

# CARVING A NEW PATH TO EQUITY CAPITAL AND SHARE LIQUIDITY

WILLIAM K. SJOSTROM, JR.\*

**Abstract:** This Article advocates regulatory reforms designed to carve a new path to equity capital and share liquidity for private companies. Specifically, the reforms would allow private companies to seek sophisticated investors through general solicitation and would foster the development of a liquid “sophisticated-investors only” (“SIO”) market for private company shares. The reforms are grounded in the fundamental principle of U.S. securities laws that sophisticated investors can “fend for themselves” and therefore require considerably fewer legal safeguards. As a result, the reforms would enhance capital formation by reducing regulatory burdens without compromising investor protection. The Article details the reforms and explains how they can be implemented under existing federal securities laws. It then considers the possibilities for new SIO markets if the reforms are adopted and theorizes about how the resulting securities regulatory void for SIO companies would be filled.

## INTRODUCTION

Many companies, especially emerging companies, depend on equity capital to finance their businesses.<sup>1</sup> Traditionally, an emerging company raises equity capital through the sale of stock to angel investors and venture capitalists.<sup>2</sup> It uses this funding to develop and commercialize a business concept, at which point it goes public through an initial public offering (“IPO”).<sup>3</sup> Going public allows the company to raise a substantial amount of additional equity capital that it can use to ramp up production, sales, and marketing. It also allows the company

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\* Professor of Law, Salmon P. Chase College of Law, Northern Kentucky University, J.D., University of Notre Dame; B.S., University of Illinois at Urbana-Champaign. I would like to thank participants at faculty workshops at University of Arizona James E. Rogers College of Law and University of Maryland School of Law for their helpful comments on earlier versions of this Article.

<sup>1</sup> U.S. GEN. ACCOUNTING OFFICE, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION I (2000) [hereinafter GAO REPORT], available at <http://www.gao.gov/archive/2000/gg00190.pdf>.

<sup>2</sup> See William K. Sjoström, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 5–7 (2004).

<sup>3</sup> See *id.*

to attain share liquidity because its shares are traded on a public market following an IPO.

As things stand today, the problem with the traditional route is that the passage of the Sarbanes-Oxley Act of 2002 (“SOX”)<sup>4</sup> has made it much more expensive to be a public company. As a result, a number of private companies have pursued alternative paths to equity capital and share liquidity.<sup>5</sup> Although these alternative paths work to some extent, they have significant drawbacks and, therefore, are unsuitable for many private companies. Consequently, this Article advocates regulatory reforms designed to carve a new path to equity capital and share liquidity.<sup>6</sup> Specifically, the reforms would allow private companies to seek sophisticated investors through general solicitation and would foster the development of a liquid “sophisticated-investors only” (“SIO”) market for private company shares. The reforms are grounded in the fundamental principle of U.S. securities laws that sophisticated investors can “fend for themselves” and, therefore, require considerably fewer legal safeguards.<sup>7</sup> As a result, the reforms would enhance capital formation by reducing regulatory burdens without compromising investor protection.<sup>8</sup>

Part I of this Article sets the stage by discussing the advantages and disadvantages of going public versus remaining private.<sup>9</sup> Part II delves into the need for a new path to equity capital and share liquidity by discussing how SOX has escalated the costs of being public and exploring the shortcomings of alternatives to going public.<sup>10</sup> Part III details proposed reforms and describes how they can be implemented under existing federal securities laws.<sup>11</sup> Part IV considers the possibilities for new SIO markets if these reforms are implemented and theorizes about how the resulting securities regulatory void for SIO companies would be filled.<sup>12</sup>

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<sup>4</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, and 28 U.S.C.).

<sup>5</sup> See *infra* notes 169–194 and accompanying text.

<sup>6</sup> See *infra* notes 195–276 and accompanying text.

<sup>7</sup> See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953).

<sup>8</sup> See *id.*

<sup>9</sup> See *infra* notes 13–137 and accompanying text.

<sup>10</sup> See *infra* notes 138–194 and accompanying text.

<sup>11</sup> See *infra* notes 195–276 and accompanying text.

<sup>12</sup> See *infra* notes 277–317 and accompanying text.

## I. GOING PUBLIC VERSUS REMAINING PRIVATE

### A. *Going Public*

#### 1. Advantages

A company typically starts off as private but for a variety of reasons may later choose to go public, usually through an IPO.<sup>13</sup> Going public offers a company a number of advantages, including enhanced reputation, establishment of a market value for the company, and a broadened ownership base.<sup>14</sup> For many companies, however, the primary advantages of going public are securing a large infusion of equity capital and attaining share liquidity.<sup>15</sup>

#### a. *Capital Infusion*

Going public enables a company to raise a sizeable amount of equity capital. The size of the infusion ranges from several million to hundreds of millions of dollars in cash, depending on the size of the offering. Additionally, going public likely makes it easier for the company to raise capital going forward because it opens up new sources and methods of financing (for example, private investments in public equity (“PIPE”) and shelf offerings).<sup>16</sup> Further, lenders are often more willing to lend to a public company because they know, as discussed below, that the company is required to make ongoing extensive public disclosures about its financial results and business operations, and that such disclosures will be scrutinized by investors, analysts, and regulators.<sup>17</sup>

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<sup>13</sup> See James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. FIN. 399, 405–07 (2006).

<sup>14</sup> See *id.*

<sup>15</sup> See *id.* at 406 (noting that creating liquid stock for use in future acquisitions scored the highest in a survey of CFOs concerning the importance of various factors in the decision to go public).

<sup>16</sup> For an overview of PIPE financing, see William K. Sjostrom, Jr., Foreword, *PIPEs*, 2 ENTREPRENEURIAL BUS. L.J. 381, 383–90 (2007).

<sup>17</sup> See Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 257 (2008); William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 574 (2001).

### b. *Share Liquidity*

Another advantage of going public is that it results in share liquidity.<sup>18</sup> Shares are considered liquid if they can be easily converted into cash. An IPO leads to share liquidity because, thereafter, the company's shares will trade on a public market, typically the New York Stock Exchange ("NYSE") or the NASDAQ Stock Market. Companies value share liquidity for a number of reasons. First, liquid stock can be used as currency for acquisitions.<sup>19</sup> This allows a public company to pursue an acquisition even if it lacks sufficient cash or borrowing capacity.<sup>20</sup> Second, a company can use liquid stock as a component of employee compensation. Liquid stock is attractive to employees because it can be easily valued and converted into cash, and it provides tax benefits and upside potential. These considerations aid in employee recruitment and retention<sup>21</sup> and better align the interests of employees and shareholders.<sup>22</sup> Third, fluctuations in the price of a company's stock in a liquid market aids management because it provides immediate feedback as to the market consensus on the company's strategy and performance.<sup>23</sup>

Company founders value share liquidity because it allows them to easily diversify their portfolios.<sup>24</sup> Company founders typically have a large portion of their wealth and human capital invested in the com-

<sup>18</sup> See James C. Brau et al., *The Choice of IPO Versus Takeover: Empirical Evidence*, 76 J. Bus. 583, 590 (2003).

<sup>19</sup> See *id.*

<sup>20</sup> See 11 SIMON M. LORNE & JOY M. BRYAN, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 3:4 (2008) (describing advantages of "tax-free" reorganization). Target companies are frequently willing to be acquired for stock because of tax considerations. See *id.*

<sup>21</sup> See Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934, Exchange Act Release No. 56,010, 72 Fed. Reg. 37,608, 37,608 (proposed July 10, 2007) ("Compensatory employee stock options provide a method to use non-cash compensation to attract, retain, and motivate company employees, directors, and consultants."); see also NASDAQ, Inc., GOING PUBLIC: A GUIDE FOR NORTH AMERICAN COMPANIES LISTING ON THE U.S. SECURITIES MARKETS 15 (Nicole Lew ed., White Page LTD 2005), available at [http://www.nasdaq.com/about/listing\\_guide.stm](http://www.nasdaq.com/about/listing_guide.stm);

Richard A. Booth, *Going Public, Selling Stock, and Buying Liquidity*, 2 ENTREPRENEURIAL BUS. L.J. 649, 663 (2008).

<sup>22</sup> See Booth, *supra* note 21, at 663.

<sup>23</sup> See Gilson & Whitehead, *supra* note 17, at 256 ("[T]he informational efficiency of public company share prices provides an important management tool—a company receives virtually instant feedback through prices and periodic feedback through analyst reports, concerning its strategy and performance and that of its competitors . . ."); see also Vojislav Maksimovic & Pegaret Pichler, *Technological Innovation and Initial Public Offerings*, 14 REV. FIN. STUD. 459, 461 (2001).

<sup>24</sup> See Booth, *supra* note 21, at 662.

pany.<sup>25</sup> Once a public market is established for the company's shares, founders can sell a portion of their holdings into the market, invest the proceeds elsewhere, and thereby reduce portfolio risk without decreasing expected returns.<sup>26</sup>

Finally, early-stage investors value share liquidity because it allows them to cash out or exit their investments.<sup>27</sup> Exit capability is particularly important to venture capitalists because their business model of providing short-term funding to start-up companies depends on it.<sup>28</sup> Exiting a company once it goes public allows a venture capitalist to recycle into new ventures the financial and nonfinancial support it provided the company to get it to its IPO.<sup>29</sup>

## 2. Disadvantages

The primary disadvantages of going public are that it triggers extensive disclosure obligations and that it subjects a company and its officers and directors to potential civil and criminal liability under federal securities laws.<sup>30</sup>

### a. Extensive Regulation

To complete an IPO, a company must register the offering under the Securities Act.<sup>31</sup> Registering involves preparing and filing a registration statement with the U.S. Securities and Exchange Commission ("SEC").<sup>32</sup> Under SEC regulations, the registration statement must contain detailed and voluminous disclosures about the issuer and the offering.<sup>33</sup> These disclosures include audited financial statements, comparative selected financial information, and management's discussion and analysis ("MD&A") of the issuer's financial condition and results of operation.<sup>34</sup> They also include a detailed description of the issuer's busi-

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<sup>25</sup> See *id.*

<sup>26</sup> See *id.*

<sup>27</sup> See Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 252 (1998).

<sup>28</sup> See D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 316 (2005).

<sup>29</sup> See Black & Gilson, *supra* note 27, at 245–46. Nonfinancial support includes monitoring and advisory services and reputational capital. See *id.* at 245.

<sup>30</sup> See *infra* notes 31–77 and accompanying text.

<sup>31</sup> See 15 U.S.C. §§ 77a–77z-3 (2006).

<sup>32</sup> See *id.* § 77f.

<sup>33</sup> See *id.* §§ 77g, 77aa.

<sup>34</sup> See 1 HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* §§ 6:24–:25, at 333–34 (2005).

ness, properties, transactions with management, legal proceedings, and executive compensation.<sup>35</sup>

Once public, a company becomes subject to the reporting requirements of the Exchange Act.<sup>36</sup> The Exchange Act requires public companies to prepare and file with the SEC annual, quarterly, and current reports.<sup>37</sup> Annual reports must include a description of the company's business, risk factors, audited financial statements for the year, MD&A, and information concerning executive compensation.<sup>38</sup> Quarterly reports must include unaudited quarterly financial statements and MD&A with respect to quarterly results.<sup>39</sup> A public company must file a current report following the occurrence of certain specified events (for example, entry into a material agreement outside the ordinary course of business, resignation of the company's independent accountant, and appointment or resignation of a principal officer).<sup>40</sup> The report must include detailed information about the event.<sup>41</sup>

Most public companies are also subject to federal proxy regulations.<sup>42</sup> These regulations require a company to furnish its shareholders a proxy statement whenever it solicits proxies.<sup>43</sup> The proxy statement is designed to provide shareholders with relevant information with respect to the matters up for vote for which proxies are solicited.<sup>44</sup> For example, a proxy statement relating to the election of directors must include biographical information about the nominees, when they first became directors, and their stock and option holdings in the corporation.<sup>45</sup> The proxy statement must also include detailed information about director compensation and transactions between any director and the corporation during the past year.<sup>46</sup> Additionally, if a proxy

<sup>35</sup> See *id.*

<sup>36</sup> See 15 U.S.C. §§ 78a–78mm (2006).

<sup>37</sup> See *id.* § 78m(a). The SEC adopted these requirements pursuant to § 13(a) of the Exchange Act, which empowers the SEC to prescribe “information and documents” and “annual reports” that it deems “as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security.” See *id.*

<sup>38</sup> See U.S. Sec. & Exch. Comm’n, Form 10-K, pt. I, at 7–9, available at <http://www.sec.gov/about/forms/form10-k.pdf>; see also 17 C.F.R. § 249.310 (2008).

<sup>39</sup> See U.S. Sec. & Exch. Comm’n, Form 10-Q, pt. I, at 5, available at <http://www.sec.gov/about/forms/form10-q.pdf>; see also 17 C.F.R. § 249.308(a).

<sup>40</sup> See U.S. Sec. & Exch. Comm’n, Form 8-K, § 1, at 4–6, §§ 4–5, at 13–18, available at <http://www.sec.gov/about/forms/form8-k.pdf>; see also 17 C.F.R. § 249.308.

<sup>41</sup> See U.S. Sec. & Exch. Comm’n, Form 8-K §§ 1, 4–5, at 4, 13–18.

