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

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Abstract: This essay explores the line between private and public markets. I propose a two-tier market system to replace initial public offerings. The lower tier would be a private market restricted to accredited investors; the top tier would be a public market with unlimited access. The transition between the two markets would be based on issuer choice and market capitalization, followed by a seasoning period of disclosure and trading in the public market before the issuer would be allowed to make a public offering. I argue that such system would promote not only efficient capital formation, but also investor protection.

I. Introduction

Milton Cohen, in his seminal article, *Truth in Securities Revisited*,[1] was the first to highlight the awkwardness created by the enactment of Securities Act of 1933,[2] which regulates public offerings of securities, prior to the enactment of the Securities Exchange Act of 1934, which governs the disclosure obligations of public companies.[3] Cohen pointed out that if the Securities Act had been adopted subsequent to, or simultaneously with, the Exchange Act, it would have been natural for public offering disclosure obligations to piggy-back on the periodic disclosure obligations mandated for public companies.[4] Franklin Delano Roosevelt's political calculation, however, ensured that the bills would be separate and that the

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[1] 79 HARV. L. REV 1340 (1966)

[2] Pub. L. No. 73-38, 48 Stat. 74 (1933), codified as amended at 15 U.S.C. § 77.

[3] Pub. L. No. 73-404, 48 Stat. 881 (1934), codified as amended at 15 U.S.C. § 78.

[4] Cohen, supra note , at 1341-1342.

Exchange Act would come second.[5] That accident of history meant that the two statutes would develop separate disclosure obligations. That separate development ignored the economic reality that the information investors would seek in valuing securities would be largely the same, regardless of whether they were purchasing from an issuer in a primary transaction or another investor in a secondary transaction.

Companies' public offering and secondary market disclosure obligations have gradually converged since Cohen wrote in the 1960s. The rise of integrated disclosure in the 1980s[6] is generally considered a way station along the path to full-blown company registration.[7] Company registration would allow a company to register as a public company just once, thereafter offering and selling securities whenever it wanted without the need to register the securities themselves.[8] Beginning with shelf registration under Rule 415,[9] and culminating in the SEC's 2005 offering reforms,[10] the goal of company registration and fully integrated disclosure is now almost complete. After the 2005 reforms streamlined shelf registration, the largest public issuers now operate under the functional equivalent of company registration. The advantages of company registration are available,

[5] See Joel Seligman, THE TRANSFORMATION OF WALL STREET 51-53 (3d ed., 2003).

[6] See Adoption of Integrated Disclosure System, Securities Act Rel. No. 6383 (1982).

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

[8] Company registration is the organizing principle underlying the American Law Institute's proposed codification of federal securities law. *See* FEDERAL SECURITIES CODE (1980). In 1996, the SEC's Advisory Committee on the Capital Formation and Regulatory Processes issued a report outlining a voluntary pilot program for company registration. Report of the Advisory Committee on the Capital Formation and Regulatory Processes (1996), available at http://www.sec.gov/news/studies/capform.htm.

[9] Securities Act Rel. No. 33-6499 (1983)

[10] Securities Act Rel. No. 33-8591 (2005).

however, only for a subset of the companies that have previously made the transition from private to public company status. Initial public offerings (IPOs), the customary path for attaining public company status, are not included in shelf registration; they continue to be subject to the traditional regulatory regime, with its "gun-jumping" restrictions intended to quell speculative fervor.

The separate enactment of the Securities Act and the Exchange Act has also influenced the development of the distinction between public and private under those two statutes. Both the Securities Act and the Exchange Act reflect a public/private divide, but they take very different approaches to drawing that line. The Securities Act draws the line between public and private in a manner that focuses explicitly on investor protection. The dividing line under the Exchange Act, by contrast, is a compromise, reflecting not only investor protection, but also interests in capital formation and practical ease of application. I argue here that the resulting mismatch between the public/private dividing lines under the two Acts means that the transition from private to public will inevitably be an awkward one, fraught with problems for issuers, investors, and regulators. Can we reconcile the two dividing lines so that companies can navigate this passage from private to public more smoothly?

Congress has addressed this problem, in a partial way, with its recent adoption of the JOBS Act (short for Jump-start Our Business Start-ups Act).[11] Unhappy with the SEC's somewhat tepid efforts to facilitate capital raising by smaller companies, Congress afforded the SEC new authority to exempt offerings

[11] Pub. L. No., – Stat. – (2012).

from the requirements for registered offerings. Along with that exemptive authority, Congress authorized the SEC to adopt less demanding periodic disclosure from companies who avail themselves of this new offering exemption. These disclosure requirements would presumably only apply until a company triggered the standards for full-fledged public company status. Those standards are also newly-raised by the JOBS Act. These JOBS Act reforms have the potential to create a lower tier of public companies, thus blurring the line between public and private. These changes have been roundly criticized by advocates for investor protection, however, as opening the door wide for fraud and manipulation.[12] Those criticisms carry some weight, given the abuses that repeatedly occur in the penny-stock market.

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

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

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

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

II. Private v. Public

The distinction between public and private is an important triggering mechanism under both the Securities Act and Exchange Act. As noted above, the two statutes' differing demarcations between public and private date back to their original enactment during the New Deal. Common to both, however, is that the public designation carries with it significant regulatory consequences. Consequently, companies and their lawyers spend considerable energy avoiding public status. This regulatory arbitrage has in turn induced the SEC to spend like effort in curtailing those attempted evasions of public status.

