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“Publicness” in Contemporary Securities Regulation after the JOBS Act

Donald C. Langevoort
Georgetown University Law Center, langevdc@law.georgetown.edu

Robert B. Thompson
Georgetown University Law Center, thompson@law.georgetown.edu

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DONALD C. LANGEVOORT* AND ROBERT B. THOMPSON**

TABLE OF CONTENTS

I. THE CHANGING FRAMEWORK FOR PUBLIC OFFERINGS AND PUBLIC COMPANIES	342
A. THE PAST	343
B. TECHNOLOGICAL CHANGE	346
II. “PUBLICNESS” UNDER THE 1934 ACT	351
A. SECTION 12(G): THE SIZE TEST	355
B. HOW TO THINK ABOUT THE THRESHOLD FOR REGISTRATION	361
1. Qualified Investors	362
2. Setting the Threshold: A Cost–Benefit Challenge	366
III. PUBLICNESS BEYOND MERELY INVESTOR METRICS, AND THE “ON RAMP”	371
A. DISCLOSURE AND THE PURPOSES OF SECURITIES REGULATION	375
B. TWO LEVELS OF PUBLICNESS	379
1. Internal Controls	380
2. Governance	381
C. CONTRASTING THE “ON RAMP”	383
CONCLUSION: OBSERVATIONS ABOUT THE REGULATORY PROCESS	384

Securities regulation is under extraordinary stress today. Part of the stress is political, as we debate the right balance among investor protection, the public’s interest in a safe and stable financial system, and the needs of private enterprise

* Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center. © 2013, Donald C. Langevoort & Robert B. Thompson.

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for access to capital, as well as the capacity of a government agency like the Securities and Exchange Commission (SEC) to carry out its sensitive mission in a complex economy. Much is asked of regulators, but regulatory budgets and resources are severely crimped. How much securities regulation we want and how much we are willing or able to pay for have become disconnected and heavily partisan.¹

The stress is also technological, played out through increasingly rapid innovation in financial products and financial markets.² There are countless examples of technology and innovation upsetting seemingly solid institutional arrangements. Markets are increasingly fragmented and often opaque, even as transparency has become the dominant regulatory objective; new entrants and new arrangements appear constantly, putting regulators under relentless pressure to respond. Regulators' ability to respond well to all this takes us back to the first form of stress, so that the political and technological stresses are inextricably linked.

We focus here on the ideologically charged question of when a private enterprise should be forced to take on public status, an extraordinarily significant change in its legal obligations and freedom to maneuver. Our interest was originally piqued by the publicity surrounding Facebook's pre-IPO effort to raise capital while staying outside of the regulatory reach of the Securities Exchange Act of 1934. In late 2010, reports surfaced that Facebook was pursuing a deal engineered by Goldman Sachs that would have brought in new capital from a sizable number of private investors whose interests would be bundled together in a single investment vehicle.³ Such private placements are standard, but the bundling was seemingly responsive in part to Facebook's desire to limit the number of shareholders of record because it was edging toward the magic number (500) that at the time would have triggered public status with its rigorous disclosure, governance, and accountability consequences. Facebook wanted to delay this until it was ready for its planned initial public offering (IPO) and a stock exchange listing, other steps that trigger 1934 Act obligations. The question was whether the bundling was just a legal artifice for avoiding a regulatory status to which the company should be subject. The

1. See, e.g., Stacy Kaper, *SEC Budget Battle Leaves Enforcement in Jeopardy*, NAT'L J. DAILY (Sept. 15, 2011, 9:30 PM) ("The question of how to make the Securities and Exchange Commission work better drew very different answers from Republicans and Democrats on Thursday, leaving the agency's might in doubt and proving that consensus is still lacking on how to regulate financial markets.").

2. There are many different dimensions to this, including the increasing financial complexity of many kinds of investments and issuers. See Henry T. C. Hu, *Too Complex To Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601, 1602 (2012). And to be sure, this has been happening for quite some time. For an earlier exploration, see Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985); for a more recent look, see Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339 (2008).

3. See Steven M. Davidoff, *Facebook and the 500-Person Threshold*, N.Y. TIMES, Jan. 3, 2011, <http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/>.

publicity generated by this question in turn endangered the exempt status of the private placement (under a different portion of the securities laws), so that the domestic portion of the deal was reportedly called off in favor of an offshore transaction, free of such requirements.⁴

Members of Congress responded quickly to Facebook’s dilemma and found that other high-tech firms had similar misgivings.⁵ At roughly the same time, other deregulatory initiatives, such as the promotion of “crowd-funding” and other kinds of small business capital raising, gained political traction in Congress as well as in the White House. These were all styled as job creation mechanisms—a particularly potent political label heading into an election year—and bipartisan momentum grew.⁶ The product was the so-called JOBS Act, which became law in April 2012.⁷ Among many other things, the new legislation raises the 500-shareholder test to 2,000 so long as no more than 499 of those are not “accredited investors.”⁸

The 2012 legislation brings new attention to what has been a fairly obscure but profound legal issue at the public–private regulatory divide. Yet the reforms were not the product of any coherent theory about the appropriate scope of securities regulation—not just because of the political dimension but also because the public–private divide has long been an entirely under theorized aspect of securities regulation. This is illustrated by the gross inconsistency in

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

5. A pivotal step here was the demand in March 2011 by Congressman Darrell Issa, chairman of the House Oversight Committee, that the SEC justify its rules relating to capital formation, particularly the 500-shareholder metric. See Letter from Darrell Issa, Chairman, House Comm. on Oversight & Gov’t Reform, to Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n (Mar. 22, 2011), available at <http://www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf>.

6. A politically striking feature of the JOBS Act was that the SEC never supported the legislation and was apparently opposed to much of it. See David S. Hilzenrath, *Jobs Act Could Remove Investor Protections, SEC Chair Mary Schapiro Warns*, WASH. POST, Mar. 14, 2012, http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html. Toward the end of the legislative process, some Senate Democrats took up the Commission’s concerns but without much effect. So far as Democratic support for the reforms was concerned, this reflected White House policy, which appeared to differ greatly in its assessment of the substance of the reforms with the SEC and certain key members of Congress. See Zachary Goldfarb, *Jobs Act: White House, Democrats at Odds over Obama-Backed Pro-Business Bill*, WASH. POST, Mar. 26, 2012, http://www.washingtonpost.com/business/economy/jobs-act-white-house-democrats-at-odds-over-pro-business-bill-set-to-pass/2012/03/26/gIQAfqn3cS_story.html.

7. Pub. L. No. 112-106, 126 Stat. 313 (2012). JOBS is an acronym for “Jumpstart Our Business Startups.”

8. Accredited investor is a term referring to large, relatively wealthy investors (for example, institutional investors, persons with an annual income above \$200,000 or a net worth of more than \$1 million). Congress also excepted from the count employees of the issuer who received shares pursuant to an employee compensation plan that was exempt from registration or shareholders who obtained their shares as part of a crowd-funding transaction. See *infra* notes 121–22 and accompanying text.

how the two main securities statutes—the Securities Exchange Act of 1934 and the Securities Act of 1933—approach this divide. Putting aside the voluntary acts of listing on an exchange or making a registered public offering, section 12(g) of the 1934 Act has, until 2012, simply counted assets and shareholders to determine companies subject to reporting and other obligations under the Act. The 1933 Act, by contrast, uses investor wealth and sophistication—in other words, investor qualification. The Facebook setting illustrates the difficulty of working in the shadow of this inconsistency. But these tests are archaic in any event, legacies of old regulatory (and to some extent judicial) choices. We want to explore this inconsistency, which takes us quickly to the innovation that is occurring today in the trading markets for smaller and nonpublic companies. We can better evaluate what Congress has done in the JOBS Act with a deeper and more connective understanding of this territory, which is our goal here.

The attention that Congress and the SEC have now given to these subjects evidences a strong political dimension to finding the right balance between investor protection and capital formation. Securities regulation has long balanced these two goals, though rarely with much candor as to the trade-offs. Sometimes these interests coincide—by most accounts, there is a baseline of regulation that efficiently lowers the cost of capital, benefiting both—but other times not. We have no problem with making these trade-offs more candid, which takes us to the task of identifying the costs and benefits associated with securities regulation. As we explore the terrain along the public–private border, we will give considerable attention to the difficulties of doing a cost–benefit analysis, which arise generally because there are so many externalities associated with regulation—positive and negative—and so many contingencies.⁹

Indeed, as we will argue, we suspect that some portion of what we call securities regulation follows from an effort to create more accountability of large, economically powerful business institutions that is only loosely coupled with orthodox (and arguably more measurable) notions of investor protection. This is the more general meaning of the term “publicness”¹⁰—what society demands of powerful institutions, in terms of transparency, accountability, and openness, in order for that power to be legitimate. The narrower meaning, which is our specific focus here, refers to the legal rules that securities law

9. In recent years, the SEC has had a number of its rules successfully challenged because of its failure to conduct what the court considered a proper cost–benefit analysis. *E.g.*, *Business Roundtable v. SEC*, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011). Our analysis is sympathetic to the Commission’s plight, but we leave it to others to evaluate the statutory interpretation and administrative law issues behind these challenges. *See, e.g.*, James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit’s Usurpation of SEC Rulemaking Authority*, 90 TEX. L. REV. 1811 (2012).

10. Publicness as a term has been used in a variety of legal settings, often in the constitutional or international law context. *See, e.g.*, Benedict Kingsbury, *The Concept of ‘Law’ in Global Administrative Law*, 20 EUR. J. INT’L L. 23, 31 (2009). For a recent article giving the term special prominence in the context in which we use it here, see Hillary A. Sale, *The New “Public” Corporation*, 74 LAW & CONTEMP. PROBS. 137, 138–41 (2011).

imposes on companies that are deemed public. We argue that, to a greater extent than generally acknowledged, the broader demands of publicness drive the creation of contemporary securities regulation, necessarily connecting both the broad and narrow meanings of publicness.

This understanding leads us to conclude that there should be two key breakpoints in the 1934 Act. One—the familiar one—is the threshold point at which companies must undertake basic public disclosure obligations, leaving behind the privacy they previously had. Congress tinkered with this line in the JOBS Act but without adequately addressing technological change that has already rendered parts of the statutory metrics archaic and is quickly reducing the ability of other parts of the statutory structure to carry out the policy choices inherent in the public–private divide. To see how and why, Part I of our Article surveys some of the history of the public–private divide in securities regulation and then looks at how technology has blurred the distinctions that have long been used by regulators. Here we look, for example, at the emergence of SharesPost and SecondMarket as trading markets to facilitate resale of securities for private companies, as well as changes in what once was known as the “pink sheets.”

Part II then looks at the Facebook problem and the JOBS Act response. Given the technological changes covered in Part I, we argue that Congress missed the real issue when it increased the trigger for a company to have obligations under the 1934 Act from 500 investors to 2,000 because it continues to base that number on shareholders “of record,” an archaic metric that has lost its ability to accurately describe the real number of owners in modern markets;¹¹ a standard focusing on a company’s trading volume more effectively captures the realities of the contemporary marketplace. If anything, the result is likely to be a de facto repeal of section 12(g), rendering the shareholder threshold no longer a binding constraint in terms of requiring companies to step up to the disclosure and other obligations of the 1934 Act. This leaves the real work to be done by the other two statutory thresholds that themselves are being eroded by technological and market changes. If these developments continue apace, even if not in the immediate future, there may well be a much larger trading market outside of the 1934 Act obligations that Congress did not consider and the SEC has not yet planned for. We are also concerned with the idea borrowed by the JOBS Act from the 1933 Act that accredited, or otherwise sophisticated, wealthy investors should not be counted in assessing public status for issuers who accrue obligations under the 1934 Act. Finally, we offer some thoughts about balancing costs and benefits with respect to drawing the line between public and private issuers.

11. We are not the only ones to come to this conclusion. For other perspectives on the right response, see Michael D. Guttentag, *Patching a Hole from the JOBS Act: How and Why To Rewrite the Rules That Require Firms To Make Periodic Disclosures*, IND. L.J. (forthcoming 2013) (setting out a three-level approach to companies subject to the federal periodic disclosure requirements); Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. (forthcoming Dec. 2012) (proposing a lifecycle model in which regulations would adapt to firms as they age).

There is a second breakpoint that we think should be just as important, and we turn to it in Part III. Our focus here is on the extent to which Congress has articulated public company responsibility and accountability with the implicit image of the large issuer in mind. Many of the modern demands on public companies are, for reasons having less to do with investor protection as traditionally imagined and more to do with setting standards to protect constituencies, well beyond their investor base. The implication thus seems clear: contemporary securities regulation should have two distinct tiers of companies, with the tier of smaller companies facing only core disclosure obligations and governance requirements. Full publicness treatment should be reserved for companies with a larger societal footprint. This shift would, among other things, ease the costs associated with transition from private to public company. There is a similarity in purpose here to another innovation of the JOBS Act—the so-called “on-ramp” initiative¹²—which provides a useful comparison and contrast to the much more expansive idea we advocate.

Part IV discusses the regulatory challenge that arises from rapid technological innovation, almost always one step ahead of the regulators.¹³ Settings like Facebook—up until the unexpected media coverage—illustrate a process in which entrepreneurs and their advisors occupy new, unregulated (or less regulated) space created in the wake of technological change or by gaps in regulation revealed as markets evolve. The regulatory response is often piecemeal and reactive, shaped by the frame that the occupiers have already defined. Overall, the process is more informal than the administrative process is often described, relying on staff interpretations more than Commission involvement, for example, and sometimes making it difficult to address concepts that may have become antiquated. We suspect that the JOBS Act will set in motion a new round of similar occupations.

I. THE CHANGING FRAMEWORK FOR PUBLIC OFFERINGS AND PUBLIC COMPANIES

The JOBS Act made the first change in the reach of the 1934 Act in almost fifty years, widening the space within which companies could stay outside the Act’s regulatory reach and creating a new category of emerging growth companies that can avoid a number of the Act’s regulatory requirements during the first years after an IPO if they stay below relatively generous size thresholds. As

12. The on-ramp proposal was the product of work by a private-sector task force that grew out of a discussion sponsored by the Obama Administration’s Treasury Department; the task force, made up mostly of professionals working with venture capital-sponsored, emerging growth companies, sought ways to facilitate IPOs by such companies. *See* IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 4 (2011), available at <http://www.wsgr.com/PDFs/rebuilding-IPO.pdf>.

13. Our Article will not attempt to analyze the entirety of the JOBS Act but instead will focus on public company status under the 1934 Act. We intend to address the 1933 Act issues in a separate paper as well as other ways—for example, reverse mergers and private investment in public equity (PIPE) transactions—that entrepreneurs negotiate the public-private divide.

a prelude to the discussion of those two changes in the next two sections, this section sets out two necessary foundational points.

Section I.A traces the evolution of the public–private line for purposes of triggering the obligations under the 1934 Act. This was a three-decades-long work in progress. Drafting statutory language that could span the different technology of trading occurring in a physical exchange and trading occurring over-the-counter between broker-dealers in different places while staying within the contemporary understanding of the power of the federal government, left a practical gap that stymied a neat agency or congressional solution for thirty years. The somewhat jerry-rigged statutory structure that resulted, with three separate thresholds that triggered coverage—based on exchange trading, a registered public offering, or the company passing certain size thresholds—made for a much more complex statutory structure than policy alone would dictate.

Section II.B develops how technological change in the trading of securities, which has accelerated in recent years, has exposed real weaknesses in each of the three existing ways to trigger coverage under the 1934 Act, suggesting that the search for the line between public and private in contemporary securities regulation should reach beyond the metrics used in existing statutes.

A. THE PAST

The bifurcation of the core of securities regulation into two separate statutes—the Securities Act of 1933 and the Securities Exchange Act of 1934—was an accident with unfortunate consequences in terms of regulatory consistency. The 1933 Act governs offerings by issuers (with the assistance of intermediaries like underwriters and dealers). Congress’s intent was to reach “public offerings,” evidenced by the seemingly universal reach of the registration requirement for issuer transactions coupled with an exemption for transactions not involving any public offering.¹⁴ Strangely, however, the Act did not define that central term that triggers the expansive disclosure requirements (and heavy responsibilities for intermediaries), letting another undefined concept, “distribution,” grow up as a term of art to bound the coverage of the Act.¹⁵ An early SEC release filled the statutory void, using various indicia of smallness and a close relationship between the issuer and the offerees to define transactions outside the reach of the Act.¹⁶ In 1953, the Supreme Court’s first entry into the debate

14. See 15 U.S.C. § 77e(c) (2006) (declaring it unlawful to sell any security through prospectus or otherwise unless registration statement is effective); *id.* § 77d(2) (declaring that Section 5 shall not apply to “transactions by an issuer not involving any public offering”). There are other exemptions, such as the intrastate exemption and those available for small dollar offerings, but publicness defines the principal transactions that were the focus of the law.

