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## Principles for Publicness

Onnig H. Dombalagian

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## PRINCIPLES FOR PUBLICNESS

*Onnig H. Dombalagian\**

## Abstract

What duties does a “public” company owe investors, markets, and society? In recent years, Congress has both strengthened and diluted the federal disclosure and corporate governance regime that applies to public companies in the United States. However, it has never articulated a framework for what it means to be “public,” and how the obligations of public companies should reflect the needs of the constituencies whose financial and social interests they affect. As a result, firms fear that becoming public is an impediment to growth, and they game gradations of publicness to avoid compliance burdens. This Article proposes reframing the regulation of public companies under U.S. securities law around three regulatory principles: (1) suitability, (2) efficiency, and (3) representativeness. These principles—and associated tiers of regulation—will enable stock exchanges, investment banks, and other market intermediaries to shepherd companies toward heightened degrees of public exposure and accountability as their capital-raising needs evolve.

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## INTRODUCTION

What duties do “public” companies owe investors, markets, and society? Policy makers and academics have struggled to provide a satisfactory answer to this question for over eight decades, and Congress has revisited the issue more than once in recent years.<sup>1</sup> The Sarbanes–Oxley Act of 2002 (Sarbanes–Oxley)<sup>2</sup> and the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd–Frank) strengthened

1. See, e.g., Donald C. Langevoort & Robert B. Thompson, “Publicness” in Contemporary Securities Regulation After the JOBS Act, 101 GEO. L.J. 337, 339–41 (2013) [hereinafter Langevoort & Thompson, *Publicness*]; A.C. Pritchard, *Revisiting “Truth in Securities” Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1013–18 (2013); Hillary A. Sale, *The New “Public” Corporation*, 74 LAW & CONTEMP. PROBS. 137, 143 (2011).

2. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of the U.S. Code).

the disclosure and corporate governance obligations of public companies,<sup>3</sup> while the Jumpstart Our Business Startups Act of 2012 (JOBS Act) later exempted “emerging growth companies” from many of those same obligations.<sup>4</sup> Commentators who favor deregulation question the utility and indiscriminate application of the disclosure, verification, and governance requirements that federal securities law imposes on public companies.<sup>5</sup> Meanwhile, advocates of greater public accountability lament that deregulatory mandates threaten not only the transparency and accountability of corporations to society but also individual investors’ access to public trading opportunities.<sup>6</sup>

The debate endures in part because federal securities law has never satisfactorily answered two fundamental questions: (1) what does it mean for a company to be “public”?; and (2) how should the law calibrate the obligations of “public” companies to the constituencies whose financial and social interests they affect? As Professors Donald Langevoort and Robert Thompson have recounted in a series of recent articles, the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) assume two very different models of publicness in imposing disclosure standards, governance requirements, compliance burdens, and other regulatory obligations on companies subject to U.S. law.<sup>7</sup> The disconnect between these Acts reflects their different

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3. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code).

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

5. See, e.g., STEPHEN M. BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* 16–19 (2012); Jill E. Fisch, *Leave It To Delaware: Why Congress Should Stay out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 744–69 (2013) (criticizing Congress’s attempt to federalize certain aspects of corporation law under Dodd–Frank in response to perceived failures of Delaware law); Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (questioning the soundness of the mandatory corporate governance provisions of Sarbanes–Oxley in light of the empirical finance and accounting literature).

6. See Zachary J. Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. REV. 745, 799–801 (2013) (noting the consolidation of share ownership and arguing that expanding private securities markets will “crowd out” retail investors); Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 235–41 (2012); Usha Rodrigues, *Securities Law’s Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3394 (2013) (arguing that private markets create “stock exchanges for the rich”).

7. See Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013) [hereinafter Thompson & Langevoort, *Redrawing*] (contrasting the regulatory regimes applicable to public and private capital-raising transactions under federal securities law); Langevoort & Thompson, *Publicness*, *supra* note 1, at 343–46 (debating the breakpoints at which companies should assume public disclosure and corporate governance obligations under federal securities law); Donald C. Langevoort & Robert B. Thompson, *IPOs and the Slow Death of Section 5*, 102 KY. L.J. 891, 911–

backstories<sup>8</sup> and the fundamental difference in their approaches: the Securities Act regulates the process of “becoming” public, whereas the Exchange Act regulates the status of “being” public.

As a practical matter, federal securities regulators and policy makers have historically deferred to exchanges, investment banks, market makers, and other market intermediaries to craft heightened degrees of public exposure and accountability as the capital-raising needs of companies (or the liquidity needs of their shareholders) evolve.<sup>9</sup> As federal securities law has calcified around metrics for scaling regulatory obligations,<sup>10</sup> market intermediaries have lost the flexibility to consider novel combinations of privileges and obligations, while policy makers have buried much of the principle that underlies the spirit of the law. Moreover, as companies increasingly find themselves in the cross fire of hot-button social issues, policy makers ratchet up disclosure without revisiting the multiplicity of roles that securities law plays.<sup>11</sup> In response, issuers increasingly perceive the cost of publicness as an impediment to growth and may game the boundary between gradations of publicness to delay or avoid compliance burdens.<sup>12</sup>

For securities law to regain its footing, the answers to these questions must be grounded in principle. When the goal of regulation is solely to level the playing field between issuers and security holders, the law should mandate governance, disclosure, and compliance mechanisms only to the extent that investors lack the sophistication and leverage to protect themselves. If confidence in the fairness and efficiency of securities markets requires heightened regulation, the law should identify the constituencies whose confidence is at issue and weigh the costs of additional obligations against the benefits to those market participants.

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12 (2013–14) [hereinafter Langevoort & Thompson, *IPOs*] (discussing the erosion of the Securities Act’s restrictions on the marketing of public offerings).

8. See generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 49–72 (3d ed. 2003) (recounting history of the Securities Act); *id.* at 73–100 (recounting the history of the Exchange Act).

9. MICHAEL E. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 21–41 (1970) (describing the role and demise of self-regulation in the decades preceding the enactment of the Securities Act); see also Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 *BROOKLYN J. FIN. CORP. & COM. L.* 317, 318–23 (2006) [hereinafter Dombalagian, *Identity Crisis*].

10. See, e.g., Jeff Schwartz, *The Law and Economics of Scaled Equity Market Regulation*, 39 *J. CORP. L.* 347, 349–50 (2014) [hereinafter Schwartz, *Law and Economics*] (discussing the trend to “gloss over” the justifications for regulatory scaling).

11. See Langevoort & Thompson, *Publicness*, *supra* note 1, at 372–73, 375–79 (describing contemporary securities regulation as a “joint project of experimentation in investor protection coupled with a public-driven demand for more transparency, voice, and accountability”).

12. See *id.* at 347; Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 *VAND. L. REV.* 1, 2 (2012).

Finally, if public companies have business relationships that are deeply interwoven in the fabric of the economy and polity of the United States, the U.S. disclosure and corporate governance regime should focus primarily on the nexus between the privileges and obligations created by those relationships.

This Article proposes reframing the regulation of public companies under U.S. federal securities law around three well-worn regulatory principles: (1) suitability, (2) efficiency, and (3) representativeness. The association of particular privileges, obligations, and regulated intermediaries with these principles is not talismanic; indeed, much of the law that governs public companies relies on these principles, implicitly or explicitly. Consequently, such principles can serve as a focal point for negotiating transitions from private to public based on the capital-raising needs of issuers and the needs of their investors, capital markets, and society. More specifically, recasting many of the privileges and obligations of federal securities law around “core principles” administered by self-regulatory bodies and regulated entities permits greater flexibility in their application over time.<sup>13</sup>

Part I of this Article briefly recites the connotations of being or becoming “public,” focusing on the burdens and benefits associated with being public or private in U.S. capital markets. Part II considers the transitions that companies face as they evolve from private to public—changes in control, transparency, and responsibility for the externalities of their business and capital-raising activities. Part III contrasts the traditional issuer-driven approach to determining how public an issuer *would* like to be with the increasing use of metrics to determine how public an issuer *ought* to be. Finally, Part IV explores an approach by which the trade-offs associated with various tiers of publicness may coalesce around the principles of suitability, efficiency, and representativeness.

## I. GRADATIONS OF PUBLICNESS

When policy makers speak of the obligations of public companies, they evoke the fabled “sweet spot” in the securities marketplace. In the United States, one might think of a corporation that: (1) is listed on a national exchange such as the New York Stock Exchange (NYSE) or the NASDAQ Stock Market (NASDAQ); (2) has shares that are actively and efficiently

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13. In the context of trading rules and business conduct regulation, policy makers have advocated the articulation of “core principles” by legislation, while leaving it to self-regulatory bodies, such as securities and futures exchanges and dealer associations, to interpret and implement them. See DEP’T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 109–13 (Mar. 2008), *available at* <http://permanent.access.gpo.gov/lps110157/Blueprint.pdf>; *see also* 7 U.S.C. § 7(d)(1) (2012) (setting forth “core principles” for the regulation of designated contract markets for futures trading).

traded by market makers and institutional investors informed by regulatory disclosures and outside information gathered by securities analysts; (3) is governed by a board elected by, and accountable to, public shareholders; and (4) offers products and services that command a national or international reach.<sup>14</sup> Of course, most companies do not spring fully formed from the forehead of Mammon: companies accumulate such privileges and assume heightened responsibilities by virtue of their capital-raising and business decisions<sup>15</sup> as well as the willingness of market participants and intermediaries to finance their progress toward various “financial milestones.”<sup>16</sup>

Nevertheless, whether one views publicness as a progressive series of stages in the “lifecycle” of a company<sup>17</sup> or simply as a series of unrelated attributes lumped under a common rubric, commentators often view publicness as an end that the law should promote in the public interest.<sup>18</sup> For example, policy makers often assert that public firms may have a better track record of creating jobs;<sup>19</sup> make investment opportunities available to a broader class of investors;<sup>20</sup> or simply provide investors, academics, and other interested parties with greater insight into how the economy operates.

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14. See, e.g., Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 564 (2013) [hereinafter Schwartz, *Twilight of Equity*]; see also Langevoort & Thompson, *Publicness*, *supra* note 1, at 374 (“[The] amorphous cluster of public law within securities regulation is meant for those companies with a large public footprint.”).

15. See *infra* Section III.A (discussing the decisions to mount an initial public offering (IPO), to list securities on an exchange, and to make securities available for trading through a central depository).

16. Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes–Oxley*, 35 CONN. L. REV. 1125, 1134 (2003); see Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 264 (1998) [hereinafter Black & Gilson, *Banks Versus Stock Markets*].

17. See Schwartz, *Twilight of Equity*, *supra* note 14, at 579 (recommending a “lifecycle model” of secondary market regulation that narrowly tailors regulatory obligations to the needs of investors as firms progress through various stages of maturity).

18. See Langevoort & Thompson, *Publicness*, *supra* note 1, at 340 (defining “publicness” as “what society demands of powerful institutions, in terms of transparency, accountability, and openness, in order for that power to be legitimate”).

19. See, e.g., H.R. REP. NO. 112-406, at 7 (2012) (asserting, as part of the justifications for the JOBS Act, that “[r]esearch indicates that 90% of the jobs that companies create are created after their IPO”).

20. See Rodrigues, *supra* note 6, at 3425, 3427–30 (surveying perspectives on the importance of investment access to unaccredited investors as a matter of providing opportunities for portfolio diversification); see also MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 28–49 (1994) (advancing the political theory that diffuse, public ownership of U.S. corporations was the product of “[p]opular animus against large financial institutions,” which led to restrictions or limitations on concentrated ownership of U.S. corporations by banks, insurance companies, mutual funds, and other financial institutions); Gubler, *supra* note

To this end, one might envision gradations of publicness delimited by market norms and investor expectations. This Article proposes four such gradations. First, one might classify a company as *publicly held* if its shares are freely alienable. Second, a company may be classified as *publicly traded* if its shares come to be actively bought and sold in a liquid secondary market. Third, a company may be classified as *publicly monitored* once an issuer adopts an internal reporting and governance architecture and engages independent external compliance oversight. Finally, a company may be classified as *publicly accountable* if its operations merit heightened public scrutiny by virtue of the economic and social impact of its business activities.