A. The Public Trigger

Under the Securities Act, public offerings are open to any and all comers. Accordingly, public offerings are subject not only to extensive disclosure requirements, but also to a byzantine array of "gun-jumping" rules intended to curb speculative frenzies for newly-issued securities.[13] Private offerings are exempted from registration and the gun-jumping rules by § 4(2) of the Securities Act. The Supreme Court has interpreted § 4(2) in *Ralston Purina* as permitting private offerings only to investors who can "fend for themselves," and therefore do not need

[13] Those rules are accompanied by an equally byzantine array of exemptions to make the whole scheme viable, if expensive. For a comprehensive summary, see Stephen J. Choi & A.C. Pritchard, SECURITIES REGULATION: CASES AND ANALYSIS 404-451 (3rd ed. 2011).

the protections afforded by registration under the Securities Act.[14] Because they are limited to sophisticated investors, private offerings are subject to considerably less onerous disclosure requirements than public offerings. Private offerings are subject, however, to a number of procedures designed to prevent end runs around the public offering process, i.e., nominally private offerings that are funneled through intermediaries to the public at large: "distributions."[15]

The SEC has provided a safe harbor for § 4(2) under Rule 506 of Regulation D.[16] Rule 506 offerings are limited to investors with the requisite sophistication to evaluate the investment.[17] This requirement is diluted somewhat, however, by Regulation D's conclusive presumption that accredited investors, which includes individuals with $200,000 in annual income or $1 million in assets, are deemed to have the requisite investment sophistication.[18] This presumption, although somewhat difficult to square with *Ralston Purina*, encourages many companies to limit their offerings to accredited investors exclusively. The regulatory presumption is that the investors are capable of assessing the merits of an investment on their own, without the disclosure mandated pursuant to the Securities Act. Market demands, however, dictate that some disclosure, comparable to the core mandatory disclosure requirements, will be forthcoming.

The Exchange Act also has a public-private dividing line, but it is framed very differently. The Exchange Act dividing line has been shaped by its history. When the

[14] SEC v. Ralston Purina Co, 346 U.S. 119 (1953).
[15] See United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968).
[16] 17 C.F.R. § 506.
[17] Rule 506(b)(2)(ii).
[18] Regulation D, Rule 501(a)(5) & (6).

Securities Exchange Act was enacted in 1934, there were two types of trading venues: stock exchanges, with the New York Stock Exchange being the most dominant, and the over-the-counter (OTC) market. At first, Congress chose to require disclosure only from exchange-listed companies.[19] In 1936, Congress added companies making a public offering to the list of public companies; periodic disclosures would be required after the IPO.[20] Both of these categories could be avoided; issuers that did not list on an exchange and did not make a public offering would not be burdened by disclosure requirements, albeit at the cost of less liquidity and less access to capital. It was not until 1964 that Congress added companies trading in the OTC market to the list, closing a loophole long disliked by both the SEC and the exchanges.[21] Even then, not all OTC companies were brought within the rubric of public status; only companies with 500 or more "record" shareholders that were also above a certain minimum asset size (currently set at $10 million) were included.[22] Smaller companies, for which the opportunities for fraud and manipulation are most prevalent, remained largely unregulated.

Notably absent from these criteria for public company status under the Exchange Act was any consideration of the character of the investors. Sophisticated institutions and small retail investors were treated alike for purposes of the tally to 500 that triggered public company status. Issuers could not avoid public company status by limiting their investor base to accredited investors. Such a limitation could

[19] Exchange Act § 12(a) & (b), 15 U.S.C. § 78l(a) & (b).
[20] Codified at Exchange Act § 15(d), 15 U.S.C. § 78o(d).
[21] 78 Stat. 565. (1964), codified at Exchange Act § 12(g), 15 U.S.C. § 78l(g).
[22] Exchange Act Rule 12g-1.

be achieved through the imposition of transfer restrictions, but it would not avoid public status. Once the 500-shareholder limit was passed – whatever the sophistication of those investors – the company had no choice but to comply with the periodic disclosure requirements of the Exchange Act.

Why the numerical trigger? Joel Seligman suggests the number reflects a political compromise, with Congress splitting the difference between the regulators and the securities industry.[23] The numerical criterion has a certain logic. Investor protection may be more important for larger companies because they have more investors, but capital formation for larger companies is also potentially more significant. Bigger companies, because of the wider scope of their operations, might have greater influence on the efficiency of capital allocation in the overall economy.[24] (Of course, smaller companies might be more significant to capital formation at the margin because they have greater potential for growth.) Whatever the motivation, the numerical trigger adopted in 1964 extended the earlier pattern of forcing disclosure from companies "presumed to be the subject of active investor interest."[25] Companies with fewer investors were excluded for reasons of "practicality," despite the SEC's recommendation of a broader reach in its Special Study of the Securities Markets.[26] Obviously, investor protection would have been maximized by giving the SEC the greater regulatory reach that it sought. Even while

[23] Seligman, supra note , at 315.

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

[25] Cohen, supra note , at 1341.