15. See, e.g., *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466–67 (2d Cir. 1959).

16. See Exchange Act Release No. 285, 11 Fed. Reg. 10,952 (Jan. 24, 1935) (identifying a number of offerees and their relationship to each other and to the issuers, the number of units offered, the size of the offering, and the manner of the offering as factors of particular importance).

declared that offerees who could “fend for themselves” had “no practical need” for the disclosures and other protections of the Act.¹⁷ Subsequent courts debated whether sophistication, access, disclosure, or relationship was sufficient to avoid registration, but the reach of the Act remained broad.¹⁸

When Congress, in 1934, extended disclosure obligations to protect not just investors buying stock from an issuer but also investors buying and selling that same stock on the secondary markets, the statute’s approach reflected a similar broad reach which was variously described as companies with widely distributed securities or those when secondary trading was significant.¹⁹ These would be the companies who had this obligation to disclose information quarterly and annually.

The statute writers in 1934 chose to tie these periodic disclosure obligations to a company’s decision to list on a national securities exchange.²⁰ There were, of course, places outside of those exchanges where shares were widely traded—the most prominent places being the over-the-counter (OTC) markets, where market makers purchased and sold particular stocks. But the exchanges were tangible, brick-and-mortar institutions well-known to the public, whereas the OTC markets were more ephemeral for legislators.²¹ So Congress put the exchange-listed stocks within the Act and let the new SEC determine what to do about the OTC stocks.²² Commentators describe the initial choice as driven by both “practical” and “constitutional” concerns.²³ The agency moved slowly, feeling vulnerable in its first years to a hostile Supreme Court willing to wield a narrow reading of the Commerce Clause to limit the reach of federal regulation.²⁴ Over the next three decades, there were a variety of unconsummated

17. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

18. See JAMES D. COX ET AL., SECURITIES REGULATION, CASES AND MATERIALS 271–73 (6th ed. 2009) (discussing case law developments as to access, sophistication, relationship, disclosure, and information).

19. See, e.g., Milton Cohen, “*Truth in Securities*” Revisited, 79 HARV. L. REV. 1340, 1341 (1966).

20. See 15 U.S.C. §§ 78m(a), 78n(a) (1934) (subjecting every issuer of a security registered pursuant to section 12 to periodic disclosures and proxy regulation). Section 12, in turn, required registration of securities listed on a stock exchange by prohibiting brokers and dealers from transacting in any security in an exchange that was not registered. See Securities Exchange Act of 1934, ch. 404, § 12, 48 Stat. 892 (as codified at 15 U.S.C. § 78l(a)–(b)).

21. An SEC study in 1936 described the over-the-counter markets of the period as “one of the enigmas of our financial system.” SEC, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER 78 (1936).

22. 4 LOUIS LOSS & JOEL SELIGMAN SECURITIES REGULATION 1746–47 (3d ed. 1990).

23. *Id.* at 1744. The limits of the original 1934 Act were “not due to any conviction on the part of Congress that similar safeguards were not equally essential with respect to securities traded in the over-the-counter market.” *Id.* Rather the over-the-counter market was “amorphous . . . [and] not a ready platform.” *Id.* at 1746–47. As Louis Loss opined, it was “solely for want of a practicable sanction [that] Congress omitted any reference to registration of securities traded in the over-the-counter market.” *Id.* at 1748.

24. Seligman describes the SEC’s policy under Chair James Landis of declining to push a legislative agenda that would invite Supreme Court invalidation. See JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 142–43 (3d ed. 2003).

agency and legislative efforts to address this regulatory gap.²⁵ Finally, impetus from one of the periodic stock-exchange scandals and the Special Committee on Securities Markets led to legislation in 1964 that added section 12(g) to the 1934 Act; this section included a trigger for reporting obligations based on size, bringing larger OTC stocks within the public realm.²⁶

The long incubation period for the legislation generated a plethora of suggestions for the threshold that should expand public status for disclosure and related obligations²⁷ but did not produce a theoretical consensus as to how to define publicness beyond Louis Loss’s odd invocation of Lincoln: that “the large, publicly held corporations of the nation could not ‘endure permanently half slave and half free.’”²⁸ Joel Seligman described the ultimate legislation as a compromise in which the regulators split the difference with the securities industry,²⁹ requiring periodic disclosure by companies with classes of equity securities with at least 500 record holders and assets above a certain threshold (currently set at \$10 million).³⁰

The key point to take away from this early period is that, for the first three decades of federal securities regulation, there was room even for large companies with widely distributed shares to avoid the periodic disclosure and proxy obligations of the 1934 Act. So long as their managers could achieve the companies’ business ends without the liquidity provided by a stock exchange listing and could obtain necessary capital without resort to public offerings, companies could avoid the obligations of the 1934 Act.³¹ Companies chose to stay dark or to go dark if either of these two economic drivers did not produce

25. See 1 LOSS & SELIGMAN, *supra* note 22, at 415; 4 LOSS & SELIGMAN, *supra* note 22, at 1746–59 (describing legislation proposed in 1941, 1946, 1949, and the mid-1950s).

26. See 4 LOSS & SELIGMAN, *supra* note 22, at 1761.

27. See SELIGMAN, *supra* note 24, at 312. SEC Chair William O. Douglas advised Roosevelt that the burden should extend to all companies with \$1 million or more in assets. See *id.* A 1936 statute, the one legislative change on this subject made in the first three decades after enactment of the 1934 Act, imposed periodic disclosure obligations based on issuance of public securities (with an out for companies that later dropped below 300 shareholders of record). 15 U.S.C. § 78o(d) (2006). A 1941 bill that did not pass used a dual trigger of \$3 million in assets and 300 security holders (counting both equity and debt). See 4 LOSS & SELIGMAN, *supra* note 22, at 1749 (noting recommendations of the two New York exchanges). Another bill would have reduced the threshold to as low as \$500,000 in assets and ten security holders. See H.R. 7955, 82nd Cong. (1952) (bill introduced by Representative Adolph Sabath). Other concepts that were suggested included earnings, number of shares outstanding, and number of shares in public hands. See 4 LOSS & SELIGMAN, *supra* note 22, at 1759 n.71.

28. See LOSS & SELIGMAN, *supra* note 22, at 1758–60 (noting that, “far from being an innovation, this legislation merely closed an irrational gap in the SEC statutes, while culminating a campaign that had been waged for at least a half a century on behalf of federal standards for interstate corporations”).

29. See SELIGMAN, *supra* note 24, at 315 (noting that 1,600 firms were removed from the bill’s coverage as a result of the final compromise, as compared to earlier SEC proposals).

30. See 4 LOSS & SELIGMAN, *supra* note 22, at 1760.

31. The 1936 addition of § 15(d) to the 1934 Act required companies registering stock under the 1933 Act to make periodic disclosures under the 1934 Act even if they do not have stock listed on a stock exchange. 15 U.S.C. § 78o(d).

more benefits than the costs of the regulation under the 1934 Act.³² The result of the 1964 amendments, which added a third trigger based on size alone, was regulation of companies even if they had not taken any affirmative steps to list or issue public securities. Thus, this limited form of issuer choice was lost.

For a time, at least, the 1964 amendments created a strong bias in favor of public status, precisely given the practical needs of most growing businesses for both equity capital and liquidity. To be sure, there were historically private (often family-owned) firms that did not need external financing,³³ and the “going private” phenomenon allowed some public firms to change that status by buying out a sufficient number of shareholders to fall below the section 12(g) requirements.³⁴ And there were inevitably smaller firms that did not need the level of capital or liquidity to bring them to public status. Finally—and of particular importance here—there were “prepublic” companies that could grow initially through some combination of family, friends, and occasional private sources of capital and were willing to accept limited liquidity, waiting to reach a level of success that would justify going public. These categories, however, appeared to be distinct exceptions to a legal regime that now presumed a broad power to require public status of companies simply based on sufficient size. Growth in and of itself would likely push private companies into the public domain.

B. TECHNOLOGICAL CHANGE

For our purposes, the category of primary interest from the foregoing discussion is the prepublic company (what, after the JOBS Act, we might call the “emerging-growth company”). For these firms, the task is to get off the ground and thrive long enough to justify a public offering that—in return for taking on public status, with the attendant costs and burdens—would bring enhanced access to capital and welcome liquidity for those who provided the initial money and ideas. Two post-1964 developments profoundly changed how this journey was negotiated.

The first has been well explored in the legal and financial literature. As technology-driven industries came to dominate innovation in the American economy, a niche emerged in which an elite group of experts could connect private sources of capital with the early-stage entrepreneurs who had the best available ideas. This phenomenon of venture capital created private equity arrangements in firms poised for high growth trajectories that both deferred the

32. The SEC studied companies that would be affected by the expanded legislation in 1946, 1949 (estimating 1,764 companies would be affected by the bill), and 1955 (estimating an additional 1,500 companies would have to register). See 4 LOSS & SELIGMAN, *supra* note 22, at 1749–58.

33. See, for example, Cargill Inc., the largest privately held firm today, and Ford Motor Company, which was privately held until 1956. See generally F. H. O'NEAL & ROBERT B. THOMPSON, O'NEAL & THOMPSON'S CLOSE CORPORATIONS AND LLCs: LAW AND PRACTICE 1.1 to 1.3 (Rev. 3d ed. 2004).

34. See Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-Private Decisions*, 76 U. CHI. L. REV. 7, 11–12 (2009).

need for public equity and made public financing easier (because of the accompanying reputational enhancement) when issuers were ready to take off.³⁵

But although venture capitalists and similar private investors are willing to tolerate a period of illiquidity, there are limits: venture capitalists require a reasonable prospect of exit, with an IPO being the most desirable exit mechanism. And, for a variety of reasons that are still not fully understood, the last decade brought both a drop in the number of IPOs and a lengthening of the time it has taken venture capital-financed firms to go public.³⁶ As we shall see, one—but only one—of the likely explanations is hesitancy to assume the increasing regulatory costs of public status.

This shift in the venture capital exit cycle put all the more stress on liquidity, because lock-in for too long a period of time is contrary to how the venture capital industry is structured. It also had a spillover effect on compensation arrangements with employees of start-up companies who are paid heavily in stock options. They, too, have an interest in exit that is threatened by the shift to a longer prepublic status. By the time of the delayed public offering, many companies will have had larger turnovers of their employee bases and thus more shareholders who have an interest in liquefying the stock they may have received in the companies where they are no longer employed.³⁷

That takes us to the second development, which is mostly technological. Today, liquidity is now much more possible outside of traditional exchanges. In the new millennium, cheap information and low communication costs have expanded markets, and SEC regulation has supported alternative trading systems.³⁸ This environment has broadened the space for active secondary trading of securities without the usual protections provided by the 1934 or 1933 Acts.³⁹

35. JAY R. RITTER, UNIV. OF FLA., INITIAL PUBLIC OFFERINGS: TABLES UPDATED THROUGH 2010, at 1, 3 tbl.4 (2011), available at <http://bear.warrington.ufl.edu/ritter/IPOs2010age052011.pdf>.

36. See *id.* (showing median age at IPO increasing from six to eight years in the early 1980s to ten to fifteen years in 2008 to 2010); see also Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 2 (2012) (discussing decline in IPOs); Jose M. Mendoza & Erik P.M. Vermeulen, *The “New” Venture Capital Cycle 2* (Lex Research Topics in Corporate Law & Econ., Working Paper No. 1/2011, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835. On the legal and economic evolution of the venture capital industry, see generally Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003).

37. See Felix Salmon, *How SecondMarket Works* (Apr. 12, 2011), <http://blogs/reuters.com/felix-salmon/2011/04/12/how-secondmarket-works/>.

38. See Roberta S. Karmel, *Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 369–70 (2002).

39. Technological developments have added stress to the traditional platforms for secondary trading in this now more active space. Electronic availability of information has facilitated a wider flow of information at lower costs, and electronic communication has provided new routes to markets for investors, giving them less reason to use traditional intermediaries such as brick-and-mortar broker-dealers. As a result there are now fewer broker-dealers overall and, within the set of broker-dealers, fewer who provide research about smaller portfolio companies as part of their service to clients. FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION 65 n.126 (2006), available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport_d.pdf (“[T]he SEC Office of Economic Analysis indicate[s] that in 2004 approximately 52% of companies with a market capitalization between \$125 million and \$750 million and 83% of

In 1964, it could justifiably be said that the world of securities trading was divided fairly cleanly between the stock exchanges (physical locations for price discovery and execution) and the OTC markets, which were simply linkages among broker-dealers that created markets in particular stocks by offering two-sided quotes on a continuous basis. But all that soon changed. The OTC linkages evolved into the NASDAQ market, as technological sophistication was brought to bear with respect to both the real-time display of quotes and the subsequent execution of orders.⁴⁰ That eventually led NASDAQ to become an exchange in and of itself—an important competitor with the established exchanges.⁴¹ This transformation left open space for trading the stock of issuers not warranting (or desiring) exchange-like trading; but even here, alternative electronic trading markets formed for the smaller issuers left behind. Until 1971, quotations on the daily “pink sheets” were the main source for brokers and dealers who wanted to trade a stock over-the-counter.⁴² At that point, the new NASDAQ electronic system permitted brokers to read up-to-the-minute quotations from desktop terminals.⁴³ In the 1990s, in response to a congressional directive to the SEC to facilitate dissemination of information regarding penny stocks, the “OTC Bulletin Board” extended the automated-quotation system to OTC stocks that were not on NASDAQ.⁴⁴ Thereafter, Internet sites of the OTC Markets Group provided Internet-based information for shares previously followed only in print on the old pink sheets.⁴⁵

But it would seem that opening up liquidity would inevitably take issuers of any appreciable size up to the 500-shareholder count and force them into public status. Here, however, technology came to frustrate the traditional counting

companies with a market capitalization less than \$125 million had no analyst coverage.”). Electronic trading, linked with the move to decimalization, has dramatically driven down spreads (the compensation a market maker receives for making a market in stocks) over the last two decades. Activity on our national exchanges today, extraordinary in volume by historical standards, is dominated by high-frequency trading (HFT) done by computers using algorithms that try to take advantage of minute differences in information, selling large volumes of shares shortly after buying them. See Concept Release on Equity Market Structure, Exchange Act Release No. 61,358, 75 Fed. Reg. 3,594, 3,606 (Jan. 21, 2010) (estimates of HFT volume are typically fifty percent of total market volume or higher).

40. JOHN C. COFFEE, JR. & HILLARY A. SALE, *SECURITIES REGULATION* 33 (12th ed. 2012) (describing the development of NASDAQ).

41. NASDAQ Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 53,128, 71 Fed. Reg. 3,550, 3,566 (Jan. 13, 2006).

42. Michael K. Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers in Quoted Securities*, 39 *IND. L. REV.* 309, 327 (2006) (reporting inefficiencies caused by brokers having to call one of the dealers listed on the pink sheets to get current quotations).

43. 5 *LOSS & SELIGMAN*, *supra* note 22, at 2487.

44. See Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 *J. ACCT. & ECON.* 233, 238 (2005).

45. See Nicolas P.B. Bollen & William G. Christie, *Market Microstructure of the Pink Sheets*, 33 *J. BANKING & FIN.* 1326, 1327 (2009); John Jiang et al., *Did Stop Signs Stop Investor Trading? Investor Attention and Liquidity in the Pink Sheets Tiers of the OTC Market* (Eli Brood Coll. of Bus., Working Paper, Aug. 2012), available at <http://www.ssrn.com/abstract=1927295>. For recent developments as to the pink sheets, see Schwartz, *supra* note 11.

process. Securities became commonly held in the street names of broker-dealers that did not require a transfer of certificates every time beneficial ownership changed.⁴⁶ The result was a disconnect in the number of record owners (the finite number of brokerage firms acting as nominees) and the much larger number of beneficial owners for whom the stock had been purchased, because high-volume trading demands that securities be held in easily transferrable form, which did not trigger the kind of “record” ownership commonplace when trading was in physical certificates.⁴⁷ That leads us directly to the Facebook issue—precisely how many shareholders a company has for regulatory purposes became disconnected from any economic reality and somewhat manipulable depending on how evidence of ownership was structured.