<sup>42</sup> See 17 C.F.R. § 240.14a-3 (2008).

<sup>43</sup> See *id.*

<sup>44</sup> See ROBERT C. CLARK, CORPORATE LAW § 9.2, at 366 (1986).

<sup>45</sup> See Schedule 14A, Items 7–8, 17 C.F.R. § 240.14a-101.

<sup>46</sup> See *id.*; see also 1 BLOOMENTHAL, *supra* note 34, § 17:6, at 969.

solicitation for the election of directors at an annual meeting is made by the corporation's management, the solicitation materials must be accompanied or preceded by an annual report to security holders.<sup>47</sup> As required by SEC regulations, the annual report provides detailed information about the corporation's performance, including audited year-end financial statements.<sup>48</sup>

Compliance with the above regulations is costly because a public company will incur legal and accounting fees and management opportunity costs year after year preparing the plethora of documents.<sup>49</sup> Compliance also costs the company a large degree of confidentiality.<sup>50</sup> A company is required to disclose in its IPO registration statement theretofore confidential information.<sup>51</sup> Thereafter, the company is required to periodically update this information in various SEC filings, all of which are freely accessible on the SEC's website.<sup>52</sup> Further, a public company is generally obligated to disclose material events to the marketplace as they occur.<sup>53</sup> More significantly, the loss of confidentiality as a result of mandatory disclosure requirements can result in lost competitive advantage. A public company's competitors can learn much more about the company's business plans, product development, and perceived risks than they ever could about a private company. Additionally, the very fact that a company has completed a successful IPO can encourage new firms to enter the industry, thus increasing the number of competitors.<sup>54</sup>

#### b. *Increased Liability Exposure*

Another disadvantage of going public is that doing so subjects a company and its officers and directors to potential civil and criminal liability under various provisions of the Securities Act and the Exchange Act.<sup>55</sup> Liability provisions under the Securities Act include Sec-

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<sup>47</sup> See 17 C.F.R. § 240.14a-3(b).

<sup>48</sup> See *id.*

<sup>49</sup> See NASDAQ, Inc., *supra* note 21, at 16 ("Compliance with disclosure requirements necessitates a comprehensive and costly expansion—or outright replacement—of existing corporate information systems.")

<sup>50</sup> See 1 BLOOMENTHAL, *supra* note 34, §§ 6:23–:29, at 332–34.

<sup>51</sup> See *id.*

<sup>52</sup> U.S. Sec. & Exch. Comm'n, Filings & Forms, <http://www.sec.gov/edgar.shtml> (last visited Mar. 5, 2009).

<sup>53</sup> See 2 BLOOMENTHAL, *supra* note 34, § 27:27.

<sup>54</sup> See Maksimovic & Pichler, *supra* note 23, at 460.

<sup>55</sup> See, e.g., 15 U.S.C. §§ 77k, 77l(a)(2), 77q(a), 77x.

tions 11,<sup>56</sup> 12(a)(2),<sup>57</sup> 17(a),<sup>58</sup> and 24.<sup>59</sup> Section 11 imposes civil liability for misstatements or omissions of material fact from a registration statement.<sup>60</sup> Potential Section 11 defendants include the issuer and its executive officers, directors, underwriters, and accountants.<sup>61</sup> Likewise, Section 12(a)(2) imposes civil liability on any person who offers or sells a security through a prospectus or oral communication that includes a misstatement of material fact or omits to state a material fact.<sup>62</sup> Additionally, Section 17(a) makes it unlawful for any person to engage in fraud or misstate a material fact or omit to state a material fact in the offer or sale of a security.<sup>63</sup> Finally, Section 24 of the Securities Act imposes criminal liability for any willful violation of the Act.<sup>64</sup>

Liability provisions under the Exchange Act include Rule 10b-5,<sup>65</sup> Rule 14a-9,<sup>66</sup> and Section 32(a).<sup>67</sup> Rule 10b-5 imposes liability for misstatements of material fact, or misleading omissions of material fact, in connection with the purchase or sale of a security.<sup>68</sup> The dissemination of Exchange Act reports is considered to be made “in connection with the purchase or sale of a security” because it is presumed that the information in such reports is quickly incorporated into the market price of a company’s securities and that investors rely on the integrity of the market price in deciding whether to purchase or sell such securities.<sup>69</sup>

<sup>56</sup> *Id.* § 77k.

<sup>57</sup> *Id.* § 77l(a)(2).

<sup>58</sup> *Id.* § 77q(a).

<sup>59</sup> *Id.* § 77x.

<sup>60</sup> *See* 15 U.S.C. § 77k.

<sup>61</sup> *See id.* § 77k(a).

<sup>62</sup> *Id.* § 77l(a)(2).

<sup>63</sup> *Id.* § 77q(a).

<sup>64</sup> *Id.*

<sup>65</sup> 17 C.F.R. § 240.10b-5(b).

<sup>66</sup> *Id.* § 240.14a-9.

<sup>67</sup> 15 U.S.C. § 78ff(a).

<sup>68</sup> *See* 17 C.F.R. § 240.10b-5(b). Rule 10b-5(b) provides:

It shall be unlawful for any person . . . (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.

*Id.*

<sup>69</sup> *See* *Basic Inc. v. Levinson*, 485 U.S. 224, 241–42 (1988) (“[T]he price of a company’s stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.” (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160–61 (3d Cir. 1986))); *see also* *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968) (noting that a material misstatement or omission is made “in connection with

Hence, a company is potentially liable under Rule 10b-5 for any material misstatements in or omissions from an Exchange Act report because the correct information it was obligated to disclose is not reflected in the market price.<sup>70</sup> Directors and officers of the company are potentially subject to controlling person or aiding and abetting liability if the company is found to have violated Rule 10b-5.<sup>71</sup>

Rule 10b-5 is very broad in its reach.<sup>72</sup> It applies not just to Exchange Act reports but to any public statements made by a company by whatever means (for example, press releases, interviews, and television appearances).<sup>73</sup> This is because it is presumed that all material public information about a company is impounded into its stock price.<sup>74</sup>

Rule 14a-9 imposes liability for misstatements of material fact, or misleading omissions of material fact, in connection with the solicitation of proxies.<sup>75</sup> Finally, Section 32(a) of the Exchange Act imposes criminal liability for any willful violation of the Act.<sup>76</sup>

Costs of this increased liability risk include director and officer liability insurance premiums, and, of course, legal fees and diversion of management time if a suit is threatened or filed, regardless of merit. Costs may also include reduced risk taking by management to minimize the chances of lawsuits and increased director and officer compensation as recompense for bearing this increased risk.<sup>77</sup>

## B. *Staying Private*

### 1. Advantages

Staying private offers a company a number of advantages, including more freedom to focus on long-term prospects and less public scrutiny. The primary advantage of staying private, however, is avoiding the ex-

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the purchase or sale of any security" if it "would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities").

<sup>70</sup> See 17 C.F.R. § 240.10b-5.

<sup>71</sup> See 15 U.S.C. § 78t.

<sup>72</sup> See 17 C.F.R. § 240.10b-5.

<sup>73</sup> See 2 BLOOMENTHAL, *supra* note 34, § 27:16, at 117 (noting that Rule 10b-5 imposes "liability and responsibility for false or misleading statements in connection with press releases, letters, and reports to shareholders, and the like").

<sup>74</sup> See *Basic*, 485 U.S. at 241-42.

<sup>75</sup> 17 C.F.R. § 240.14a-9.

<sup>76</sup> See 15 U.S.C. § 78ff(a).

<sup>77</sup> See HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT* 45-46 (2006).

tensive federal regulation and increased liability exposure triggered by going public. Most of the rules and regulations described above simply do not apply to a private company.<sup>78</sup> Specifically, Exchange Act reporting requirements apply only to a company with securities registered under Section 12 of the Exchange Act<sup>79</sup> or a company that has filed a registration statement that has become effective under the Securities Act.<sup>80</sup> A company is required to register securities under Section 12 only if (1) it desires to list the securities on a “national securities exchange,” (e.g., the NYSE or NASDAQ) or (2) it has \$10 million or more in total assets and a class of equity securities held of record by 500 or more persons.<sup>81</sup> Hence, a private company will simply refrain from filing a registration statement under the Securities Act or listing securities on a “national securities exchange” until it is ready to go public, and it will keep careful track of the number of shareholders it has in order to avoid surpassing the 499 threshold.<sup>82</sup> Similarly, SEC proxy regulations apply only to a company with securities registered under Section 12 of the Exchange Act.<sup>83</sup> As a result, a private company will not be required to file annual, quarterly, or current reports or any proxy materials with the SEC.<sup>84</sup>

Furthermore, there is much less liability risk for a private company and its officers and directors.<sup>85</sup> Because a private company does not prepare and file annual, quarterly, and current reports or proxy statements, there are no such documents that a plaintiff can claim deficient in a lawsuit. Moreover, because private companies do not have publicly traded stock, there are no large one-day drops in stock price to trigger class action lawsuits.

A private company, however, does face potential liability under Securities Act Section 17<sup>86</sup> and Exchange Act Rule 10b-5,<sup>87</sup> as these provisions apply to all sales of securities, whether by a public or private com-

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<sup>78</sup> See, e.g., 15 U.S.C. §§ 78l, 78o.

<sup>79</sup> *Id.* § 78l.

<sup>80</sup> *Id.* § 78o(d).

<sup>81</sup> See *id.* § 78l(g). Note that section 12(g)(1) provides for a total asset threshold of \$1 million, but through Rule 12g-1 under the Exchange Act, the SEC has exempted a company from having to register under section 12(g) if its total assets do not exceed \$10 million. See 17 C.F.R. § 240.12g-1.

<sup>82</sup> See 15 U.S.C. § 78l(g)(1)(B).

<sup>83</sup> See 17 C.F.R. § 240.14a-2 (providing that proxy solicitation rules “apply to every solicitation of a proxy with respect to securities registered pursuant to section 12 of the [Exchange] Act”).

<sup>84</sup> See *id.* §§ 240.12g-1, 240.14a-2.

<sup>85</sup> See *id.*

<sup>86</sup> 15 U.S.C. § 77q.

<sup>87</sup> 17 C.F.R. § 240.10b-5.

pany.<sup>88</sup> Thus, a private company could get sued under Section 17(a) and Rule 10b-5, if, for example, the offering memorandum it used to sell securities in a private placement contained material errors or omissions.<sup>89</sup> Section 17(a), however, does not include an express private right of action, and numerous courts have ruled that none exists.<sup>90</sup> Further, Rule 10b-5 does not cast the same specter of liability as, for example, Section 11 under the Securities Act, because to prevail in a Rule 10b-5 claim, a plaintiff must prove, among other things, scienter, reliance, and causation,<sup>91</sup> none of which are elements of a Section 11 claim.<sup>92</sup> And, again, a private company does not distribute the quarterly, annual, and current reports that often serve as the basis for Rule 10b-5 lawsuits against public companies.<sup>93</sup>

## 2. Disadvantages

The primary disadvantages of staying private are constraints on capital raising and share illiquidity.

### a. *Constraints on Raising Capital*

Federal securities laws impose a variety of restraints on a private company's ability to raise capital. These restraints stem from Section 5 of the Securities Act, which makes it unlawful for any person to offer and sell a security unless the transaction is registered with the SEC.<sup>94</sup> Congress recognized, however, that it is inefficient to require the registration of all securities offerings and therefore included a number of registration exemptions in the Securities Act.<sup>95</sup> As a result, if a private company needs to raise capital through the sale of securities, it must do so in compliance with an exemption from Section 5 to avoid triggering reporting and other obligations under the Exchange Act.<sup>96</sup> Because an exempt offering is, by definition, not registered with the SEC, and

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<sup>88</sup> JAMES D. COX ET AL., *SECURITIES REGULATION CASES AND MATERIALS* 629–30 (4th ed. 2004).

<sup>89</sup> See 15 U.S.C. § 77q; 17 C.F.R. § 240.10b-5.

<sup>90</sup> See 2 THOMAS L. HAZEN, *THE LAW OF SECURITIES REGULATION* § 7.11[1][c], at 165 (5th ed. 2005); see also, e.g., *Crookham v. Crookham*, 914 F.2d 1027, 1029 (8th Cir. 1990).

<sup>91</sup> See 3 HAZEN, *supra* note 90, § 12.4, at 199.

<sup>92</sup> See 2 HAZEN, *supra* note 90, § 7.3[4], [7]–[8], at 71–81.

<sup>93</sup> See 17 C.F.R. §§ 240.12g-1, 240.14a-2.

<sup>94</sup> 15 U.S.C. § 77e; see 1 LOUIS LOSS ET AL., *SECURITIES REGULATION* 580–781 (4th ed. 2006).

<sup>95</sup> See, e.g., 15 U.S.C. §§ 77c, 77d.

<sup>96</sup> See *infra* notes 196–201 and accompanying text.

therefore investors forego the protections afforded by registration (mandatory disclosure, SEC review, and anti-fraud causes of action), exemptions include various conditions.