[26] Cohen, supra note , at 1368. The SEC's recommendation is found in *Report of the Special Study of Securities Markets of the Securities and Exchange Commission,* H.R. Doc. 95, 88th Cong., 1st Sess., pt.3, at 62-64 (1963).

greatly expanding the scope of regulation, however, politicians were concerned by the negative effects on small companies if they were roped into the burdens of public company status. Investor protection would have to be balanced against the need to foster capital formation.

B. Facebook

The Exchange Act's numerical trigger for public company status recently emerged from technical obscurity as Facebook inched its way toward becoming a public company. In late 2010, Goldman Sachs proposed selling a significant block of Facebook shares.[27] The transaction drew attention because Facebook at that time was a private company and was planning to maintain that status, at least in the short term. Goldman planned to preserve Facebook's private status by selling the company's shares to private investors via a trust that would bundle their interests in a single investment vehicle.[28] The bundling was the unusual feature of the transaction, designed to keep the number of Facebook investors under the Exchange Act's 500-shareholder filing threshold.[29] Whether this approach was a viable strategy, however, was open to debate. Rule 12g5-1(a) of the Exchange Act allows shares held of record by a legal entity to be counted as one person. Rule 12g5-1(b), however, stipulates that "[i]f the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent" the filing

[27] Evan Weinberger, *Goldman's Facebook Stake May Force SEC's Hand*, Law 360 (Jan. 4, 2011).
[28] Id.
[29] Facebook's assets were already well in excess of $10 million.

requirement, "the beneficial owners of such securities shall be deemed to be the record owners thereof." In other words, subsection (b) suggests that the SEC would look through the legal entity to the actual owners, *if* the issuer knows that the entity is being used to avoid public company filing.

The proposed transaction attracted considerable media attention, which led to the offering's eventual demise. The deal was pulled because of concerns that the media attention could be deemed to be a "general solicitation," which would cause the deal to run afoul of the Securities Act of 1933.[30] Goldman instead placed the shares in an off-shore transaction.[31] Facebook has subsequently proceeded with plans for an initial public offering, making it a public company. Facebook's transition to a public company is discussed in greater detail below. [32]

Facebook's interaction with the private/public divide was also highlighted in another story that surfaced at around the same time. Word leaked that the SEC was investigating secondary trading markets for violations relating to the resale of securities issued by private companies.[33] Facebook was among the more notable companies traded on one of these venues, SecondMarket. These markets cater mainly to employees (both current and former) of private companies, but also some early-round investors. They have experienced strong growth in recent years.

[30] Regulation D, Rule 502(c) (prohibiting general solicitations in connection with private placements under Rule 506).

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

[32] See text at *infra* notes .

[33] Peter Lattman, *Stock Trading in Private Companies Draws S.E.C. Scrutiny*, N.Y. Times (Dec. 27, 2010).

According to the *New York Times*, "In 2009, SecondMarket completed $100 million worth of transactions in private shares. Last year, its volume was nearly six times that amount, with Facebook trades making up the bulk. Its rival SharesPost logged $625 million in transactions last year, more than double its total from 2010."[34] Despite this growth, these trading venues are still dwarfed by the trading of public company shares on registered exchanges. There are substantial limits on the volume of trading in these private markets as currently structured. SecondMarket and similar venues do not provide the liquidity afforded by an exchange, as they lack specialists and market makers. Instead, they provide the more limited liquidity service of matching buyers and sellers in a central (virtual) location.[35] These trading venues are limited to accredited investors, and the venues screen prospective investors to ensure that they qualify as accredited.[36] These precautions are taken to help ensure that the shares are not being "distributed" to the public, which could render the trading venue an underwriter for purposes of the Securities Act.[37] Notwithstanding these limitations under current regulation, the growth of these venues suggests clear potential for expansion, if the regulatory scheme would accommodate it. The SEC's investigation, however, makes the future of private markets uncertain.

[34] Evelyn M. Rusli & Peter Lattman, *Losing a Goose That Laid the Golden Egg*, N.Y. TIMES (Feb. 2, 2012).

[35] Richard Teitelbaum, *Facebook Drives SecondMarket Broking $1 Billion Private Shares*, Bloomberg Markets Magazine, April 27, 2011 available at http://www.bloomberg.com/news/2011-04-27/facebook-drives-second.

[36] Id.

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

The SEC later announced that it had reached a settlement of an enforcement action with SharesPost. The agency's complaint in that action alleged that the trading venue had been operating as an unlicensed broker-dealer.[38] At the same time, the SEC announced the filing of an enforcement action against Felix Investments. The SEC's complaint alleged that Felix took secret commissions from the sellers of private shares, in addition to the fees paid by purchasers. The agency also alleged that Felix had mislead investors in connection with the sale of Facebook shares. The SharesPost enforcement action is a mere regulatory violation; the Felix action, however, is a reminder of the vulnerability to manipulation of thinly-traded markets.[39]

C. The JOBS Act

The fallout from Goldman's failed private offering of Facebook shares triggered a rather dramatic legislative response. Lawmakers in Congress seized upon the salient occasion to attack the SEC for the obstacles that it was placing in the path of capital formation.[40] The SEC responded in time-worn fashion, promising a review of its regulations to assess their effect on the U.S. capital markets.[41] The SEC's delaying tactic did not work, however, as a Republican House of

[38] Evelyn M. Rusli, *Charges Filed Against Brokerage Firms That Trade Private Shares*, N.Y. TIMES (March 14, 2012).