#### A. *Publicly Held*

The most basic gradation of publicness might encompass companies that have offered for sale to the general public debt or equity interests that are freely alienable without further negotiation of exit rights.<sup>21</sup> The canonical example is a company that has made a “registered public offering” under section 5 of the Securities Act.<sup>22</sup> A company may pursue a public offering for a variety of reasons, such as to access new and diverse sources of financing for growth, promote name recognition, provide an objective value for shares (and other components of managerial compensation), or provide founders and other early investors with an opportunity to exit their interest.<sup>23</sup> The expense of preparing a registration statement and prospectus that complies with the requirements of the Securities Act<sup>24</sup> and the underwriting fees charged in initial public offerings (IPOs) are, nevertheless, considerable barriers to such offerings.<sup>25</sup>

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6, at 799–801 (discussing, in addition to the benefits of portfolio diversification, the specter of wealth inequality, sharpening of class differences, and undesirable “political correctives”).

21. As a matter of state law, such companies would be distinct from those that place conditions or restrictions on the transfer of securities (such as through an agreement with or among security holders) or those whose organizational form does not permit alienation of ownership interests (such as many partnerships or member-managed LLCs).

22. See 15 U.S.C. § 77e (2012).

23. See JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* 93–94 (2006).

24. See 15 U.S.C. §§ 77f, 77j, 77aa.

25. See TIROLE, *supra* note 23, at 92–93 (noting that going public “is costly” in part because firms must incur “substantial underwriting and legal fees”); Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1116 (2000) (discussing, among other explanations for the high cost of IPO underwriting clustered at a spread of around 7%, the inelastic demand for underwriter prestige, the cost of analyst coverage and price stabilization, and syndication); Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79, 92 (1997) (noting the expense of creating registration statements and other documents incident to going public). As will be discussed in Section I.B, a public offering under the Securities Act also triggers the compliance costs, periodic disclosure requirements, and heightened liability associated with the public trading of securities.

For this reason, federal securities law has provided issuers with an ever-expanding menu of options for offering freely tradable securities to the public without the cost of mounting an IPO. The Securities and Exchange Commission's (SEC) Regulation A, for example, permits a tier of direct public offerings of up to \$5 million subject to a less onerous offering statement and circular.<sup>26</sup> In light of Regulation A's limited utility, the JOBS Act mandated a second tier of Regulation A offerings of up to \$50 million subject to enhanced disclosure obligations.<sup>27</sup> The SEC also permits offerings of up to \$1 million under various exemptions, such as the exemption in Rule 504 geared toward offerings registered or exempt under state law<sup>28</sup> and the exemption for crowdfunded offerings mandated by the JOBS Act.<sup>29</sup>

As commentators have observed, however, a new trend is to use private placements or other "back door" transactions to place securities indirectly with the public to avoid the heightened disclosure requirements for direct offerings.<sup>30</sup> Generally speaking, issuers may privately place securities (for

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*See* 15 U.S.C. § 78o(d)(1).

26. 17 C.F.R. § 230.251–263 (2014). For a description of Regulation A, see Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3927 (proposed Jan. 23, 2014); Rutheford B. Campbell, Jr., *The New Regulation of Small Business Capital Formation: The Impact—If Any—Of the JOBS Act*, 102 KY. L.J. 815, 839–40 (2013–2014) (providing that under Regulation A, the issuer may make a public offering of up to \$5 million, predicated on the filing of an offering statement and an offering circular); *see also id.* at 844 (noting Regulation A's tiered offerings).

27. 15 U.S.C. § 77c(b)(2) (requiring the SEC by rule or regulation to add a class of securities exempted under section 3(b) that may be offered in an aggregate amount not to exceed \$50 million during a twelve-month period); *see also* Campbell, *supra* note 26, at 840–41 (noting that, in the wake of the "failure" of Regulation A, the JOBS Act added section 3(b) providing an exemption for offerings of up to \$50 million); Proposed Rule Amendments, 79 Fed. Reg. at 3927.

28. 17 C.F.R. § 230.504; *see also* Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1444 (2012) (comparing Rule 504 and the JOBS Act's crowdfunding exemption).

29. 15 U.S.C. § 77d(a)(6) (requiring the SEC by rule or regulation to implement a crowdfunding exemption); Rules Governing the Offer and Sale of Securities Through Crowdfunding Under Section 4(a)(6) of the Securities Act, Securities Act Release No. 9470, 78 Fed. Reg. 66427 (Nov. 5, 2013); *see also* Cohn, *supra* note 28, at 1438 ("The exemption allows for up to one million dollars to be raised during a twelve-month period, reduced by the amount of any other securities sold by the issuer during that period."). The offering of shares through such arrangements poses idiosyncratic regulatory issues, particularly to the extent that investors may participate in crowdfunded offerings for a variety of reasons other than an expectation of profit. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 14–27 (classifying motivations for investing in crowdfunding enterprises); Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 358–61 (2012) (describing the "market for crowdfunding and crowdfunded interests in business ventures" before the JOBS Act).

30. *See generally* Thompson & Langevoort, *Redrawing*, *supra* note 7, at 1588–1604 (describing "back door" transactions such as private investments in public equity (PIPEs) and

example, in reliance on Rule 506 under Regulation D)<sup>31</sup> with certain categories of “accredited investors”<sup>32</sup> as well as additional offerees who possess the sophistication and access to information necessary to be “able to fend for themselves.”<sup>33</sup> Rule 506 placements have long enjoyed greater popularity than other exemptions (including exemptions for direct offerings) due to the opportunity for unlimited sales, no minimum disclosure requirements for accredited investors, and preemption of state law registration and qualification.<sup>34</sup> Nevertheless, the SEC has faced

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reverse mergers). Reverse mergers with an Exchange Act reporting company allow affiliates of an issuer to resell their securities immediately to the public under the cloak of the reporting company’s public status, *id.* at 1588–98, while PIPEs may allow investors in a private placement by a public company to resell their securities without triggering “underwriter” liability. *Id.* at 1598–1604.

31. 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 4.25 (6th ed. 2009); *see also* Dustin G. Hall, Note, *The Elephant in the Room: Dangers of Hedge Funds in Our Financial Markets*, 60 FLA. L. REV. 183, 190 (2008).

32. 17 C.F.R. § 230.501(a) (defining “accredited investor” by reference to regulatory status, net worth, or net income). The development of criteria for “accredited investors” is critical to the success of these efforts. *See* U.S. GOV’T ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED, GAO 13-640, 8–12 (July 2013), *available at* <http://www.gao.gov/assets/660/655963.pdf> [hereinafter 2013 AI Report] (relating the history of the definition of accredited investor). Congress and the SEC have allowed issuers to place unlimited quantities of securities with an unlimited number of accredited purchasers without any minimum disclosure requirement on the theory that accredited investors have the sophistication and leverage to negotiate for information or the capacity to absorb risk. *See, e.g.*, 17 C.F.R. § 230.501(e)(1)(iv) (excluding “accredited investors” for purposes of calculating the number of investors in Rule 505 and Rule 506 offerings); *id.* § 230.502(b)(1) note (establishing disclosure requirements for sales of securities to persons other than accredited investors subject to the caveat that the issuer “should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws”).

33. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). The SEC has implemented this principle through various safe harbors and exemptions. Among other factors, such relief may limit the number and qualifications of individuals to whom an issuer may offer or sell a security, the use of mass media and other forms of “general solicitation,” and the ability of successive purchasers to resell such securities until the issuer’s securities have “come to rest.” *See* 17 C.F.R. §§ 230.501, .502(c), .505, .506; *see also* Busch v. Carpenter, 827 F.2d 653, 656 (10th Cir. 1987).

34. Campbell, *supra* note 26, at 826–27 (discussing the reasons why Rule 506 is “very popular”). For a discussion of state law preemption, see *infra* text accompanying note 187. According to a recent series of studies by SEC staff, the amount of capital raised under Regulation D rivals that of both IPOs and Rule 144A offerings. VLADIMIR IVANOV & SCOTT BAUGUESS, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009–2012, at 8–9 (2013), *available at* <http://www.sec.gov/divisions/riskfin/whitepapers/dera-unregistered-offerings-reg-d.pdf>. Moreover, 99% of capital raised under Regulation D was raised under Rule 506, even though (1) 50% of Rule 506 offerings were for \$1 million or less and (2) an additional 20% of such offerings were for \$5 million or less, therefore qualifying for less restrictive offering rules under Rules 504 and 505. *Id.* at 7, 11; *see also* Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3967–71 (proposed Jan. 23, 2014) (proposing preemption of state

significant pressure to liberalize resales of such “restricted securities” to reduce the economic risk of participating in private placements. Today, initial investors may resell such securities after a relatively short holding period with few restrictions on the manner of offering or the extent of public diffusion.<sup>35</sup>

More recent deregulatory efforts may facilitate public diffusion of such privately placed securities more rapidly than Congress or the SEC ever intended. As required by the JOBS Act,<sup>36</sup> the SEC eliminated the prohibition against the use of the Internet and other mass media to solicit accredited investors in Rule 506 private placements.<sup>37</sup> Although Rule 506 requires issuers to take “reasonable steps” to verify the status of purchasers,<sup>38</sup> the shift from regulating offerings to verifying purchasers allows issuers to raise the public profile of their private capital-raising

securities law registration and qualification requirements for “Tier 2” Regulation A offerings of up to \$50 million); Rutheford B Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC’s Crown Jewel Exemptions*, 66 BUS. LAW. 919, 940 (2011) (criticizing the SEC’s failure to liberalize Rules 504 and 505).

35. The resale of privately placed securities by affiliates or nonaffiliates of the issuer to the public may constitute a “distribution” that exposes both the issuer and selling security holders as “underwriters” to liability for noncompliance with the registration requirement of the Securities Act. See 1 LOUIS LOSS ET AL., FUNDAMENTALS OF SECURITIES REGULATION 566–76 (6th ed. 2011) (describing interpretation of section 4(a)(1) of the Act, 15 U.S.C. § 77d(a)(1) (2012)). The SEC adopted Rule 144, 17 C.F.R. § 230.144, as a safe harbor for resales of such “restricted” securities based on factors that courts had developed to distinguish issuer “distributions” from routine “trading” transactions, including the investor’s holding period, the information available about the issuer, the amount of securities resold, the character of the selling effort, and the availability of public information about the issuer. See *id.* § 230.144(c)–(g); Definition of Terms “Underwriter” and “Brokers’ Transactions,” 37 Fed. Reg. 591, 592 (Jan. 14, 1972) (codified at 17 C.F.R. § 230.144); 1 LOSS ET AL., *supra*, at 566–81 (describing private resales under section 4(1) of the Securities Act prior to Rule 144). Over the past two decades, the SEC has progressively reduced the holding period for restricted securities and has substantially eliminated restrictions on the amount and manner of resale for persons other than affiliates of the issuer. See Revisions to Rules 144 and 145, 72 Fed. Reg. 71,546, 71,546 (Dec. 17, 2007) (to be codified at 17 C.F.R. pts. 230, 239); Revision of Holding Period Requirements in Rules 144 and 145, 62 Fed. Reg. 9242, 9242 (Feb. 28, 1997) (to be codified at 17 C.F.R. pt. 230).

36. See Pub. L. No. 112-106, § 201, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

37. See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,796 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239, 242).