As a result, trading platforms, such as SecondMarket and SharesPost, emerged and are said to have handled more than \$4.6 billion in private shares transactions in 2010.⁴⁸ SecondMarket resembles eBay or StubHub in that a seller posts a willingness to sell, and a buyer agrees to that price, makes a lower offer, or sets up a meeting to negotiate. The market was strong enough for Facebook prior to its IPO that there were weekly auctions.⁴⁹ In these transactions, SecondMarket employees vetted the buyer to make sure it was accredited and met the issuer’s approval because there often is a right of first refusal.⁵⁰ Another SecondMarket employee ensured compliance with regulations and oversaw settlement.⁵¹ SharesPost began with a somewhat different business model that focused more on online information sharing but adapted in the face of an SEC enforcement action in early 2012 that forced it to register as a broker-dealer in executing trades.⁵²

Because the trading in these privately issued securities can be relatively thin, both SecondMarket and SharesPost have been concerned with providing a richer informational environment that would promote fair (and not wildly volatile) pricing. SharesPost, for instance, developed an index for shares traded there that aggregates information about not only recent trade prices, but also

46. See DEPOSITORY TRUST & CLEARING CORP., AN INTRODUCTION TO DTCC: SERVICES AND CAPABILITIES 1 (2009), available at http://www.dtcc.com/downloads/about/Introduction_to_DTCC.pdf (describing the rise of its street name business as growing out of the back-office crisis of the late 1960s). See generally 5 LOSS & SELIGMAN, *supra* note 22, at 2897–2907 (describing the back-office crisis and how many brokerage firms could not keep up with the flow of paperwork as trading grew).

47. 2 MOD. BUS. CORP. ACT ANN. § 7.23 cmt. (4th ed. 2008) (describing the tendency to use the street-name title for shares).

48. Richard Teitelbaum, *Facebook Drives SecondMarket Broking \$1 Billion Private Shares*, BLOOMBERG MARKETS MAGAZINE, Apr. 27, 2011, <http://www.bloomberg.com/news/2011-04-27/facebook-drives-second> (estimating \$1 billion of business in 2011 based on first-quarter results). For further discussions of these two markets (and more recent entrants into the field), see Ibrahim, *supra* note 36, at 36–39, and Mendoza & Vermeulen, *supra* note 36, at 3.

49. Teitelbaum, *supra* note 48.

50. *Id.*

51. *Id.*

52. SharesPost, Inc. & Greg Brogger, Exchange Act Release No. 66,594 (Mar. 14, 2012) (order instituting administrative and cease-and-desist proceedings).

posted interest in future transactions, valuations reflected in third-party research, and “premoney” valuations in earlier venture capital rounds for the issuer.⁵³

Although these markets provide trading for private company stock that previously was difficult to trade, note that the intermediaries are not acting as traditional market makers in whom they use their own capital to buy from sellers and then turn around and resell to buyers. The traders have no obligation to make a market, and in times of stress—for example, when there is a great imbalance between those who want to sell and those who want to buy—there is good reason to think this liquidity will vanish.⁵⁴

These new platforms do provide liquidity, but their impact remains focused on growth stocks in the technology industries that are not capital intensive. Thus, none of the fifty stocks traded on SecondMarket as of mid-2011 had paid dividends, and the firms that were traded did not typically include environmentally friendly “green” firms or similar companies that need large capital raises.⁵⁵ These intermediaries act more like brokers for the seller (although SecondMarket’s 3% to 5% commissions are typically split between the buyer and the seller); before company shares are posted, the issuing company can decide how often the stock can trade, whether current employees can buy and sell (insider trading is a concern driving many companies to prevent current employees from trading), whether institutions, such as hedge funds, can buy, and what information about the company will be posted.⁵⁶

Other platforms have developed for providing liquidity for a variety of financial interests such as auction-rate notes, restricted stock, bankruptcy claims, limited partnership interests, and mortgage-backed Securities (MBS)/Collateralized Debt Obligations (CDOs).⁵⁷ For example, PORTAL Alliance⁵⁸ and FBR Plus⁵⁹ target the resale market for Rule 144A securities, which are securities permitted to be sold without registration to Qualified Institutional Buyers (QIBs), a term defined by the SEC to cover investors who own and invest \$100 million in securities.⁶⁰

Regulatory changes have also facilitated liquidity outside of an exchange

53. See Mendoza & Vermeulen, *supra* note 36, at 20.

54. Teitelbaum, *supra* note 48 (quoting Professor John Coffee) (“These private secondary markets give the illusion, but not the reality of liquidity. They are matching systems, and the broker does not function as a dealer committing its own capital. In a period of market distress, liquidity will vanish.”).

55. Salmon, *supra* note 37.

56. Teitelbaum, *supra* note 48.

57. See, e.g., Adam Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP., FIN., & COM. L. 67, 67 (2009).

58. See *About the Portal Alliance*, PORTAL ALLIANCE, www.portalalliancemarket.com/about_portal_alliance.aspx (last visited Sept. 18, 2012).

59. *FBR Capital Markets Launches FBR Plus: An Enhanced Trading Platform for Unregistered Securities*, PR NEWswire (June 27, 2011), <http://www.prnewswire.com/news-releases/fbr-capital-markets-launches-fbr-plustm-an-enhanced-trading-information-platform-for-unregistered-securities-58514092.html> (last visited Sept. 18, 2012).

60. See 17 C.F.R. § 230.144A (2011). It reduces the need for nonaffiliated investors to seek registration rights to ensure their ability to sell their stock and also broadens the market for Rule 144A

listing or a public offering. The 1933 Act’s restriction on resales of restricted securities that began at three years in the early years of the Act has now shrunk to one year because of the changes to Rule 144,⁶¹ and some exempt securities (for example, Regulation A) can be resold without restriction.⁶² With the growth of these platforms, we again have a situation not unlike the pre-1964 period in which there are companies with widely traded secondary shares that are outside of the disclosure and other regulatory requirements of the 1934 Act.⁶³

We do not mean to suggest that technological innovation is a bad thing that should be chilled. Quite the contrary, investors are often better off because of the market enhancements that we will be exploring. A good example is the evolution of the pink sheets—the original and relatively inefficient once-a-day, paper-based way of disseminating quotes in OTC stocks—which have now moved onto the Internet.⁶⁴ The major platform for electronic pink-sheet trading, OTC Markets Group, has innovated in imaginative ways, including by posting a vivid “stop sign” icon when issuers cease providing baseline information and posting a skull and crossbones (and suspending quotes) when there are even stronger danger signs.⁶⁵ This seems to have improved the liquidity and freshened the trading environment and is an example of something that is possible only because of technological evolution.

II. “PUBLICNESS” UNDER THE 1934 ACT

A company becomes public for purposes of the 1934 Act by one of three distinct gateways: by making a registered public offering under the 1933 Act (section 15(d) of the 1934 Act); by listing on a national securities exchange (section 12(b)); or simply by having enough record shareholders and total assets (section 12(g)). Each of these standards has been under severe stress as a result of the technological and marketplace forces described in Part I. In this Part, we explain why and, more importantly, what that says about rethinking the standard for public status. We concentrate here on section 12(g), the size threshold that is best suited to determining when to protect investors in the trading market. It is also the only one of these affected by the recent legislation where Congress raised the record shareholder metric from 500 to 2,000, so long

stock, which after one year can be sold by nonaffiliates to buyers other than QIBs. See Samuel Wolff, *Trading Restricted Stock for Private Companies—Part 2*, 33 SEC. FED. CORP. L. REP., July 2011.

61. See 17 C.F.R. § 230.144(d) (2011) (setting a holding period of one year for restricted stock if there is no public disclosure or six months if there is). We will explore the consequences of this more fully in a separate paper.

62. *Id.* §§ 230.251–.263.

63. The provision of the JOBS Act that requires the SEC to provide a new exemption for offerings up to \$50 million also authorizes the agency to provide periodic disclosure, including its financial condition and corporate governance principles. This permits expansion of 1934 Act regulation to companies outside of those registered under the 1934 Act. JOBS Act, Pub. L. No. 112-106, § 401, 126 Stat. 306, 323–25 (2012) (codified at 15 U.S.C. § 77c(b)(4)).

64. See Molitor, *supra* note 42, at 327.

65. See Jiang et al., *supra* note 45, at 9–10, 21.

as most of these are accredited investors (but not counting employees or “crowd-funders” as shareholders).⁶⁶

The first gateway, found in section 15(d),⁶⁷ is ancillary to the issuer’s choice to raise capital through a registered public offering and is hence bound up with that distinct phenomenon that is less relevant to a statute seeking to protect traders in the secondary market. And at the back end, the obligations it imposes cease upon showing that the company has fewer than 300 record shareholders, so that the issue of scope and coverage overlaps with the size definition of publicness.⁶⁸ The key section 15(d) issue for 1934 Act coverage is the de facto requirements it imposes for public companies because the 1933 Act registration process acts as a “rite of passage” by which the company’s system that will produce the periodic and other disclosures required of a reporting company are subject to the intense agency review and gatekeeper oversight that is a part of the 1933 Act requirements. This rite of passage is not just the act of making disclosure; it is also the process by which teams of lawyers and accountants engage in clean-up operations to cure any weaknesses that come from what may be years of operating in a comparatively lax governance and disclosure environment and prepare the issuer and its management for the demands of more sustained transparency. This passage includes an eventual negotiation with SEC staff about how the company will be portrayed in the prospectus and it includes strict liability for misrepresentations under section 11 of the 1933 Act. This affects not only the disclosure itself, but the conduct of management, which knows that, for at least that short time, federal regulators are staring at them and their handiwork thus far in building the company. The policy question is the degree to which these should remain as requirements to be a public company.

Many would regard the second gateway, found in section 12(b), as the most important, but we will say less about it, too.⁶⁹ To be sure, issuers today often seek to list their shares on a national securities exchange, which creates public company status regardless of size. However, the importance of listing and trading on a national securities exchange is both historically and economically contingent. Exchanges began as physical locations for traders to make purchases and sales of securities—the idea of securities “listed” for trading followed fairly naturally as a way of allocating scarce institutional resources and

66. A slightly different standard is set in the JOBS Act for banks and bank-holding companies. See JOBS Act, Pub. L. No. 112-106, § 601, 126 Stat. 306, 326. This is beyond the scope of our paper, and reflects a long-standing inclination to relax securities regulation in the context of otherwise fairly intense banking law.

67. 15 U.S.C. § 78o(d) (2006). A company brought into the 1934 Act by § 15(d) faces the obligations of periodic disclosure and internal controls, but not the proxy requirements or section 16 reporting obligations.

68. *Id.*

69. Section 12(a) makes it unlawful for any broker-dealer to effect a transaction in any security on a national securities exchange unless the security is registered on that exchange. 15 U.S.C. § 78l(a) (“[U]nless a registration statement is effective . . .”). Section 12(b) then creates the process for the issuer to register a security by filing certain information (Form 10) with the Commission. *Id.* § 78l(b).

specialized knowledge to certain stocks, thereby attracting order flow. At a time when securities regulation had not yet come to exist, listings were a means of signaling quality to potential traders. Exchanges that could afford to be more exclusive in determining whether a stock qualified for trading created a brand that was to the benefit of both the exchange and the listed company. Exchange listing standards grew out of this form of branding.⁷⁰

Today, as we have seen, exchanges themselves play a diminished role in providing liquidity in the securities marketplace—though it is still big. This is because, even though the statutory definition of an exchange is fairly broad,⁷¹ the SEC has deliberately encouraged the growth of trading facilities that do not have to bear the burdens of registration as a national securities exchange.⁷²

In today’s fragmented trading world, where shares of a reporting company are traded in multiple platforms beyond traditional exchanges,⁷³ it makes little sense to make public company regulation turn on whether an issuer is listed on an *exchange* unless (a) we are prepared to reverse course and insist that all significant trading platforms be deemed national securities exchanges or (b) we want to make public company status elective through issuer choice to pursue a listing. Our sense is that the idea of a listing is becoming anachronistic as a result of this evolution. Listings were once a means by which exchanges sought near-exclusive rights to trading in a particular security, from which they would profit in terms of both listing fees and the income from the order flow.⁷⁴ In return, exchanges could be expected to offer some quality assurance with respect to listed companies, particularly in the time prior to federal securities regulation. Today, however, neither exchanges nor competitive trading platforms can capture more than a portion of the order flow, and new entrants continue to threaten even that.⁷⁵

70. See John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1765 (2002). On how this has come to generate a transnational system of legal obligations, see Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435, 1437 (2008).

71. 15 U.S.C. § 78c(a)(1).

72. See Mark Klock, *The SEC’s New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753, 765–66 (1999); Jonathan R. Macey & Maureen O’Hara, *Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective*, 28 J. LEGAL STUD. 17, 18 (1999); Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 J. CORP. L. 865, 866 (2008).

73. See Special Study Grp. of the Comm. on Fed. Regulation of Sec., Am. Bar Ass’n Section of Bus. Law, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1489, 1492 (2002) (addressing the then-recent evolution of the securities marketplace, including market fragmentation caused by the proliferation of automated trading systems and internationalization).

74. See Jonathan Macey & Maureen O’Hara, *The Economics of Stock Exchange Listing Fees and Listing Requirements*, 11 J. FIN. INTERMED. 297, 298 (2002).

75. Just from 2005 to 2009, the NYSE’s share of trading in listed stocks declined from around eighty percent to twenty-five percent. See SEC Concept Release on Equity Market Structure, Exchange Act Release No. 61,358, 17 C.F.R. § 242 (Jan. 2010), available at <http://www.sec.gov/rules/concept/2010/34-61358.pdf>.

As a result, we are not convinced that section 12(b) will remain a particularly robust test for public company status for long. As an alternative to a size test, however, it does little harm and may remain a useful mechanism by which certain issuers (for example, foreign ones) might voluntarily assume U.S. disclosure obligations.⁷⁶ But we suspect that section 12(g), the third gateway, will increasingly bear more of the load with respect to answering the hard questions about the public–private divide, and so we turn to it for the remainder of this section.⁷⁷ In section A, we explore the market changes since 1964 that make section 12(g)’s reliance on record shareholders problematic; in its place we believe a metric like average daily trading volume would work far better in

76. Listing provides an ancillary benefit for certain foreign issuers who choose to list on a national securities exchange in the United States, likely seeking to signal to investors that they adhere to disclosure and disclosure-related corporate governance responsibilities that are more stringent than those in their home countries—the “bonding” hypothesis. See Coffee, *supra* note 70, at 1770–71 (explaining that the number of foreign companies listed on the two principal U.S. stock markets grew from 170 in 1990 to more than 750 in 2000). Such cross-listings have dropped in frequency over the last decade, which has been one of the trigger points to the debate over whether U.S. markets are losing their competitive appeal because of over regulation. See Steven M. Davidoff, *Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers*, 79 U. CIN. L. REV. 619, 628 (2010) (“In the wake of the technology bubble and the accompanying worldwide recession, companies stopped cross-listing and engaging in initial public offerings.”). We do not rehash that debate here. See, e.g., Craig Doidge et al., *Why Do Foreign Firms Leave U.S. Equity Markets?*, 65 J. FIN. 1507, 1508, 1528 (2010) (suggesting most of the reduction is because other countries have gotten better at offering investor protection with respect to both trading markets and issuer disclosure as well as providing evidence that some of the desire to avoid U.S. listings is driven by large block-holders who are seeking to preserve the private benefits of control).

Within a discussion of determining metrics for publicness, this issue seems of lesser importance and ought not to deter a move away from listings as a focus for publicness. The SEC’s budget is notoriously thin, so it has to allocate its own resources carefully. Policing foreign issuers is difficult (travel, language barriers, home country barriers to cooperation, etc.), and it is hard to see how or why the SEC would undertake this task if the consequence is to lessen the attention given to domestic issuers (and other tasks of securities regulation) where there is proportionately greater U.S. investor interest. The primary economic benefit of cross-listing goes not to the SEC itself, but to the exchanges where the listing occurs, with some spillover to the Wall Street community. With exchanges being publicly owned and those shareholders having a global footprint, the disconnect with costs borne by domestic taxpayers becomes more noticeable. What little empirical evidence there is suggests that the SEC quietly devotes less than a proportionate share of resources to foreign issuers, in which case the economic value of bonding is less than advertised. See Jordan Siegel, *Can Foreign Firms Bond Themselves Effectively by Renting U.S. Securities Laws?*, 75 J. FIN. ECON. 319, 335–43 (2005); Natalya Shnitser, Note, *A Free Pass for Foreign Firms? An Assessment of SEC and Private Enforcement Against Foreign Issuers*, 119 YALE L.J. 1638, 1658 (2010) (“[T]he single empirical study on specific treatment of foreign firms suggests that the SEC has rarely taken action against crosslisted firms or their insiders for violations of the federal securities laws, even when well-publicized misconduct has taken place.”).