[39] Facebook's initial registration statement for its IPO disclosed that it had been contacted by SEC staff in connection with its investigation into alternative trading venues. Alison Frankel, *What everyone missed in Facebook's IPO filing*, ThomsonReuters News & Insight Feb. 2, 2012). No enforcement action, however, was filed against Facebook.

[40] Letter from U.S. Representative Darrell Issa to Mary Schapiro, Chairman, SEC (March 22, 2011), *available at* http://www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf.

[41] Letter from S.E.C. Chairman Mary Schapiro to U.S. Representative Darrell Issa, Chairman, U.S. House Oversight Committee, *available at* http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf (April 6, 2011).

Representatives, anxious to latch on to a wedge issue to make the Democrats look bad in an election year, pushed forward with legislation. That bill would ultimately become the JOBS Act. President Barack Obama, anxious to be seen as "pro-growth" while facing an economy still plagued by high levels of unemployment, signed the JOBS Act into law.[42] The SEC's opposition to the bill[43] carried little weight in the face of those electoral imperatives.

A key goal of the JOBS Act was to jump start the market for IPOs by easing the burden of public company status on newly public companies. A substantial expense was eliminated for post-IPO companies by exempting them from § 404 of the Sarbanes-Oxley Act, which requires auditor assessment of a company's internal controls.[44] The JOBS Act also reduced the audited financial statement requirement for IPOs to only two years.[45] These regulatory relaxations last for five years from a company's IPO or until the company reaches $1 billion in annual revenue, whichever is sooner.[46]

The JOBS Act also loosens the gun jumping rules. The JOBS Act authorizes issuers to "test the waters" with qualified institutional buyers and accredited

[42] Jonathan Weisman, *Final Approval by House Sends Jobs Bill to President for Signature*, N.Y. Times (March 27, 2012).

[43] David Hilzenrath, *Jobs Act could remove investor protections, SEC chair Mary Schapiro warns*, WASH. POST (March 14, 2012)(" "Too often, investors are the target of fraudulent schemes disguised as investment opportunities," Schapiro wrote. "As you know, if the balance is tipped to the point where investors are not confident that there are appropriate protections, investors will lose confidence in our markets, and capital formation will ultimately be made more difficult and expensive.""). State securities regulators also voiced their opposition. North American Securities Administrators Association, *The JOBS Act an Investor Protection Disaster Waiting to Happen* (March 22, 2012).

[44] JOBS Act § 103.

[45] JOBS Act § 104, codified at Securities Act § 7(a)(2)(A).

[46] JOBS Act § 101, codified at Securities Act § 2(a)(19) and Exchange Act 3(a)(80).

investors prior to filing a registration statement.[47] The goal is to assess whether there is demand for the company's shares, allowing the company to avoid the expense of the registration process if interest is lacking. In addition, the law frees analysts to issue research reports for new issuers during the offering process.[48] The goal of this provision is to promote demand for the company's shares.

The JOBS Act targeted two SEC regulations relevant to the Facebook affair. The first, pertaining to the Securities Act, was the SEC's ban on general solicitation in private placements; the JOBS Act repeals that prohibition outright.[49] Under the JOBS Act, the media attention that Goldman's proposed offering drew would not have jeopardized the § 4(2) exemption, as long as actual sales were made only to accredited investors. The second was the 500-shareholder limit for triggering public company status under the Exchange Act. The JOBS Act raises that number to 500 persons who are not accredited investors, or the more critical number, 2,000 investors overall.[50] Excluded from that number are shareholders who received the securities under an employee compensation plan exempted from registration.[51] This latter provision promises to substantially delay the point at which a growing company would be forced to make the periodic disclosures required of public companies.

[47] JOBS Act §105(c), codified at .

[48] JOBS Act § 105, codified as .

[49] JOBS Act § 201, codified at Securities Act § 4(b).

Congress also authorized an exemption for "crowdfunding." JOBS Act §§ 301-305, codified at Securities Act §§ 4(6), 4A, & 18(b)(4); Exchange Act §§ 3(a)(1)(h) & 12(g)

[50] JOBS Act § 501, codified at Exchange Act § 12(g)(1)(A).

[51] JOBS Act § 502, codified at Exchange Act § 12(g)(5)(A).

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

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

Another provision of the JOBS Act, however, has the potential to blur the distinction between private and public in a much more profound way. Congress opened the door for public offerings by smaller companies with substantially fewer restrictions. It did so by increasing the SEC's authority to exempt offerings from registration under § 5, raising the offering limit under § 3(b) tenfold from $5 million to $50 million.[52] The gun jumping rules are put aside, as companies are allowed to "test the waters" prior to filing a registration statement.[53] Moreover, Congress also stipulated that the securities sold be unrestricted, i.e., they could be freely resold to retail investors.[54] In a somewhat unusual move, Congress mandated the adoption of a new exemption by the SEC pursuant to this authority (perhaps recognizing that the SEC would simply ignore it otherwise). In a concession to investor protection, however, Congress did allow the agency to require periodic disclosures by companies that avail themselves of this new exemption.[55] It also made offering disclosures subject to § 12(a)(2) liability under the Securities Act, but not, conspicuously, § 11's strict liability regime.[56]