38. 17 C.F.R. § 230.506(c). The ability to rely on a third-party certification from a broker-dealer (among other professionals) presents an opportunity for the Financial Industry Regulatory Authority (FINRA) to play a greater oversight role in private placements—similar to broker-dealers using their “preexisting relationships” with customers to place securities in compliance with the prohibition against “general solicitation.” See Jennifer J. Johnson, *Private Placements: Will FINRA Sink in the Sea Change?*, 82 U. CIN. L. REV. 465, 479–88 (2013); see also *infra* Subsection II.A.2.ii (discussing FINRA’s “suitability rule”).

transactions.<sup>39</sup> In light of the limited holding period for resales of privately placed securities under the SEC’s Rule 144 safe harbor, one may effectively prime the secondary retail market simultaneously with a high-profile private placement—a potential Facebook, for instance—thereby creating a “[d]eregulatory securities nirvana.”<sup>40</sup>

### B. Publicly Traded

The mere fact that securities may be freely alienated does not guarantee a secondary market populated with prospective buyers and sellers. Such a vibrant secondary market may be of critical importance to an issuer that wishes to raise money (or compensate its executives and employees) through the issuance of additional shares in subsequent transactions. The second gradation of publicness might therefore include issuers of securities traded in a secondary market that provides investors with a reasonable expectation of liquidity.<sup>41</sup> The degree of liquidity a firm enjoys depends not only on quantitative factors, such as the size and diffusion of the issuer’s capital stock, but also on the participation of intermediaries, such as broker–dealers and market makers, to facilitate investment in and trading of its shares.<sup>42</sup>

Issuers who seek to foster a secondary market for their securities must generally provide sufficient ongoing information to allow prospective buyers, sellers, and market intermediaries to negotiate prices reasonably

39. See *infra* note 115 and accompanying text.

40. Panel Discussion, *Deregulating the Markets: The JOBS Act*, 38 DEL. J. CORP. L. 476, 491 (2013) (statement of Professor Robert Thompson). Business considerations may prevent a full-blown indirect public resale market. Issuers may refuse to eliminate contractual restrictions or stop-transfer instructions to prevent the resale of securities otherwise eligible for immediate sale to avoid dealing with new configurations of shareholders. See Ibrahim, *supra* note 12, at 44. Venture Capitalists (VCs) may wish contractually to lock founders in as well. See Jose M. Mendoza & Erik P.M. Vermeulen, *The “New” Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity* 24 (Lex Research Topics in Corp. L. & Econ., Working Paper No. 1, 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1829835](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835) (explaining that founders may lose motivation to contribute to the corporation when they can start selling their shares, so firms may want to use restrictions in their “by-laws, investment term sheets or employment contracts” to prevent founders from selling their shares).

41. State corporation laws may treat securities as increasingly passive investments as the number of holders increases. For example, many states limit appraisal rights when there is an adequate opportunity to sell shares into the market. See, e.g., DEL. CODE ANN. tit. 8, § 262(b)(1) (West 2013) (creating a market-out exception from the appraisal statute for firms whose shares are held of record by more than 2,000 holders); see also MODEL BUS. CORP. ACT § 13.02(b)(1)(ii) (2002) (same). The Model Business Corporation Act further defines the oversight responsibilities of directors of public companies in light of the separation of ownership from management. *Id.* § 8.01 & cmt. (setting forth and discussing the “oversight responsibilities” of directors of public companies).

42. See generally LARRY HARRIS, TRADING AND EXCHANGES 394–409 (2003) (defining “liquidity and its various dimensions,” and identifying the “types of traders who supply liquidity” and discussing “how they compete with each other”).

related to a market equilibrium. The gold standard is the reporting regime established under section 13 of the Exchange Act.<sup>43</sup> The Exchange Act imposes reporting requirements on companies that have a class of securities listed on a national securities exchange,<sup>44</sup> meet the Act's shareholder numerosity and asset thresholds,<sup>45</sup> or undertake to become reporting companies when making a public offering.<sup>46</sup> As will be discussed in Section I.C, Exchange Act reporting subjects public companies to many additional monitoring obligations as well.

Issuers may also commit to disclosures comparable to the Exchange Act even when they are not otherwise subject to the Act's reporting regime.<sup>47</sup> Holders of publicly traded debt might require an issuer to commit to periodic reporting beyond the Exchange Act's requirements,<sup>48</sup> and qualified institutional buyers (QIBs) might require comparable compliance to sustain secondary trading under the QIB Rule.<sup>49</sup> As trading in institutional and public debt markets has become increasingly transparent,<sup>50</sup> exchanges and investment banks have renewed efforts to

43. 15 U.S.C. § 78m(a) (2012). The Exchange Act requires reporting companies to make annual, quarterly, and episodic filings with the SEC regarding their financial condition, business and operations, and management and corporate governance. 1 LOSS ET AL., *supra* note 35, at 670–88 (summarizing the reporting requirements).

44. 15 U.S.C. § 78l(a)–(b).

45. *Id.* § 78l(g)(1)(A) (raising the numerosity threshold for equity shareholders from 500 shareholders to either 2000 persons or 500 persons who are not accredited investors); 17 C.F.R. § 240.12g-1 (2014) (raising asset threshold from \$1 million to \$10 million); *see* 17 C.F.R. § 240.12g5-1 (providing rules for counting legal entities, such as corporations, for numerosity purposes); *see also infra* note 56 (critiquing counting of shareholders under section 12(g)). The JOBS Act requires the SEC to exempt crowdfunded offerings from section 12(g). 15 U.S.C. § 78l(g)(6).

46. *See* 15 U.S.C. § 78o(d).

47. *See infra* note 129–130.

48. An issuer's obligation to publish Exchange Act reports with respect to a publicly offered class of securities, such as a class of unlisted debt securities, is "automatically suspended as to any fiscal year" after the first fiscal year in which the securities of the class are "held of record by less than 300 persons." 15 U.S.C. § 78o(d).

49. Rule 144A permits unlimited resales of certain privately placed securities among QIBs subject to minimum disclosure requirements with a view to facilitating immediate trading of corporate debt and other securities in segregated institutional markets. *See* 17 C.F.R. § 230.144A (Rule 144A or the QIB Rule).

50. FINRA requires real-time reporting of corporate debt transactions. FIN. INDUS. REGULATORY AUTH. MANUAL R. 6200 et seq. (2014), *available at* [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4412](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4412) (last visited Mar. 14, 2015) [hereinafter FINRA MANUAL]; *see, e.g.*, Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change Relating to the Dissemination of Transactions in TRACE-Eligible Securities that are Effected Pursuant to Securities Act Rule 144A, Exchange Act Release No. 70,009, 106 SEC Docket 15 (July 19, 2013), *available at* <http://www.sec.gov/rules/sro/finra/2013/34-70009.pdf> (setting forth FINRA's proposal for greater post-trade transparency in Rule 144A transactions).

establish trading platforms that provide liquidity among QIBs;<sup>51</sup> ongoing reporting is a necessary complement to such efforts. Moreover, while offerings of equity securities under Rule 144A remain rare,<sup>52</sup> public or privately placed debt securities that are convertible or exchangeable into publicly tradable equity securities may create additional incentive for issuers to develop or maintain Exchange Act disclosure controls.<sup>53</sup>

Not all trading in secondary markets relies on the availability of Exchange Act reports.<sup>54</sup> Securities sold in smaller public or private equity offerings but that do not enjoy deep trading interest may rely predominantly on individual market makers in “over-the-counter” markets.<sup>55</sup> Individual dealers acting as over-the-counter market makers may hold themselves out as willing to buy and sell securities of an issuer with or without the issuer’s consent.<sup>56</sup> Market makers and broker–dealers

51. 1 EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 5.05 (11th ed. 2014) (describing unsuccessful attempts to develop organized markets or trading systems for Rule 144A securities); see Peter Lattman, *Private Goldman Exchange Officially Closes for Business*, N.Y. TIMES (Apr. 12, 2012, 5:09 PM), <http://dealbook.nytimes.com/2012/04/12/private-goldman-exchange-officially-closes-for-business/> (describing the demise of the Goldman Sachs Tradable Unregistered Equity (GSTRUE) platform due to a lack of liquidity); see also HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 3A SEC. & FED. CORP. LAW § 4:12 (2d ed.) (describing PORTAL Alliance as “an open, industry-wide platform to facilitate over the counter trading of 144A equity securities” co-sponsored by NASDAQ OMX Group and various investment and commercial banks).

52. See CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS § 7.09[A][2] (4th ed. 2006 & Supp. 2013).

53. 1 GREENE ET AL., *supra* note 51, § 7.08[3] (describing Rule 144A convertible and exchangeable securities); JOHNSON & MCLAUGHLIN, *supra* note 52, § 7.09[A] (same); see also *infra* note 129.

54. Because the Exchange Act reporting obligation terminates once the number of holders of record of a class of unlisted securities is reduced to less than 300 persons, issuers may take steps—some questionable—to exit Exchange Act reporting. See Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 140–43 (2009) (describing how firms might use reverse stock splits or self-tender offers to withdraw from Exchange Act reporting requirements); Langevoort & Thompson, *Publicness*, *supra* note 1, at 357 (suggesting that issuers might use the divergence of record and beneficial ownership to withdraw from Exchange Act reporting requirements under section 12(g)). But see 17 C.F.R. § 240.12g5-1(b)(3) (“If the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of section 12(g) or 15(d) of the Act, the beneficial owners of such securities shall be deemed to be the record owners thereof.”).

55. These may include securities listed and traded on platforms such as the Over-the-Counter Bulletin Board (OTC BB) and OTC Markets. See *infra* note 222.

56. Exchange Act 12g3-2(b), 17 C.F.R. § 240.12g3-2(b) (2014), generally exempts foreign private issuers that are not listed in the United States from Exchange Act reporting, although involuntary trading of their shares can nevertheless subject them to increased compliance costs in the United States. See Peter Iliev et al., *Uninvited U.S. Investors? Economic Consequences of Involuntary Cross-Listings*, 52 J. ACCT. RES. 473, 480–85 (2014) (noting that “[u]nsponsored OTC cross-listings can impose several costs on foreign firms, including increased exposure to U.S. legal

quoting prices for such securities must nevertheless ensure the availability of a minimum quantum of information about the issuer,<sup>57</sup> though the risk of price inefficiency, manipulation, and insider trading increases as trading interest and the degree of issuer disclosure decreases.<sup>58</sup>

In recent years, prospective purchasers of securities in traditional private placements have likewise looked to electronic trading venues for liquidity. Trading venues such as SecondMarket and SharesPost typically operate as traditional agency markets.<sup>59</sup> These venues provide only limited information to prospective purchasers<sup>60</sup> and often give issuers significant control over who can buy and sell shares, the volume of transactions, and price-setting mechanisms.<sup>61</sup> As a result, the participants in these electronic trading venues generally have independent access to (or leverage to obtain) information from the issuer without the need for mandatory disclosure.<sup>62</sup> In

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and regulatory enforcements, risk of future exchange act registration, adverse treatment of U.S. security holders, and increased difficulty in establishing a future sponsored ADR program”).

57. See 17 C.F.R. § 240.15c2-11. Compare FINRA MANUAL, *supra* note 50, R. 6530 (requiring OTC BB issuers to comply with Exchange Act reporting requirements) with *id.* R. 6432 (requiring members to comply with SEC Rule 15c2-11 to quote nonexchange-listed securities in any quotation medium). Rules 144 and 144A similarly impose minimum information requirements for resales of “restricted” securities. 17 C.F.R. § 230.144(c) (requiring public availability of information regarding the issuer by reference to Rule 15c2-11); 17 C.F.R. § 230.144A(d). The SEC has also proposed semiannual and current reporting requirements for “Tier 2” Regulation A companies. Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, 79 Fed. Reg. 3926, 3959–61 (proposed Jan. 23, 2014).

58. Pollman, *supra* note 6, at 205–20. As will be discussed in more detail below, U.S. companies may occasionally seek to list on foreign securities markets, such as alternative tiers catering to small to medium-sized companies, to take advantage of laxer disclosure requirements. See William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 659 (2009) [hereinafter Sjostrom, *Carving a New Path*].