77. In recent years both Congress and the SEC have relied heavily on listing standards, particularly in the Sarbanes–Oxley and Dodd–Frank Acts. See 15 U.S.C. §§ 78j-4(b), -1(m), -3 (2006) (prohibiting listing if no policy for claw backs from executive officers after accounting restatement and requiring all audit or compensation committee members to be independent); *id.* § 78j-1(m) (directing national securities exchanges to prohibit listing of companies where each member of audit committee is not independent); *id.* § 78j-3 (directing national securities exchanges to prohibit listing of companies where each member of compensation committee is not independent). Limiting obligations to a subset of listed companies traded on exchanges may be an indirect way of “tiering” public company obligations, but in our view, explained more fully below, such separation should be more careful and thought out than this.

gauging the extent of investor interest in, and need for, disclosure. In section B, we broaden the discussion to examine how best to think about the threshold, whichever metric is used. Here, we consider the JOBS Act’s importation of the “accredited investor” concept from the 1933 Act in counting the number of shareholders, a choice that we believe has less utility given the policies of the 1934 Act. We also examine what existing data tell us about doing a cost–benefit analysis in that context.

A. SECTION 12(G): THE SIZE TEST

As we have seen, section 12(g) was added to the 1934 Act in 1964, partly because of the availability of nonexchange (that is, over-the-counter) stocks to retail investors in the trading market not subject to the reporting obligations of the Act.⁷⁸ In the pre-1964 period, investors trading in these stocks could participate in the riskier end of the investing continuum, for which they would expect bigger payoffs if the investments turned out well. Brokers and promoters were quite active in pushing low priced speculative OTC stocks.⁷⁹

Because the OTC market was simply a network of dealers posting quotes in securities in which they were making markets, there was no institutional infrastructure to which to refer when Congress decided to expand the definition of public company—hence, the size test. The 500-or-more-shareholder-of-record metric stayed the same over time until the JOBS Act;⁸⁰ the conjunctive \$10-million-in-asset figure is the product of SEC exemptive relief, raising the original 1964 threshold of \$1 million.⁸¹ While roughly a size test, it is not really: as the Facebook example and the world of private equity show, many extraordinarily large and powerful companies have few enough record shareholders to avoid registration.⁸²

The dysfunction here comes from the reference to “record” ownership. The term necessarily invites a distinction between the record owner and someone else who has the real economic interest in the shares. If there are multiple beneficial economic owners for one or more record owners, the potential difficulty in applying a consistent statutory policy regarding the threshold for regulation under the 1934 Act based on the number of shareholders becomes manifest. Two contexts are of particular concern. First, nominee accounts by which title to the securities is held in the name of broker-dealers or their designated depository agent have become ubiquitous for practical reasons as the

78. SEC, *supra* note 21, at 66–67 (“Even with respect to some common stocks admitted to exchange trading, the volume of trading over the counter frequently exceeds that on the exchange.”).

79. *Id.* at 76.

80. There was a two-year phase-in period during which only companies with 750 or more shareholders of record had to meet the obligations of the 1934 Act. *See* 15 U.S.C. § 781(g).

81. The amount was increased to \$3 million in 1982, \$5 million in 1986, and \$10 million in 1996. *See* Relief From Reporting by Small Issuers, Exchange Act Release No. 37,157, 61 Fed. Reg. 21,354, 21,354 (May 9, 1996).

82. *See* O’NEAL & THOMPSON, *supra* note 33, at 11.

preferred method for holding title to securities in publicly held companies; physical transfer of securities is no longer necessary when stock is sold, just an electronic transfer in the records of the title holder. Second, entities such as corporations, limited liability companies, or trusts can aggregate the funds of multiple investors with title in the name of the entity. The Facebook example flows from this second branch of the analysis.

The first context is much more visible but turns out to have less of a practical disruption on the application of the threshold for regulation. Since 1964, there has been a massive change in the practice of how title to stock is held for individual owners. No longer are shares recorded in the name of individual owners, as was usually still the case in 1964. Instead, for exchange-listed companies, broker-dealers (or banks) hold vast numbers of shares of vast numbers of investors under a single name. Realistically, this practice developed as a response to the back-office crisis created by the massive flow of paper and the costs of transferring stock as the volume of trading accelerated in a time before electronic transfers were common.⁸³

SEC rules, unchanged on this point since the promulgation of what is now Rule 12g5-1 shortly after the enactment of the 1964 statute, fail to account for this development.⁸⁴ The language initially proposed for the rule would have counted owners by looking through the title held in the name of a nominee broker-dealer or bank to get to the customers who hold the real economic interest,⁸⁵ but the final rule omitted such language and SEC interpretations make clear that a look through is not required (even though other SEC rules do provide for a look through in other circumstances).⁸⁶ The absence of a look through widens the range of trading that can occur without 1934 Act regulation because beneficial owners can, and do, make individual decisions to sell their stock, so that one broker-dealer as record owner may reflect the reality of hundreds of investors trading. The disparity between the number of record and beneficial owners has not caused a significant disruption in the application of the statute, however, because the separation of ownership status practically takes place only after a company goes public.⁸⁷ Until a company goes public,

83. See LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 486 (2d ed. 1988) (noting the steps taken by the securities industry to immobilize certificates in depositories in “an attempt to cope with the burgeoning paperwork problem” that “greatly increased the proportion of shares held in the names of nominees”); see also 6 LOSS & SELIGMAN, *supra* note 22, at 2959 (describing securities immobilization).

84. See 17 C.F.R. § 240.12g5-1 (2011) (defining securities “held of record” by a corporation, a partnership, a trust, or other organization as “so held by one person”).

85. See “Held of Record” and “Total Assets” Proposed Definitions, Exchange Act Release No. 34-7426, 29 Fed. Reg. 13,487, 13,488 (Sept. 29, 1964).

86. Exchange Act Rules Compliance and Disclosure Interpretations §§ 152, 252.01 (Sept. 30, 2008). Rule 12h-6, relating to foreign issuers, and Rule 405, defining foreign private issuer, do contain a look through as does Rule 12g3-2(a). See 17 C.F.R. §§ 230.405, 240.12g3-2, 240.12h-6.

87. Companies must apply for book-entry trading status of their shares. The guidelines of the Depository Trust Company (DTC), which provides this service, specify that this status is available to firms with securities registered under the 1933 Act; with exempt securities, if there are no transfer restrictions; or firms with securities issued under Rule 144A. See DEPOSITORY TRUST CO., OPERATIONAL

there has not been the same practical need to use nominee shares, so this disparity has only occurred in the shadow of companies that already are subject to public status, and rules to leave such status have been sufficiently sticky that the question of broker-dealer nominee accounts causing companies to fall before the statutory threshold has not frequently arisen.⁸⁸

The use of a legal entity to “bundle” multiple investors has likewise been part of the “counting” discussion since 1964, but with recent developments adding stress not previously visible.⁸⁹ Since its inception, Rule 12g5-1 has provided that securities held of record by a corporation, partnership, trust, or other organization shall be counted as one record owner.⁹⁰ Indeed, many institutional investors are collectives of individual economic investors—for example, mutual funds, private equity funds, and venture capital funds, many of which invest in pre-IPO companies—and there has been little question that their ownership interest is that of a single shareholder. At the same time, Rule 12g5-1 contains a broad anti-evasion clause ((b)(3)) that deems each beneficial owner to be a record owner if the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the minimum shareholder count.⁹¹

The Facebook deal with Goldman Sachs hit at the intersection of these two concepts. If Goldman Sachs created a single record-holder entity to invest in Facebook, with a thousand participating investors (all presumably wealthy and sophisticated), would this be one extra Facebook shareholder or a circumvention?⁹² And precisely the same process seemed to be occurring in connection with the emergence of SecondMarket and SharesPost. SharesPost, for instance, had an affiliate that created limited liability companies formed solely to hold shares in private companies traded there (for example, Facebook).⁹³ Buyers who wanted Facebook would be able to buy interests in the LLC, instead of buying Facebook directly.⁹⁴ Thus, substantial demand could be accommodated without enlarging Facebook’s shareholder base by more than one.⁹⁵

ARRANGEMENTS NECESSARY FOR AN ISSUE TO BECOME AND REMAIN ELIGIBLE FOR DTC SERVICES 2 (2012), available at http://www.dtcc.com/downloads/legal/rules_proc/eligibility/operational.arrangements.memo.pdf. Practically, we have been told by those in the industry that, if there are enough broker-dealers who want book-entry transfers, this service is available, which opens up the possibility, at least, that record ownership will diverge from beneficial ownership in the prepublic period as well.

88. See 15 U.S.C. § 781(g)(4) (2006) (providing that registration is terminated when record shareholders reduced to fewer than 300 shareholders). That is not to say that it could not arise, of course. If so, it would raise the question of the anti-evasion clause of Rule 12g5-1(b)(3) discussed below.

89. See *supra* text accompanying note 3.

90. 17 C.F.R. § 240.12g5-1(a)(2).

91. *Id.* § 240.12g5-1(b)(3).

92. Of course this is not just a section 12(g) issue. The deal would have to be structured to avoid other regulatory obstacles, most importantly to ensure that Facebook would not make an unregistered public offering of its securities under the 1933 Act.

93. See SharesPost, Inc. & Brogger, *supra* note 52, at *4.

94. See *id.*

95. See *id.* At the same time as the enforcement action against SharesPost, the SEC brought an antifraud action against a promoter (unaffiliated with either marketplace) involved in the creation of

The legal background for this discussion is undeveloped. In the half century since the rule and its anticircumvention exception were put in place, there has been one clear-cut judicial application to a long-standing family business that resembled a voting trust, a context unlikely to provide much guidance to the Facebook example.⁹⁶

The Facebook hypothetical has some elements of the pure nominee status discussed above. It differs from the mutual funds and venture funds that have traditionally been thought to come under the corporate exemption where the focus is on one security. To the extent that there is a market for the shares in this fund, either through a SecondMarket/SharesPost type of trading platform or by Goldman Sachs agreeing to make its own market in this fund, there will be investors who seek to participate in secondary trading as to Facebook. Assume that Facebook were to do the same thing with two other investment banks. If all this were to work, Facebook could raise a massive amount of capital and bring in thousands of indirect shareholders—and yet only add three record sharehold-

several Facebook “bundles.” See Laurence Albuquerk and EB Financial Group, LLC, Exchange Act Release No. 3383, 2012 WL 1023978 (Mar. 14, 2012).

96. *Tankersley v. Albright*, 514 F.2d 956, 969–70 (7th Cir. 1975) (holding a formal trust for employees created prior to the adoption of Rule 12g5-1 and “clearly serv[ing] other important purposes” was not a device to avoid the holder of record threshold). Litigation over control of the Bacardi Corporation raised the circumvention problem, without clear-cut guidance. See *Bacardi v. Bacardi Corp.*, [1987–88 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,712 (D. Del. 1988). For the SEC’s view, see *Bacardi Corp.*, [1989–90 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,515 (Admin. Proc. 1990). In 1975, a privately held company in Wisconsin requested interpretation on whether its retirement trust would destroy its nonreporting status under section 12(g). See *H.C. Prange Co.*, SEC No-Action Letter, 1975 WL 10006, at *1 (May 30, 1975). The company held assets of over \$1 million and had issued multiple shares of a single common stock held “of record” by 224 shareholders. *Id.* The company’s retirement trust consisted of 188 participants, but the company planned to revise the trust, making it available to more than 500 employees. *Id.* at *2. Under the previous trust, each participant had limited voting rights. *Id.* Concerned that allowing more than 500 employees voting rights would amount to “circumvention” under Rule 12g5-1, the company limited participants’ voting rights such that they could only direct the trustee on how to vote. *Id.* The SEC initially responded that allowing participants voting rights in any form—even if only through a trustee—may constitute circumvention. *Id.* at *4. The company then asked the SEC to reconsider its initial decision, citing to the legislative history of section 12(g). See *H.C. Prange Co.*, SEC No-Action Letter, 1978 WL 13,118, at *4–5 (Feb. 20, 1978). Congress’s main concern in enacting section 12(g), according to the company, was to balance two interests: the need to prevent companies from raising large sums of capital through public trading without the discipline of the disclosure requirements of the Exchange Act and the freedom that closely held companies needed to self-manage without the costs associated with disclosure. *Id.* The company further noted that certain factors that Congress specifically contemplated as being indicative of circumvention—such as the large number of record transfers among shareholders and corresponding single holders of records as well as broker-dealer marketing aimed at shareholders—were not present in the trust. *Id.* The SEC thus revised its position, concluding that the shares “held of record” by the revised trust may be counted as being “held of record by one person” under section 12(g). *Id.* at *6.

The SEC staff, in a report mandated by the JOBS Act, concluded that “current tools available to the Commission are adequate to enforce the anti-evasion provisions of Rule 12g5-1” in an era where the increase in the section 12(g) threshold may reduce the motivation to engage in circumvention efforts. See SEC, REPORT ON AUTHORITY TO ENFORCE EXCHANGE ACT RULE 12g5-1 AND SUBSECTION (b)(3), at 33–34 (2012) [hereinafter SEC, AUTHORITY TO ENFORCE], available at <http://www.sec.gov/news/studies/2012/authority-to-enforce-rule-12g5-1.pdf>.

ers. That roadmap would surely be tempting to many emerging growth companies who desire not to be 1934 Act registrants.

How would this fund seek to defuse a claim that it was merely an indirect economic interest in its portfolio company and make itself more like the mutual fund or venture capital funds? Those funds, besides having a more diversified portfolio, have separate professional management that provides investment expertise as well as the economic interest. Assume that the Facebook entity was structured so that there was a professional manager (or elected committee of investors) who would own the shares and otherwise act on behalf of the investors. That solves an otherwise common collective-action and coordination problem, making the form of shareholding more potent—something akin to a voting trust. It may not be a simple circumvention of section 12(g) because there is some economic value added by the delegated ownership structure. But, if that is all it takes to avoid the anticircumvention rule, then it is not much of an obstacle.

Given the contemporary setting, the application of the (b)(3) anti-evasion clause would have to take on a more nuanced and complex structure, including consideration of the number of portfolio investments, the range of management services provided, the secondary market that is available, the degree of trading on that market, and the life cycle of the company. The Facebook example, if it were a one-portfolio special-purpose vehicle (SPV) whose shares would be widely traded in circumstances where the company was interested in postponing its move to public regulation, would seem a likely case for application of the anticircumvention clause of (b)(3). And that is pretty much what we believe was happening.

But there is uncertainty about this. For now, note that bundling seems to have emerged in private spaces, maybe over quite a period of time, with the SEC either letting it happen or being oblivious to it. We see this as a theme in technology-driven markets, which regularly create such opportunities that are filled before the SEC can respond. We will comment more on this in the conclusion.

Would we get a result that was more consistent and easier to apply by moving to another concept for measuring publicness?⁹⁷ We face two questions here.⁹⁸ The first may be the easier: is there an objective test for publicness that is better than the record ownership standard and usable in the real world? The second, explored in the next subsection, derives from the first and is much harder: how and where *should* we draw the line between public companies and nonpublic companies for 1934 Act purposes? Even if we were to stick with record

97. The rule presumably could be modified to refer to beneficial ownership known or reasonably available to the issuer. See SEC, ADVISORY COMM. ON SMALLER PUB. COS., FINAL REPORT 76–80 (2006), available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport_d.pdf (proposing amendment to Rule 12g5-1 to interpret “held of record” to mean held by actual beneficial holders).

98. See William K. Sjostrom, Jr., *Questioning the 500 Equity Holders Trigger*, 1 HARV. BUS. L. REV. ONLINE 43 (2011), <http://www.hblr.org/wp-content/uploads/2011/03/Second-Sjostrom-Online-Article1.pdf>.

shareholders, how would we know whether the right number is 500, 2,000, or more (or fewer)? If—as seems likely—there is a better test than record ownership, how would we go about finding the right tipping point to trigger public company status?

As to the first question, history is a useful guide. As noted earlier in Part II, the record shareholder test is used both at the front end (the duty to register) and back end (the ability to deregister) of public company status.⁹⁹ Foreign companies who came into the system via section 12(b) or 15(d)—listing on an exchange or making a registered public offering in the United States—were entitled to exit if they could establish that they had fewer than 300 U.S. shareholders.¹⁰⁰ But nominee ownership (and the burden of making a showing being put on the issuer) did not allow for confident assessments of the nationality of the shareholder, making counting difficult. Hence, there was a lock-in effect, which the stock exchanges and others came to believe was discouraging foreign issuers from coming to the United States in the first place.¹⁰¹ In 2004, the SEC revised Rule 12h-6 to make it easier for foreign issuers to deregister.¹⁰² One of the solutions was to substitute a trading volume test: if the foreign issuer can show that the average daily trading volume in the United States over a twelve-month period was less than 5% of the average world-wide trading volume, it can leave.¹⁰³ As anticipated, many foreign issuers left as soon as the rule became effective, taking prompt advantage of the usability of the new standard.¹⁰⁴

Exit and entry are different issues (as is the treatment of foreign issuers), but our sense is that a metric like average daily trading volume captures, in principle, far better than number of record shareholders the purpose for 1934 Act registration, gauging the extent of investor interest in and need for *disclosure*. Of course this depends on there being accurate reporting of trade activity along the full spectrum of fragmented markets in the United States, but that has long been the goal, at least, of SEC market regulation.¹⁰⁵

99. For a useful discussion of this deregistration process as applied to domestic issuers, containing a critique of the record ownership test, see Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135 (2009).