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

[52] JOBS Act § 401, codified at Securities Act § 3(b)(2)(A).
[53] JOBS Act § 401, codified at Securities Act § 3(b)(2)(E).
[54] JOBS Act § 401, codified at Securities Act § 3(b)(2)(B).
[55] JOBS Act § 401, codified at Securities Act § 3(b)(4).
[56] JOBS Act § 401, codified at Securities Act § 3(b)(2)(D).

with it the intriguing possibility that the SEC will create a junior varsity level of public companies. At this point, the creation of a public company incubation pool is only a possibility, as it is easy to see the SEC dragging its heels in implementing this exemption, and Congress has not mandated a date for its adoption. Certainly nothing will happen at the SEC anytime soon. The agency is still struggling to get out from under a rulemaking backlog created by the Dodd-Frank Act. After the 2012 election, with the spotlight from Capitol Hill perhaps less glaring,[57] the SEC may feel that it has a freer hand in imposing substantial requirements on the exemption that it eventually promulgates. If it does so, the SEC may strangle the JOBS Act offering exemption in its crib.

III. Mediating the transition from private to public

Milton Cohen's central insight was that the disclosure needs of investors were the same in the primary and secondary markets for securities. Since Cohen wrote his article in the mid-1960s, the force of his insight has been reinforced by the widespread acceptance of the efficient capital market hypothesis by both regulators and courts. Cohen's argument was that disclosure obligations should be made consistent for the two markets. The implication of the efficient capital market hypothesis, however, is that disclosure particular to securities offerings might be largely redundant. If the market has the information prior to the issue of the securities, investors already have the tools that they need to assess the value of that

[57] See Mary L. Shapiro, Chair, SEC, Testimony Concerning the "JOBS Act in Action Part II: Overseeing Effective Implementation of the JOBS Act at the SEC" (June 28, 2012) (announcing that SEC would not meet deadlines imposed in JOBS Act).

new issue. Moreover, retail investors can free ride on the efforts of institutional investors when purchasing if they are all participating in the same market, purchasing from the same fungible pool of securities. The pricing decisions of the institutional investors will determine the market price, thereby providing some assurance that retail investors are getting a fair deal.

More fundamentally, with the advent of the efficient capital market hypothesis and its acceptance by the SEC, the regulatory focus of the Exchange Act has shifted. Although the Exchange Act may have been originally about investor protection, the development of the efficient capital market hypothesis has pushed toward accurate pricing as the goal of the Exchange Act. Investor protection is simply a happy by-product of efficient pricing. If markets are fully informed, the theory goes, risks will be accurately priced.

A. IPOs: Bad Deals

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

IPOs are bad for companies, bad for insiders, and bad for investors. The only parties that clearly benefit from these deals are the individuals who service them:

accountants, lawyers, and underwriters. Especially underwriters, who take a standard commission of 7% in the overwhelming majority of IPOs.[58] In economic jargon, these professionals are termed "transactions costs;" the term is not intended as a compliment. It is, however, less tendentious than "blood-sucking parasite," which is the term that more than one entrepreneur might use, pained by giving away such a substantial slice of their growing business to a mere salesman.

Why are IPOs bad for companies? Apart from the substantial sums paid to the blood-sucking parasites, IPOs suffer from the well-known phenomenon of underpricing. Underpricing is the tendency for the price of stocks to rise significantly above the offering price on the first day of secondary market trading.[59] From the perspective of the issuer, the gap between the secondary market price and the offering price reflects unexploited market demand for the company's shares. The explanations offered for underpricing are varied, including insurance against the risk of liability,[60] and compensation to institutional investors for the cost of collecting information about the issuer.[61] Another theory is that underpricing encourages institutional owners to retain the shares at least until the lock-up period

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

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

[60] See, e.g., Philip D. Drake & Michael R. Vetsuypens*, IPO Underpricing and Insurance Against Legal Liability*, 22 Fin. Mgmt. 1 (1993); Seha M. Tinic, *Anatomy of Initial Public offerings of Common Stock*, 43 J. Fin. 789 (1988). But see Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. Rev. 17 (1993).

[61] Ravi Jagannathan & Ann E. Sherman, *Reforming the Bookbuilding Process for IPOs*, 17 J. Applied Corp. Fin. 2, 6 (2005).

expires, typically six-months after the offering, when the insiders will be free to sell their shares.

These factors may play a role, but there is also the intriguing possibility that the run-up in the secondary market reflects speculative frenzy among retail investors. This speculative frenzy could not be captured by the issuer because the run-up is driven, at least in part, by the run-up itself, momentum trading on steroids if you will. The role of speculation would appear to be part of the story of why book-built offerings continue to dominate auctions as a means of selling securities. According to this account, auctions have failed to attract a market following because they offer no way of restricting the "dumb money."[62] If retail investors are allowed to dominate the pricing of shares, institutional investors, wary of the "winner's curse," will avoid the offering. If institutional investors refuse to participate, the prospects for a complete unraveling become all too real. Underpricing is simply the by-product of the need to exclude the undesirables from the initial pricing process.

Whatever the cause of underpricing, companies pay it as the cost of entry into the public markets. IPOs are less capital raises than they are debutante balls. Newly public companies are jostling for the attention of investors, and a big bump in price on the first day of trading, like a fabulous gown, is sure to be noticed and attract trading volume. The media treat a sharp rise in the after-market price as a

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

reflection of the offer's "success," ignoring the money the issuer has left on the table during the bookbuilding process.