The most commonly relied upon exemption is Rule 506 of Regulation D under the Securities Act.<sup>97</sup> To fall within Rule 506, the issuer must limit the offering to accredited investors and what it reasonably believes are no more than thirty-five non-accredited investors.<sup>98</sup> Rule 501(a) defines “accredited investor” as, among other things, banks, insurance companies, mutual funds, and certain other specified institutional investors;<sup>99</sup> individuals with net worths in excess of \$1 million,<sup>100</sup> annual incomes in excess of \$200,000, or joint annual incomes in excess of \$300,000;<sup>101</sup> and executive officers and directors of the issuer.<sup>102</sup> Additionally, all non-accredited investors in the offering must be sophisticated, or the issuer must reasonably believe that they are sophisticated.<sup>103</sup>

Rule 506 requires the issuer to furnish any non-accredited investors that purchase securities in the offering certain specified information about the issuer and the offering at a reasonable time prior to the purchase.<sup>104</sup> The rule contains no specific requirement that the issuer furnish accredited investors information but does essentially instruct an issuer to provide to accredited investors any information it furnished to non-accredited investors.<sup>105</sup> Further, the issuer is required to afford all investors, whether accredited or not, “the opportunity to ask questions and receive answers concerning the terms and conditions of the offering.”<sup>106</sup>

Additionally, Rule 506 prohibits the issuer and anyone acting on its behalf from soliciting investors in an offering made in reliance on Rule

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<sup>97</sup> 17 C.F.R. § 230.506 (2008).

<sup>98</sup> *Id.* §§ 230.501(e), 230.506(b)(2)(i).

<sup>99</sup> *Id.* § 230.501(a)(1).

<sup>100</sup> *Id.* § 230.501(a)(5).

<sup>101</sup> *Id.* § 230.501(a)(6).

<sup>102</sup> *See* 17 C.F.R. § 230.501(a)(4).

<sup>103</sup> *See id.* § 230.506(b)(2)(ii). Sophistication in this context means that the investor “has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment,” either in his own right or with the aid of one or more “purchaser representatives.” *Id.* For the definition of “purchaser representative,” *see id.* § 230.501(h).

<sup>104</sup> *Id.* § 230.502(b)(1)–(2); *see also id.* § 230.506(b)(1).

<sup>105</sup> *See id.* § 230.502(b)(1). Rule 502(b)(1) includes a note that provides as follows: “When an issuer provides information to investors pursuant to paragraph (b)(1), it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws.” *Id.*

<sup>106</sup> *Id.* § 230.502(b)(2)(v).

506 through any form of “general solicitation” or “general advertising.”<sup>107</sup> The SEC has interpreted this prohibition to restrict investors in a company’s private placement to those with whom the company or someone acting on its behalf has a preexisting, substantive relationship.<sup>108</sup> According to the SEC, the restriction is necessary because the SEC has “long construed general solicitation or advertising to impart a public character to an offering.”<sup>109</sup> Consequently, “[t]he prohibition on general solicitation and advertising is what keeps the offering ‘private’ . . . .”<sup>110</sup>

Finally, Rule 506 requires an issuer to take reasonable steps to prevent resales of securities issued under the rule in violation of Section 5 of the Securities Act.<sup>111</sup> Typical steps include (1) placing a restrictive legend on the certificates representing the securities specifying that they may not be sold unless the transaction is registered or the seller furnishes the issuer an opinion of counsel that the proposed sale is exempt from registration, and (2) instructing the issuer’s transfer agent not to process any transfer of the securities unless the transfer is cleared by company counsel.<sup>112</sup>

Regulation D contains two additional exemptions, Rules 504<sup>113</sup> and 505,<sup>114</sup> which the SEC promulgated under Section 3(b) of the Securities Act.<sup>115</sup> Section 3(b) empowers the SEC to exempt offerings of up to \$5 million if a small amount is involved or if the offering is of limited character.<sup>116</sup> Under Rule 504, a company may offer and sell securities to an unlimited number of persons.<sup>117</sup> The total dollar amount of the offering, however, cannot exceed \$1 million.<sup>118</sup> Unlike Rule 506, Rule 504 has no specific information requirements or limit on the

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<sup>107</sup> 17 C.F.R. §§ 230.502(c), 230.506(b)(1).

<sup>108</sup> See Sjoström, *supra* note 2, at 13–14.

<sup>109</sup> Integration of Abandoned Offerings, Securities Act Release No. 7943, 66 Fed. Reg. 8887, 8889 n.28 (Feb. 5, 2001).

<sup>110</sup> See GAO REPORT, *supra* note 1, at 30.

<sup>111</sup> See 17 C.F.R. § 230.502(d) (“The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(a)(11) of the [Securities] Act . . . .”); *id.* § 230.506(b)(1) (requiring offers and sales under the rule to satisfy all the conditions of Rule 502).

<sup>112</sup> See 3 LOSS ET AL., *supra* note 94, at 411–14; see also 17 C.F.R. § 230.502(d) (listing measures the issuer can take to assure that investors are not underwriters).

<sup>113</sup> 17 C.F.R. § 230.504.

<sup>114</sup> *Id.* § 230.505.

<sup>115</sup> 15 U.S.C. § 77c(b).

<sup>116</sup> *Id.*

<sup>117</sup> Revision of Rule 504 of Regulation D, the “Seed Capital” Exemption, Securities Act Release No. 7644, 64 Fed. Reg. 11,090, 11,090 (Mar. 8, 1999).

<sup>118</sup> 17 C.F.R. § 230.504(b)(2).

number of “non-accredited” investors that may participate in the offering,<sup>119</sup> and it permits general solicitation and advertising under limited circumstances.<sup>120</sup> Rule 505 is identical to Rule 506 except that the total dollar amount of the offering cannot exceed \$5 million,<sup>121</sup> and Rule 505 does not impose a sophistication requirement for non-accredited investors.<sup>122</sup>

Although Rule 504 and Rule 505 offer some advantages over Rule 506, Rule 506 is generally the preferred Regulation D exemption because a security sold under it falls within the definition of “covered security” and is, therefore, exempt from state registration and qualification requirements.<sup>123</sup> Conversely, a security sold under Rule 504 or 505 is not a covered security.<sup>124</sup> As a result, an offering under either of these exemptions would need to be registered, qualified, or exempt under the securities laws of each state in which offers were made, adding to

<sup>119</sup> 1 BLOOMENTHAL, *supra* note 34, § 9:29, at 529–31.

<sup>120</sup> 17 C.F.R. § 230.504(b)(1). General solicitation is permitted only in an offering in reliance on Rule 504 if the offering is made

(i) [e]xclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions;

(ii) in one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure); or

(iii) exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to “accredited investors” . . . .

*Id.*

<sup>121</sup> *Id.* § 230.505(b)(2)(i).

<sup>122</sup> *Cf. id.* § 230.506(b)(2)(ii).

<sup>123</sup> See 15 U.S.C. § 77r(a)–(b) (defining “covered security”). As a general matter, anyone offering or selling securities must also comply with the securities laws of the states in which they are making the offers and sales, all of which, except for the state of New York, require registration of the offering with state regulators unless the offering falls within an exemption. I LOSS ET AL., *supra* note 94, at 155–222. In 1996, however, Congress passed the National Securities Markets Improvement Act (“NSMIA”) which preempts state registration requirements for “covered securities.” See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, §§ 301–308, 110 Stat. 3416, 3436–40 (codified as amended in scattered sections of 15 U.S.C.).

<sup>124</sup> 15 U.S.C. § 77r.

the transaction costs associated with the offering.<sup>125</sup> Rule 506 has the additional advantage of having no monetary cap on the size of the offering.<sup>126</sup>

Obviously, a private company's ability to raise capital through a securities offering is greatly constrained. If the company relies on Rule 506, it may solicit only potential investors with whom the company or someone acting on its behalf has a preexisting, substantive relationship; it cannot allow more than thirty-five non-accredited purchasers to invest in an offering; and it must reasonably believe that any non-accredited investors it does allow to invest are sophisticated.<sup>127</sup> If the company instead opts for Rule 504 or Rule 505, it has more flexibility with respect to taking non-accredited investors (Rule 504 has no cap on number, and neither rule has a sophistication requirement), but the company will be limited to raising \$1 million or \$5 million, respectively, in the offering.<sup>128</sup> Further, various institutions (for example, national banks, state commercial banks, federal and state savings associations, and federal savings banks), although falling under the definition of accredited investor, are prohibited from purchasing private company securities.<sup>129</sup>

#### b. *Share Illiquidity*

Another disadvantage of remaining private is share illiquidity.<sup>130</sup> Because SEC regulations restrict the resale of securities issued by a company in an exempt offering or private placement, there is no public market for the securities of a private company and, therefore, its shares are illiquid.<sup>131</sup> As a result, the company is unable to use its stock as currency for an acquisition, equity compensation is not particularly attractive to employees, founders are not able to diversify easily, and early-stage investors are not able to cash out.

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<sup>125</sup> Each of the fifty states has its own securities laws. See I LOSS ET AL., *supra* note 94, at 61–142. These laws lack uniformity in many areas, including registration requirements and exemptions. See *id.* (emphasizing the need for uniformity). Thus, an issuer conducting a multistate private placement subject to state registration requirements would incur additional legal fees in navigating what could be a complicated maze of overlapping and varying state laws. See Sjoström, *supra* note 17, at 587.

<sup>126</sup> See 17 C.F.R. § 230.506.

<sup>127</sup> See *id.*

<sup>128</sup> See *id.* §§ 230.504(b)(2), 230.505(b)(2)(i).

<sup>129</sup> See Jeanne M. Campanelli & Peter Castellon, *The Mechanics of Rule 144A/Regulation S Underwritings*, in SECURITIES OFFERINGS 2006: OPERATING UNDER THE NEW RULES 387, 426–27 (William J. Whelan III ed., 2006).

<sup>130</sup> See 17 C.F.R. § 230.144 (2008).

<sup>131</sup> See *id.*

Resales of privately placed securities are restricted to prevent an issuer from circumventing the registration requirements of the Securities Act by selling securities to persons in a private placement with the intent that those persons will immediately resell the securities to the public.<sup>132</sup> The restrictions are reflected in Rule 144 under the Securities Act.<sup>133</sup> Rule 144 specifies conditions under which an investor can resell “restricted securities,” the definition of which includes securities issued in a private placement.<sup>134</sup> The rule essentially requires investors to hold the stock of a private company for at least one year before reselling.<sup>135</sup> Even after the one year holding period has run, investors must contend with a number of formalities to sell the shares, including filling out various forms and obtaining a legal opinion that the resale can be made without registration.<sup>136</sup>

Given the holding period and other requirements of Rule 144 and the formalities associated with selling restricted stock, it is not possible for a liquid market to develop for private company stock. As a result, a private company has to offer its stock at a discount to what it would command in a public offering.<sup>137</sup> Put differently, investors require compensation in the form of a price discount for investing in private company stock because it will be much more difficult for investors to later liquidate their investments. In the absence of a public market, an investor will have to search for and locate a willing buyer and then negotiate and document the transaction as opposed to simply calling a broker or entering a trade online.

## II. THE NEED FOR A NEW PATH

Exchange listed companies have been subject to extensive regulation and liability exposure since 1934, yet countless companies have transitioned seamlessly from private to public companies over the decades, raising billions of dollars of equity capital in the process.<sup>138</sup> Con-

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<sup>132</sup> See 7 J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 1:6 (2007).

<sup>133</sup> 17 C.F.R. § 230.144.

<sup>134</sup> See *id.* § 230.144(a)(3).

<sup>135</sup> See *id.* § 230.144(d)(1)(ii).

<sup>136</sup> See 8B ARNOLD S. JACOBS, OPINION LETTERS IN SECURITIES MATTERS § 58 (2008) (describing formalities associated with selling restricted stock).

<sup>137</sup> See Aswath Damodaran, Marketability and Value: Measuring the Illiquidity Discount 17 (July 30, 2005) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=841484](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=841484).

<sup>138</sup> See SEC. INDUS. & FIN. MKTS. ASS'N, FACT BOOK 2007, at 22 (2007) (detailing total equity raised from 1985 to 2006).

sequently, there has been no apparent need for an additional path to equity capital and liquid stock. The passage of SOX, however, appears to have changed this situation. For example, in the last few years an increasing number of U.S. private firms have gone public outside the United States,<sup>139</sup> an increasing number of U.S. public firms have gone private,<sup>140</sup> and an increasing number of foreign firms have left or eschewed the U.S. public markets.<sup>141</sup> Regardless, adding a new path should enhance capital formation, part of the stated mission of the SEC.<sup>142</sup> This Part describes the increased regulation and liability exposure imposed on public companies by SOX.<sup>143</sup> It then discusses the shortcomings of available IPO alternatives for private companies.<sup>144</sup>

### A. Sarbanes-Oxley Act

SOX was passed in 2002 in the wake of the massive accounting frauds discovered at Enron and WorldCom.<sup>145</sup> It imposes an array of additional requirements on public companies and ramps up liability exposure. The stated purpose of SOX is “[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.”<sup>146</sup> In that regard, SOX includes various provisions addressing the content, timing, and reliability of disclosure.<sup>147</sup>

As for content, the most infamous provision is undoubtedly Section 404.<sup>148</sup> Section 404(a) directs the SEC to adopt rules requiring firms’ annual reports to include an internal control report that “state[s] the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for fi-

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<sup>139</sup> See COMM. ON CAPITAL MKTS. REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET 2 (2007), available at [http://www.capmksreg.org/pdfs/The\\_Competitive\\_Position\\_of\\_the\\_US\\_Public\\_Equity\\_Market.pdf](http://www.capmksreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf).