100. See Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty To File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 55,540, 72 Fed. Reg. 16,934, 16,953 (Apr. 5, 2007).

101. *See id.*

102. This revision reduced the value of the bonding in the first place. *See* 17 C.F.R. § 240.12h-6 (2011); Edward Rock, *Securities Regulation as a Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 684 (2002) (discussing the deregistration process for foreign issuers before 2004); *see also* Nuno Fernandes et al., *Escape from New York: The Market Impact of Loosening Disclosure Requirements*, 95 J. FIN. ECON. 129 (2010) (discussing the negative market impact on firms subject to escape).

103. 17 C.F.R. § 240.12h-6.

104. Samuel Wolff & Clarence D. Long IV, *Post-Sox Trends in Delistings and Deregistration*, 9 RICH. J. GLOBAL L. & BUS. 53, 55 (2010).

105. 17 C.F.R. § 242.302(b) (requiring an alternative trading system to records including daily summaries of trading covering securities for which transactions have been executed and transaction

A few issues might seem bothersome here. One has to do with variability. Manipulative trading happens most frequently with small issuers: trading spikes only briefly while the “pump and dump” is in process, and then it diminishes.¹⁰⁶ These situations might push daily volume over the threshold for a while but not long enough to require registration and reporting—which would come too late anyway. But we regard manipulation as a securities trader/broker-dealer issue, for which there are other forms of regulation and remedies. Our view is that registration is meant for situations where there is *sustained* investor attention in the company. More of a concern is if a company sought to suppress average trading volume over the applicable period of time, but that standard seems less manipulable than the number of record owners on one day a year.¹⁰⁷

B. HOW TO THINK ABOUT THE THRESHOLD FOR REGISTRATION

The original 500-record-shareholder/\$1-million-in-assets standard in section 12(g) (chosen in 1964) was arbitrary; as we saw earlier in section II.A, other numbers were considered contemporaneously, and there is no explanation for how we would know that 500, or some larger asset size, is the right tipping point. Most all of securities regulation is educated guesswork rather than rigorous cost–benefit analysis because we lack the ability to capture the full range of possible costs or benefits with anything remotely resembling precision. That opens the door to bias—whether the influence of deliberate rent seeking, ideological preferences, or just preconceived (and unfalsifiable) notions—on the part of the many actors who contribute to the process of policy formulation. But this is inevitable.

That, however, does not mean there is no rational basis from which to estimate, at least roughly, the effect of either a policy change or the status quo—there is by now a great deal of both theoretical and empirical work on

volume, expressed with respect to equity securities in number of trades, number of shares traded, and total settlement value in terms of U.S. dollars). Filings are required within thirty days of the end of each quarter. *Id.* § 242.301(b)(9). These records are not available to the public. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40,760, 63 Fed. Reg. 70,844, 70,914 (Dec. 22, 1998).

106. The “pump and dump” term refers to schemes to tout the stock of companies, often small, in an effort to create a buying frenzy and raise the price, so the instigator can sell all his stock, often causing the price to decline afterwards. See *Pump and Dump Schemes*, SEC, http://www.sec.gov/answers/pump_dump.htm (last visited Sept. 18, 2012); see also Rajesh K. Aggarwal & Guojun Wu, *Stock Market Manipulations*, 79 J. Bus. 1915, 1936 (2006) (finding most manipulation cases occur in small and illiquid markets).

107. An alternative to trading volume would be the issuer’s public float, that is, its total market capitalization in the hands of nonaffiliates. See *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing Before the S. Comm. on Banking, Housing, & Urban Dev.*, 112th Cong. 13 (Dec. 1, 2011) (statement of John C. Coffee), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d580503c-a7f3-4db5-b9f5-968d03af374f. This, however, would require a great deal of confidence in the valuation process for thinly traded securities and no doubt would be subject to considerable volatility. It might also be possible to have companies estimate the number of beneficial owners from certain indicators—such as how many proxy ballots and annual reports they are asked to prepare in connection with an election of directors.

financial reporting to help frame any inquiry and pose useful questions.¹⁰⁸ Asking any more of cost–benefit analysis to justify regulation itself displays a bias, or a presumption against the desirability of regulation. That might be sound—certainly the presumption has many adherents¹⁰⁹—but it is by no means self-evident and can easily become a normative cover for lobbying in favor of deregulation that is purely self-serving. In this vein, there are two policy questions that we consider here: one that focuses on whether an investor’s qualitative characteristics should be part of the standard, and a second that addresses how to assess costs and benefits no matter which metric is chosen.

1. Qualified Investors

The first question brings to light a profound difference in philosophy between the 1933 and 1934 Acts. The latter, as we saw in section II.A, uses issuer size as the default standard, without much interest (at least prior to the JOBS Act) in whom the shareholders might be. The JOBS Act moves the 1934 Act in this direction by permitting a larger, but not unlimited, number of accredited investors before triggering 1934 Act responsibilities, yet that legislation produced no public debate on the point or its theoretical justifications. By contrast, the 1933 Act depends crucially on an assessment of whether investors can be expected to “fend for themselves”¹¹⁰ and hence gets into questions of offeree sophistication, wealth, and access to information before deciding that the regulation is needed at all. In a world where we try to integrate the two statutes, does such a difference make sense?¹¹¹

The Facebook plan poses the question quite clearly. Assuming that all the investors in the entity formed to hold the shares were able to “fend for themselves,” why should it matter whether there are one, one thousand, or one million such investors? Arguably, if a private equity arrangement permits a company to go or stay dark, this plan should too. We can address this in two ways. The first is to question the 1933 Act assumption—if we really do not have enough confidence in supposedly sophisticated investors fending for themselves, then simply counting might be preferable under both statutes. The second is to ask whether there are differences in the purposes of the two statutes to justify the disparate treatment.

As to the first, we have plenty of anecdotal evidence of institutional and wealthy individual investors fending for themselves poorly.¹¹² Ponzi schemes

108. For a thorough survey of the recent financial economics literature on both mandatory and voluntary financial reporting, see Anne Beyer et al., *The Financial Reporting Environment: A Review of the Recent Literature*, 50 J. ACCT. & ECON. 296 (2010).

109. See, e.g., Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

110. See *supra* note 15 and accompanying text.

111. For a discussion and proposal that makes much of the distinction, see William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639 (2009).

112. See Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025 (2009).

can be successful in a regulatory vacuum, and the 2008 financial meltdown shows institutional purchasing behavior that was woefully insensitive to the embedded risk. Aspects of the Dodd–Frank Act (for example, the asset-backed securitization reforms and hedge-fund adviser regulation) at least implicitly call into question the disclosure and other customer protections in the offering process even where the offerings are unregulated.¹¹³ If the question is whether we can count on large or wealthy investors to act prudently, the answer is surely no. But, in our view, this does not fully capture the fend-for-themselves exemptions. Instead, it reflects a broader principle that, in a world of thin regulatory resources, larger and relatively more sophisticated investors are lower priority. They will *sometimes* protect themselves, and in many situations where investments are standardized, the presence of *some* prudent buyers will redound to the benefit of the less prudent. And even when an investment goes awry, large investors by and large have reasonable access to legal remedies for fraud or negligent misrepresentation, albeit subject to fairly potent “reasonable reliance” defenses.¹¹⁴ Moreover, even when all else fails, they are less likely to suffer severely from any particular issuer-specific wrongdoing because their portfolios are larger and more diversified.

Of course, there will be instances to the contrary—the Madoff scandal, perhaps, or the massive losses suffered by smaller public retirement funds from buying complex derivatives before the onset of the global financial crisis.¹¹⁵ But even here, we suspect that the primary problems go more to the sales practices in the securities industry than the registration and disclosure rules themselves, so that, if there are cost-justified solutions, they will more likely be found in broker-dealer and investment-adviser regulation than corporate disclosure reforms.

The remaining question is whether there is something in the purposes behind the issuer registration regime that counsels against extending the private-issuer exemption (regardless of number of shareholders) to an arrangement like our hypothetical Facebook deal. The crucial difference between the 1933 and 1934 Acts is that the former deals mostly with primary offerings of securities by the issuer, as opposed to secondary trading among investors. Fending for oneself is easier when the investor is in privity or near privity with the issuer because representations and warranties can be extracted fairly directly; in aftermarket trading, by contrast, the link between issuer and investor is broken. Arguably,

113. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 124 Stat. 1376, 1571 (2010) (codified as amended at 15 U.S.C. § 80b-3) (eliminating hedge fund exemption); 15 U.S.C. § 77g(c), (d) (2006) (requiring registration statements and disclosure for asset-backed securities).

114. *See, e.g.,* Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1027–31 (4th Cir. 1997) (rejecting bank’s claim against investment bank for misleading it about the risk in collateralized mortgage obligation).

115. *See* Press Release, SEC, SEC Charges RBC Capital Markets in Sale of Unsuitable CDO Investments to Wisconsin School Districts, Rel. 2011-191 (Sept. 27, 2011), *available at* <http://www.sec.gov/news/press/2011/2011-191.htm>.

this is one reason the SEC was so restrictive in authorizing the more deregulated 144A marketplace, choosing to authorize free resales of privately placed securities but only among large institutions—not among all accredited investors.¹¹⁶

However, this concern may be overstated. There are many examples in private, negotiated transactions where the issuer commits to ongoing disclosure—including, sometimes, the contractual obligation to be a “voluntary filer,” so that reporting occurs as per SEC rules, even though the issuer is not required by securities law to do so. It has been pointed out that “going dark” may actually be a less troublesome phenomenon than assumed, precisely because the deals that take issuers out of the public realm often have such covenants.¹¹⁷ Some investors will be willing to take on the additional risk from high volatility, for example, because they expect higher returns for that risk. The bigger point is that disclosure and corporate governance (including market constraints and the impact of various gatekeepers) are often substitutes. Required disclosure is more valuable (and necessary) in the presence of dispersed shareholdings facing a collective-action problem. If we believe that corporate governance is likely to be relatively strong because of the way these arrangements would be structured—again, imagine some kind of centralized voting arrangements—we could plausibly conclude that mandated disclosure is inefficient.

On the other hand, if we have doubts about collective action as the number of investors grows—even assuming wealth or sophistication—the case for mandatory periodic disclosure strengthens. In the face of dispersion, both shareholders and potential investors have to glean information on their own to compensate for any lack of voluntary disclosure, which produces inefficient duplication of effort.¹¹⁸ Here, a disclosure regime makes sense, although we have to balance this benefit against the risk that government-mandated disclosure will turn out not to be cost efficient.

So far, however, this discussion has assumed that efficient disclosure is simply a matter of bargaining between shareholders (current and potential) and management for the benefit of the former. But both the theory and practice of public-company disclosure emphasize that the externalities associated with disclosure are as important, maybe more so. The orthodox economic case for disclosure is that the benefits are captured by a host of constituencies—including the economy generally, in terms of efficient allocation of capital among companies.¹¹⁹ Competitors and peer companies benefit from one another

116. 17 C.F.R. § 230.144A (2011).

117. Bartlett, *supra* note 34, at 9 (noting that “firms going private frequently remain subject to [Sarbanes–Oxley’s] compliance costs owing to the fundamental need to finance a going-private transaction” via publicly held debt).

118. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 281 (1991) (“When investors spend time and resources inspecting, each one’s effort will duplicate what another has done.”).

119. See Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1379 (1999); see also Michael Guttentag, *Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 133–38 (2004).

er’s performance data, which is socially valuable so long as disclosure does not create an undue disincentive to productive activity. There may be more diffuse social value to transparency as well, an argument we develop in the next Part. So, the argument goes, there will be too little disclosure if the matter is left simply to management and shareholders. Disclosure is a public good.¹²⁰

To be sure, this point is not so compelling that we prohibit large companies from being private; public company status is reserved for those issuers that seek public capital in the securities markets or otherwise make their shares available for secondary trading. But presumably this suggests that private issuer status be limited to those situations where the bargaining over the allocation of capital to the issuer gives us enough confidence that the price at which buyers are attracted will be a fully informed one. An active trading market disconnected from such bargaining, even among the sophisticated or wealthy, will not by itself generate a socially optimal amount or type of information. If we trust the SEC to set disclosure standards efficiently—a big “if” to many people, to be sure—it makes sense to construe the public issuer definition expansively, which means limiting any exception based on investor qualification to situations where we expect private bargaining to adequately protect not only initial but also after-market buyers in a sufficiently robust trading market.

Against this background, we understand better how Congress ultimately resolved this issue in the JOBS Act. As noted earlier, the number of record shareholders is increased to 2,000 but only if there are no more than 499 nonaccredited investors (not including employees).¹²¹ This is a bow to the idea that such investors should protect themselves in terms of information rights, but the number of shareholders is then capped at 1,999, so that the idea cannot be taken to the extreme of an unlimited “sophisticated” shareholder base that never triggers 1934 Act registration. Once again, however, that simply brings us back to how record shareholders are counted and the shakiness of tolerating formalism so easily subject to manipulation unless regulators are carefully on guard.¹²²

120. See *infra* notes 128–31 and accompanying text.

121. JOBS Act, Pub. L. No. 112-06, § 501, 126 Stat. 306, 325 (2012) (codified at 15 U.S.C. § 78l(g)(1)(A)).

122. We leave to the side Congress’s other innovation here, which is to say that shareholders obtained via the crowd-funding exemption in new section 4(6) of the 1933 Act are not counted for purposes of 1934 Act registration under section 12(g). See *id.* § 302, 126 Stat. 315. This is bound up in the extraordinarily deregulatory thrust of section 4(6), which to us is the most aggressive feature of the JOBS Act but outside the scope of this Article. This connection between crowd funding and section 12(g) is fraught with ambiguity, as crowd-funded issuers will have to struggle with what it means for the shareholder to have “purchase[d] such securities in transactions described under section 4(6).” Entrepreneur Access to Capital Act, H.R. 2930, 112th Cong. § 3 (2011). Does this also include downstream purchasers of those securities? What if those securities are exchanged for new ones? Suffice it to say for now, that nothing in the foregoing discussion would offer a principled basis for the crowd-funding exemption and its collateral effects. This is a pure trade-off of investor protection in the hope of job creation.

2. Setting the Threshold: A Cost–Benefit Challenge

Putting aside the point that record shareholders is a foolish number to count in the first place, how would we know whether a change in the size threshold was good or bad policy? Our aim in this section is to describe how best to assess the costs and benefits with any such steps—the tools that can help, or not. To be clear at the outset, we are skeptical that formal cost–benefit analysis can generate confident policy prescriptions. At the same time, policy makers should be as open as possible to considering the full range of possible costs and benefits, and economic analysis has much to contribute. We would support a greater formalization of the prominence of economists at the SEC and do not want any of our impressions about the limitations of such analysis, or the inevitably political nature of the regulatory task, to suggest otherwise. There is some irony here that for all of the insistence by some in Congress about the need for more rigorous cost–benefit analysis, Congress prepared nothing of the sort before adopting the JOBS Act.

Disclosure required by the SEC provides some numerical data (although just an approximation and not by reference to beneficial ownership) with which to work to identify how many companies would be in the range under consideration and from which we could also learn about other financial and structural attributes.¹²³ But even this would be of limited help because, presumably, the target group about which we would like to know are companies that had chosen to stay under the 500-shareholder threshold until they were ready for an IPO or similar event, thereby jumping quickly to a large number of shareholders (with an exchange listing that makes counting unimportant).