Why are IPOs bad for insiders? Primarily because insiders suffer substantial dilution of their interests in the company as a result of the IPO. For companies with the best prospects, the information asymmetry between the insiders and outside investors (along with the potential for fraud by insiders) means that investors are likely to substantially discount the amount they are willing to pay for the company's shares. That discounting will be mitigated, but not eliminated, by mandatory and voluntary disclosures. Anti-fraud enforcement operates substantially below 100% accuracy, so some stretching of the truth will slip through unsanctioned. Moreover, complete disclosure is a practical impossibility even for companies anxious to be forthcoming. Worse yet, disclosure will sometimes be bad for business, as it conveys useful information to a firm's competitors.[63] Given these limitations on disclosure, companies with below average prospects will be able to hide themselves in the pool of all IPO firms. The inclusion of "bad" firms in the IPO pool means that better than average firms will suffer from discounting, a partial lemons effect.[64] Notwithstanding these dilution costs, the benefit to insiders is that they will eventually enjoy a liquid market for their shares after the lock-up expires. The costs are worth it – for some. Others stay private.

[63] See Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. L. REV. 132, 151 (2004) (noting greater disclosure in private deals relative to disclosures made by public companies).

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

Why are IPOs bad for investors? Despite the underpricing that manifests itself in the secondary market on the day that the company goes public, the long-term performance of IPO stocks trails the risk-adjusted returns available from holding the market portfolio.[65] Given that this underperformance is both long-standing and well-documented, why do investors continue to invest in IPOs? One answer is that they are lured into foolish purchases by crafty Wall Street salespeople. It is a Wall Street truism that "new issues are sold, not bought."[66] This proposition is somewhat difficult to square with the prevalence of institutional investors among the lucky recipients in IPO allocations.[67] Those institutional investors, however, may be counting on the ability to flip the shares to retail investors in the secondary market.[68] Lurking in the background here, especially when combined with the underpricing phenomenon, is the worry that secondary market prices may be driven by a lottery mentality, at least in the near term. Investors may be willing to tolerate market-lagging returns overall in exchange for the possibility that one of their purchases may turn out to be the next Apple or Microsoft.

B. Facebook Again

[65] Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 448 VAND. L. REV. 965, 970 (1995); Terzah Ewing, *Burnt Offerings? Street Debuts Are Fizzling After Pop*, WALL ST. J., Apr. 26, 2000, at C1.

[66] Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 Colum. L. Rev. 979, 998 (1989).

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

[68] D. Cook et al., *On the marketing of IPOs*, 82 J. Fin. Econ. 35.

Facebook's eventual IPO provided a high profile example of how IPOs can go badly wrong. Running contrary to the typical pattern of underpricing in IPOs, Facebook's secondary market price took a steep plunge, dropping in its first week of trading from the $38 offer price to less than $32. A good deal of finger pointing followed. A variety of factors were identified as the culprit, with the most straightforward being the company's decision to issue 25% more shares than originally contemplated.[69] That decision no doubt played a part in the unusually large allocation of shares to retail investors in the offering.[70] That influx of "dumb money" gave rise to the spectre of the "winner's curse."[71] Morgan Stanley, Facebook's underwriter, was faulted for its aggressive pricing of the stock.[72] Nasdaq, the exchange where Facebook listed its shares, had a technological meltdown, causing a substantial number of orders to apparently disappear into the ether on the first day of trading.[73] Most damning, however, was the revelation that analysts at a number of banks, including Morgan Stanley, had revised downward their earnings projections for Facebook, based on difficulties the company had disclosed with making money off of users who accessed Facebook through mobile devices. Analysts revised estimates were shared with the banks' institutional clients, but not with

[69] Joe Nocera, *Facebook's Brilliant Disaster*, NY Times (May 25, 2012).

[70] See Jacob Bunge, Aaron Lucchetti & Gina Chon, *Investors Pummel Facebook*, WALL ST. J. A1 (May 22, 2012) ("Retail, or individual investors usually allocated up to 20% of the total shares allotted in an IPO, but in Facebook's case, retail allocation was around 25%").

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

[72] Michael J. De La Merced, Evelyn M. Rusli, and Susane Craig, *As Facebook's Stock Struggles, Fingers Start Pointing*, NY Times (May 2, 2012).1

[73] Chuck Mikolajczak and John McCrank, *Facebook shares sink 11 percent as reality overtakes hype*, Reuters (May 22, 2012).

retail investors.[74] Those lowered projections no doubt fueled the interest of those institutional investors in flipping their shares to retail investors as quickly as possible after the IPO. Lawsuits quickly followed,[75] and Congress called hearings to examine the IPO process generally.[76]

C. Why Do IPOs Persist?

If IPOs are such bad deals, why do they persist? Under the current regime, IPOs are a practical necessity, but from the perspective of efficient capital allocation they have little to commend them. The common theme running through the problems with IPOs for companies, insiders, and investors is information asymmetry. Investors are not fully informed and it is costly to provide them with credible information. Speculation and irrational exuberance, fueled by Wall Street marketing and media attention, grease the wheels for deals that do not have a lot to recommend them other than the fact that they are the entrée to the big leagues of public company status. From the perspective of both capital formation and investor protection, IPOs are a failure. We see similarly poor results for reverse mergers and PIPEs, alternative (and somewhat dimly lit) avenues for reaching the ultimate goal of public company status.[77] These transactions share with the IPOs the expectation

[74] Evelyn M. Rusli, Ben Protess, and Michael J. De La Merced, *Questions of Fair Play Arise in Facebook I.P.O. Process*, NY Times (May 23, 2012).