59. Much of the interest in and publicity surrounding SharesPost and SecondMarket was attributable to pre-public trading interest in Facebook. See Sam Mamudi, *Nasdaq CEO Sees SEC Approval for Private Market*, BLOOMBERG (Feb. 5, 2014, 4:44 PM), <http://www.bloomberg.com/news/2014-02-05/nasdaq-ceo-sees-winning-sec-approval-for-private-market.html>. Nevertheless, NASDAQ has continued with plans to launch the NASDAQ Private Market to enter this marketplace. See *NASDAQ OMX and SharesPost to Form Private Market*, NASDAQ (Mar. 6, 2013), <http://ir.nasdaqomx.com/releasedetail.cfm?ReleaseID=745594>.

60. See, e.g., Pollman, *supra* note 6, at 209–10 (discussing the potentially limited value of reports coming from SharesPost). Some electronic trading venues may seek to aggregate publicly available information for the benefit of their participants as a means of quelling concerns about the lack of sufficient information or the accuracy of their valuation. See Mendoza & Vermeulen, *supra* note 40, 19–20 (describing SharesPost’s Venture-Backed Index and the additional informational services provided with respect to its component securities).

61. Memorandum from Annemarie Tierney, General Counsel, SecondMarket 2, 5 (Sept. 12, 2011), available at <https://www.secondmarket.com/wp-content/uploads/2014/12/Memo-on-SecondMarkets-Legal-Framework-SecondMarket.pdf>.

62. Sellers in such markets have consisted largely of founders, employees, and early investors. See Ibrahim, *supra* note 12, at 16–18; Mendoza & Vermeulen, *supra* note 40, at 17

raising the Exchange Act's reporting threshold with respect to accredited investors and eliminating the prohibition against general solicitation for certain Regulation D offerings, the JOBS Act has signaled a willingness to promote secondary trading in these systems.<sup>63</sup>

### C. Publicly Monitored

A third gradation of publicness might encompass those firms whose demand for liquidity requires greater accountability to a larger financial community, including analysts, market makers, investment and commercial banks, and brokers.<sup>64</sup> Internal and external monitors provide assurances as to the accuracy of historical information and the good faith basis for forward-looking information: analysts, market makers, and professional traders transform such information into prices, price targets, or trading interest, while banks and broker-dealers rely on such prices for purposes of extending credit against securities collateral and managing their trading inventory and financial exposure.<sup>65</sup> In response to Enron-era

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(describing the composition of sellers in SecondMarket). Buyers have included venture capital firms, private equity funds, and other institutional and accredited investors. *See* Ibrahim, *supra* note 12, at 19–20; Mendoza & Vermeulen, *supra* note 40, at 18 (describing the composition of buyers in SecondMarket). These buyers might also simultaneously purchase securities in such markets alongside direct purchases from an issuer or otherwise negotiate for direct access to information from an issuer. *See* Ibrahim, *supra* note 12, at 19–20.

63. *See* JOBS Act of 2012, Pub. L. No. 112-106, 126 Stat. 306, 325 (codified as amended in scattered sections of 15 U.S.C.); *supra* note 37 and accompanying text; *see also* *Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation: Hearing Before the H. Subcomm. on Capital Mkts. and Gov't Sponsored Enterprises*, 112th Cong. 35–36 (2011) (statement of Barry E. Silbert, Founder and CEO, SecondMarket), available at <http://financialservices.house.gov/uploadedfiles/112-63.pdf> (highlighting the 500-shareholder reporting threshold and the prohibition against general solicitation as “regulatory hurdles” that restricted the ability of start-ups to remain private).

64. This notion of public monitoring to a certain extent relates to the need for accurate pricing of securities, particularly in response to new information such as earnings estimates, business projections, and contingencies. Studies of the “mechanisms of market efficiency” focus on the variety of mechanisms and degree of costs incurred in acquiring, processing, and validating information. Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 594–609 (1984) (observing that the cost of acquiring, processing, and validating information turns on factors such as the initial distribution of information, the size and organization of the marketplace, and the incentives of the analysts, market makers, exchanges, and other intermediaries that sustain it).

65. *See, e.g.*, Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW. 863, 867 (1992) (describing how the real-time calculation of broker-dealer net capital under the SEC's Net Capital Rule relies on the market prices of its securities and commodities positions); NYSE Rule 431 (margin rule for NYSE members); *see infra* note 184 (discussing the Federal Reserve Board's margin rules for broker-dealers and banks). Institutions that extend securities credit are arguably among the most sensitive to disruptions in price continuity to the extent that the value of their collateral is pegged to market prices. *See, e.g.*, Securities Credit Transactions, 61 Fed. Reg. 20,399, 20,402 (proposed May 6, 1996) (seeking comment as to whether the SEC's “ready market” criteria

accounting scandals, Sarbanes–Oxley requires all Exchange Act reporting companies to establish and maintain internal controls over financial reporting and disclosure and to obtain an attestation on management’s internal control assessment from its external auditor.<sup>66</sup>

Higher levels of public monitoring may also follow from the voluntary decision to list on a stock exchange (and the attendant market making and analyst exposure that follows). To be eligible for listing on an exchange, issuers must typically meet certain quantitative thresholds that build on Exchange Act metrics.<sup>67</sup> Moreover, stock exchanges may apply additional disclosure obligations through their listing standards to ensure real-time price discovery and price continuity<sup>68</sup> as well as corporate governance criteria aimed at “maintaining appropriate standards of corporate responsibility, integrity and accountability to shareholders.”<sup>69</sup>

Federal securities law has long viewed an issuer’s voluntary decision to seek an exchange listing as sufficient justification to impose additional disclosure and governance rules.<sup>70</sup> Building upon existing exchange

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are sufficient to warrant permitting extensions of credit against over-the-counter equity securities by broker–dealers).

66. 15 U.S.C. § 7262(b) (2012).

67. These include total market capitalization, number of shareholders, before-tax earnings from operations, cash flows, and revenues. *See, e.g.*, N.Y. STOCK EXCH. LISTED CO. MANUAL § 102.01 (2012) [hereinafter NYSE MANUAL]; NASDAQ STOCK MKT. R. 5315(e), (f) (NASDAQ Global Select Market), 5405(a), (b) (NASDAQ Global Market), and 5505(a), (b) (NASDAQ Capital Market).

68. *See, e.g.*, NYSE MANUAL, *supra* note 67, § 201.00 (emphasizing the need for continuous and timely disclosure of information “that may affect security values or influence investment decisions” or that is necessary to enable the exchange “to efficiently perform its function of maintaining an orderly market for the company’s securities”). In addition to timely disclosure of material news, such standards might include greater sensitivity with respect to the handling of confidential corporate matters; fair disclosure of information to analysts and institutional investors; prompt confirmation, denial, or clarification of rumors; or other steps to address unusual market activity and procedures for the public release of information through trading halts or otherwise. *See, e.g., id.* § 202.01–.06. The SEC’s Regulation FD and related interpretations provide further guidance to public companies on their public obligations. 17 C.F.R. §§ 243.100–.103 (2014); Commission Guidance on the Use of Company Web Sites, Exchange Act Release No. 58288, 73 Fed. Reg. 45,862, 45,867–68 (Aug. 7, 2008); Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings, Exchange Act Release No. 69,279 (April 2, 2013).

69. NYSE MANUAL, *supra* note 67, § 301.00.

70. National securities exchanges developed many of the innovations of corporate governance relating to board composition and audit requirements in the United States for their top-tiered companies at the urging of the SEC. *See* Audit Committee Disclosure, 64 Fed. Reg. 55,648, 55,649–51 (Oct. 14, 1999) (summarizing the history of interplay of SEC and SRO rules in promoting the independence and accountability of audit committees); SELIGMAN, *supra* note 8, at 547–51; *infra* note 179.

standards,<sup>71</sup> Sarbanes–Oxley requires listed companies to establish an audit committee composed entirely of independent directors with responsibility for the “appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.”<sup>72</sup> Dodd–Frank similarly requires listed companies to establish compensation committees with similar qualifications and powers.<sup>73</sup> State corporation law has not been immune to these trends, particularly in the context of monitoring high-profile transactions and business combinations.<sup>74</sup>

Federal securities litigation serves as another external monitoring tool for publicly traded issuers in an efficient market. Despite criticism from commentators and second-guessing by courts, the “fraud on the market” theory articulated in *Basic, Inc. v. Levinson*<sup>75</sup> remains the touchstone for securities class action litigation.<sup>76</sup> Accordingly, courts use relative price efficiency and the existence of mechanisms for acquiring, verifying, and digesting new information as the evidentiary filter for determining whether a court will presume reliance on the integrity of market prices.<sup>77</sup> Several

71. See *infra* Subsection III.B.1 (discussing in greater detail the creeping federalization of exchange rules).

72. 15 U.S.C. § 78j-1(m) (2012); see also 17 C.F.R. § 240.10A-3 (2014). To maintain their independence, the members of such committees must meet certain criteria of financial independence and the committees must enjoy plenary authority and adequate corporate resources to carry out their responsibilities. For example, members of the committee must be directors who are not affiliated with the issuer and do not “accept any consulting, advisory, or other compensatory fee from the issuer.” 15 U.S.C. § 78j-1(m)(3)(A)–(B); see also NYSE MANUAL, *supra* note 67, § 303A.01 (requiring listed companies to “have a majority of independent directors” as defined in NYSE Rules).

73. 15 U.S.C. § 78j-3; see also 26 C.F.R. § 1.162-27(e)(3) (2014) (setting forth qualifications for “outside directors” for purposes of the Internal Revenue Code’s deduction for incentive-based compensation determined by a compensation committee composed of such directors); NYSE MANUAL, *supra* note 67, §§ 303A.04, 303A.05 (requiring that nominating, corporate governance, and compensation committees consist entirely of independent directors).

74. State corporation law has increasingly recognized the desirability of delegating certain board functions to independent directors and committees as monitors of regulatory compliance or as bargaining agents for shareholders in transactions in which management’s interest may diverge from that of public shareholders, such as takeover bids. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1581 (2007). Professor Jeffrey Gordon suggests that the “overriding effect” of this trend “is to commit the firm to a shareholder wealth-maximizing strategy as best measured by stock price performance” because independent directors “are less committed to management and its vision;” they tend to “look to outside performance signals and are less captured by the internal perspective, which, as stock prices become more informative, becomes less valuable.” *Id.* at 1563.

75. 485 U.S. 224, 241–42 (1988).

76. See, e.g., *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2408–13 (2014) (declining to reconsider the “fraud on the market” presumption).

77. Many courts apply the factors of market efficiency described in *Cammer v. Bloom*, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989), *appeal dismissed*, 993 F.2d 875 (3d Cir. 1993), to determine whether to certify a securities class action. These factors include:

SEC initiatives, such as integrated disclosure and shelf registration, have invoked efficiency as justification for conferring regulatory privileges as well.<sup>78</sup>

#### D. Publicly Accountable

A final gradation of publicness might encompass “large, economically powerful business institutions” whose business activities compel the highest degree of public accountability.<sup>79</sup> Large, multinational firms may maintain such extensive relationships with suppliers, vendors, employees, customers, creditors, financial counterparties, and other constituencies that their corporate decision-making reverberates throughout the national and international economy. By and large, most economic and social regulation of such companies takes place through bodies of law such as antitrust, bankruptcy, tax, labor, and civil rights laws. Proponents of corporate social responsibility nevertheless view the mandatory disclosure mechanisms of federal securities law as a tool for communicating information to the investing community and the broader public when voluntary disclosures fail.<sup>80</sup>

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(1) the stock’s average trading volume; (2) the number of securities analysts that followed and reported on the stock; (3) the presence of market makers and arbitrageurs; (4) the company’s eligibility to file a Form S-3 Registration Statement; and (5) a cause-and-effect relationship, over time, between unexpected corporate events or financial releases and an immediate response in stock price.