So what could we know about the consequences of taking such a group out of the registration requirement or—more importantly—giving emerging companies in the future the ability to increase their shareholder base without triggering registration? The benefits of requiring registration depend on an estimation of how much secondary trading there is likely to be; we would also need to know who is likely to be trading in this enhanced secondary market, how information sensitive they are, etc. Disclosure can also reduce agency costs, making self-

123. 17 C.F.R. § 229.201(b)(1) (2011). As a point of reference, John Coates provides data that the median record shareholder count for a large sample of public companies (Compustat) is just 700. See *Examining Investor Risk in Capital Raising: Hearing Before the S. Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. (2011) (statement of John C. Coates IV, Prof. of Law and Economics, Harvard Law School). Based on 2011 data, a SEC staff report found that only thirteen percent of companies registered under section 12(g) (318 of 2,524 for which data was available for the number of shareholders of record) would be required to initially register with the Commission under the new section 12(g) threshold. See SEC, AUTHORITY TO ENFORCE, *supra* note 96, at 26. That report likely understates the number of companies because use of street-name registration, which brings down the number of record holders as measured in the data, typically occurs after a company goes public and becomes subject to the 1934 Act. See DEPOSITORY TRUST CO., *supra* note 87, at 12. Nevertheless, the change in the section 12(g) threshold seems certain to reduce the number of companies required to register because of section 12(g), a question the SEC report did not address.

dealing less likely and facilitating greater investor influence.¹²⁴ And of course there are the positive externalities of disclosure in terms of product market competition and whatever else we deem desirable about public status.¹²⁵ Simply by way of recent example, public status will now trigger “conflict mineral” disclosure—Congress’s view that it is desirable for public companies to investigate and report (at considerable cost, apparently) on the extent to which their products incorporate tainted African minerals.¹²⁶ Without expressing any opinion about the relative costs and benefits of this particular initiative, that desired transparency is gained or lost from some number of companies depending on where we set the threshold. There are many other possible examples on which we elaborate more in Part III.

On the cost side, the direct costs are the marginal costs in time, manpower, and professional service fees associated with public company registration responsibilities over and above what is currently being spent or would be spent to meet obligations associated with, say, alternative forms of financing for the issuer’s capital needs. These weigh heavily on smaller firms and may introduce agency cost problems if accountants’ or lawyers’ advice tends toward the self-serving (as apparently happened in the aftermath of Sarbanes–Oxley).¹²⁷ Just as important are indirect costs. Threat to corporate secrecy is a well-known externality, albeit one with both positive and negative aspects. Disclosure does promote competition by helping identify businesses that are earning supra-normal returns; on the other hand, too extensive or premature disclosure of competitive plans, research, and development diminish the value of preferred business strategies and, at the margin, may deter investment in the first place—a concern the SEC has tried to address in Reg S-K but which remains potentially troubling.¹²⁸ Disclosure of bad news can become a self-fulfilling prophecy, especially to companies struggling to grow.

There are effects on management associated with public transparency. The best known are the opportunity costs in terms of the time and attention that executives and board members spend on compliance as opposed to growing the business. Interesting research has shown that reporting can distort real economic

124. Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048–49 (1995).

125. 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) (examining the effects of accounting fraud on the product market); J. Gregory Sidak, *The Failure of Good Intentions: The WorldCom Fraud and the Collapse of American Telecommunications After Deregulation*, 20 YALE J. ON REG. 207, 235 (2003) (estimating WorldCom’s misreporting caused more than \$7 billion in harm to other telecommunications providers and frustrated key elements of national telecommunications policy).

126. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1502, 124 Stat. 1376, 2213 (2010) (codified at 15 U.S.C. § 78m(p)).

127. Donald C. Langevoort, *The Social Construction of Sarbanes–Oxley*, 105 MICH. L. REV. 1817, 1854 (2007) (discussing rent seeking by lawyers, accountants, and others).

128. Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995).

choices—for instance, projects foregone because of accounting uncertainties or consequences.¹²⁹ It is entirely plausible that public reporting responsibilities, in general, dampen the inclination to take risk.

Aggregating and netting out all these possible benefits and costs is impossible, of course—which makes something like choosing the threshold for public company status a work of political impressionism. But if that is all we have to say here, we have not been particularly helpful because anyone who has had a hand in crafting securities law knows that much already.

Indeterminacy notwithstanding, we do have some data points. Of most relevance—because it was specifically motivated by moves to tweak the 500-shareholder threshold—is work by Leuz, Triantis, and Wang, who study the firms that, in unusually large numbers, went dark in the time period after Sarbanes–Oxley.¹³⁰ They document significant abnormal negative returns when firms voluntarily moved to the Pink Sheets, consistent with investors valuing the information now lost. But this leaves two motivational possibilities. One, an agency cost story, is that managers prefer the private benefits of control threatened by Sarbanes–Oxley’s enhanced regulation.¹³¹ Alternatively, this is a value-based decision, reflecting the increased costs of compliance for smaller firms whose growth prospects (and hence future public capital needs) are poor—the negative returns explained by the going dark signal, which communicates to investors that the firm is indeed facing a bleak future. The authors find support for both propositions. The agency cost explanation dominates when corporate governance and other investor protections are weak.¹³² Otherwise, the results are consistent with smaller firms that have limited growth opportunities,

129. See Leonce L. Barger et al., *Sarbanes-Oxley and Corporate Risk-Taking*, 49 J. ACCT. & ECON. 34 (2012); Daniel A. Cohen et al., *Real and Accrual-Based Earnings Management in the Pre- and Post-Sarbanes-Oxley Periods*, 83 ACCT. REV. 757 (2008).

130. Christian Leuz et al., *When Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181, 183 (2008). For analysis in a similar vein with similar results, see András Marosi & Nadia Massoud, *Why Do Firms Go Dark?*, 42 J. FIN. & QUANTITATIVE ANALYSIS 421, 436–38 (2007). For further analysis of some of this data, see Fried, *supra* note 99, at 151–52. Fried notes, for example, that the vast majority of smaller firms that went dark provided absolutely no disclosure to shareholders. *Id.* It is important to note a striking asymmetry between the obligation to register as a public company under section 12(g) after the JOBS Act and the ability to deregister. Although the former number grew to 2,000, the threshold for going dark remained at 300 (except for banks and bank holding companies). As a result, the JOBS Act cannot be said to increase the “going dark” risk but rather is directed at prepublic issuers.

131. Private benefits of control are those forms of insider enrichment made possible by the absence of transparency and are thus seen as inversely related to the degree of required disclosure and its related legal requirements. See, e.g., Craig Doidge et al., *Private Benefits of Control, Ownership, and the Cross-listing Decision*, 64 J. FIN. 425, 450 (2009).

132. Firms going dark are more likely to face financial distress and a deteriorating trading environment, which they take as evidence that these firms are making a rational cost–benefit calculation. Leuz et al., *supra* note 130. But there is also evidence that going dark firms have weaker governance and outside monitoring and greater free cash flow and voluntary accounting accruals, which is consistent with the agency cost hypothesis. In addition, firms that go dark tend not to provide even inexpensive voluntary disclosures. Their inference, then, is that both of these explanations are at work, with the weaknesses in governance associated with a greater likelihood of a “private benefits” motivation.

reasonably concluding that the regulatory costs exceed the benefit to investors—evidence that the costs associated with registration can be prohibitively high for some smaller firms.

Earlier work by Bushee and Leuz offers another useful glimpse.¹³³ They study the 1999 rule change that required all OTC Bulletin Board companies to adhere to SEC reporting rules, a move that would make a firm’s decision to be on the Bulletin Board as also a choice to voluntarily submit to regulatory disclosure, even if below the section 12(g) threshold. Most firms responded by dropping to the Pink Sheets, while others chose to remain and become compliant; a third subset was already compliant because of section 12(g).¹³⁴ The authors interpret the results for the first two groups—the decision of the first group to avoid the new obligation and the lower abnormal return around the announcement dates that they find for the second group—as evidence that expected registration costs exceeded expected benefits. On the other hand, liquidity was enhanced for all firms remaining on the Bulletin Board, and already compliant firms received a boost in returns, which suggests the presence of positive externalities from the reformed institutional structure of the market.¹³⁵

What does this tell us? It is broadly consistent with the presence of significant investor protection benefits even at the small firm level, but with costs that, for firms with minimal growth prospects that would require public financing at least, create on balance a negative value proposition.¹³⁶ But note that this tells us little about the category of firms (like Facebook), whose motivation would be to delay the transparency associated with public status but who might benefit from enhanced liquidity associated with a higher section 12(g) threshold. We doubt that there is much of an agency cost story to be told for most such firms, especially those anxious to buy some extra private time, but still grow, prior to a significant liquidity event like an IPO,¹³⁷ but the evidence does not speak one way or the other.

There are other data points of use, although none particularly more helpful. Allen Ferrell’s study of section 12(g)’s adoption in 1964 suggests that the

133. Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACCT. & ECON. 233 (2005).

134. *Id.* at 235 (noting that seventy-six percent of OTCBB firms not previously filing with the SEC chose not to meet the new disclosure requirements and thus were removed from OTCBB).

135. *Id.* at 235–36.

136. This, in turn, is consistent with the fairly widespread sense among commentators that compliance costs are unnecessarily burdensome for smaller issuers, especially after the Sarbanes–Oxley Act. See, e.g., Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 232 (2009). For a discussion of the challenges associated with evaluating such claims, see Ehud Kamar et al., *Sarbanes-Oxley’s Effects on Small Firms: What Is the Evidence?*, in *IN THE NAME OF ENTREPRENEURSHIP? THE LOGIC AND EFFECTS OF SPECIAL REGULATORY TREATMENT FOR SMALL BUSINESS* 143, 164 (Susan M. Gates & Kristin J. Leuschner eds., 2007); see also *supra* notes 127–29.

137. Because these firms will undergo the obligations of public status under both the 1933 and 1934 Acts soon enough and are dealing with private capital from relatively sophisticated sources, there seems to be less opportunity or incentive to cheat in the period of time just before the IPO.

movement of so many OTC stocks to registrant status both reduced volatility and generated abnormal positive returns—consistent with enhanced stock price accuracy.¹³⁸ But this shift included many quite large issuers that had chosen to avoid exchange listings and cannot necessarily be taken as strong evidence at the margins of registration. There are a rapidly increasing number of empirical studies on the benefits of specific changes (or clusters of changes) to SEC disclosure requirements.¹³⁹ Because of the greater data availability and statistical power when focusing on widely traded securities, these studies usually tell us more about consequences with respect to larger issuers.¹⁴⁰ Many of these studies support the intuition that mandatory disclosure has positive payoffs, but even at that level, most would conclude that we are far from being able confidently to assess the social welfare effects of financial reporting obligations generally on any category of issuer.

All this suggests to us a range of reasonableness for setting the threshold (based on market cap, public float, or number of shareholders) without setting off loud public-interest alarms; within that range, we can tolerate outcomes based on intuitions and subjective (including ideological) preferences for more or less regulation. We would add to this the effect of any change on SEC resources, which usually favors a restricted scope to regulation in close cases, so as to free up precious resources for other work. Based on all of this, we think there was a good case to be made for moving to a higher threshold, with an exemption for issuers with qualified shareholders beyond 500, measured by beneficial, not record, ownership, although not—for the reasons stated earlier about active aftermarkets¹⁴¹—to an unlimited number.

In that sense, the direction of the JOBS Act section 12(g) reform should not be judged too harshly. The JOBS Act encourages the development of trading sites, like SharesPost and SecondMarket, which are open only to accredited investors and, in that sense, might well set in motion a new round of market building closed off to public retail investors. What is most bothersome, of course, is that the metric remains record ownership, which is rendered useless so long as simple bundling mechanisms are permitted to flourish.

What does not make sense is to continue the facade of a third threshold based on size when it has little practical effect. A threshold of 2,000 record shareholders, excluding employees and crowd-funding investors, is not going to reach many companies in today's market before they seek a stock-exchange listing or a registered public offering. Although we have noted how those two requirements are likely to be of reduced importance going forward given technological and market changes, the greater use of street-name ownership and bundling of

138. Allen Ferrell, *Mandatory Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, 36 J. LEGAL STUD. 213, 214 (2007).

139. For a literature review, see Beyer et al., *supra* note 108.

140. See Merritt B. Fox et al., *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 346–48 (2003).

141. See *supra* text accompanying notes 115–19.

multiple investors within a single nominee is also likely to provide an easy way around section 12(g) in such a world. We are already at a point where the section 12(g) size requirement will seldom be a binding constraint in forcing a company into the public status of the 1934 Act, and we may in the future find ourselves where many more companies have a size and impact comparable to a pre-2012 reporting company but can approach the 1934 Act obligations as a voluntary choice.

The exercise we have just undertaken leads us to another insight, which we will develop in the next Part. Public company status brings with it the cumulative effect of hundreds of line-item disclosure requirements, statutory obligations, and corporate governance rules that demand a complex and costly negotiation among executives, directors, accountants, and lawyers (if not IT professionals, bankers, employees, and a host of other constituents as well). At the section 12(g) threshold of public status, where the costs and benefits probably run close together, even when each category is viewed capaciously, it is best to impose on relatively smaller companies only those obligations that clearly relate to core investor protection goals, not necessarily those that, although articulated in terms of investor protection, are really the product of an inchoate social and political intuition about publicness that is neither necessary nor appropriate for smaller public companies. Securities regulation does this to some extent already, but the distinctions are haphazard and under theorized. We turn now to that task.

III. PUBLICNESS BEYOND MERELY INVESTOR METRICS, AND THE “ON RAMP”

The threshold question that we have just considered stresses how momentous it is for a company to shift from private to public. Those companies take on a host of obligations—not just the disclosure obligations that have always been a central focus of the federal securities laws, but also regulation relating to internal controls and a variety of corporate governance obligations imposed in the years since 1934, particularly in the mammoth reforms of the Sarbanes–Oxley and Dodd–Frank Acts. It is not surprising that many issuers would be hesitant to make the jump.

That takes us to a second important reform in the JOBS Act—the “on ramp” for emerging growth companies. This is a fairly complicated provision that says that a list of 1934 Act obligations otherwise imposed on public companies will not attach for five years after a company’s IPO unless the issuer either passes \$1 billion in annual revenues or reaches a certain high level of market capitalization before that fifth anniversary.¹⁴² These delayed-onset provisions run the gamut from auditor certification for the adequacy of the issuer’s internal controls through executive compensation provisions like “say on pay” and disclosure of the ratio between the pay of the CEO and that of the issuer’s

142. JOBS Act, Pub. L. No. 112-106, § 101, 126 Stat. 306, 307 (2012).

median employee.¹⁴³

When we started our project, we had a similar intuition as to the burdens that the growth of securities regulation was imposing on smaller companies, and thus find ourselves sympathetic to the thrust of the on-ramp idea. Easing the transition from private to public should encourage public offerings at the margins and make the debate about the right metrics for publicness under section 12 less consequential. Our sense, however, was that this was not just about incentives with respect to issuer choice about crossing the public-private divide. A separation between what is expected of smaller and emerging issuers and what is expected of large established issuers makes sense for a more profound set of reasons. As a result, in some ways the on-ramp reform does not go as far as it could have or should have. On the other hand, the Act's list of what emerging growth companies can avoid seems something of a wish list for issuers rather than a conceptually well-grounded set of exemptions. Our effort here will be both to make the stronger case and suggest a more principled way to think about the separation.

Why do we regulate the disclosure practices of public companies or impose internal controls or governance provisions on them? The orthodox account is that mandatory disclosure and its accompaniments correct for a potential market failure in the socially optimal production of information and shed sunlight on markets that otherwise would be easier candidates for fraud and manipulation.¹⁴⁴ Both of these explanations can be stated in investor protection terms as well as in terms of lowering the cost of public capital available to issuers—an efficiency-based story. Under this orthodoxy, we seek an optimal balance of the costs and benefits of disclosure given the competing interests of suppliers and users of capital (which might be internalized, in part, when the suppliers of capital become “owners” of the firm).

But there are externalities to disclosure and its adjuncts that play a large role in answering the question as well. Issuer-specific information and the integrity of stock prices generate benefits for society in many different ways—for example, in capital allocation among competing users, in promoting more competitive product markets, in helping measure wealth for tax and similar purposes, or to assist in the regulation of certain industries.¹⁴⁵ Optimal disclosure policy is never as simple as estimating whether investors would consider it cost efficient, even if that may be an important thing to know.

Although the externalities issue is well-known and widely discussed, our claim in this Part is that the extent to which—purely as a descriptive matter—securities regulation is about social, political, and economic interests, in addition to investor protection and capital formation, has been seriously

143. *Id.* §§ 102–06, 126 Stat. at 308–12.

144. Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 9 (1983).

145. Marcel Kahan, *Securities Laws and the Social Cost of “Inaccurate” Stock Prices*, 41 DUKE L.J. 997, 1005–06 (1992).

underestimated. Even though we can find hints of this going back much further in time,¹⁴⁶ we are talking here about a fairly contemporary phenomenon. It is probably safe to say that when Congress changed the definition of public status in 1964, it was creating mandatory disclosure obligations for a broader class of issuers but little else.