[75] Peter J. Henning and Steven M. Davidoff, *The Facebook I.P.O.'s Potential Legal Exposure*, NY Times (May 23, 2012).

[76] Jean Eaglesham and Telis Demos, *Lawmakers Push for Overhaul of IPO Process*, Wall St. J. (June 21, 2012).

[77] See Langevoort and Thompson, Cornell L. Rev.

that the issued shares will be dumped on public investors after a holding period, perhaps accompanied by aggressive selling efforts.

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

IV. A Two-Tier Alternative

The public-private dividing line is on shaky ground. Congress has pushed back the public line for the Exchange Act with the JOBS Act. For the Securities Act, the SEC's adoption of the effective equivalent of company registration suggests a loss of faith in the gun-jumping rules; Congress is unlikely to lead a revival. At least for seasoned offerings by the largest public issuers, the SEC no longer believes that the gun jumping rules are needed to quell speculation. If we have full disclosure, the technology to distribute that information, and an informationally efficient market, do we need the gun-jumping rules of § 5? The gun jumping rules linger on, in rather diluted form after the JOBS Act, only for IPOs. And yet we saw in the last section that the gun-jumping rules leave much to be desired if the goal is efficient capital formation; the rules fall far short of achieving that goal in IPOs. The only remaining justification for the gun-jumping, if any, is investor protection and even there, the rules are of dubious utility. The inefficiency of the IPO market persists.

This shift by Congress and the SEC raises a number of questions for the dividing line between private and public. What if all public offerings were seasoned offerings with a price informed both by full disclosure and a pre-existing trading market? Would investors be harmed if we eliminated IPOs? Could we achieve more efficient capital formation and better investor protection simultaneously?

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

Under my proposal, companies would go up – and down – between the markets as warranted. The number of companies in the public market would not be limited, however, as teams are in the Premier League. Any company reaching a certain quantitative bench mark – say $75 million in market capitalization, a threshold currently used by the SEC for shelf registration[78] – would be eligible for elevation to the public market.[79] Issuers would be able to choose their status; companies would not be dragged into the top tier against their will. Once they opted for public status, however, companies would be obliged to satisfy the periodic reporting obligations of the Exchange Act for as long as they remained public. I develop below how I anticipate the process might work.

[78] Securities Act, Rule 415.
[79] I use market capitalization here simply for ease of exposition. The quantitative benchmark might alternatively be based on trading volume. See Langevoort & Thompson, supra note.

A. The private market

Issuers below the quantitative benchmark would be limited in their access to both the primary and secondary markets. Their securities could be sold only to accredited investors, pursuant to the standards under Regulation D or § 4(2). In contrast to current practice, however, those securities could not be freely resold after a minimum holding period.[80] Instead, the issuer would be required to limit transfer of those shares to accredited investors.[81] Among accredited investors, however, the securities could be resold without jeopardizing the issuer's exemption.

I anticipate organized markets for private trading along the lines of SecondMarket and SharesPost; the advent of these markets makes my proposal feasible. The proposal here takes advantage of those developments, but it also works off the success of the Rule 144A market, which is currently limited to Qualified Institutional Buyers (QIBs). The proposal here would be largely an extension of that existing market for QIBs, by including accredited investors. The QIB market is estimated by industry sources to have over 14,000 participants; the number of accredited investors surely dwarfs that. The success of that QIB market suggests that the private market proposed here would have enough liquidity to function effectively.

[80] That period is currently one year for non-public companies. Securities Act, Rule 144.

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

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

The question of disclosure in this market poses a challenging issue. It would defeat the market's purpose to require the disclosure expected of a public company. On the other hand, some standardization of disclosure practices would likely benefit both investors and issuers. There are some fundamentals hard to imagine doing without, such as audited financial statements. Beyond that baseline, however, are a range of difficult questions regarding materiality.

One possibility would be to allow private markets to establish disclosure requirements pursuant to their listing agreements, with those listing agreements subject to SEC approval.[82] Such an arrangement would allow for some flexibility and responsiveness to market forces, while still ensuring that disclosure did not fall below some desired minimum. The SEC could perhaps implement regulatory oversight through an exemption for the trading venues from exchange status by

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[82] Mary Kissel, *So Who Needs Wall Street*, WALL ST. J. A13 (Oct. 29-30, 2011) ("SecondMarket requires companies to provide 'audited financials and risk factors' to potential investors. 'That's not required under the SEC rules,' [SecondMarket's CEO] says. 'We don't want to see fraudulent companies on SecondMarket. We don't want to see people, you know, making investment decisions witho8ut being swell-informed. That's bad for us as a marketplace.'").

imposing conditions on the exemption. Alternatively, the SEC could rely on its new § 3(b) exemption authority. The SEC could impose periodic disclosure requirements on companies relying on the § 3(b) exemption to sell shares to retail investors. Companies that limited their sales to accredited investors and restricted the transfer of those shares only to other accredited investors could be exempted from those disclosure requirements.