*In re Xcelera.com Secs. Litig.*, 430 F.3d 503, 511 (1st Cir. 2005) (footnote omitted) (citing *Cammer*, 711 F. Supp. at 1286–87). Evidence of market inefficiency that courts may consider at the certification stage might include impediments to short selling, violations of put-call parity, and serial correlation of prices. *See, e.g., In re Polymedica Corp. Secs. Litig.*, 453 F. Supp. 2d 260, 273–79 (D. Mass. 2006).

78. The SEC has taken steps to reduce the compliance costs of disclosure for highly-capitalized and well-known seasoned firms on the assumption that their securities trade in an efficient market. *See, e.g.,* Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, 72 Fed. Reg. 73,534, 73,536 (Dec. 27, 2007) (reaffirming that the “system of integrated disclosure has, since its inception, been premised on the idea that a company’s disclosure in its registration statement can be streamlined to the extent that the market has already taken that information into account”); *see also* Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 136–44 (1984) (describing the relationship between integrated disclosure and shelf registration).

79. Langevoort & Thompson, *Publicness*, *supra* note 1, at 340.

80. *See, e.g.,* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Shining Light on Corporate Political Spending*, 101 GEO. L.J. 923, 942–44 (2013) (discussing the divergence of “the interests of directors and executives . . . from those of shareholders,” the “expressive significance for shareholders beyond the direct financial effects,” and justifications for disclosure of political spending); Galit A. Sarfaty, *Human Rights Meets Securities Regulation*, 54 VA. J. INT’L L. 97, 115, 125 (2013) (arguing that securities disclosure can promote international regulatory convergence around social and, particularly, human rights); David W. Case, *Corporate Environmental Reporting*

At the federal level, advocates of socially responsible corporate decision-making have pressed for the use of federal securities disclosure to establish norms of conduct in areas such as bribery, environmental responsibility, executive compensation, campaign finance, conflict minerals, and consumer protection.<sup>81</sup> As Professor Cynthia Williams has argued, public disclosures under federal securities law not only aim to improve the accuracy of financial information but also to “provide additional information bearing on *how* profits are being generated.”<sup>82</sup> Compelling “disclosure of considerable information about policies, choices, and processes” may establish an “information-forcing-substance regime” that ultimately forces substantive engagement with such issues.<sup>83</sup>

Disclosure is not the only tool that advocates of corporate social responsibility have sought to employ. Congress, the SEC, and the listing exchanges have considered or adopted shareholder voting requirements on specific corporate governance matters, such as equity compensation plans and “say-on-pay” votes on executive compensation,<sup>84</sup> in addition to greater disclosure about compensation practices.<sup>85</sup> These advocates have also attempted to reform the process and reduce the cost of nominating institutional shareholder representatives to corporate boards to encourage proxy contests based on corporate policy.<sup>86</sup> Shareholder initiative rules

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*as Informational Regulation: A Law and Economics Perspective*, 76 U. COLO. L. REV. 379, 440 (2005) (arguing that “environmental performance information” is a “public good” that companies will underproduce and understandardize without mandatory disclosure).

81. *See, e.g.*, 15 U.S.C. § 78m(p) (2012) (requiring disclosures relating to conflict minerals originating in the Democratic Republic of the Congo); *id.* § 78m(q) (requiring disclosure of payments by resource extraction issuers); Dodd–Frank Act, Pub. L. No. 111-203, § 953(b)(1), 124 Stat. 1376, 1904 (2010) (codified as amended at 15 U.S.C. § 78l note) (requiring disclosure of the ratio of the median annual total compensation of all employees of the issuer and the annual total compensation of the CEO); Bebchuk & Jackson, *supra* note 80, at 928 (advocating SEC rule making following *Citizens United v. FEC*, 130 S. Ct. 876 (2010)).

82. Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1201 (1999).

83. Sale, *supra* note 1, at 143.

84. *See* 17 C.F.R. § 240.14a–21 (2014).

85. *See, e.g.*, 17 C.F.R. § 229.402 (2014); NYSE MANUAL, *supra* note 67, § 312.00.

86. Institutional investors have made such efforts both through lobbying for mandatory rules and through private ordering. Dodd–Frank authorized the SEC to “issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer.” Dodd–Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1915 (2010) (codified as amended in scattered sections of the U.S. Code). The SEC adopted such a requirement shortly thereafter. *Facilitating Shareholder Director Nominations*, 75 Fed. Reg. 56668 (Sept. 16, 2010) (adopting Rule 14a-11). Nevertheless, the U.S. Court of Appeals for the D.C. Circuit vacated Rule 14a-11 as “arbitrary and capricious” due to the SEC’s failure “adequately to assess the economic effects of the new rule.” *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011). Not coincidentally, Delaware contemporaneously amended its general corporation law to permit the adoption of bylaws that

likewise give both institutional and retail activists a tool for lobbying for or against particular business practices.<sup>87</sup>

## II. MANAGING TRANSITIONS TO PUBLICNESS

U.S. federal securities law does not hold out a unitary concept of publicness, nor does it necessarily mandate a single path to becoming public. Some firms resist becoming publicly held or traded as long as they are able to secure private financing and restrict ownership or resale of their securities. Other companies contemplate a public offering on a specific timetable with a view toward providing exit opportunities for founders and investors, but they may elect not to pursue an exchange listing to avoid the higher levels of visibility, transparency, and accountability that such commitment entails. Yet others may oscillate between higher and lower states of transparency as the costs of public exposure wax and wane in relation to the benefits of access to capital markets.

Regardless of how companies make the transition, each aspect of publicness discussed in Part I transforms the relationship between a company and its investors, capital markets, and society—often abruptly and at substantial short-term cost to the issuer. This Part considers three of the critical transitions that regulation and market norms must address on the road to higher orders of publicness: (1) the shift from control to liquidity; (2) the shift from negotiated to standardized disclosure; and (3) the gradual internalization of negative externalities. As the number of holders of, or the volume of transactions in, a class of equity securities increases, those equity holders simultaneously lose control and gain liquidity. Standardized disclosures and external research come to replace negotiated access to information and individualized due diligence. As the issuer's social footprint grows, policy makers look to the issuer to minimize the spillover effects of its financial reporting, corporate governance, and business operations.

### A. *The Exit Gap: From Control to Liquidity*

The most critical transition a company undergoes is the shift in leverage between managers and investors as public investors increasingly hold and

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provide comparable access to proxy materials. DEL. CODE ANN. tit. 8, § 112 (2009); *see also* Fisch, *supra* note 5, at 769 (commenting on continuing efforts to obtain shareholder proxy access through “private ordering” under Delaware law); Mark J. Roe, *The Corporate Shareholder’s Vote and Its Political Economy, in Delaware and in Washington*, 2 HARV. BUS. L. REV. 1, 36 (2012) (characterizing Delaware’s decision to amend its corporation law to allow shareholders access to the company’s proxy solicitation materials as “giv[ing] enough of what the relevant federal players want so that . . . the federal authorities will refrain from seeking more and will instead turn their attention elsewhere”).

87. *See* 17 C.F.R. § 240.14a-8 (2014).

trade the company's shares. Sophisticated creditors and investors may wish to share control (or at least have the option to assert control) over a nascent enterprise and its founders in light of significant uncertainty as to how to maximize value at the outset of a relationship.<sup>88</sup> Consequently, the managers of an enterprise that seeks to raise more than trivial amounts of capital must decide how much autonomy they are willing to cede to attract sophisticated investors.<sup>89</sup> As a company's equity base grows, the dilemma abates: the availability of liquidity reduces the need for sophisticated investors to participate in control because they have an exit option.<sup>90</sup>

Shepherding this transition raises two questions of regulatory policy. First, to what extent should regulators deliberately restrict (or refuse to expand) the exit options of sophisticated investors? On the one hand, constraining exit options means that fewer ventures will get off the ground.<sup>91</sup> On the other hand, if venture capitalists (VCs) and institutions play a vital quality assurance role in vetting pre-public companies,<sup>92</sup> constraining their entry and exit options might induce them to be more selective in making investment decisions and negotiating for a greater role in governance when they elect to invest.<sup>93</sup> This, in turn, might help ensure that firms that go public through this route are better managed and better suited to public trading.

Second, to what extent should federal securities law protect unsophisticated investors from opportunistic behavior as the offering options for issuers increase and the exit options for sophisticated investors expand? Participants in the secondary private market have traditionally

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88. Shared control may take a number of forms, including staged financing, seats on the board, the right to remove the founders from management, and covenants against certain opportunistic behavior. See TIROLE, *supra* note 23, at 90–92; see also William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 893–94 (2002) (discussing investors' relative preference for shared and absolute control in the face of uncertainty and noncontractability).

89. Crowdfunded or other microcap offerings may not require such trade-offs, to the extent that investors in such offerings may not be inclined to impose such discipline on issuers. See *supra* note 29.

90. See TIROLE, *supra* note 23, at 172 (discussing the long-standing trade-off between liquidity and accountability for both entrepreneurs and institutional investors).

91. See Ibrahim, *supra* note 12, at 2 (noting that “the success of venture capital depends on the ability of venture capitalists . . . to exit their investments”).

92. See Black & Gilson, *Banks Versus Stock Markets*, *supra* note 16, at 272–74 (discussing the superiority of the IPO as the exit strategy for venture capital in the United States and the corresponding influence that this strategy has had on the incentives and governance of VC firms).

93. See Ibrahim, *supra* note 12, at 30–32 (describing such concerns but downplaying the extent to which a secondary market for VC firms would eliminate incentives for disciplined investment).

avoided retail markets for a variety of reasons.<sup>94</sup> As a result, such resales have not caused regulators to demand heightened information production and sales practice requirements comparable to the initial public offering.<sup>95</sup> As policy makers liberalize secondary market trading as an alternative pathway to publicness, however, regulators must consider whether to take additional steps to protect unsophisticated investors.<sup>96</sup>

### 1. Facilitating Resales

The first of these two questions—regarding exit options for sophisticated investors—has generated significant commentary in recent years. Within the U.S. capital markets system, the IPO remains a vital exit route for VCs and entrepreneurs.<sup>97</sup> From the perspective of a company’s founders, an IPO is likely to yield the greatest autonomy; from the perspective of the VCs, an IPO may often yield the highest return in light of the limited number of potential purchasers with whom to negotiate a private sale.<sup>98</sup> Nevertheless, a VC may negotiate additional exit options

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94. See Mendoza & Vermeulen, *supra* note 40, at 22–25. In addition to triggering the Exchange Act’s numerosity threshold, public secondary trading could subject the issuer and its owners to double taxation. See Ibrahim, *supra* note 12, at 43 (discussing the impact of classification as a “publicly traded partnership[.]” under the Internal Revenue Code).

95. See, e.g., Panel Discussion, *supra* note 40, at 491 (“[W]hen your sellers get ready to resell their shares, because you’re under 2,000 and because you haven’t registered on a stock exchange and listed on a stock exchange and you haven’t done IPO, the resale occurs without any periodic 10-K, 10-Q disclosure for the resale market.”); cf. Pollman, *supra* note 6, at 205–06 (noting the debate between regulators over how much restraint is necessary to control secondary markets).

96. See Thompson & Langevoort, *Redrawing*, *supra* note 7, at 1624–27 (discussing the role of sales practice regulation as a substitute for the Securities Act regime).

97. See Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 883 (1997); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 356 n.136 (2005).