The transformation began in earnest in the 1970s in the aftermath of the Watergate scandals. Most directly, this led to the Foreign Corrupt Practices Act of 1977, where Congress reacted to the phenomenon of public companies paying bribes to foreign officials, even if such actions promoted the issuer’s competitiveness or profitability.¹⁴⁷ More recently, as discussed in the previous section,¹⁴⁸ Dodd–Frank imposed expensive information search and disclosure obligations on companies that use “conflict minerals” or are covered by certain mine safety rules.¹⁴⁹

These are the easy illustrations, however, and might be seen as outliers. In more subtle ways, societal interests intermingle with investor protection rationales, reaching deeply into the regulatory regime of the 1934 Act. A slightly more textured example would be environmental disclosure. Environmental compliance costs and climate change impacts can affect issuers in a material way, making this fair game for mandatory disclosure.¹⁵⁰ At the same time, however, environmental disclosure can be designed to produce societal benefits, and we strongly suspect that the motivation for action in this area cannot be explained by investor needs alone. In the pages that follow, we will survey other areas where we think the securities law responsibilities of public companies have motivations and explanations not strictly confined to their contributions to investor protection or capital formation.

To be sure, the expanding scope of securities regulation and its deep seepage into corporate governance is a familiar theme, especially among conservative critics of the growing federal presence.¹⁵¹ But we think that the debate has missed the bigger picture of what has been happening and why. In our view, securities regulation over the last four decades or so has been the joint project of experimentation in investor protection coupled with a public-driven demand for more transparency, voice, and accountability—that is, publicness as that term is

146. For a discussion, see Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

147. 15 U.S.C. § 78dd-1(a) (2006).

148. See *supra* text accompanying note 116.

149. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1502, 1503, 124 Stat. 1376, 2213, 2218 (codified at 15 U.S.C. §§ 78m(p), 78m-2). The SEC has implemented these provisions in Exchange Act Release No. 34-67716, 2012 WL 3611799 (Aug. 22, 2012) (regarding conflict minerals); Exchange Act Release No. 33-9286, 2011 WL 6415434 (Dec. 21, 2011) (regarding mine safety).

150. See Commission Guidance Regarding Disclosure Related to Climate Change, Securities Act Release No. 9106, Exchange Act Release No. 61,469, 75 Fed. Reg. 6,290 (Feb. 8, 2010).

151. See, e.g., Romano, *supra* note 109, at 2361.

applied, for example, to the evolution of global administrative law¹⁵²—as to systemically significant business enterprises.

There are two implications to all this. The first has to do with the engineering of securities law. If securities regulation were entirely (or almost entirely) about finding the efficient sweet spot that melds investor needs with promoting capital formation, the cost–benefit analysis would be a challenging but meaningful exercise. There are boundaries to how benefits and costs play out, and there are metrics to test investor reaction to regulatory changes from which we can infer whether regulation is too costly. But once we start adding layers of social and economic externalities (many of them highly complex and contingent) the exercise starts unraveling. In principle, we have no objection to asking any regulator to consider quite seriously the costs associated with any proposed change, but the benefits of focused consideration on costs diminish when there are potentially expansive and immeasurable social benefits. Cost–benefit analysis as a formal exercise, then, might not do all that much good. In the end, these are political choices, not simply economic ones. To the extent that these motivations originate from Congress, moreover, strict judicial insistence on paying attention to costs—to which the SEC has certainly been subjected recently¹⁵³—might interfere with law making entrusted to democratically elected or appointed policy makers. Costs could exceed investor benefits and still be politically legitimate.

But there is a more specific payoff to this exercise. We believe that nearly all the examples of the melding of investor and broader social interests that have changed the meaning of publicness are reactions to highly salient (usually scandalous) events involving large public companies. The FCPA was a response to foreign and domestic bribery allegations against more than four hundred large companies;¹⁵⁴ Sarbanes–Oxley was driven by the financial fraud at Enron and WorldCom; Dodd–Frank targeted the seemingly heedless risk taking by Lehman, Bear Stearns, and numerous other financial firms that survived only with extraordinary governmental intervention.

If that is right, then it is fair to say that this amorphous cluster of public law within securities regulation is meant for those companies with a large public footprint. When Enron and WorldCom fell, for example, the failures caused much damage to their shareholders and debt holders, to be sure. But the fraud also caused immense pain to employees and retirees as well as billions of dollars of losses to competitors and severe distortions in the regulated markets in which they operated.¹⁵⁵ These highly visible harms were surely part of Congress’s implicit cost–benefit assessment in designing a response.

However, most public companies have no similar footprint. They have local

152. *See supra* note 7.

153. *See* *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011) (striking down, as arbitrary and capricious, the SEC’s proxy access rule).

154. *See, e.g.*, SELIGMAN, *supra* note 24, at 449.

155. *See* Sidak, *supra* note 125.

stakeholders, to be sure, but the ripple effects from fraud or wrongdoing are contained; they are not systemically important businesses in the sense that their wrongdoing or failure will be absorbed with relatively little public notice. Yet precisely because they are public companies, they presumptively have the full burden of—increasingly costly—public company regulation under the 1934 Act. This is not entirely so—there is some element of “tiering” in both the statute and SEC rulemaking that lessens the burdens on smaller issuers.¹⁵⁶ We suggest a bolder move. We would create a distinct class of systemically significant public issuers whose regulation would be separate from most other issuers under the 1934 Act. These would be considered “public issuers.” Publicly reactive regulation (and most of the inchoate social agenda) would presumably be concentrated here, which would leave small and mid-cap companies—to which we would attach the label “reporting issuer”—free of the unintended burdens of publicness, while preserving the core of investor protection and capital formation that should be the touchstone of securities regulation in this domain. Were that to happen, in turn, some of the stress might be taken off the section 12(g) question because the burden of moving from private to public would be less.

Of course, measuring the footprint is hard as is deciding what part of securities law is the investor protection core and what is public law supplementation. The remainder of this Part elaborates on why we think that contemporary securities regulation is more of a “public law” subject than the orthodoxy assumes and then takes on that latter question by looking for the places where there may be a broader dimension to publicness than just protecting investors. We then show how our separation of public issuers into two categories would work and how this differs from what Congress has just done in the JOBS Act.

A. DISCLOSURE AND THE PURPOSES OF SECURITIES REGULATION

As we have seen, disclosure has long been the dominant thrust of federal securities regulation, so that explanations for disclosure seem to define the reach of regulation and the line between public and private. Mandatory disclosure is required by the government, as the now orthodox argument has been made, because information, if left to normal market forces, will be underproduced; information is a public good with a nonexcludability characteristic.¹⁵⁷ Manage-

156. For some time, the SEC has applied a less burdensome set of disclosure requirements on smaller issuers, first defined by reference to revenue and public float below \$25 million and more recently at a \$75 million float. 15 U.S.C. § 78(m), n(a) & (d) (2006). In determining where to place the line for a scaled requirement, however, the SEC drew on long-standing 1933 Act lines as opposed to developing any new theory. The SEC’s explanation—that the break point was intended “to include the companies that are least likely to find such a change overly burdensome”—seemed to be little more than practicality—“to use a preexisting threshold to reduce regulatory complexity” without consideration of policy on which determinations of publicness obligations should be based. Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Exchange Act Release No. 33-8089, 67 Fed. Reg. 19,896, 19,900 (Apr. 23, 2002).

157. See EASTERBROOK & FISCHER, *supra* note 118, at 286–87.

ment of the issuer, who likely will have the greatest access to information, may seek to withhold valuable information so as not to alert competitors of proprietary information; managers of individual companies might be willing to disclose such information but only if all others were required to do so.¹⁵⁸ Such mandatory disclosure can also overcome insufficient investment in standardization and specialized language, given similar collective-action problems.¹⁵⁹

Managers may also not disclose because they can benefit from the asymmetry of information. Shareholders' efforts to respond to such agency costs by managers will be limited by the collective-action problems of a large group taking the necessary action. Even if those collective-action problems could be solved, verification may be incomplete because such costs can suck up all the benefits of division of labor upon which the public corporation has been based. To the extent that multiple shareholders can and do seek to verify the same information, the result will be to overproduce some information at the same time that the overall amount of information may be underproduced.

Those arguments provide the conventional story for mandatory disclosure by government with the focus on the impact on individual firms and its investors. But the theoretical justification has also been grounded on benefits to all citizens, not just investors. Merritt Fox has noted that acceptance of the efficient market hypothesis means "the primary function of disclosure is . . . efficiency in the real economy, not investor protection."¹⁶⁰ Jack Coffee has argued that successfully reducing the costs of capital would produce macroeconomic benefits for the entire society: mandatory disclosure is the lowest costs means of correcting private markets' failures to provide adequate securities research and verification because it is a public good.¹⁶¹ As a result, Coffee says, "[o]nce we recognize that there is a social interest associated with an allocatively efficient capital market, then it is an overly narrow form of social cost accounting to calculate only the costs to issuers and benefits to investors."¹⁶²

One specific context where the public or social benefits will exceed the private benefits relates to risky deals in which the gains and losses of company decisions are not felt symmetrically. In a pattern prominently featured in analysis that followed the financial crisis, this can occur when the upside benefits of the deal, if events turn out well, produce outsized gains for the managers and the shareholders, but if the decision turns out badly, the diversified shareholder and officers who have received excessive compensation can

158. *Id.* at 290–91.

159. *Id.* at 303–04.

160. Fox, *supra* note 119, at 1415.

161. John C. Coffee, Jr., *Market Failure and the Economic Case for Mandatory Disclosure*, 70 VA. L. REV. 717, 722 (1984).

162. *Id.* at 737; *see also* COFFEE & SALE, *supra* note 40, at 6 (noting that the goal of ensuring accuracy of securities prices is "important, even apart from the goal of investor protection, because capital markets allocate a scarce resource (capital) among competing users . . . [thereby] promot[ing] efficiency and economic growth and thereby benefit[ing] all citizens, not simply investors," and arguing that public and social benefits of disclosure exceed private benefits of disclosure).

walk away from a limited liability entity and the costs are borne by the taxpayer providing deposit insurance or a government bailout.¹⁶³ As occurred in the aftermath to the financial meltdown, employees of such firms that experience the negative impacts lose jobs, the unemployment rate rises, government revenue drops and its safety-net expenditures increases, and, in a worst case scenario, credit freezes up and economic activity stalls.¹⁶⁴

American securities regulation reflects recurring efforts to prevent such externalization and those efforts have grown over the last decade. Congress included in the 1934 Act a detailed description of the necessity for regulation, which specified “widespread unemployment and the dislocation of trade, transportation, and industry” that required such great expense from Government “as to burden the national credit.”¹⁶⁵ Various New Deal iterations of social control over finance reflect the benefits for the public as much or more than investor benefits.¹⁶⁶

The last two important securities reform laws illustrate this broader focus. Sarbanes–Oxley reflects the “political instinct that the incentive structures in modern public corporations generate risks that require public (not just investor) accountability to be legitimate.”¹⁶⁷ Section 404 of Sarbanes–Oxley enhances auditing and financial reporting as too risky behavior; there is a ban on loans providing too tempting an incentive structure for executives; independent directors are given special responsibility for promoting more transparency and given additional functions that are likely to shift more of their role from solely monitoring investor concerns to risks that unduly affect the larger society;¹⁶⁸ and auditors and lawyers are drafted to help independent directors to perform this public accountability function as gatekeepers, not only to protect investors, but perhaps to serve the broader public purpose.

The learning of the financial crisis, as reflected in the provisions of Dodd–Frank, seems to underline and highlight the earlier worry. Dodd–Frank doubles down the focus on misaligned incentives and their adverse impact on the larger economy. In executive compensation, for example, it imposes new requirements on shareholder say on pay, requires claw backs from executives after financial restatements, and mandates a greater role for independent directors on compen-

163. See generally DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD–FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* (2011) (discussing moral hazard in the banking context).

164. See generally Frederic S. Mishkin, *Over the Cliff: From the Subprime to the Global Financial Crisis*, 25 J. ECON. PERSP. 49, 49 (2011) (discussing the job loss and recession that followed the onset of the financial crisis).

165. 15 U.S.C. § 78(b) (1934).

166. See generally A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 VA. L. REV. 841 (2009) (describing social control over finance).

167. Langevoort, *supra* note 127, at 1820.

168. *Id.* at 1831 (“[I]ndependent directors are meant to be speed bumps for otherwise risky behavior.”).

sation committees.¹⁶⁹ Requiring disclosure of a ratio between the CEO's pay and the median worker's pay at the company seems to reflect concern for stakeholders other than shareholders. Admittedly, more of Dodd–Frank's reforms (capital requirements, resolution authority) are limited to entities in the financial sector but illustrate a generic concern for externalization.

The externalization-based theory of securities regulation has not received as much academic attention as traditional economic theories framed as investor protection. The point is fairly simple. As public law scholars have been pointing out for some time, there are certain norms of social legitimacy increasingly placed not only on government actors, but on private institutions that exercise substantial power and have the capacity to inflict considerable harm on society.¹⁷⁰ These norms include a reasonable degree of transparency, some level of accountability, and an openness to external voices. We believe that any rule of securities regulation that promotes any of these norms is likely to be motivated, at least in part, by that inchoate sense of the public responsibility of "private" institutions.

We are not the only ones to suggest something like this. Hillary Sale has said recently: "The scrutiny comes from more than just shareholders—the traditional governance partners. It comes from the media and Main Street. Publicness results."¹⁷¹ The core sense is that things like transparency, accountability, and openness to external voices are expected of large American corporations. This is the world more often populated by administrative and constitutional law and political science, where the sovereign's power, along with its monopoly powers and ability to coerce, require such characteristics to legitimize the exercise of power. Cary Coglianese analogizes corporations to government based on the presence of power triggering a similar need for legitimacy and suggests a movement in corporate America toward institutional features that typically have been characteristics of government.¹⁷² He finds corporate governance as akin to procedural legitimacy, which in the political realm is defined in terms of democratic accountability with elections as its principal defining characteristic along with separation of power, transparency, and rule of law. Government regulation in the corporate realm is analogous to substantive legitimacy in the political realm akin to what a constitution does. It says even a procedurally legitimate board "cannot take actions that will pollute the environment, treat their workers badly, or take money from investors."¹⁷³

There are, of course, obvious differences. Corporations do not typically have

169. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 951–52, 954, 124 Stat. 1376, 1899–1900, 1904 (2010) (codified at 15 U.S.C. §§ 78n-1, 78j-3, 78j-4).

170. See, e.g., Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543 (2000); see also *supra* note 9.

171. Sale, *supra* note 10, at 148.

172. See generally Cary Coglianese, *Legitimacy and Corporate Governance*, 32 DEL. J. CORP. L. 159 (2007) (arguing that the parallels between state governance and corporate governance are growing).

173. *Id.* at 162.

the power of coercion that governments have and monopolies in the corporate realm are subject to government challenge. Corporations are subject to the constraints of various private markets, including the ability to exit that does not regularly happen in government given the monopoly powers of government and the coercive characteristics already mentioned. Yet, the size of many corporations gives them a power that can justify public concepts of legitimacy. As evidenced by the financial crisis, overpowering management incentives and the ability to externalize losses to others when risks turn out badly creates something like a negative monopoly for an individual company over the larger market that can create a similar need for legitimacy. We do not resolve here the degree of explanatory power of this externalizing justification except to recognize congressional decision to base some additional regulation on this source. Where the size of the corporation, the large incentives to management, and the interconnection of downside risks means that corporations will have an externalizing effect beyond their own shareholders, government cares about using independent directors to bring transparency for audiences beyond just shareholders and to let independent directors act as conduits as to matters that might put some stakeholder groups at risk.¹⁷⁴

B. TWO LEVELS OF PUBLICNESS

Our proposal would separate out the largest issuers (public issuers) for full publicness treatment rather than just exempting the smallest. It is based on an entirely different theory of why we regulate public companies than heretofore has been articulated for any “tiering” of issuers and would put a far larger number in the residual category of “reporting issuers.” Hence, our break point would be at a different end of the spectrum, reflecting the view that “big footprint” issuers are the exception, not the norm. The current standard (embedded in the JOBS Act’s on ramp and other securities law contexts) for the largest issuers uses a \$700-million-market capitalization test,¹⁷⁵ which strikes us as suitable enough for our purposes—the top 20% to 30% of all registered companies.