<sup>140</sup> See William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of “Going Private,”* 55 EMORY L.J. 141, 154 (2006).

<sup>141</sup> See COMM. ON CAPITAL MKTS. REGULATION, *supra* note 139, at 3.

<sup>142</sup> See U.S. Sec. & Exch. Comm’n, The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 4, 2009) (“The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”).

<sup>143</sup> See *infra* notes 145–168 and accompanying text.

<sup>144</sup> See *infra* notes 169–194 and accompanying text.

<sup>145</sup> See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005).

<sup>146</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, Preamble, 116 Stat. 745, 745 (2002).

<sup>147</sup> See I BLOOMENTHAL, *supra* note 34, § 1.34, at 32.

<sup>148</sup> See Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7262 (2006).

financial reporting” and “contain[s] an assessment . . . of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.”<sup>149</sup> The SEC adopted elaborate rules implementing Section 404(a) in June 2003.<sup>150</sup> Section 404(b) requires firms’ auditors to “attest to, and report on, the assessment made by the management of the issuer.”<sup>151</sup> In March 2004, the Public Company Accounting Oversight Board, a board created by SOX Section 101 “to oversee the audit of public companies,”<sup>152</sup> adopted Audit Standard No. 2, which provides extensive guidelines and rules for auditing a firm’s internal controls in connection with providing the required attestation and report.<sup>153</sup>

As for timing of disclosure, Section 409 of SOX amended the Exchange Act to require public companies to “disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer . . . as the [SEC] determines, by rule, is necessary or useful for the protection of investors and in the public interest.”<sup>154</sup> In response, the SEC expanded the list of events that trigger a public company’s obligation to file a current report.<sup>155</sup> The SEC also decreased the filing deadline for a current report from five or fifteen calendar days (depending on the triggering event) following the triggering event to four business days for most events.<sup>156</sup>

<sup>149</sup> *Id.* § 7262(a).

<sup>150</sup> See Management’s Report on Internal Control over Financial Reporting, Securities Act Release No. 8238, Exchange Act Release No. 47,986, Investment Company Act Release No. 26,068, 68 Fed. Reg. 36,636 (June 18, 2003). For a description of these rules, see 1 BLOOMENTAL, *supra* note 34, § 12:48.20, at 672.

<sup>151</sup> 15 U.S.C. § 7262(b).

<sup>152</sup> Sarbanes-Oxley Act of 2002 § 101, 15 U.S.C. § 7211.

<sup>153</sup> See PUB. CO. ACCOUNTING OVERSIGHT BD., AUDITING STANDARD NO. 2 (2004), available at [http://www.pcaobus.org/Rules/Rules\\_of\\_the\\_Board/Auditing\\_Standard\\_2.pdf](http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_2.pdf). Note that Auditing Standard No. 2 has been superseded by Auditing Standard No. 5 for audits of fiscal years ending on or after November 15, 2007. See PUB. CO. ACCOUNTING OVERSIGHT BD., AUDITING STANDARD NO. 5, at 397 n.2 (2007), available at [http://www.pcaobus.org/Rules/Rules\\_of\\_the\\_Board/Auditing\\_Standard\\_5.pdf](http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf); Pub. Co. Accounting Oversight Bd., Standards and Related Rules, [http://www.pcaobus.org/Standards/Standards\\_and\\_Related\\_Rules/Auditing\\_Standard\\_No.5.aspx](http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.5.aspx) (last visited Mar. 4, 2009).

<sup>154</sup> Sarbanes-Oxley Act of 2002 § 409, 15 U.S.C. § 78m(l).

<sup>155</sup> See Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8400, Exchange Act Release No. 49,424, 69 Fed. Reg. 15,594, 15,594 (Mar. 25, 2004) [hereinafter Form 8-K Release]. The Release notes that in response to § 409 the “amendments add eight new items to the form, transfer two items from the periodic reports and expand disclosures under two existing Form 8-K items.” See *id.* For an overview of the amendments, see 1 BLOOMENTAL, *supra* note 34, § 12:52, at 680. For a brief discussion of current reports, see *supra* notes 36–41 and accompanying text.

<sup>156</sup> See Form 8-K Release, *supra* note 155, at 15,594.

SOX includes several provisions relating to the reliability of disclosure. Section 302 requires senior officers to certify in each annual and quarterly report that they have reviewed the report, that the report is free of misstatements of material fact or misleading omissions of material fact, and that the report fairly presents the financial condition and results of operation of the company.<sup>157</sup> Additionally, signing officers must certify that they are responsible for establishing and maintaining the company's internal controls, have evaluated the effectiveness of such controls, and disclosed to the company's auditor and audit committee all significant deficiencies in the design or operation of such controls.<sup>158</sup>

Similarly, Section 906 requires a company's chief executive officer and chief financial officer to certify in each annual and quarterly report "that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer."<sup>159</sup> An erroneous certification can lead to personal liability for the certifier, and hence a certifier has a strong incentive to ensure reliability of the reports.<sup>160</sup> In fact, Section 906 provides for criminal fines of up to \$1 million and jail time of up to ten years for a knowingly false certification, and \$5 million and twenty years for a willfully and knowingly false certification.<sup>161</sup>

SOX also amended the federal criminal code to make it unlawful to knowingly execute or attempt to execute a scheme or artifice (1) "to defraud any person in connection with any security" of a reporting company or (2) "to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with

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<sup>157</sup> Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241.

<sup>158</sup> *Id.*

<sup>159</sup> Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1350 (2006).

<sup>160</sup> *See* Sarbanes-Oxley Act of 2002 § 3(b), 15 U.S.C. § 7202. Section 3(b) of SOX provides:

A violation by any person of [SOX] [or] any rule or regulation of the [SEC] issued under [SOX] . . . shall be treated for all purposes in the same manner as a violation of the [Exchange Act] or the rules and regulations issued thereunder . . . and any such person shall be subject to the same penalties, and to the same extent, as for a violation of [the Exchange Act] or such rules or regulations.

*Id.*

<sup>161</sup> Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1350.

the purchase or sale of any security” of a reporting company.<sup>162</sup> Violators are subject to fines and imprisonment up to twenty-five years.<sup>163</sup>

Costs of SOX include increased audit, human capital, and other compliance expenses. A recent survey conducted by Financial Executives International found that compliance costs for SOX Section 404 alone averaged \$1.66 million per U.S. accelerated filer.<sup>164</sup> Costs of SOX also likely include reduced risk taking by management in light of the heightened liability risk.<sup>165</sup> Additionally, many of the increased compliance costs disproportionately effect smaller firms because of the firms’ reduced economies of scale.<sup>166</sup>

No one disputes that SOX has increased the cost of being public. What is disputed is whether the benefits of SOX outweigh the costs. At a macro level, the debate is unlikely ever to be resolved.<sup>167</sup> At a micro level, however, there undoubtedly are companies for which the costs outweigh the benefits, thus underscoring the need for a SOX-free path to equity capital and share liquidity.<sup>168</sup>

<sup>162</sup> Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C. § 1348.

<sup>163</sup> *Id.*

<sup>164</sup> FIN. EXECUTIVES INT’L, FEI AUDIT FEE SURVEY 12 (2008). An accelerated filer is a reporting company that “had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of \$75 million or more, but less than \$700 million, as of the last business day of the [company’s] most recently completed second fiscal quarter.” 17 C.F.R. § 240.12b-2(1) (i) (2008).

<sup>165</sup> See Daniel A. Cohen et al., *The Sarbanes-Oxley Act of 2002: Implications for Compensation Contracts and Managerial Risk-Taking* 4 (Nov. 9, 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=1027448> (finding that risky investments by companies declined significantly following the passage of SOX).

<sup>166</sup> See Ehud Kamar et al., *Sarbanes-Oxley’s Effects on Small Firms: What Is the Evidence?* 1 (Harvard Law Sch., Harvard Law and Economics Discussion Paper No. 588, 2007), available at <http://ssrn.com/abstract=993198>.

<sup>167</sup> See Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 762 (2007) (“[I]t is impossible at this point in time to accurately weigh SOX’s total benefits against its total costs. None of the scores of academic studies cited in this article purports to settle definitively the question of whether SOX in general or SOX 404 in particular have been, on balance, beneficial.”); see also Christian Leuz, *Was the Sarbanes-Oxley Act of 2002 Really This Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions*, 44 J. ACCT. & ECON. 146, 146–65 (2007).

<sup>168</sup> See Feng Gao et al., *Unintended Consequences of Granting Small Firms Exemptions from Securities Regulation: Evidence from the Sarbanes-Oxley Act* 3 (Simon Sch. of Bus. Admin., Univ. of Rochester, Working Paper No. FR 07-07, 2008), available at <http://ssrn.com/abstract=1014054> (noting that managers may seek to avoid application of SOX to their companies because they believe complying reduces shareholder value).

### B. Shortcomings of Alternatives

One alternative to a U.S. IPO is to go public abroad.<sup>169</sup> For example, in recent years a number of U.S. firms have listed their shares on the London Stock Exchange's Alternative Investment Market following an overseas IPO.<sup>170</sup> This route allows a company to raise equity capital and attain share liquidity without subjecting itself to U.S. securities regulations.<sup>171</sup> A company that goes public abroad, however, does not realize all of the benefits that accrue from a U.S. IPO. For example, the company does not have freely tradable U.S. stock at its disposal to use as currency in an acquisition or as a component of employee compensation. Further, the company must carefully monitor its shareholder base to ensure that it has fewer than 300 U.S. shareholders and 500 total shareholders because surpassing these thresholds would subject the company to U.S. securities regulations.<sup>172</sup> Additionally, as the Committee on Capital Markets Regulation has argued, losing listings to overseas markets weakens the U.S. capital markets, which means "higher costs of capital for U.S. companies, reduced asset values, fewer jobs, and less economic activity across the entire country."<sup>173</sup>

Another alternative to going public is a Rule 144A equity offering.<sup>174</sup> Rule 144A under the Securities Act enables a company to market and sell securities through an underwriter to "qualified institutional buyers" ("QIBs") without registering the offering with the SEC or triggering Exchange Act reporting obligations.<sup>175</sup> The definition of a QIB includes institutional investors (for example, insurance companies, pension funds, mutual funds, employee benefit plans, hedge funds, and banks) that have at least \$100 million of securities under management.<sup>176</sup> Until recently, however, Rule 144A was unheard of as an IPO

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<sup>169</sup> See Jose M. Mendoza, *Securities Regulation in Low-Tier Listing Venues: The Rise of the Alternative Investment Market*, 13 FORDHAM J. CORP. & FIN. L. 257, 284–85 n.145 (2008); Stephen Taub, *VCs Look for Payday in London*, CFO.COM, Feb. 3, 2006, [http://www.cfo.com/article.cfm/5487545/c\\_5487722?f=home\\_todayinfinance](http://www.cfo.com/article.cfm/5487545/c_5487722?f=home_todayinfinance).

<sup>170</sup> See Mendoza, *supra* note 169, at 284–85 n.145 (noting that fifty-one U.S. companies had listed on AIM as of Oct. 30, 2006); Taub, *supra* note 169 (noting that nineteen U.S. companies went public on AIM in 2005).

<sup>171</sup> See Mendoza, *supra* note 169, at 258.

<sup>172</sup> *Id.* at 324–25.

<sup>173</sup> COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 23 (2006), available at [http://www.capmksreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf).

<sup>174</sup> See 17 C.F.R. § 230.144A (2008).

<sup>175</sup> See *id.*

<sup>176</sup> *Id.* § 144A(a)(i). A registered broker-dealer qualifies as a QIB if it owns and invests on a discretionary basis an aggregate of at least \$10 million of securities of non-affiliated

substitute. This changed in May 2007 when Oaktree Capital Management LLC, a leading private U.S. hedge fund advisory firm, sold a 15 percent equity stake in itself for \$880 million under Rule 144A.<sup>177</sup>

Following the sale, Oaktree's equity securities immediately started trading on the GS Tradable Unregistered Equity OTC Market ("GSTRUE"), a new market created by Goldman Sachs Group, Inc. to facilitate trading in Rule 144A equity securities.<sup>178</sup> GSTRUE, it was hoped, would enable a liquid QIB trading market to develop for Rule 144A-eligible equity securities.<sup>179</sup> This, in turn, would provide a private company a route to share liquidity without going public.<sup>180</sup> Although it is too early to tell whether the Oaktree deal represents a watershed event—especially given recent market turmoil—initial reports indicated that trading of Oaktree's securities on GSTRUE was not particularly active with shares "sometimes not trading for days at a time."<sup>181</sup> Since then, GSTRUE has been consolidated with PORTAL, a QIB-only market for Rule 144A-eligible securities operated by NASDAQ.<sup>182</sup>

Several months after the Oaktree deal, Goldman managed a similar \$828 million Rule 144A equity offering for Apollo Global Management, LLC, a renowned U.S. private equity firm.<sup>183</sup> Apollo's securities also immediately started trading on GSTRUE.<sup>184</sup> Unlike Oaktree, Apollo entered into a registration rights agreement with investors in the deal. The registration rights agreement obligated Apollo to file with the SEC a shelf registration statement covering resale of its shares within 240 days.<sup>185</sup> Apollo filed the registration statement on April 8, 2008,<sup>186</sup> essentially transitioning from a private to a public company.<sup>187</sup>

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companies, excluding securities that are part of an unsold public offering allotment. *See id.* § 144A(a)(1)(ii).