98. See, e.g., Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?*, 11 J. APPLIED CORP. FIN. 36, 42 (1999) [hereinafter Black & Gilson, *Active Stock Market*] (describing the potential exit through an IPO as part of an “implicit contract” over control between VCs and entrepreneurs to encourage high performance). Commentators generally perceive other options, such as trade sales or put rights, as inferior. See, e.g., Pierre Giot & Armin Schwienbacher, *IPOs, Trade Sales and Liquidations: Modelling Venture Capital Exits Using Survival Analysis 1–2* (unpublished manuscript) (Mar. 14, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=461840](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=461840). Trade sales create potential for opportunistic behavior insofar as senior investors may have an incentive to cash out earlier and at a lower valuation, whereas junior shareholders and founders have an incentive to hold out for higher valuations. See Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 994–97 (2006). *But see* Ibrahim, *supra* note 12, at 28–29 (suggesting that incentives might be inverted in some cases as entrepreneurs seek an early exit while VCs hold out to maximize return). Fiduciary remedies, voting rights, appraisal rights, and other legal rights may or may not be sufficient to constrain such behavior. See Fried & Ganor, *supra*, at 999–1008.

with respect to the businesses in which it invests—such as the right to sell its stake to another VC, to compel a sale of the business or its assets to a third party, or to liquidate the firm and exercise contractual priority with respect to the distribution of its assets.<sup>99</sup>

Although regulators cannot create liquidity, they have some flexibility to influence this dynamic by regulating or deregulating the resale of securities in ways other than through a registered public offering. Some defenders of the status quo have suggested that maintaining the IPO as the preferred regulatory exit option is advantageous because it forces founders and investors to operate the firm in a sufficiently disciplined manner to induce a third party (i.e., an investment bank acting as underwriter) to commit capital to taking the firm public.<sup>100</sup> In their view, delinking capital lockup (permanence of capital) from investor lockup (permanence of investment) might reduce the incentive for VCs to monitor or assert control over the activities of an enterprise.

However, other commentators argue that expanding exit rights for sophisticated investors—perhaps to include less-regulated tiers of trading for sophisticated investors or members of the public—may encourage capital formation by reducing the risk faced by VCs in committing to uncertain investments.<sup>101</sup> Companies may delay an IPO to take advantage of the higher valuations that are possible in heady market cycles or to avoid lower valuations in underwhelming cycles;<sup>102</sup> thus, market conditions may lengthen the time frame between initial investment and a successful IPO,

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99. See DAVID P. STOWELL, *INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY* 346–48 (2d ed. 2013). VCs organized as private funds typically have an investment horizon limited by the life of the fund (e.g., five to ten years). As a result, such VCs must structure their investments to arrange for exit prior to the dissolution of the fund. See *id.* at 346–47; TIROLE, *supra* note 23, at 90–92.

100. See Black & Gilson, *Active Stock Market*, *supra* note 98, at 43–44 (implying that the advantage of the IPO is the intermediation of a third-party investment bank willing to certify public worthiness of a firm).

101. See Ibrahim, *supra* note 12, at 28–29 (“When VC and entrepreneur incentives are not aligned, the direct market provides a solution.”). VCs may want to lockup founders as well. Mendoza & Vermeulen, *supra* note 40, at 23–24 (suggesting that misalignment of incentives can occur if founders or key employees sell a significant part of their shares and that transfer restrictions can help prevent this problem). Commentators nevertheless express skepticism that liberalizing resales—without a means for investors to interact with the issuer in the same way as first-round investors—creates sophisticated secondary market liquidity. See Black & Gilson, *Active Stock Market*, *supra* note 98, at 47–48 (explaining that companies have tried the “straightforward approach” of bank-centered capital markets creating stock markets and failed); see also *infra* note 128 and accompanying text (discussing the composition of secondary private markets and their independent access to information).

102. See generally Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795 (2002) (discussing the relevance of market timing).

despite the contractual time line for the liquidation of a private fund.<sup>103</sup> As a result, the lack of alternative exit options may force VCs to avoid capital-intensive, longer-to-maturity industries to focus on late-stage ventures or serial entrepreneurs<sup>104</sup> or to bargain for greater control.<sup>105</sup>

## 2. Facilitating Purchases by Unsophisticated Investors

If liberalization of private resales is desirable to encourage capital formation, one must ask whether the public offering process remains a necessary filter to protect unsophisticated investors. The Securities Act's registration regime contemplates the broadest possible diffusion of securities in a single transaction to create immediate availability of institutional and retail liquidity.<sup>106</sup> The decision to go public, as described above, has nevertheless become as much a matter of timing as a matter of reaching financial milestones.<sup>107</sup> Moreover, academic commentators have questioned the value of the underwriting spreads, the risks of short-term underpricing and long-term overpricing, and the retail frenzy associated with the U.S. IPO process.<sup>108</sup>

Resales among sophisticated investors, by contrast, raise fewer regulatory problems. As long as secondary investors have either the opportunity to negotiate for a voice in governance, the right to demand a public offering to create instant liquidity for their securities, or the ability to evaluate the merits of an investment in the absence of influence, regulators should feel no obligation to step in to balance control and liquidity. The challenge regulators have faced is determining whether there is a risk that such securities will eventually penetrate the retail market before a company has conducted a public offering—and if so, developing a strategy for restricting or filtering such transactions to protect unsophisticated investors.<sup>109</sup>

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103. See Ibrahim, *supra* note 12, at 14.

104. See Mendoza & Vermeulen, *supra* note 40, at 9 (noting that “VC funds tend to avoid risky investments in ‘capital intensive’ and ‘longer-to-maturity’ start-up companies” and that “VC funds have generally become more conservative and risk-averse”).

105. See *id.* at 12 (“Under the traditional VC cycle, venture capitalists bargain explicitly for convertible preferred stock with its attached control and information rights to protect their investments against the downside risk.”).

106. See Ritter & Welch, *supra* note 102, at 1798 (discussing the conventional lifecycle theory of IPOs).

107. See *supra* text accompanying notes 102–05; see also Langevoort & Thompson, *IPOs*, *supra* note 7, at 909 (noting that section 5 of the Securities Act is now a lesser restraint on the IPO selling process than it once was and that such deregulation “reflects a faith that [IPO] selling efforts are not so troubling”).

108. See Pritchard, *supra* note 1, at 1013–16; Ritter & Welch, *supra* note 102, at 1802–22 (discussing explanations for short-term underpricing and long-term underperformance); Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965, 986 (1995) (criticizing underwriter behavior).

109. See, e.g., Pritchard, *supra* note 1, at 1019 (questioning whether “retail investors [would] be harmed if we eliminated IPOs” but required issuers of public offerings to be seasoned).

i. Restrictions on Offers and Resales to Unaccredited Investors

The SEC has traditionally justified restrictions on the offer and resale of securities as anti-evasion rules to discourage issuers from effecting unregistered public offerings.<sup>110</sup> Mechanistic limitations on the resale of securities have arguably lost some of their luster as a strategy to check the emergence of secondary markets in privately placed securities. Time and size restrictions—such as holding periods or limitations on the amount of securities that can be freely resold in the wake of an unregistered offering<sup>111</sup>—are crude tools to slow the penetration of securities into a secondary market because they force initial purchasers to assume economic risk for a longer period of time.<sup>112</sup>

Likewise, the prohibition against public offers in connection with private placements—the “general solicitation” prohibition—has provided some assurance that issuers would not condition the retail market, including a retail resale market, for their securities.<sup>113</sup> The cost of the prohibition has been that it limits the flexibility of issuers to communicate information to otherwise eligible investors.<sup>114</sup> The JOBS Act’s elimination of the prohibition in connection with offerings to accredited investors may nevertheless lead to the type of mass media coverage—newspaper, internet, and social media advertising—that ultimately draws in the retail

110. See Revisions to Rules 144 and 145, 72 Fed. Reg. 71,546, 71,546–49 (Dec. 17, 2007) (codified at 17 C.F.R. pts. 230 & 239) (describing the purpose of the Rule 144 safe harbor for resales); Revision of Holding Period Requirements in Rules 144 and 145, 62 Fed. Reg. 9242 (Feb. 28, 1997) (codified at 17 C.F.R. pt. 230).

111. See 1 LOSS ET AL., *supra* note 35, at 576–80 (describing the history of Rule 144).

112. See Revisions to Rules 144 and 145, 72 Fed. Reg. 71,546, 71,548 (commenting on the reduction of the holding period for Rule 144); Revision of Holding Period Requirements in Rules 144 and 145, 62 Fed. Reg. 9242, 9242 (discussing the benefits of adopting shortened holding periods). To the extent that the Securities Act contemplates direct offerings to unaccredited investors, there may be little justification (except as a means of prohibiting evasion of offering rules) to prohibit the resale of such securities to other nonprofessional investors through holding periods and size restrictions. This is particularly true if professional investors can provide liquidity to nonprofessional investors. For example, the JOBS Act codifies a one-year holding period for resales to persons other than accredited investors in the wake of an unregistered crowdfunded offering. See 15 U.S.C. § 77d-1(e) (2012); see also Sara Hanks, *JOBS Act Crowdfunding Provisions Await Clarification by SEC*, 17 ELEC. COMMERCE & L. REP. (BNA) 1741, 1745 (2012) (recognizing the resale restrictions imposed by the JOBS Act).

113. 17 C.F.R. § 230.502(c) (2014); see Elan W. Silver, Comment, *Reaching the Right Investors: Comparing Investor Solicitation in the Private-Placement Regimes of the United States and the European Union*, 89 TUL. L. REV. 719, 735 (2015) (discussing the evolution of the prohibition against “general solicitation” in private placements).

114. See Lawrence A. Hamermesh & Peter I. Tsoflias, *An Introduction to the Federalist Society’s Panelist Discussion Titled “Deregulating the Markets: The JOBS Act,”* 38 DEL. J. CORP. L. 453, 454 n.3, 464–65 (2013) (citing discussion by Joanne Medero, Managing Director, BlackRock).

public when a resale market develops.<sup>115</sup> If so, then the onus shifts irreversibly to investor intake—ensuring that accredited investors are in fact accredited—and the suitability of the offered securities for downstream purchasers.

In theory, the SEC could tighten resales to nonaccredited investors in high-end private placements while simultaneously liberalizing resales among accredited investors. As Professors Thompson and Langevoort point out, the disconnect between the Securities Act and the Exchange Act makes it difficult for the SEC to do so.<sup>116</sup> Once the risk of Securities Act evasion has passed or the statute of limitations on associated remedies runs out, the Securities Act provides little authority to restrict resales on investor-protection grounds. Conversely, the Exchange Act's antifraud provisions may favor increased diligence and disclosure by broker-dealers when dealing in unregistered securities in the secondary market,<sup>117</sup> but the Exchange Act arguably also offers little authority to restrict resales to specific tiers of investors.

## ii. Suitability

Suitability is a complementary tool that provides additional protection in connection with the sale of privately placed or publicly offered securities to retail investors.<sup>118</sup> Under the Financial Industry Regulatory Authority's (FINRA) suitability rule, broker-dealers generally must exercise "reasonable diligence" when recommending an investment transaction or investment strategy, which includes an obligation to ascertain information about both the investment itself and "the customer's investment profile."<sup>119</sup>

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115. Professor Lawrence Hamermesh and Peter Tsoflias contend that "the chances of a company's general solicitation or advertisement reaching, let alone causing significant damages to, non-accredited investors [are] relatively low" in light of the relative shareholdings of accredited investors and retail investors. *Id.* at 472.

116. Thompson & Langevoort, *Redrawing*, *supra* note 7, at 1575–76.

117. *See, e.g.*, 17 C.F.R. § 240.15c2-11 (listing the information and documentation that the SEC requires broker-dealers to possess prior to publishing, or submitting for publication, any quotation for a security).

118. *See, e.g.*, Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1560–61 (1989) (suggesting that suitability rules "provide an alternative solution" to the problem of protecting unsophisticated investors); Jeffrey J. Hass, *Small Issue Public Offerings Conducted over the Internet: Are They "Suitable" for the Retail Investor?*, 72 S. CALIF. L. REV. 67, 128 (1998) (proposing a federal suitability standard as part of Regulation A and Regulation D).

119. FINRA MANUAL, *supra* note 50, R. 2111(a). FINRA's suitability rule comprises three components: "reasonable-basis suitability, customer-specific suitability, and quantitative suitability." *Id.* at supp. material .05. Under the first component, the broker must have "a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least *some* investors." *Id.* Customer-specific suitability requires diligence into customers' investment profile, including their "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any

To the extent that JOBS Act reforms have shifted the focus from regulating offerings to regulating transactions with specific offerees, some commentators have suggested that sales practice rules, such as suitability, may eventually supply the infrastructure for primary transactions in unregistered offerings.<sup>120</sup> *A fortiori*, they might play an equally significant role in secondary resales in the wake of such placements.