As to the substance of disclosure in the two realms, we do not have the time or space to go item by item through Reg S-K and other disclosure instructions to decide what should apply to both and what applies only in the true public

174. See Langevoort, *supra* note 127, at 1831.

175. JOBS Act, Pub. L. No. 112-106, § 101(a), 126 Stat. 306, 307 (2012) (referencing the definition of “large accelerated filer” in Rule 12b-2). This is also the test for “well-known seasoned issuer” for 1933 Act purposes, and when that designation was adopted in 2005, the SEC estimated that it covered approximately thirty percent of all public issuers and that the total market capitalization for such issuers was approximately ninety-five percent of total equity market capitalization. See Securities Offering Reform, Exchange Act Release No. 52,056, 70 Fed. Reg. 44,722, 44,727 (Aug. 3, 2005). In the SEC’s 2011 staff study relating to internal controls, the category of “large accelerated filer” included 18.4% of public issuers. See OFFICE OF THE CHIEF ACCOUNTANT, SEC, STUDY AND RECOMMENDATIONS ON SECTION 404(b) OF THE SARBANES-OXLEY ACT OF 2002 FOR ISSUERS WITH A PUBLIC FLOAT BETWEEN \$75 AND \$250 MILLION, at 29–30 (2011), available at <http://www.sec.gov/news/studies/2011/404bfloat-study.pdf>.

sphere. We have already noted a number of requirements that we are quite sure were meant for large issuers (conflict minerals, some environmental disclosures) but there are many more that, on reflection, belong only in the public issuer category. The touchstone for what is meant for reporting companies alone should be strict value relevance, that is, a tight connection between the information and the process by which conventional fundamental investment analysis is done. To be sure, this will not always be an easy separation to draw, as the following two examples will show. The payoff for our approach is in the separation itself—we expect that where the broader conception of publicness is at work in producing regulation, it is less likely to spill over to companies that are not in the top-tier public category.

1. Internal Controls

Government requirements for corporate internal controls over auditing processes increased with SEC action in 1978, but Sarbanes–Oxley brought a new specificity and a new visibility to this element of regulation.¹⁷⁶ Section 404(a) required management to maintain an adequate internal control structure with a yearly assessment.¹⁷⁷ Section 404(b), in turn, required the company’s auditor to “attest to, and report on, the assessment made by the management,” a task that added considerable expense to public companies.¹⁷⁸

This new requirement for internal controls produced the sharpest cleavage in terms of differentiating public companies. The SEC initially gave smaller public issuers additional time to come into compliance,¹⁷⁹ and Dodd–Frank permanently exempted smaller companies from the requirements of 404(b).¹⁸⁰ Until the further reform in the JOBS Act, the break point chosen for companies that would remain subject to a higher level of internal controls was the \$75 million public float threshold from the prior rule making.¹⁸¹

This particular break point aside, we see internal controls as a good example of a melding of investor and societal interests. Simply on investor protection grounds, evidence supports the view that internal control improvements have generated substantial benefits to investors but at fairly high costs. These costs

176. *See, e.g.*, 15 U.S.C. § 78dd-1(a) (2006); *id.* § 78m(b)(2)(B) (requiring public companies to “devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are executed in accordance with management’s general or specific authorization” and “as necessary . . . to permit preparation of financial statements in conformity with generally accepted accounting principles”).

177. *Id.* § 7262(a).

178. *Id.* § 7262(b).

179. *See, e.g.*, Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 49,313, 69 Fed. Reg. 9722, 9722 (Mar. 1, 2004).

180. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989G(a), 124 Stat. 1376, 1948 (2010) (codified at 15 U.S.C. § 7262(c)).

181. *Id.* (“Subsection (b) shall not apply with respect to any audit report prepared for an issuer that is neither a ‘large accelerated filer’ nor an ‘accelerated filer’ as those terms are defined in Rule 12b–2 of the Commission (17 C.F.R. 240.12b–2).”).

diminish in relation to those benefits as the size of the issuer grows larger. This suggests that Congress had Enron and WorldCom firmly in mind, so that internal controls have a public (in addition to investor) purpose. The story is not hard to tell. The cluster of internal control rules try to mandate the involvement of outside auditors, lawyers, and independent directors more deeply inside the ordinary business operations of the firm as an attempt to loosen the autonomy of management over the company’s core operations, including its ability to determine in secret how much risk to take on. The financial crisis has taught that this hope may have been in vain, at least at highly complex banking and quasi-banking institutions, but that does not diminish the obvious intrusion into managerial prerogative occasioned by the rules. Indeed, the governance reforms taken in Dodd–Frank just push on this harder.

That said, it does seem clear enough that internal controls (including auditor certification) have some value relevance. A Dodd–Frank generated special study by the SEC staff looked at the economic consequences and academic literature on the role of internal controls for smaller companies above the \$75 million threshold and concluded that the case for keeping the Sarbanes–Oxley standards for that category of issuers was stronger than the case for relaxing them.¹⁸² It seems intuitive enough that internal controls are a healthy discipline for smaller issuers—and that investors consider information about material weaknesses of the sort generated by this discipline valuable—but the question is at what cost (with costs understood broadly, as described above).¹⁸³ We regard this as a close call that could go either way on narrow investor protection grounds but do not think that investors would be seriously threatened by limiting auditors’ review of internal control procedures to truly public companies. The investor capital at risk with respect to material weaknesses in internal controls is heavily concentrated among large issuers.¹⁸⁴

2. Governance

If the political instinct in securities law reform over the past few decades

182. See SEC STAFF STUDY, *supra* note 175, at 112. This issue was complicated when the SEC and the Public Company Accounting Oversight Board (PCAOB) changed the interpretation of the internal controls requirement in 2007 in a fairly issuer friendly way, which significantly changed the cost-benefit calculus from before. For a study of the earlier period concluding that, “[o]n net, [Sarbanes–Oxley] compliance reduced the market value of small firms,” see Peter Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices*, 65 J. Fin. 1163, 1163 (2010).

183. A separate study by SEC staff of issuer perceptions of the costs and benefits of section 404 notes a significantly more negative perception by managers of smaller firms as to the net of costs and benefits than among larger issuers. See Cindy Alexander et al., *The Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective* 22, 27 (Mar. 2010) (unpublished manuscript) (on file with the Financial Intermediation Research Society), available at <http://apps.olin.wustl.edu/FIRS/PDF/2010/1608.pdf>.

184. See Cindy R. Alexander & Kathleen Weiss Hanley, *Regulatory Monitoring Under the Sarbanes–Oxley Act* 25 (Sept. 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=1022161> (finding that “the potential economic capital at risk of a disclosure of a material weakness in [a] large compan[y] is 11 times greater than in a smaller company”).

includes the desire to open up private control over socially important businesses, the “creep” in federal corporate governance found in Sarbanes–Oxley and Dodd–Frank is surely an expression of that instinct. For example, both laws imposed broad new roles on independent directors, roles that take them beyond their traditional role of looking out for shareholder interests. In Sarbanes–Oxley, the focus was the audit committee, requiring independent members with at least one financial expert. Dodd–Frank requires independence for compensation committee members.¹⁸⁵ Both of these requirements turn on exchange listing, a subset of public companies, and the threshold for the original 1934 Act.¹⁸⁶ Directors’ and officers’ roles have not been a typical subject of federal law, which leaves the core boundaries of duties and procedures to laws provided by the states.¹⁸⁷ When Congress did act, it chose to focus on defining director duties in a way that would address the public impact of corporate decisions more than the investor impact. Now we see new federal efforts to regulate officer conduct, particularly to restrain misaligned incentives of officers leading to decisions that visited harm on employees, consumers, and others outside the corporation.¹⁸⁸

Enhancement of shareholder governance had not been part of the reforms of Sarbanes–Oxley, suggesting less of a direct concern about the need to protect investor rights.¹⁸⁹ They returned in Dodd–Frank via authorization of proxy access for shareholders to nominate candidates for board of directors and advisory shareholder votes on compensation. Notably, these are parts of the shareholder process that have been most of interest to institutional shareholders and particularly the subset of institutional shareholders made up of public employee pension funds and union pension funds, the portion of the shareholder census that is most open to concerns of the impact of corporations beyond the corporation’s internal boundaries. The new whistleblower rules also seem designed to cut open the corporation to expose wrongdoing, in ways that have seriously antagonized corporate managers.

The obvious criticism of characterizing the federal governance reforms in this way is that there is, as yet, little evidence of observable payoff in terms of either shareholder or stakeholder interests. Proxy access might be a way of moderating the risk preferences of company insiders who otherwise have control over the election process, for example, but that requires the assumption that shareholders’ nomination and voting preferences will display greater risk aversion. In

185. See Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (codified at 15 U.S.C. § 78j-3).

186. See *supra* Part I.

187. See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 860–61 (2003).

188. See *supra* text accompanying note 142; see also JOBS Act, Pub. L. No. 112-106, §§ 101–106, 126 Stat. 306 (2012).

189. Langevoort, *supra* note 127, at 1829 (noting that Sarbanes–Oxley’s failure to empower shareholders suggests that the act was not intended to address classic agency cost problems but was meant to create more public accountability).

fact, as Bill Bratton and Michael Wachter have shown, shareholders are likely to be cheerleaders for risky behavior, especially during boom times.¹⁹⁰ It is hard to find dramatic results from increased independent director involvement on audit and other key committees, although there is some evidence linking independence (especially when the directors are trained in accounting or law) to greater conservatism in financial reporting.¹⁹¹

But our claim here does not depend on the success of the intervention in serving social ends. We concede that these may be emotional, expressive, or purely political moves by Congress, although our impression is that they have—combined with other social forces affecting large businesses—lessened the free exercise of private managerial power inside public companies. And these can be costly interventions, so that we can hardly be sure that the cost–benefit trade-off is necessarily favorable when the benefits are so diffuse. But that is precisely our point: we cannot deny the democratic legitimacy of subjecting private institutions to greater public transparency, but we do hope to focus this attention on the largest of companies whose footprints are substantial and separate off those public companies with smaller footprints that are most at risk from costly interventions without offsetting social benefits.

C. CONTRASTING THE “ON RAMP”

Our proposal would have a permanent separation of the two classes of issuers, public and reporting, with firms crossing from one category to another based on a fairly simple metric of market capitalization. We suspect that the differences between what is required of merely reporting companies would be significantly (and justifiably) less than what is required of public companies.

This gives us the opportunity to compare and contrast the on-ramp innovation of the JOBS Act, which puts a temporal dimension to this separation, allowing issuers as much as a five-year break from full 1934 Act regulation after their IPO unless they hit a high revenue or market capitalization threshold before that anniversary. On the other hand, the list of privileges associated with on-ramp status is fairly small in contrast to what we envision. To us, it is little more than a list of items managers of emerging growth companies find discouraging, with the hope that taking them away will make it somewhat less bothersome to make a public offering. Congress could have made a much bolder statement by following our proposal.

Does it make sense to introduce a temporal dimension to 1934 obligations? We see some point to connecting how recent the IPO was to the issuer’s size. Because such a company will almost always be going through the rite of passage of an IPO, there is an alternative discipline of SEC review and a more

190. William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69 (2011).

191. Jayanthi Krishnan et al., *Legal Expertise on Corporate Audit Committees and Financial Reporting Quality*, 86 ACCT. REV. 2099, 2103 n.5, 2126–27 (2011).

intensive liability regime to which it will recently have been subject. In addition, we suspect that some of the pathologies that require strong disclosure and governance interventions are associated with issuer age—firms acquire bad habits in terms of things like internal controls and executive compensation over time, in ways that are different in companies still in the fast-growth stage following their IPO. On the other hand, precisely because the immediate post-IPO period is characterized by rapid growth, the change itself may introduce stresses that suggest the need for special caution.

Having said all this, it should be emphasized that the exercise leading to the on ramp in the JOBS Act was not a rigorous assessment of the relative costs and benefits to investors of the list of rules to which emerging growth companies would not be subjected. It was instead presented simply as a set of incentives to go public. The test for whether this was good public policy will come only to the extent that entrepreneurship is encouraged and jobs created—on which we are skeptically agnostic—in ways that outweigh any harm to investors from the regulation that disappears.

CONCLUSION: OBSERVATIONS ABOUT THE REGULATORY PROCESS

Our inquiries into the various issues put in play by the Facebook problem reflect the fact that these boundary issues along the public–private divide are under theorized and, up until recently, left to resolution by reference to regulatory legacies from a time far different from today’s trading markets. The JOBS Act has no theoretical coherence either—it is a bundle of changes united simply by the hope that they will promote capital formation and create jobs—and so this effort to bring more rigor to the publicness question remains important. We have tried to sort out what regulatory objectives are of enduring value in the context of technology-driven markets from what no longer makes much sense.

But we mapped this area for another reason. While statutory law, rule making, and enforcement capture most of the attention, most of securities regulation happens through less formal channels—staff judgments expressed through negotiations over transactional filings (word of which gets out), staff pronouncements, “telephone interpretations,” no-action letters, and the like.¹⁹² With respect to our subject, this takes place within one division of the SEC, Corporation Finance, and without much, if any, involvement by the Commissioners themselves. It is generally outside the purview of what we would formally call administrative law.¹⁹³ The obvious example here is the tolerance—intentionally or not—of widespread bundling and other mechanisms that made a

192. See Cox et al., *supra* note 18, at 12–13. On the motivations behind these informal processes, see Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591 (2006).

193. The failure of administrative law to address adequately what agencies do not do as well as what they formally do is well recognized. See, e.g., Lisa Schultz Bressman, *Judicial Review of Agency Inaction: An Arbitrariness Approach*, 79 N.Y.U. L. REV. 1657, 1684–85 (2004).

mockery of section 12(g) long before the Facebook problem burst out of these back channels into the political and legislative process. By and large, issues like the ones we have addressed along the public–private divide are handled informally by the SEC staff. After an initial round of rule makings under the JOBS Act, its implementation will be informal as well.

Informal regulation is usually reactive, which ties back to our interest in marketplace technology and innovation. As innovation occurs, new spaces open rapidly, and the question of what regulation applies will often not easily be answered. Nimble lawyers and their clients will quickly claim—and maybe go ahead and occupy—these spaces as involving low-intensity regulation. Sometimes they will quietly clear this occupation with the SEC staff in advance and sometimes they just move in, waiting to see if there is push back. In turn, sometimes the staff acquiesces (perhaps with conditions or stipulations), while other times it simply does nothing.¹⁹⁴ If no barriers appear, the movers claim their interpretation as good law and pack more and more deals into that space. Over time, the space can become densely occupied and a way of doing business. By the time Facebook and others were able to take advantage of the fast-growing marketplaces for private share trading, for example, established practice was on their side, even if the law was still murky.

Sooner or later, the staff and others may realize that there are problems. But the regulatory dynamic is now different. The Commissioners and staff may be reluctant to acknowledge publicly that their earlier inaction may have contributed to the problems, which may make it harder to address them candidly. More importantly, once the space is heavily and profitably occupied, the occupants will use whatever political resources are at their disposal to hold onto it. They will cry about the costs and burdens of upsetting established transactional routines. Although reforms may well occur, they are likely to be less than what the Commission would have done *ex ante*.

This kind of reactive, informal regulation has both advantages and disadvantages—we do not necessarily mean to be critical here. As is the goal of much “new governance” theory, this style of regulation is incremental and experimental and, hence, fairly flexible.¹⁹⁵ That is a tremendous virtue when the costs and benefits associated with some innovation are ambiguous, as they frequently are. Real empirical data can be generated to aid in further consideration. Moreover, the informality and opaqueness of the regulatory action or inaction may insulate it to some degree from the political posturing and bargaining that occurs with legislation and formal administrative rule making. John Coates has written about how quiet flexibility contributes significantly to the success of U.S.

194. This can be the product of deliberate choice, lack of information, cognitive limitations, or some combination of the three. On the latter, see Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 *STAN. L. REV.* 1, 21–36 (2003); Langevoort, *supra* note 192, at 1608–12.

195. See, e.g., Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 *AM. BUS. L.J.* 1, 6–11 (2008).

securities regulation.¹⁹⁶

But the success of any such informality is highly contingent. It requires a motivated SEC staff, reasonably prompt awareness of the nature of the innovations, the resources to find out what is not known, and enough sophistication to bargain hard with the fast movers. When political winds change frequently, other priorities call, and top staff come and go, we cannot always count on these. The connection between the technology-driven pace of innovation and this style of regulation then becomes a significant concern. As that pace accelerates, more and more spaces open up for potential occupation.

We stress this because we have some unease with what certain of the JOBS Act reforms are likely to set in motion. As we have noted, for example, the section 12(g) change from 500 record shareholders to 2,000 may not mean all that much so long as exchange-based listings are normal for issuers seeking liquidity for their shares. But the stealth growth of alternative markets for “private” and smaller issuers and the creative ways that shareholdings can be fashioned in high-tech settings, coupled with the global fragmentation of trading across the board for all kinds of issuers, raises the distinct possibility that, in a few years from now, listings will not be an obvious preference for many issuers. If that happens, the JOBS Act reform will be seen in an entirely different light. How well the public interest will be served by the interplay between opportunistic innovation and reactive informal regulation remains to be seen. But, without more stable funding and support for the work of the SEC, we worry that this will be an increasingly one-sided sequence of negotiations. Although the political battles over the Commission’s resources have many dimensions, we fear that some of the motivation for keeping the agency partially starved is to assure precisely that outcome.

196. See John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT’L L. 531 (2001).