<sup>177</sup> *See Oaktree Stock Sale Completed*, WALL ST. J., May 23, 2007, at C2.

<sup>178</sup> *See Henry Sender, Oaktree to Try a New Twist for Share Sale: Use of Goldman Market Avoids Regulations, Doesn't Cede Control*, WALL ST. J., May 10, 2007, at C1 (describing GSTRUE).

<sup>179</sup> *See id.*

<sup>180</sup> *See id.*

<sup>181</sup> Andrew Ross Sorkin & Michael J. de la Merced, *Buyout Firms Said to Seek a Private Market Offering*, N.Y. TIMES, July 18, 2007, at C3.

<sup>182</sup> *See William K. Sjostrom, Jr., The Birth of Rule 144A Equity Offerings*, 56 UCLA L. REV. 409, 430–32 (2008) (discussing PORTAL).

<sup>183</sup> *See Apollo Raises \$828 Million*, WALL ST. J., Aug. 7, 2008, at C6.

<sup>184</sup> *See id.*

<sup>185</sup> *See Apollo Global Mgmt., LLC, Registration Statement (Form S-1)*, at 220 (Apr. 8, 2008).

<sup>186</sup> *See id.*

<sup>187</sup> *See id.* Apollo technically will not be required to file Exchange Act reports until its registration statement is declared effective. *See supra* notes 36–41 and accompanying text (describing Exchange Act reporting triggers).

It is unclear why the Apollo deal included registration rights, but the fact that it did, and the fact that trading in Oaktree's securities has not been active, may indicate that Rule 144A equity offerings are not a panacea.<sup>188</sup> Rule 144A was not specifically designed to facilitate equity offerings by private companies and, hence, has its limitations as applied in that context. Most notably, companies have to put some sort of mechanism in place (contractual restrictions, minimum lot sizes, etc.) to ensure that they do not exceed the 499 record holder cap as a result of secondary trading by investors.<sup>189</sup> This undoubtedly makes the shares less attractive to investors and negatively impacts liquidity. Furthermore, Rule 144A does not allow general solicitation and advertising, and individual investors cannot participate in Rule 144A equity offerings, regardless of net worth.<sup>190</sup> As a result, the deals cannot be publicly marketed, and the pool of potential investors is limited to institutions.<sup>191</sup>

Finally, a private company has the option of selling itself to a larger company instead of pursuing an IPO.<sup>192</sup> A sale would allow founders and investors to cash out, as their shares would typically be exchanged for cash or liquid stock in the acquisition.<sup>193</sup> A sale, however, also requires founders to relinquish control.<sup>194</sup> Thus, from a founder's standpoint, a sale is not really an IPO substitute.

### III. PROPOSAL

To address the rising cost of going public and shortcomings of existing alternatives, this Part outlines and justifies proposed changes to federal securities laws. Specifically, it calls for (1) a new exemption from Section 5 of the Securities Act that allows general solicitation and advertising for offerings limited to sophisticated investors, (2) an amendment to Rule 144 to allow immediate resales to sophisticated investors of securities issued under the new Section 5 exemption, (3) a new rule preempting the application of state registration or qualification requirements to securities offered and sold under the new Section 5 exemption, and (4) a new exemption from Section 12(g)(1) of the Exchange Act exempting companies with 100 or fewer unsophisticated sharehold-

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<sup>188</sup> See Sorkin & de la Merced, *supra* note 181.

<sup>189</sup> See 15 U.S.C. § 78l(g) (2006).

<sup>190</sup> See Sjoström, *supra* note 182, at 445.

<sup>191</sup> See *id.*

<sup>192</sup> See Black & Gilson, *supra* note 27, at 261.

<sup>193</sup> See *id.*

<sup>194</sup> See *id.*

ers from having to register under the Act.<sup>195</sup> The objective of this proposal is to carve a new path to equity capital and share liquidity for private companies without compromising investor protection. Suggested text for these provisions is included in the Appendix to this Article.

#### A. Section 5 Exemption

A new Section 5 exemption is necessary to allow a private company to market and sell its shares publicly in a similar fashion to an IPO.<sup>196</sup> Existing exemptions either do not work for large, widespread offerings or specifically prohibit the use of general solicitation and advertising.<sup>197</sup> Hence, the new exemption would eliminate a major constraint on private company capital raising. Although the exemption would limit sales to sophisticated investors, it would not so limit offers.<sup>198</sup> Thus, a company could use a full range of marketing techniques without having to worry about inadvertently soliciting unsophisticated investors.

Arguably, adopting an exemption that permits general solicitation and advertising could lead to more securities fraud. Promoters of fraudulent investment schemes could engage in widespread advertising claiming it is allowed by the new exemption. Although the current federal and state regulatory scheme may not deter such promoters from using all forms of public advertising, it likely curtails their activities. For example, if their solicitation activities are too public they will attract the attention of the SEC or state regulators. With this in mind, the Section 5 exemption proposed here would allow general solicitation and advertising, but only through broker-dealers registered with both the SEC and the states in which the solicitation is directed.<sup>199</sup> The exemption also would require that written solicitation materials specify the name of the registered broker-dealer making the solicitation.<sup>200</sup> Presumably, a promoter of a fraudulent scheme will not have the requisite registration or will omit listing a broker-dealer entirely, either of which would serve as an easily verifiable basis for the SEC or state securities regulators to pursue a cease and desist order or injunction.

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<sup>195</sup> See *infra* app. at 681–83.

<sup>196</sup> See 17 C.F.R. § 230.506 (2008).

<sup>197</sup> See *id.*

<sup>198</sup> See *infra* app. at 681–82 (proposing a new § 230.508(c)(2)).

<sup>199</sup> See *id.* at 681 (proposing a new § 230.508(c)(2)(ii)).

<sup>200</sup> See *id.*

Because this proposal is targeted at private company capital raising, the exemption would not be available to a company with securities registered under the Exchange Act.<sup>201</sup>

### B. Rule 144 Amendment

An amendment to Rule 144 is necessary because Section 5 of the Securities Act prohibits the offer and sale of any security unless the *transaction* is registered with the SEC or is exempt from registration.<sup>202</sup> Consequently, every sale of securities must be registered or exempt.<sup>203</sup> Put differently, because of the transactional focus of Section 5, a reseller of securities must either register the resale with the SEC or structure the resale so that it qualifies for an exemption from registration.<sup>204</sup> The issuer's registration or exemption covers only the original sale transaction; that is, the sale from the issuer to the reseller.

Typically, resales of securities are exempt from registration under Section 4(1) of the Securities Act.<sup>205</sup> Section 4(1) exempts from registration "transactions by any person other than an issuer, underwriter, or dealer."<sup>206</sup> Section 4(1), however, is not available for the immediate resale of privately placed securities.<sup>207</sup> This is because Section 2(a)(11) of the Securities Act defines the term "underwriter," among other things, as "any person who has purchased from an issuer with a view to . . . the distribution of any security."<sup>208</sup> Under SEC interpretations, anyone who sells privately placed securities is presumed to be an underwriter unless the sale is made in compliance with Securities Act Rule 144.<sup>209</sup> Rule 144 sets forth conditions under which a person who sells privately placed securities "is deemed not to be engaged in a distribution of [such] securities and therefore not an underwriter of the securities for purposes of Section 2(a)(11) [of the Securities Act]."<sup>210</sup> A non-affiliate of an issuer—such as a person who does not directly or indirectly control the

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<sup>201</sup> See *id.* (proposing a new § 230.508(b)).

<sup>202</sup> See 15 U.S.C. § 77e (2006).

<sup>203</sup> See 17 C.F.R. § 230.144, Preliminary Note ("If any person sells a non-exempt security to any other person, the sale must be registered unless an exemption can be found for the transaction.").

<sup>204</sup> See *id.*

<sup>205</sup> 15 U.S.C. § 77d(1).

<sup>206</sup> *Id.*

<sup>207</sup> See *id.* § 77b(a)(11).

<sup>208</sup> *Id.*

<sup>209</sup> 17 C.F.R. § 230.144, Preliminary Note.

<sup>210</sup> *Id.*

issuer<sup>211</sup>—must hold privately placed securities issued by a private company at least one year before the securities can be sold under Rule 144.<sup>212</sup>

This proposal includes an amendment to Rule 144 to allow the immediate resale to sophisticated investors of securities issued under the Section 5 exemption proposed above.<sup>213</sup> The aim is to provide a regulatory avenue for an active SIO secondary market to develop for shares issued under the exemption so that a private company could attain share liquidity without going public.<sup>214</sup>

### C. Preemption

Similar to the Securities Act, most states require the registration of a securities offering with state regulators unless the offering falls within a state registration exemption.<sup>215</sup> State exemptions generally track existing federal exemptions. That is, with certain exceptions, if an offering is exempt under federal securities laws it will fall into an exemption under state securities laws.<sup>216</sup> This, however, would not necessarily be the case for a new federal exemption, especially one that allows general solicitation and advertising. Unless a large majority of jurisdictions amend their exemptions to accommodate the proposed Section 5 exemption, the attractiveness of relying on the new exemption would be greatly diminished. This is because an issuer would have to register the offering in each unaccommodating jurisdiction or not offer securities in the jurisdiction. Registering is costly and time consuming, especially because of the lack of uniformity among state registration requirements,<sup>217</sup> and not marketing an offering in a particular state obviously reduces the pool of potential investors. This proposal sidesteps the state law issue by providing that state registration requirements with respect to offerings under the proposed Section 5 exemption would be preempted by federal law.

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<sup>211</sup> See *id.* § 230.144(a)(1) (defining “affiliate”).

<sup>212</sup> See *id.* § 230.144(b)(1)(i), (d)(1)(ii). In some situations, Rule 144 allows investors to include the holding period of previous investors in determining when their holding period ends. See *id.* § 230.144(d). Rule 144 imposes additional conditions for the resale of restricted stock by an “affiliate” of an issuer. See, e.g., *id.* § 230.144(c), (e), (h).

<sup>213</sup> See *infra* app. at 682 (proposing a new § 230.144).

<sup>214</sup> See *id.*

<sup>215</sup> See 1 LOSS ET AL., *supra* note 94, at 195.

<sup>216</sup> See *id.* at 222.

<sup>217</sup> See Sjostrom, *supra* note 17, at 544–50 (providing an overview of state registration requirements).

#### D. Exchange Act Section 12(g) Exemption

An exemption from Section 12(g) of the Exchange Act is necessary so that an SIO company does not have to monitor and limit the number of record holders of its equity securities.<sup>218</sup> As mentioned above, Section 12(g)(1) of the Exchange Act requires any company with more than \$10 million in total assets and a class of equity securities held of record by 500 or more holders to register such security under the Exchange Act.<sup>219</sup> This inherent monitoring and limiting obligation would impede the development of a liquid SIO market.<sup>220</sup> As is the case for Rule 144A offerings by private companies, issuers would, for example, have to impose contractual restrictions on transfer or establish minimum lot sizes in which their shares could be transferred to ensure a maximum number of record holders below 500.<sup>221</sup> Such restrictions would make the shares more difficult to trade and, therefore, less liquid. To address this issue, this proposal includes an exemption from Section 12(g)(1) for a class of equity securities beneficially owned by 100 or fewer unsophisticated investors.<sup>222</sup> The exemption would permit companies to have up to 100 unsophisticated shareholders to allow them to issue shares to unsophisticated employees and as built-in relief for companies that have inadvertently issued shares to a limited number of unsophisticated investors.<sup>223</sup>

#### E. “Sophisticated Investor” Definition

A key component of this proposal is the definition of “sophisticated investor,” given that the concept is embodied in three of the four proposed rule changes.<sup>224</sup> The SEC has previously formulated a definition. Specifically, the SEC considers an investor sophisticated “if the

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<sup>218</sup> See 15 U.S.C. § 78(g)(1).

<sup>219</sup> See *id.* Note that Section 12(g)(1) actually specifies a “total assets” cutoff of \$1 million, but Rule 12g-1 under the Exchange Act exempts issuers with \$10 million or less in total assets from the application of Section 12(g)(1), essentially setting the cutoff at \$10 million. See 17 C.F.R. § 240.12g-1.

<sup>220</sup> See 15 U.S.C. § 78(g)(1).

<sup>221</sup> See 17 C.F.R. § 230.144A.

<sup>222</sup> This approach is similar to one taken by Congress in the Investment Company Act of 1940. See 15 U.S.C. §§ 80a-1 to 80a-64 (2006). Specifically, an investment company whose securities are owned “exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers” and that is not making or proposing to make a public offering is not considered an investment company for purposes of the Investment Company Act and is therefore not required to register under it. *Id.* § 80a-3(c)(7).

<sup>223</sup> See *infra* app. at 683 (proposing a new § 240.12g-1).

<sup>224</sup> See *infra* app. at 681–683.

investor, either alone or with his or her representative, has such knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment.”<sup>225</sup> The problem with this formulation is that it requires subjective investor-specific determinations of knowledge and experience that a court or the SEC could later decide were erroneous.<sup>226</sup> Hence, many attorneys would likely view reliance on an exemption containing such a standard as too risky and would advise their clients accordingly, which would render this proposal of limited value.