Consider, for example, how the principles-based approach for verifying accredited investor status mirrors the suitability rule.<sup>121</sup> Under Rule 506(c), an issuer has to consider a number of factors when determining the reasonableness of its effort at verification, including: the “nature of the purchaser”; the “type of accredited investor that the purchaser claims to be”; the “amount and type of information that the issuer has about the purchaser”; the “nature of the offering”; and the “manner in which the purchaser was solicited to participate in the offering.”<sup>122</sup> Likewise, the crowdfunding rules suggest that Congress favors a regulatory approach that protects investors by imposing limitations on the amount invested in relation to their means.<sup>123</sup>

Suitability-based approaches have nevertheless proven unsatisfactory because violations of the rules or regulatory requirements of self-regulatory organizations (SROs) are generally not actionable *per se*.<sup>124</sup> Private rights

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other information the customer may disclose.” *Id.* R. 2111(a). Quantitative suitability requires the broker to “have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer’s investment profile.” *Id.* at supp. material .05.

120. *See, e.g.*, Thompson & Langevoort, *Redrawing*, *supra* note 7, at 1624–27 (suggesting that enhanced sales practice regulation might compensate for deregulation of the public offering process under the Securities Act).

121. *See* 17 C.F.R. § 230.506(c)(2)(ii) (2014).

122. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 9415, 78 Fed. Reg. 44,771, 44,776 (July 24, 2013) (codified at 17 C.F.R. pts. 230, 239 & 242). While private funds that routinely offer interests in reliance on Rule 506 may build this structure internally, there is a sense that some of this diligence could be professionalized through broker–dealer sales practice rules. *See, e.g.*, IVANOV & BAUGUESS, *supra* note 34, at 16–17 (discussing the use of finders in Regulation D offerings).

123. *Cf.* Regulation D Revisions, 53 Fed. Reg. 7866–71 (Mar. 10, 1988) (eliminating “accredited investor” status for individuals who purchase at least \$150,000 in securities if the amount purchased does not exceed 20% of the person’s net worth). In some ways, capping an individual offeree’s investment as a percentage of income or net worth improves upon Regulation D’s net-income and net-worth tests by regulating the amount of an investment as opposed to the mere act of investment. From the perspective of individual investors, such an approach would seem to tailor the protections of federal securities law to the ability of individual investors to absorb risk.

124. *See, e.g.*, GMS Grp., LLC v. Benderson, 326 F.3d 75, 81–82 (2d Cir. 2003) (“Although arguably there is no right of action simply for a violation of NASD rules, violations may be considered relevant for purposes of § 10(b) unsuitability claims.” (citations omitted)); Jablon v. Dean Witter & Co., 614 F.2d 677, 681 (9th Cir. 1980) (“[T]here is no implied right of action for an NASD rule violation.”). In the securities context, the availability of mandatory arbitration of

of action are typically rooted either in breach of a common law duty of care or, in the context of securities law, in breach of an implied representation that broker-dealers will conduct themselves in accordance with industry norms.<sup>125</sup> Reliance on the antifraud provisions of securities law thus gives rise to the same burdens of proof and affirmative defenses that frustrate private litigants in the context of affirmative misstatements or misleading omissions.<sup>126</sup> Moreover, the requirement of due diligence in assessing a customer's status and objectives assumes that customers are entirely forthcoming about their financial situation; judicial inquiry may therefore often focus on the customer's actual circumstances rather than the broker-dealer's diligence into the security being sold.

### B. *The Transparency Gap: From Negotiated to Standardized Disclosure*

In addition to balancing control and exit rights, federal securities law naturally plays a key role in managing the flow of information to investors as a company transitions to increasing levels of public trading and monitoring. Specifically, federal securities law must bridge the gap between a system in which investors privately negotiate access to confidential information and a system in which investors enjoy the benefit of an efficient informational marketplace informed by periodic and episodic issuer disclosures and driven by external research and analysis.

Information disclosure functions relatively well at the extremes. Controlling or anchor investors in privately held firms are able to negotiate for board seats, access to records, periodic meetings with founders, and other sources of information necessary for them to monitor and guide management.<sup>127</sup> In addition to the considerable diligence undertaken by secondary purchasers of venture capital interests in private companies, the networks through which VCs seek to transfer such interests may exist in a geographically-concentrated marketplace where investors are able to meet face to face with entrepreneurs.<sup>128</sup>

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disputes under the auspices of self-regulatory bodies creates further uncertainty, for good or for ill. See generally 2 LOSS ET AL., *supra* note 35, at 1795–1808 (analyzing arbitration under the SEC statutes).

125. See generally Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995) (describing implied representations of broker-dealers that they will deal fairly with customers).

126. Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 677–78, 681 (1996) (explaining the concept of a customer's right to rely and noting the judicial imposition of a duty to read).

127. See TIROLE, *supra* note 23, at 90.

128. Mendoza & Vermeulen, *supra* note 40, at 34–36 (providing an example of the India Venture Board); see also Pollman, *supra* note 6, at 203 (“[T]he secondary markets make it easier and more efficient for buyers and sellers to identify each other and transact.”); *supra* note 101 and

At the other extreme, the discipline imposed by institutional investors may be able to enforce adequate disclosure in highly sophisticated secondary markets without regulatory intervention. For example, investors in debt securities may require issuers to comply with reporting requirements similar to those of Exchange Act reporting companies through standard indentures or negotiated covenants.<sup>129</sup> Moreover, some firms may commit to maintain compliance with SEC internal reporting controls and other quality-assurance rules even after withdrawing from Exchange Act reporting.<sup>130</sup> For internet companies whose valuation turns in significant part on the availability of user metrics, public information or otherwise easily verifiable information may suffice to make valuation determinations.<sup>131</sup>

Federal securities law, however, has never successfully developed a set of disclosure, compliance, and governance rules to facilitate a measured transition between these two extremes. For firms that pursue an IPO and simultaneously pursue an exchange listing, this transition is abrupt and expensive,<sup>132</sup> many private ventures therefore cannot afford to go public,

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accompanying text (discussing limitations on private secondary markets). For example, markets such as SecondMarket and SharesPost have largely functioned as venues for VCs and institutional investors to snap up shares sold by founders or employees. *See* Ibrahim, *supra* note 12, at 36–37. Professor Darian Ibrahim asserts that participants in such secondary markets are investing in late-stage companies that pose a reduced risk of lemons, and participants often purchase additional shares from the issuer directly, which permits direct bargaining for information. *See id.* at 17–20.

129. *See, e.g., Revised Model Simplified Indenture*, 55 BUS. LAW. 1115, 1184 (2000) (noting that when a company making a debt offering “is not publicly-traded or ceases to be subject to the reporting requirements of the Exchange Act, many indentures add a provision which requires the filing, with the Trustee, of the information, documents, and reports comparable to those required [for listed securities under the Exchange Act]”). Because section 12(g) of the Exchange Act only counts the number of holders of equity securities, private placements of debt securities cannot trigger Exchange Act reporting unless the issuer lists securities on an exchange or they are the subject of a public offering. *See* 15 U.S.C. § 78l(g)(2)(A)–(C) (2012).

130. 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, 10 (2009) (noting that “the rate at which formerly publicly traded companies have remained SEC reporting companies after going private has significantly *increased* since SOX’s enactment,” particularly because of the use of high-yield institutional debt).

131. Internet firms whose profitability is directly linked to the volume of hits or the size and churn of the user base may provide investors with sufficient and verifiable information to extrapolate values from the publicly available financial disclosures of comparable publicly traded firms. *See* Langevoort & Thompson, *Publicness*, *supra* note 1, at 347 n.39.

132. *See supra* note 25 and accompanying text; *see also* Thomas G. James, *Far from the Maddening Crowd: Does the JOBS Act Provide Meaningful Redress to Small Investors for Securities Fraud in Connection with Crowdfunding Offerings?*, 54 B.C. L. REV. 1767, 1773 (2013) (“The costs associated with observing applicable securities regulations, in particular registration under Section 5 of the Securities Act, would likely exceed the financing available to startups through a public offering.”); *Id.* at 1773 n.47 (providing that under the registration and disclosure requirements of the Securities Act, offerors incur “a litany of fees for underwriters, legal counsel,

and smaller post-IPO companies struggle to comply with Exchange Act disclosures. As a result, the tendency is to assume that regulators should scale the costs of Exchange Act disclosures to the ability of the firm to bear them rather than assess whether the production costs, compliance costs, and litigation risk warranted by any disclosure scheme are reasonable in relation to anticipated (if unquantifiable) regulatory benefits.<sup>133</sup>

While the scope of the content of disclosures is almost always a relevant factor, the context in which companies produce the disclosures is perhaps more important: namely, the *ex ante* compliance cost and *ex post* litigation risk associated with periodic disclosures and other public communications. To the extent that internal controls and other compliance processes entail a high fixed cost of implementation, they may have a disproportionate impact on smaller firms.<sup>134</sup> Moreover, to the extent that their securities do not actively trade, any accuracy-enhancing benefits of such controls may largely be wasted.

By the same token, however, increased litigation risk may be appropriate to discourage manipulative or deceptive behavior by managers of issuers that are bridging the transparency gap.<sup>135</sup> To be sure, companies already face a heightened risk of litigation in the wake of an IPO,<sup>136</sup> particularly in light of the higher due diligence standard imposed by the Securities Act.<sup>137</sup> However, a heightened diligence requirement for

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electronic filings, accountants, broker-dealers, and stock exchange listings, as well as the fees owed to the SEC and state securities regulators”).

133. See Schwartz, *Law and Economics*, *supra* note 10, at 349–50.

134. See, e.g., Ehud Kamar et al., *Going-Private Decisions and the Sarbanes–Oxley Act of 2002: A Cross-Country Analysis*, 25 J.L. ECON. & ORG. 107, 129 (2009) (finding support for the hypothesis that Sarbanes–Oxley disproportionately affected smaller firms).

135. For a discussion of the desirability of class action remedies in light of the net social welfare cost of litigation that appears to reallocate wealth among shareholders holding diversified portfolios, see John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1556–66 (2006). Individual shareholders may nevertheless receive a net benefit from the ability to sue statutory defendants and offering participants other than the issuer. See, e.g., Verity Winship, *Fair Funds and the SEC’s Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1127–30 (2008) (discussing the “circularity” critique of public and private actions against issuers and other disclosure participants); Merritt B. Fox, *Rethinking Disclosure Liability in the Modern Era*, 75 WASH. U. L. Q. 903, 913–17 (1997) (proposing an external certification regime for corporate disclosures to this end).

136. One study found that companies mounting an IPO from 1996 to 2000 faced a cumulative risk of litigation of approximately 28% within the ten years following the offering. *Securities Class Action Filings: 2014 Mid-Year Assessment*, CORNERSTONE RESEARCH, 26 (2014), <https://www.cornerstone.com/CMSPages/GetFile.aspx?guid=8b34f0cd-79a2-497a-9821-a2893928506f> [hereinafter *Cornerstone Study*]. Exchange-listed companies faced an average 2.9% risk of Rule 10b-5 litigation on average from 1997 to 2013. *Id.* at 8.

