joint welfare of issuers and investors. For issuers that do not trade in an informationally efficient market, we propose a pre-IPO seasoning period to foster market informational efficiency. After this pre-IPO seasoning, we would allow the issuer to go public, including listing on a national securities exchange, without jumping through the hoops of the Securities Act. Instead, such companies would face the periodic disclosure and general antifraud requirements under Rule 10b-5 imposed generally on all public companies.

Alternatively, a private company that does not enjoy a thick information environment could follow the traditional IPO process. For such companies, the internalization justification to reduce mandatory regulatory requirements does not apply. Here, greater mandatory regulation is potentially warranted. We propose imposing a post-IPO heightened regulatory period, which may include heightened liability, during which the increased regulatory protections for periodic filings will ameliorate the risks facing investors in a company that does not trade in an informationally efficient environment. By having heightened regulatory requirements turn on the company's status, rather than a particular transaction, our proposal avoids the regulatory arbitrage that is possible under the transaction focus of the current regime. SPACs are just the latest example of market efforts to evade the SEC's heavy-handed regulatory approach.

Our post-IPO proposal that focuses on heightened liability is at best a blunt tool for promoting informational efficiency. As with any mandatory regulatory intervention, regulators may get the required level and type of mandatory intervention needed to compensate for a lack of internalization wrong. Perhaps having one year of heighted Section 11 liability after a traditional IPO imposes greater joint costs than benefits to issuers and investors. Our post-IPO proposal nonetheless serves as a stick, discouraging companies from going public without a thick information environment. Companies that encourage informationally efficient markets for their securities by making robust disclosures during a pre-IPO seasoning period, should in turn be rewarded with lower liability exposure, the carrot in our proposal. The goal of public offering regulation should be securities trading in informationally efficient markets, with pricing driven by sophisticated investors. Retail investors can participate in such markets with minimal investor protection concerns.

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