The SEC is cognizant of the practical effect of using subjective standards. Thus, over the years it has developed various objective tests that use wealth as a proxy for determining sophistication in different contexts based on the assumption that the wealthy are sophisticated in financial matters or can afford to hire advisers who are. Two of these tests were mentioned above: the QIB test of Rule 144A and the accredited investor test of Regulation D.<sup>227</sup> Other tests include the “qualified purchasers” test of Section 3(c)(7) of the Investment Company Act of 1940, under which entities with \$25 million in investments and individuals with \$5 million in investments are considered qualified purchasers;<sup>228</sup> and the “qualified client” test of Rule 205-3 of the Investment Advisers Act of 1940, under which individuals are considered qualified clients if they have at least \$750,000 under management with the adviser, have a net worth of more than \$1.5 million, are qualified purchasers under the Investment Company Act, or are employees of the adviser who have participated in the investment activities of the adviser for at least twelve months.<sup>229</sup>

The accredited investor concept is the logical choice to serve as a proxy for sophistication for purposes of this proposal.<sup>230</sup> Unlike the qualified purchaser and qualified buyer tests, it was designed specifically with reference to exempt offerings, and unlike the QIB test, it would allow individuals (and not just institutional investors) to invest in

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<sup>225</sup> Integration of Abandoned Offerings, Securities Act Release No. 7943, 66 Fed. Reg. 8887, 8888 n.15 (Feb. 5, 2001).

<sup>226</sup> *See id.*

<sup>227</sup> For an explanation of the QIB test, see *supra* notes 174–177 and accompanying text. For an explanation of the accredited investor test, see *supra* notes 97–103 and accompanying text.

<sup>228</sup> 15 U.S.C. §§ 80a-2(a)(51), 80a-3(c)(7).

<sup>229</sup> 17 C.F.R. § 275.205-3 (2006). Rule 205-3 provides a limited exemption from the Investment Company Act’s prohibition on charging clients performance fees. *See id.*

<sup>230</sup> *See id.* § 230.501.

SIO companies.<sup>231</sup> Further, the SEC has used the accredited investor concept as a sophistication proxy for over twenty-five years and recently stated that “it strikes the appropriate balance between the necessity for investor protection and meaningful relief for issuers offering securities.”<sup>232</sup> Additionally, Congress endorsed the concept when it amended the Securities Act in 1980 to provide a registration exemption for offerings limited to accredited investors.<sup>233</sup> The legislative history of the amendment states that the concept is “based on the assumption that accredited persons are sophisticated and able enough to protect their own financial interests without regulatory assistance.”<sup>234</sup>

A common criticism of the accredited investor concept, especially as applied to individuals, is that the net worth and income dollar thresholds were set in 1982, but have never been adjusted upward for inflation.<sup>235</sup> One dollar in 1982 has the same buying power as \$2.19 in 2009, meaning that the thresholds have essentially been reduced by more than 50 percent.<sup>236</sup> These implicit decreases have been ameliorated to some extent, at least according to the SEC, by “the general increased sophistication and financial literacy of investors in today’s markets, coupled with the advantages of modern communication technologies.”<sup>237</sup> Additionally, the SEC recently proposed adjusting the thresholds for inflation “on a going forward basis, starting on July 1, 2012, and every five years thereafter” using 2006 as the base year.<sup>238</sup>

The accredited investor concept has also been criticized for being under-inclusive.<sup>239</sup> For example, a finance professor with net worth under \$1 million and yearly income under \$200,000 would not qualify as an accredited investor even though he surely would be considered sophisticated with respect to financial matters. This is a cost of using an

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<sup>231</sup> See *id.*

<sup>232</sup> Defining the Term “Qualified Purchaser” Under the Securities Act of 1933, Securities Act Release No. 8041, 66 Fed. Reg. 66,839, 66,840 n.18 (proposed Dec. 27, 2001).

<sup>233</sup> See Small Business Issuers’ Simplification Act of 1980, Pub. L. No. 96-477, § 602, 94 Stat. 2275, 2294 (1980) (codified as amended at 15 U.S.C. § 77d(6)).

<sup>234</sup> H.R. REP. No. 96-1341, at 21 (1980), as reprinted in 1980 U.S.C.C.A.N. 4800, 4803.

<sup>235</sup> See Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8825, 72 Fed. Reg. 45,116 (proposed Aug. 10, 2007).

<sup>236</sup> See U.S. Dep’t of Labor, Bureau of Labor Statistics, CPI Inflation Calculator, <http://data.bls.gov/cgi-bin/cpicalc.pl> (enter “1.00” in the “\$” field, select “1982” in the first “in” field, and select “2009” in the second “in” field) (last visited Mar. 4, 2009).

<sup>237</sup> See Revisions of Limited Offering Exemptions in Regulation D, 72 Fed. Reg. at 45,118.

<sup>238</sup> See *id.* at 45,126.

<sup>239</sup> See Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 310–11 (2000).

objective rule as opposed to a subjective standard to determine sophistication, but, in my view, the cost is outweighed by the benefits of the certainty provided by the rule. Further, the situation could be remedied by allowing non-accredited investors to demonstrate sophistication by passing a sophisticated-investor licensing exam created and administered by the SEC.<sup>240</sup> Regardless, non-accredited investors would be free to invest indirectly in companies listed on an SIO market through intermediaries such as mutual funds. Presumably, if an SIO market were to develop, new mutual funds would be launched that target companies listed on the market, thereby providing investors an easy way to allocate a slice of their portfolios to the sector.

#### F. Implementation

The Securities Act reforms proposed here can be implemented under existing federal securities laws as a result of the National Securities Markets Improvement Act of 1996 (“NSMIA”).<sup>241</sup> Among other things, NSMIA added Section 28 to the Securities Act, which provides the SEC with the power to exempt any class of securities or transactions from any provision of the Securities Act “to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”<sup>242</sup> NSMIA also added subsection (b) to Section 2 of the Securities Act, which provides that when the SEC “is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the [SEC] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”<sup>243</sup>

The Section 5 exemption and the amendments to Rule 144 proposed here meet the standard of Section 28 as elucidated by Section 2(b).<sup>244</sup> As discussed above, this proposal would facilitate capital raising by creating a new path to equity capital and liquid stock without subjecting the issuer to extensive regulation and liability exposure. At the same time, these provisions are consistent with investor protection because their scopes are limited to sophisticated investors. At least since 1953, when the Supreme Court decided *SEC v. Ralston Purina Co.*, it has

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<sup>240</sup> See *id.* at 311 (discussing investor licensing as a screening mechanism).

<sup>241</sup> See National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, §§ 301–308, 110 Stat. 3416, 3436–40 (codified as amended in scattered sections of 15 U.S.C.).

<sup>242</sup> 15 U.S.C. § 77z-3.

<sup>243</sup> *Id.* § 77b.

<sup>244</sup> See *id.* §§ 77b, 77z-3.

been firmly established that sophisticated investors do not need the same protections as unsophisticated ones.<sup>245</sup> In the words of the Supreme Court, the sophisticated can “fend for themselves” and, therefore, require considerably fewer legal safeguards.<sup>246</sup> As the SEC has recognized, “[t]he Securities Act was remedial legislation designed ‘to protect the investing public and honest business.’ The ‘investing public’ intended to benefit from the registration provisions of the Securities Act was unsophisticated, individual investors.”<sup>247</sup> Hence, it is axiomatic that because this Article’s proposal excludes participation by the unsophisticated, it is consistent with investor protection as espoused in the Securities Act.<sup>248</sup>

Furthermore, the proposed amendment to Rule 144 is in harmony with the so-called “Section 4(1-½) exemption” under the Securities Act. Although not actually appearing in the statute, the Section 4 (1-½) exemption has long been recognized by the SEC.<sup>249</sup> As a general matter, the exemption allows an investor to immediately resell privately placed securities to someone who could have bought them in the original offering.<sup>250</sup> For example, if the offering was made in reliance on Rule 506, an investor could likely immediately resell the securities to an accredited investor. Nonetheless, the amendment to Rule 144 is included in this proposal because the parameters of the Section 4(1-½) exemption remain unsettled.<sup>251</sup> This uncertainty would likely impede the development of a secondary market. In fact, commentators have characterized selling restricted securities outside of Rule 144 as “imprudent or impossible.”<sup>252</sup> Hence, this proposal opts for the certainty of a formal rule.

As for preemption of state registration requirements, this can be achieved through Section 18 of the Securities Act as amended by

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<sup>245</sup> See 346 U.S. 119, 124–25 (1953). Congress recognized this fact when it enacted the Commodity Futures Modernization Act of 2000. See Pub. L. No. 106-554, 114 Stat. 2763. The Act, among other things, created a new category of futures markets for certain commodities-based products that is generally only open to specified qualified investors. See HAZEN, *supra* note 90, § 22.7.

<sup>246</sup> See *Ralston Purina*, 346 U.S. at 125.

<sup>247</sup> See Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6806, 53 Fed. Reg. 44,016, 44,023 (proposed Nov. 1, 1988).

<sup>248</sup> See *id.*

<sup>249</sup> See Employee Benefit Plans; Interpretations of Statute, Securities Act Release No. 6188, 45 Fed. Reg. 8960, 8977 n.178 (Feb. 11, 1980) (acknowledging the existence of the section 4(1-½) exemption).

<sup>250</sup> See *id.*

<sup>251</sup> See Sjostrom, *supra* note 182, at 420.

<sup>252</sup> 1 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, GOING PUBLIC HANDBOOK § 2:77, at 171 (2006).

NSMIA.<sup>253</sup> Section 18 provides that states may not directly or indirectly require registration of offerings involving “covered securities,”<sup>254</sup> thus preempting state registration requirements for covered securities.<sup>255</sup> The definition of a covered security includes a security listed or authorized for listing on the NYSE, NASDAQ, or the American Stock Exchange,<sup>256</sup> or sold pursuant to Rule 506 of Regulation D.<sup>257</sup> Section 18 also provides that “[a] security is a covered security with respect to the offer or sale of the security to qualified purchasers, as defined by the [SEC] by rule.”<sup>258</sup> Legislative history suggests any definition should “be rooted in the belief that ‘qualified’ purchasers are sophisticated investors, capable of protecting themselves in a manner that renders regulation by State authorities unnecessary.”<sup>259</sup> Thus, the SEC could adopt a rule including within the definition of “qualified purchaser” all offerees and purchasers of securities pursuant to the proposed Section 5 exemption because the exemption is limited to sophisticated investors. This, in turn, would bring securities issued under the exemption within the definition of a covered security, resulting in preemption of state registration requirements.<sup>260</sup>

Notably, in December 2001, the SEC proposed a definition of “qualified purchaser” for purposes of the definition of a “covered security” under Section 18 of the Securities Act that mirrors the definition of accredited investor under Regulation D.<sup>261</sup> The SEC reasoned that the accredited investor concept is “based upon . . . notions of the financial sophistication of investors” and “strikes the appropriate balance between the necessity for investor protection and meaningful relief for issuers offering securities.”<sup>262</sup> To date, the SEC has not acted on its proposal.

As for implementing the Section 12(g)(1) exemption proposed here, the SEC would have two choices. It could adopt the exemption under Section 12(h) of the Exchange Act, which allows the SEC to ex-

<sup>253</sup> 15 U.S.C. § 77r(b).

<sup>254</sup> *Id.*

<sup>255</sup> Rutherford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 196–97 (1997).

<sup>256</sup> 15 U.S.C. § 77r(b)(1)(A); see also BLOOMENTHAL, *supra* note 34, § 10:21, at 579.

<sup>257</sup> 15 U.S.C. § 77r(b)(4)(D). Rule 506 was issued by the SEC under § 4(2) of the Securities Act.

<sup>258</sup> *Id.* § 77r(b)(3).

<sup>259</sup> H.R. REP. NO. 104-622, at 31 (1996), as reprinted in 1996 U.S.C.C.A.N. 3877, 3893.

<sup>260</sup> See Campbell, *supra* note 255, at 207.

<sup>261</sup> Defining the Term “Qualified Purchaser” Under the Securities Act of 1933, Securities Act Release No. 8041, 66 Fed. Reg. 66,839 (proposed Dec. 27, 2001).

<sup>262</sup> *Id.* at 66,840.

empt by rule a class of issuers or securities from Section 12(g)'s registration requirement if it "finds, by reason of the number of public investors . . . that such action is not inconsistent with the public interest or the protection of investors."<sup>263</sup> Although not defined in the Exchange Act, the legislative history of Section 12(h) indicates that the phrase "public investors" refers to investors who cannot "fend for themselves," as expressed in *Ralston Purina*.<sup>264</sup>

Because the proposed exemption is available only to an issuer with 100 or fewer unsophisticated shareholders, the issuer would have at most 100 "public investors." In recommending the scope of Section 12(g)(1) to Congress, the SEC recognized that the record holder cutoff had to be set at a level that was "manageable from the regulatory standpoint and not disproportionately burdensome on issuers in relation to the national public interest to be served."<sup>265</sup> Hence, it advocated a cutoff of 300 shareholders of record, and Congress ultimately settled on 500.<sup>266</sup> Thus, under current law a company could conceivably have 499 unsophisticated shareholders and not be subject to Exchange Act reporting and other requirements.<sup>267</sup> This obviously was not viewed as inconsistent with the public interest, and, therefore, neither should the proposed exemption because it sets the cutoff at a lower level.