B. The public market

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

Companies would graduate to the public market based on market capitalization or trading volume for common equity. These criteria are similar to the Exchange Act's proxies for active investor interest, but they are more readily measured and less vulnerable to manipulation. Once a company elected to become public, it would first need to file a Form 10-K before its shares would be cleared for trading in the public market. A seasoning period would follow, with the filing of requisite 10-Qs during which the shares would continue to be traded in the private market. The prices in the private market, however, would now be informed by full disclosure. After the seasoning period, accredited investors would be able to sell their shares in the public market. This opportunity would be available whether the accredited investor had purchased their shares from the company or from other accredited investors in the private trading market. That public market could be an exchange, if the company chose to list, or the over-the-counter market. Either way, the trading price in the public market would be informed by the prior trading in the private market, as well as the new information released in the company's 10-K and 10-Qs.

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

Only after the company graduated to having its shares traded in the public market would the company be free to sell additional equity to public investors. What form should sales by the issuer take? The logic of the proposal, with its preference for the superior informational efficiency of trading markets, suggests that issuers selling equity should be limited to at-the-market (ATM) offerings. Issuers would sell directly into the public trading market instead of relying on an underwriter to identify (create?) demand. This approach puts its faith in markets, rather than salesmen, for efficient pricing. Unfortunately, this strategy has its limits. ATM offerings are a rapidly growing portion of seasoned equity offerings,[83] but they are still dwarfed by traditional bookbuilt offerings. Particularly for larger offerings, the liquidity of the secondary trading market may be insufficient to absorb such a large number of shares without substantially diluting existing shareholders. Could we nudge issuers toward ATM offerings, without mandating them?

One possibility would be to eliminate § 11 and § 12(a)(2) liability for at-the-market offerings, while retaining it for underwritten offerings. At a minimum, it makes little sense to impose underwriter liability on the broker-dealers hired by issuers to manage ATM offerings. If large volumes need to be "sold, not bought," the opportunities for abuse come in the selling process. SEC and FINRA enforcement would be needed to ensure that no there no back-door selling efforts to prime the market for an ATM offering. Even for the issuer, the draconian threat of § 11's strict

[83] James D. Small III, W. Clayton Johnson, & Leslie Silverman, The resurgence of Untied States at-the market equity offerings to raise capital in volatile equity markets, 4 Capital Markets L. J. 290, 292 (2009) ("From June 2008 through the end of April 2009, more than 25 issuers registered with the SEC almost $6.9 billion of equity securities for sales under equity distribution programmes (of which more than $3.2 billion was subsequently sold to investors).")

liability seems excessive for an ATM offering. ATM offerings do not really require a registration statement or a prospectus; at most they need an 8-K announcing the number of shares to be offered, followed by another 8-K disclosing the number actually sold. Anti-fraud concerns could be addressed by the less draconian Rule 10b-5.

C. Relegation

If there are private companies wanting to rise to the public level in my scheme, it follows that there are likely to be public companies wanting to pursue the reduced burdens of private status. An attractive feature of a two-tier market is that retail investors would not be completely cut off from liquidity if a company chooses to relegate itself to the private market. There is no reason to preclude retail investors from *selling* their shares in the private market, even if they would be barred from purchasing shares in companies that dropped down to private company status. Moreover, there is little to be gained by prohibiting companies from exiting the public pool; a restrictive approach will simply discourage companies from pursuing public company status in the first place. On the other hand, too lenient an approach may put too much stress on the fiduciary duties of directors under state law to prevent abuses.

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

D. Objections

Won't an expanded private market open the door to fraud and manipulation? The short answer is that as long as people are infected by the love of money, fraud will always be with us. Given that sad fact of human nature, we should funnel transactions to the venues that make it most difficult to get away with fraud. To be sure, the private market proposed here is likely to have a higher incidence of fraud and manipulation than the public market. But the scope of that fraud will necessarily be limited by the smaller size of the private markets relative to their public counterparts. Moreover, the entities sponsoring trading in those private markets will have competitive incentives to take cost effective measures to discourage fraud.[84] And the SEC and FINRA enforcement would be available to counter the most egregious abuses.

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

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

V. Conclusion

What if we just focused on capital formation in drawing the line between private and public markets? A focus on capital formation suggests that we should put an end to IPOs, if we can establish a viable alternative. My proposed alternative would require private companies to go through a seasoning period – with mandatory disclosure – before selling securities to the public. This seasoning period

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

would mark the line between private and public, rather than the current standards of exchange listing, number of shareholders, or the filing of a registration statement for an initial public offering.

The foundation of my proposal rests on two central premises: (1) IPOs are an inefficient means of capital formation; and (2) private markets, with pools of liquidity that are continuing to expand, will be sufficient to satisfy the capital needs of growing companies until they are ready for the burdens that come with public company status. The evidence for the first proposition is consistent and strong. The second proposition blazes a path into still uncharted territory. The Rule 144A QIB market and the rise of private markets like SecondMarket and SharesPost show the potential of private trading markets. Until the passage of the JOBS Act, however, those markets have been hamstrung by the 500-shareholder limit triggering public company status. That limit has now been raised to 2000 shareholders of record. On its face, this change promises to substantially increase the liquidity of private markets. More time will be needed, however, before we can assess whether this expansion of the private markets gains market acceptance.

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