To be sure, both sophisticated and unsophisticated shareholders are counted toward the 499 record holder cap, but the proposed Section 12(g)(1) exemption has no cap on the number of sophisticated shareholders.<sup>268</sup> The concept of not counting the sophisticated toward a cap, however, is not unique to this proposal. Both Rules 505 and 506 of Regulation D under the Securities Act cap the number of investors in an offering relying on the rule at thirty-five but do not count accredited investors toward the cap.<sup>269</sup>

Alternatively, the SEC could adopt the proposed Section 12(g)(1) exemption under Section 36 of the Exchange Act.<sup>270</sup> Section 36 was

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<sup>263</sup> 15 U.S.C. § 78l(h).

<sup>264</sup> See H.R. Doc. No. 88-95, pt. 3, at 17 (1963) (citing *Ralston Purina* and equating "public" with investors that "need the protection of disclosure").

<sup>265</sup> *Id.*

<sup>266</sup> 15 U.S.C. § 78l(g)(1).

<sup>267</sup> See *id.*

<sup>268</sup> See *infra* app. at 683 (proposing a new § 240.12g-1).

<sup>269</sup> See 17 C.F.R. § 230.501(e)(1)(iv) (specifying that accredited investors are not included for purposes of calculating the number of purchasers under Rules 505 or 506); see also *supra* notes 114–122 and accompanying text (discussing Rule 505); *supra* notes 97–112 and accompanying text (discussing Rule 506).

<sup>270</sup> 15 U.S.C. § 78mm.

added to the Exchange Act by NSMIA and, like Section 28 under the Securities Act, provides the SEC with the power to exempt any class of securities or persons from any provision of the Exchange Act “to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”<sup>271</sup> Additionally, as was the case with the Securities Act, NSMIA also amended the Exchange Act to require the SEC to consider capital formation in addition to investor protection when determining whether a new rule is in the public interest.<sup>272</sup> Hence, the same arguments for why the Securities Act portions of this proposal meet the standard of Securities Act Section 28 may also be advanced for why the Exchange Act portion of this proposal meets the standard of Exchange Act Section 36.

It may strike some as ironic that this proposal is targeted at fostering a quasi-public market whose listed companies are not subject to Exchange Act reporting and other requirements given the history of Section 12(g) of the Exchange Act. Section 12(g) was added to the Exchange Act by Congress in 1964.<sup>273</sup> Its purpose was “[t]o extend to investors in certain over-the-counter securities the same protection now afforded to those in listed securities by providing that the issuers of certain securities now traded over the counter shall be subject to the same requirements that now apply to issuers of securities listed on an exchange.”<sup>274</sup> As the legislative history indicates, however, Section 12(g) was directed at protecting the public investor<sup>275</sup>—the unsophisticated.<sup>276</sup> An exemption from 12(g) directed to spurring the development of an SIO market is not inconsistent with protecting the unsophisticated.

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<sup>271</sup> *Id.*

<sup>272</sup> *See id.* § 78c(f).

<sup>273</sup> *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565, 566–68 (codified as amended at 15 U.S.C. § 78l).

<sup>274</sup> H.R. REP. NO. 88-1418, at 1 (1964), *as reprinted in* 1964 U.S.C.C.A.N. 3013, 3027.

<sup>275</sup> *See* H.R. Doc. No. 88-95, pt. 3, at 18 (referring to “public-investor interest”); *id.* pt. 3, at 33 (referring to public shareholders); *see also* Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934, Exchange Act Release No. 56,010, 72 Fed. Reg. 37,608, 37,609 (proposed July 10, 2007) (“The Commission has noted that the registration requirement of Section 12(g) was aimed at issuers that had ‘sufficiently active trading markets and *public* interest and consequently were in need of mandatory disclosure to ensure the protection of investors.” (emphasis added)).

<sup>276</sup> *See supra* notes 224–225 and accompanying text.

## IV. THE AFTERMATH

### A. *New Markets*

If the proposal advanced in this Article is put into effect, the NYSE and NASDAQ likely would launch SIO markets in an effort to gain (or not lose) listings.<sup>277</sup> This would be consistent with their approach of offering multiple markets with varying listing standards in order to maximize listings.<sup>278</sup>

The London Stock Exchange's Alternative Investment Market ("AIM") provides an example of what a new U.S. market could look like. AIM is structured in such a way that its companies can avoid complying with various U.K. and European securities regulations, including the U.K. Combined Code on Corporate Governance and the European Prospectus Directive.<sup>279</sup> This allows AIM to provide its listed companies with "a simplified regulatory environment."<sup>280</sup> The hallmark of AIM is its lighter listing and ongoing disclosure requirements. For example, unlike the NYSE and NASDAQ, AIM has no minimum public float or market capitalization requirement.<sup>281</sup> Further, AIM companies are required to prepare only semi-annual reports, not the quarterly reports required for companies with securities registered under the Exchange Act.<sup>282</sup> As a counterbalance to these reduced requirements, a company must have a Nominated Advisor ("Nomad") in order to list on AIM.<sup>283</sup> Nomads include accounting firms and investment banks, and they must

<sup>277</sup> For example, the NYSE currently operates the NYSE, NYSE Arca, NYSE Euronext, and NYSE Alternext. See N.Y. Stock Exch., Listing Services, <http://www.nyse.com/about/listed/1170350259553.html> (last visited Mar. 4, 2009). Likewise, NASDAQ currently operates the NASDAQ Capital Market, NASDAQ Global Market, and NASDAQ Global Select Market. See NASDAQ, Inc., NASDAQ GLOBAL SELECT MARKET 1 (2006), available at [http://www.nasdaq.com/newsroom/presskit/reports/NASDAQ\\_Global\\_Select\\_Fact\\_sheet.pdf](http://www.nasdaq.com/newsroom/presskit/reports/NASDAQ_Global_Select_Fact_sheet.pdf).

<sup>278</sup> See NASDAQ, Inc., *supra* note 277, at 1; N.Y. Stock Exch., *supra* note 277.

<sup>279</sup> See Mendoza, *supra* note 169, at 296.

<sup>280</sup> LONDON STOCK EXCH., A PROFESSIONAL HANDBOOK: JOINING AIM 3 (2005) (listing admissions criteria), available at <http://www.londonstockexchange.com/NR/rdonlyres/2FFDF9AD-2A8A-4EE6-B094-0A505E922F9A/0/LSEAIMGuidenographicsFINAL.pdf>.

<sup>281</sup> London Stock Exch., AIM: Admission Criteria & Process, [http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim\\_new/About+AIM/admissioncriteria.htm](http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new/About+AIM/admissioncriteria.htm) (last visited Mar. 4, 2009); see also OXFORD ANALYTICA, ASSESSMENT OF THE ECONOMIC BENEFITS AND OPPORTUNITIES FOR A PAN-EUROPEAN GROWTH MARKET 15 (2005), available at <http://www.londonstockexchange.com/NR/rdonlyres/6321B61F-B501-4CFD-BE57-148CB10F5E5E/0/AIMStudyfinal.pdf> ("AIM sets no formal admission criteria with respect to factors such as company size, track record, or free float.").

<sup>282</sup> See Mendoza, *supra* note 169, at 311.

<sup>283</sup> See LONDON STOCK EXCH., *supra* note 280, at 19.

be approved by the London Stock Exchange.<sup>284</sup> A Nomad determines a company's suitability for listing on AIM, manages the offering process, and advises the company on regulatory matters.<sup>285</sup> The idea is that reputational concerns will incentivize Nomads to perform these roles diligently.<sup>286</sup> The AIM model has proved quite successful. Since its inception in 1995, over 2900 companies have listed on AIM, and it currently has over 1500 listed companies.<sup>287</sup>

Although an AIM-type market could perhaps be partially replicated in the United States through reliance on Rule 144A, this Article's proposal would provide greater flexibility.<sup>288</sup> The market could be designed without concern for the prohibition on general solicitation or the 500 record holder trigger.

An AIM-type model represents just one possibility for an SIO market. For example, the exchanges could also tailor an SIO market to attract foreign listings. Numerous foreign companies have cross-listed shares on U.S. exchanges purportedly to "bond" their disclosures to the global market by voluntarily subjecting themselves to the stricter U.S. regulatory regime.<sup>289</sup> By doing so, they attain a valuation premium on their equity and, therefore, a lower cost of capital.<sup>290</sup> Cross-listings, however, have declined post-SOX, and some have attributed this decline to overregulation.<sup>291</sup> Hence, there could be demand for an SIO market with stringent listing standards designed to provide a cheaper bonding mechanism to foreign companies.<sup>292</sup>

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<sup>284</sup> See *id.*

<sup>285</sup> See *id.* at 19–20.

<sup>286</sup> See Mendoza, *supra* note 169, at 295.

<sup>287</sup> See London Stock Exch., AIM, [http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim\\_new](http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new) (last visited Mar. 4, 2009).

<sup>288</sup> See 17 C.F.R. § 230.144A (2008). Pink Sheets LLC, an operator of an electronic quotation service named the Pink Sheets, has launched a new trading designation called OTCQX that includes a Nomad-type concept. See Kevin M. LaCroix, *The Pink Sheets Take Aim at AIM*, D&O DIARY, Mar. 6, 2007, <http://dandodiary.blogspot.com/2007/03/pink-sheets-takes-aim.html>. OTCQX, however, is not exactly comparable to AIM because OTCQX companies are generally subject to the provisions of the Exchange Act to the same extent as any other public company.

<sup>289</sup> See John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 284–92 (2007) (describing the bonding hypothesis).

<sup>290</sup> See *id.* at 236.

<sup>291</sup> See *id.* at 235.

<sup>292</sup> See *id.* If one accepts Coffee's view that enforcement intensity is the key to the bonding premium, it is unclear whether an SIO market could serve as a bonding mechanism. See *id.* at 242. A company listing on the SIO market would not be subject to many—but would be subject to some—of the liability provisions of federal securities laws, and thus there would be less ammunition for enforcement.

In any case, a market could ensure that all of its buyers are sophisticated by requiring them to certify as such as a condition to accessing the market. This approach is used by NASDAQ for its QIB-only PORTAL market and has been endorsed by the SEC.<sup>293</sup> Limiting buy-side access to sophisticated investors would allow an investor to resell securities issued under the new Section 5 exemption without having to incur any costs to verify that the counterparty to the trade is a sophisticated investor.

### B. Filling the Regulatory Void

As discussed above, a company with shares listed on an SIO market would not be required to register the shares under the Exchange Act so long as the company had 100 or fewer non-sophisticated shareholders.<sup>294</sup> Hence, the company would fall within a regulatory void because it would not be subject to the mandatory disclosure requirements or proxy regulations of the Exchange Act. This raises the question of who, if anyone, would fill the void.

The most likely candidate would be the SIO markets themselves. These markets would have strong financial incentives to compete for listings and trading volume. As a result, they would need to impose sufficient regulation through listing standards so that investors would have the confidence to buy and sell the securities listed on the markets.<sup>295</sup> Without investors, there would be no trading volume, and without trading there would be no listings.

Currently, both the NYSE and NASDAQ impose a host of listing standards on companies that list on their various markets. For example, both the NYSE and NASDAQ require a listed company to timely disclose material information,<sup>296</sup> make available to shareholders an annual

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<sup>293</sup> Order Approving NASDAQ Proposed Rule Change Relating to Reestablishment of the PORTAL Market, Exchange Act Release No. 56,172, 72 Fed. Reg. 44,196, 44,199 (Aug. 7, 2007) (noting that the fact that NASDAQ limits access to PORTAL to QIBs is a sufficient basis for a reseller through PORTAL to establish a reasonable belief, as required by Rule 144A, that a prospective purchaser is a QIB). For a discussion of PORTAL, see generally Sjoström, *supra* note 182.

<sup>294</sup> See *supra* notes 218–223 and accompanying text.

<sup>295</sup> See Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1458 (1997) (“[A]n exchange will survive only if a sufficient number of investors find it worthwhile to use the exchange’s facilities to purchase the securities listed on the exchange.”).

<sup>296</sup> See NASD, NASD MANUAL § 4310(c)(16), [http://cchwallstreet.com/nasd/nasdviewer.asp?SelectedNode=3&FileName=/nasd/nasd\\_rules/RulesoftheAssociation\\_mg.xml](http://cchwallstreet.com/nasd/nasdviewer.asp?SelectedNode=3&FileName=/nasd/nasd_rules/RulesoftheAssociation_mg.xml) (last visited Mar. 5, 2009) (“Except in unusual circumstances, [a NASDAQ-listed] issuer shall make prompt disclosure to the public through any Regulation FD compliant method (or combination of methods) of disclosure of any material information that would reasonably be ex-

report that includes audited financial statements,<sup>297</sup> hold annual shareholders' meetings, and solicit proxies for such meetings.<sup>298</sup> They also impose various corporate governance standards including requirements with respect to independent directors, audit and nominating committees, and shareholder voting.<sup>299</sup> These were put in place against the backdrop of federal securities laws but provide an example of the types of listing standards an SIO market may put in place.

Leaving the SIO markets to fill the regulatory void would introduce market competition to disclosure and proxy regulation. This is desirable because, as Roberta Romano has explained, "no government entity can know better than market participants what regulations are in their interest . . . . Competing regulators would make fewer policy mistakes than a monopolistic regulator as competition harnesses the incentives of the market to regulatory institutions."<sup>300</sup> Hence, this Article's proposal may result in the additional benefit of better regulations than those produced by the SEC—regulation that could serve as a model for future SEC initiatives concerning public companies.

A common concern regarding the regulatory competition model is that it may lead to a "race to the bottom" where competitors are driven to supply rules that benefit managers at the expense of investors.<sup>301</sup> Certainly, SIO markets would have to cater to management because management makes the listing decision.<sup>302</sup> This, however, does not mean SIO market competition would lead to a race to the bottom.

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pected to affect the value of its securities or influence investors' decisions."); NYSE, Inc., Listed Company Manual § 202.05 (2006), [http://www.nyse.com/lcm/lcm\\_manual.shtml](http://www.nyse.com/lcm/lcm_manual.shtml) ("A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities."). In July 2007, the NASD and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange were consolidated into the Financial Industry Regulatory Authority ("FINRA"). FINRA is in the process of consolidating NASD and NYSE rules into a single set of FINRA rules but has not yet completed the process. See Fin. Indus. Regulatory Auth., FINRA Rules, <http://www.finra.org/Industry/Regulation/FINRARules/index.htm> (last visited Mar. 31, 2009).

<sup>297</sup> NASD, *supra* note 296, § 4350(b); NYSE, Inc., *supra* note 296, § 203.01.

<sup>298</sup> NASD, *supra* note 296, § 4350(g); NYSE, Inc., *supra* note 296, §§ 401.00, 402.00.

<sup>299</sup> See NYSE, Inc., *supra* note 296, § 301.00.

<sup>300</sup> See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *YALE L.J.* 2359, 2365–66 (1998).

<sup>301</sup> See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *HARV. L. REV.* 1435, 1444–48 (1992). For example, corporate scholars have vigorously debated whether state competition for incorporations leads to a "race to the top" or a "race to the bottom" with respect to state corporate law. See *id.* (providing an overview of the debate).

<sup>302</sup> See Robert A. Prentice, *Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred*, 66 *OHIO ST. L.J.* 1155, 1185 (2005).

The more likely outcome, given financial incentives, is that the markets would be driven to strike an optimal balance (in terms of maximizing trading volume and listings) between investor welfare and management accommodation. At the same time, SIO markets would have to be mindful of possible SEC intervention if the balance leans too far toward management accommodation.<sup>303</sup> Because this proposal would be implemented largely through SEC-adopted exemptions, the SEC could easily add mandatory disclosure obligations as a requirement of one the exemptions.<sup>304</sup>

The fact that the SEC could intervene is an important consideration as recent events have demonstrated that sophisticated investors are not immune from making terrible investment decisions.<sup>305</sup> The idea behind distinguishing between sophisticated and unsophisticated investors, however, is not that sophisticated investors never make bad investment decisions, but that they have the tools to evaluate an investment and, therefore, require considerably fewer legal safeguards. If, however, bad decision making by sophisticated investors poses systemic risk, additional regulation may be justified, not specifically to protect the sophisticated but to protect the markets and economy generally. Because I do not believe an SIO market poses systemic risk of any consequence, my preference would be to leave regulation of SIO companies and markets largely to the markets themselves. There is, however, no reason that this would have to be the case. If the proposal made here raises systemic risk issues, the SEC could adopt rule changes along the lines sketched above but impose some level of regulation to address these issues.

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<sup>303</sup> As Mark Roe has argued in the context of state competition for incorporations, "Delaware's chief competitive pressure comes not from other states but from the federal government. When the issue is big, the federal government takes control of it or threatens to do so, or Delaware players are conscious that the federal government, even if silent, could step in if roused." Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 (2003).

<sup>304</sup> Several existing exemptions do require disclosure as a condition. For example, both Rules 505 and 506 under the Securities Act require an issuer to make certain specified disclosures to non-accredited investors. See *supra* notes 97–122 and accompanying text.

<sup>305</sup> See, e.g., Katharina Bart & Ragnhild Kjetland, *Crisis on Wall Street: Credit Suisse Logs Big Loss, Dims View—Effort to Rein in Risk Will Be Ramped Up as Bank Moves to Smooth Volatility*, WALL ST. J., Oct. 24, 2008, at C3 (noting that Credit Suisse lost billions of dollars on mortgage securities and buyout loans); Randall Smith & Jed Horowitz, *Merrill Takes \$8.4 Billion Credit Hit—O'Neal Faces Grilling as Loss Tops Forecast; Stock Price Falls 5.8%*, WALL ST. J., Oct. 25, 2007, at A1 (noting that Merrill Lynch lost billions of dollars on mortgage-backed securities).

A less likely candidate for filling the regulatory void would be the states. Although this Article's proposal preempts state registration requirements with respect to SIO company offerings, it has no effect on state corporate law. State corporate law currently imposes minimal requirements concerning disclosure and proxy solicitation because federal law occupies the field.<sup>306</sup> This, however, would no longer be the case for the SIO segment of the market, thereby potentially exposing SIO company disclosure and proxy solicitation rules to corporate federalism.<sup>307</sup>

Under the theory of corporate federalism, competition among states for corporate charters leads to the production of corporate codes that generally maximize shareholder value.<sup>308</sup> Managers are free to incorporate a business in any state, regardless of where the firm's operations are located. Hence, they will choose the jurisdiction that maximizes the joint welfare of management and investors because this will result in the lowest cost of capital.<sup>309</sup> Because incorporations generate revenues for the state and work for local attorneys, states compete with one other in attracting incorporations and, therefore, will generally seek to produce corporate codes that maximize shareholder value.<sup>310</sup> Not knowing what in fact is the best mix of corporate law provisions, states experiment with different rules, and the market determines the winner.<sup>311</sup> Over time the "losing" states adopt similar rules in response,

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<sup>306</sup> A prominent exception is Delaware common law, which does impose a duty of disclosure on Delaware corporations. See *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 356–63 (Del. Ch. 2008) (providing an overview of and applying the duty).

<sup>307</sup> Professor Romano has previously argued that the corporate federalism model should be extended to securities regulation. See generally Romano, *supra* note 300. To achieve this, she calls for changes to current law to allow a corporation to opt out of federal securities laws coverage and instead be regulated by the securities laws of its selected domicile. See *id.* at 2365. This, in theory, would spur states to attempt to attract additional incorporations by offering desirable securities regulation regimes. See *id.* at 2388. Competition concerning regimes 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." *Id.* at 2366. Hence, states would be incentivized to "produce rules more aligned with the preferences of investors, whose decisions drive the capital market." *Id.* at 2362.

<sup>308</sup> See *id.* at 2365–66; see also FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 218 (1991).

<sup>309</sup> See EASTERBROOK & FISCHEL, *supra* note 308, at 213.

<sup>310</sup> See *id.* at 212.

<sup>311</sup> See *id.* at 218.

and the preferred solution eventually predominates.<sup>312</sup> The end result is typically policy innovation and better rules.<sup>313</sup>

Competition among fifty states is more desirable than competition among a handful of SIO markets because the more competitors, the more experimentation, and therefore the greater likelihood of yielding optimal rules.<sup>314</sup> Unfortunately, it is unlikely that states would actually compete concerning SIO company securities regulations if given the chance. Because Delaware long ago established itself as the runaway winner of the competition,<sup>315</sup> states likely view Delaware's lead as insurmountable and, therefore, conclude that competing is pointless.<sup>316</sup> There is no reason to believe that states would suddenly start competing simply because securities laws are added to the mix.<sup>317</sup>

### CONCLUSION

The success of AIM and the recent increase in the number of companies that have exited or passed on our public markets underscore the need for a new path to equity capital and share liquidity. The proposal in this Article seeks to fill this need by exempting SIO compa-

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<sup>312</sup> See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 5 (1993) [hereinafter ROMANO, GENIUS]; Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?* 10 (Yale Univ., Int'l Ctr. for Fin., Working Paper No. 05-02, 2005), [hereinafter Romano, *Competition*] available at <http://ssrn.com/abstract=693484>.

<sup>313</sup> See ROMANO, GENIUS, *supra* note 312, at 5; Romano, *Competition*, *supra* note 312, at 10.

<sup>314</sup> See EASTERBROOK & FISCHEL, *supra* note 308, at 216 (noting that even fifty competitors is likely insufficient to yield optimal laws).

<sup>315</sup> See *id.*; see also Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 701–24 (2002).

<sup>316</sup> See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 597 (2002) (“[B]arriers to entry, network effects, large sunk costs, managerial control over reincorporation decisions, and risk of strategic response by Delaware will deter rival states from mounting a meaningful challenge to Delaware in the ordinary course of events.”).

<sup>317</sup> See Prentice, *supra* note 302, at 1175–76. As Professor Prentice explains:

If state competition for corporate charters via corporate regulation is largely a myth, then state competition for securities law is likely to be equally fanciful. State legislatures have long been the dominant players in corporate law, yet they do not meaningfully compete there. How much less likely is it that they will compete in the realm of securities regulation where they have less experience and interest, where they have been only marginal players for at least seventy years, and where there is no obvious motive to induce foreign corporations to choose their body of securities law? Why, pray tell, would Texas, for example, desire that a California corporation choose Texas law to govern transactions in its securities?

nies from many of the federal securities laws. Consequently, the proposal would unleash the creativity and judgment of the marketplace in establishing SIO markets and determining disclosure and other obligations.

Undoubtedly, there is risk involved in this approach. The fundamental purpose of the federal securities laws is to protect investors, and this proposal puts the bulk of the protections aside. Hence, SIO markets could end up primarily attracting companies that want to preserve the private benefits of control that they would lose by going public. Consequently, there would likely be increased risk associated with investing in SIO companies. Sophisticated investors, however, are better able to appreciate and bear risk than the general public. As the Supreme Court has stated, they can “fend for themselves.” In the end, the reforms proposed here would enhance capital formation by reducing regulatory burdens without sacrificing investor protection and, therefore, should be adopted.

## APPENDIX

## TEXT OF PROPOSED AMENDMENTS

NEW SECTION 5 EXEMPTION (to be added to Regulation D of the Securities Act):

**§ 230.508 Exemption for offers and sales to accredited investors only.**

(a) *Exemption.* Offers and sales of securities that satisfy the conditions in paragraph (c) of this section by an issuer shall be exempt from the provisions of section 5 of the Act under section 28 of the Act.

(b) *Issuer eligible to use this section.* This section is available to any issuer that is not subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934 and is not an investment company registered or required to be registered under the Investment Company Act of 1940.

(c) *Conditions to be met.*

(1) *General conditions.* To qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of §§ 230.501 and 230.502(a), (c), and (e) to the extent not superseded by paragraph (c)(2)(ii) of this section.

(2) *Specific Conditions.*

(i) *Limitation on purchasers.* All purchasers are or the issuer reasonably believes that all purchasers are accredited investors.

(ii) *General Solicitation and Advertising.* Notwithstanding § 230.502(c), a broker-dealer acting on the issuer's behalf may solicit offers and sales of securities through oral or written communications constituting general solicitation and general advertising so long as (1) any such oral communication is directed only at persons the broker-dealer reasonable believes are accredited investors, (2) any such written communication prominently states that sales will be made to accredited investors only, no money or other consideration is being solicited or will be accepted through the written communication, the securities have not been registered with or approved by the U.S. Securities and Exchange Commission and are being offered and sold pursuant to an exemption from registration, and the name and address of the broker-dealer making the solicitation, and (3) such broker-dealer is registered with the Commission and each state in which the solicitation or advertising is directed.

(iii) *Limitations on resale.* Securities acquired in a transaction made pursuant to the provisions of this section are deemed to be restricted

securities within the meaning of Rule 144(a)(3). The issuer must provide written disclosure to each purchaser prior to sale that the securities have not been registered under the Act and, therefore, cannot be resold unless they are registered under the Act or unless an exemption from registration is available.

RULE 144 AMENDMENTS:

**§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.**

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(b) \* \* \*

(iii) If the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, and the securities were issued by the issuer under § 230.508, any person who is not an affiliate of the issuer at the time of the sale, and has not been an affiliate during the preceding three months, who sells restricted securities of the issuer for his or her own account shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the Act if the condition of paragraph (d) of this section is met.

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(d) \* \* \*

(1) \* \* \*

(iii) If the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, and the securities were issued by the issuer under Rule 508 of the Act, the securities may be immediately offered and resold to any person who is an accredited investor or whom the seller reasonably believes is an accredited investor.

## PREEMPTION:

**§ 230.146 Rules under section 18 of the Act.**

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(c) *Definition of Qualified Purchaser.* A “qualified purchaser” as used in Section 18(b)(3) of the Act means any person who is offered or sold securities by an issuer in reliance on §230.508.

## EXCHANGE ACT § 12(g) EXEMPTION:

**§240.12g-1 Exemptions From Section 12(g).**

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(b) An issuer shall be exempt from the requirement to register a class of equity securities pursuant to section 12(g)(1) if there are 100 or fewer or the issuer reasonably believes there are 100 or fewer beneficial owners of such equity securities who were not accredited investors (as defined in § 230.501(a) of the Securities Act) on the date they acquired such equity securities.