137. 15 U.S.C. § 77k(b) (2012); see also *id.* § 77m (setting the statute of limitations for actions under section 11 of the Securities Act at the earlier of one year after the discovery or three years after the security was bona fide offered to the public).

managers, broker–dealers, and other intermediaries may be appropriate for firms that do not have an extensive analyst or institutional following. Not only are the securities of such issuers uniquely exposed to the risks of retail panic and euphoria,<sup>138</sup> but their managers may also have an incentive to offload shares during heady market conditions if there is no sobering pushback from institutional interests.<sup>139</sup>

### C. *The Spillover Gap: Internalizing Externalities*

The final transition policy makers face entails shifting the accountability of corporate managers away from an exclusive focus on shareholder value and toward capital markets and the public generally.<sup>140</sup> Public monitoring and accountability entails building compliance and disclosure mechanisms for the benefit of constituencies other than shareholders.<sup>141</sup> Regulatory policy must therefore manage the imposition of such incremental costs on companies. Direct costs may include additional production and verification requirements and associated litigation risk; indirect costs may include loss of confidentiality and competitive disadvantage vis-à-vis private companies or smaller public companies.<sup>142</sup> Benefits are more difficult to quantify: regulators must consider first for whose benefit these additional obligations are created and for which subset of companies the public benefits of compliance outweigh the private costs.

One might classify such obligations as: (i) efforts to improve the operation of financial markets; (ii) efforts to improve the relationship of a company with its stakeholders; and (iii) efforts to serve social or political goals unrelated to capital allocation or corporate governance. Capital-markets externalities generally relate to the transparency, efficiency, and continuity of market prices. Professor Marcel Kahan argued that inaccurate

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138. See, e.g., Mendoza & Vermeulen, *supra* note 40, at 33–34.

139. See, e.g., Ritter & Welch, *supra* note 102, at 1799 (discussing market-timing theories of IPO cycles).

140. Cf. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 (1999) (articulating a theory of directorial primacy based on the idea that “boards exist not to protect shareholders *per se*, but to protect the enterprise-specific investments of *all* the members of the corporate ‘team,’ including shareholders, managers, rank and file employees, and possibly other groups, such as creditors”).

141. See, e.g., Larry Catá Backer, *Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes–Oxley*, 2004 MICH. ST. L. REV. 327, 334, 341 (describing the regulatory framework of Sarbanes–Oxley as one of surveillance for the protection of investors: “The behavior of insiders is to be constantly monitored. The public corporation has become an entity under surveillance by gatekeepers (outside directors, lawyers, and auditors) and government.”).

142. Moreover, because such rules apply to all Exchange Act reporting companies indiscriminately, they may discourage smaller issuers from accessing public capital markets altogether. Comm. on Capital Mkts. Regulation, *Interim Report*, UNIV. DENVER, 130 (Nov. 30, 2006), <http://www.law.du.edu/images/uploads/corporate-governance/empirical-committee-capital-markets-regulation.pdf>.

stock prices not only harm existing investors but may also systematically discourage investment in the stock market if investors are unwilling to make long-term commitments or expose themselves to unnecessary market volatility.<sup>143</sup> Scholars routinely debate the effectiveness of the “accuracy-enhancing” aspect of such internal controls over financial reporting.<sup>144</sup> Some post-Sarbanes–Oxley studies have found little evidence that the Act’s reforms improved the financial performance of public companies as reflected in stock prices,<sup>145</sup> while other studies suggest that institutional investors sufficiently value such mechanisms to negotiate for them in voluntary filings.<sup>146</sup>

Similarly, advocates for corporate governance reform often speak in the name of improving accountability to shareholders,<sup>147</sup> even though the

143. See Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977, 1006, 1019, 1025 (1992). Among other consequences, the withdrawal of investors from capital markets may impair capital allocation, liquidity, and willingness to absorb risk, see, e.g., *id.* at 1034; cause management to focus on stock price performance rather than long-term growth, *id.* at 1028–29; increase the frequency of insider trading, macroeconomic shocks, and changes in control resulting from abrupt changes in market price; and decrease the desirability of long-term corporate contracting and capital budgeting. See generally *id.* (discussing the panoply of market maladies caused by inaccurate stock prices).

144. Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1093–95 (1995) (questioning the value of accuracy-enhancing aspects of mandatory disclosure rules). To the extent that investors are most concerned about management’s expectations as to future prospects rather than historical information, critics suggest that the additional information conveyed by these mechanisms may yield to investors only marginal benefits that do not justify their significant compliance costs. See, e.g., *id.* at 1106–07.

145. Romano, *supra* note 5, at 1529 (finding that the literature in the field “indicates that the data do not support the view that the SOX initiatives will improve corporate governance or performance”). Professor Roberta Romano has observed that many of the corporate governance innovations introduced by Sarbanes–Oxley—such as independence requirements for boards and audit committees, limitations on non-audit services by external auditors, and executive certifications—have little or ambiguous empirical support. See *id.* at 1529–43. Additionally, several studies have attempted to evaluate the impact of new compliance and disclosure obligations on the efficiency and accuracy of stock prices. See ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES LITIGATION* 16–29 (2002) (noting that a number of scholars have “sought to ascertain how the SEC’s mandatory disclosure regime has fared compared with voluntary practices by firms” with results indicating that the “agency has added little value”). But see FRANK B. CROSS & ROBERT A. PRENTICE, *LAW AND CORPORATE FINANCE* 152–89 (2007) (surveying empirical studies suggesting that “restrictive securities law rules may also produce significant economic benefits” and that the “pure private ordering paradigm is not optimal for securities markets”).

146. Professor Robert Bartlett III’s study of high-yield debt markets suggests that issuers with publicly or privately traded debt may covenant to file voluntary disclosures under the Exchange Act relating to economic performance, even as they avoid disclosure requirements relating to qualitative matters or corporate governance. See Bartlett, *supra* note 130, at 19–20.

147. See, e.g., Julian Velasco, *Shareholder Ownership and Primacy*, 2010 U. ILL. L. REV. 897, 901 (discussing corporate governance reforms from the perspective of shareholder primacy).

interests of other constituencies often fuel their momentum.<sup>148</sup> For example, executive compensation has been a primary target of the shareholder primacy movement.<sup>149</sup> Measures that strengthen the link of pay to performance, such as more detailed disclosure and “say-on-pay” votes,<sup>150</sup> might confer some benefit on public corporations even as they create opportunities for vocal constituencies to use such disclosures and voting power to achieve other ends.<sup>151</sup> In recent years, compensation reform efforts have drifted more aggressively to serve other goals—such as promoting pay equity for employees and reducing systemic risk of financial institutions—with only attenuated benefits to shareholders.<sup>152</sup>

Finally, social disclosure and corporate social responsibility reforms are at best “only loosely coupled with orthodox (and arguably more measurable) notions of investor protection.”<sup>153</sup> These might include disclosures relating to environmental impact or climate change, provenance of materials, bribes or other illegal payments, labor practices, and similar matters.<sup>154</sup> In many cases, the benefits of such legislation are not susceptible to any politically meaningful cost-benefit analysis because it is difficult to quantify either the impact of the activities at issue or the effect of disclosure on the extent to which firms engage in those activities.<sup>155</sup> Moreover, while such disclosures may benefit investors in that they foreshadow the likelihood of corporate liability, they arguably aim to serve as the catalyst, rather than bellwether, of further governmental action.

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148. See Langevoort & Thompson, *Publicness*, *supra* note 1, at 380–81.

149. See Paul Rose, *Shareholder Proposals in the Market for Corporate Influence*, 66 FLA. L. REV. 2179, 2208 (2014).

150. Both federal securities law and exchange listing rules have mandated incrementally greater disclosures and shareholder participation regarding executive compensation. See 15 U.S.C. § 78n-1 (2012) (requiring a periodic, nonbinding shareholder vote on executive compensation); NYSE MANUAL, *supra* note 67, § 303A.08 (requiring that shareholders be “given the opportunity to vote on all equity-compensation plans”).

151. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 8 (2004) (distinguishing the authors’ “completely pragmatic and consequentialist” approach to improving managerial accountability from “alternative critiques” of executive compensation).

152. See, e.g., 12 U.S.C. § 5641(b) (requiring federal financial regulators to prescribe rules prohibiting “any types of incentive-based payment arrangement” that “encourages inappropriate risks by covered financial institutions”); Pay Ratio Disclosure, 78 Fed. Reg. 60,560, 60,582–85 (Oct. 1, 2013) (to be codified at 17 C.F.R. pts. 229 & 249) (weighing the possible benefits to shareholders as well as the public policy benefits of adopting a rule requiring each reporting company to disclose the ratio of the median of the “annual total compensation” of all employees excluding its chief executive officer to the annual total compensation of its chief executive officer).

153. Langevoort & Thompson, *Publicness*, *supra* note 1, at 340.

154. See *id.* at 372–73; *supra* note 81 and accompanying text.

155. See, e.g., Langevoort & Thompson, *Publicness*, *supra* note 1, at 376 (stating that verification may be incomplete because “such costs can suck up all the benefits of division of labor” to the corporation and, if shareholders do seek information, the “result will be to overproduce some information at the same time that the overall amount of information may be underproduced”).

If the goal of such obligations is to promote investment in firms with good governance or socially responsible business practices,<sup>156</sup> reliance on the reporting obligations of public companies poses particular problems because the coverage of the Exchange Act is both over- and under-inclusive.<sup>157</sup> Even if a representative sampling of large public companies would suffice to provide the markets with adequate information about the spillover effects of corporate activity, the SEC is not necessarily the right agency to oversee such disclosures. Scholars have questioned whether the SEC has the resources or expertise to develop criteria that impose disclosures not only in proportion to the materiality of the information to the firm's business<sup>158</sup> but also in proportion to the materiality of the firm's activities in the economic and social mosaic.<sup>159</sup>

### III. REGULATING THE TRANSITION

As implied by previous discussion, two competing approaches manage the transition from private ordering to public regulation today. Issuer-

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156. See, e.g., David Monsma & Timothy Olson, *Muddling Through Counterfactual Materiality and Divergent Disclosure: The Necessary Search for a Duty to Disclose Material Non-Financial Information*, 26 STAN. ENVTL. L.J. 137, 158–61 (2007) (noting that an expanding number of socially responsible investors “seek information about company management commitments” and “[c]ompared to past generations, investors today seek more and better information from companies about a complex range of issues”). But see Ian B. Lee, *Corporate Law, Profit Maximization, and the “Responsible” Shareholder*, 10 STAN. J. L. BUS. & FIN. 31, 71 (2005) (“As much as one might like for investors to be more interested than they are in information about the social impact of corporate activities, it might be misguided to implement a costly new disclosure regime on the theory that their better selves would want the information.”).

157. Exchange Act reporting obligations are under-inclusive because private firms may engage in equivalent conduct with no public accountability. The omissions of nonreporting companies may not only impair the comprehensiveness of the reporting regime, but may exacerbate the competitive gap between public and private companies. Such obligations are likely to be over-inclusive in that the activities of smaller reporting firms may not be of a scope or scale sufficient to provide nonobvious, nonredundant information to policy makers. For these reasons, encouraging disclosures by all companies—regardless of their status under federal securities law—might be a preferable approach to achieve these broader policy objectives.

158. To a degree, the SEC has standardized environmental disclosures to this end, but consistent with its expertise and statutory mission, it has focused on the materiality of information to investors rather than the public interest. See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-808, ENVIRONMENTAL DISCLOSURE: SEC SHOULD EXPLORE WAYS TO IMPROVE TRACKING AND TRANSPARENCY OF INFORMATION 44 app. II (2004).

159. See, e.g., Joel Seligman, *Key Implications of the Dodd–Frank Act for Independent Regulatory Agencies*, 89 WASH. U. L. REV. 1, 16–17 (2011) (“The broader an agency’s jurisdiction, the more likely it is to lack the resources or focus to address all appropriate priorities.”); Barbara Black, *The SEC and the Foreign Corrupt Practices Act: Fighting Global Corruption Is Not Part of the SEC’s Mission*, 73 OHIO ST. L.J. 1093, 1117 (2012) (“The SEC has consistently, and with good reason, asserted that it has inadequate resources to address all the increased demands placed upon it, particularly by growth in the securities industry and by Dodd–Frank.”).

driven approaches allow issuers to elect higher or lower levels (or simply different categories) of regulatory scrutiny in exchange for specific public benefits, often from a menu prescribed by a regulator or market intermediary. Metrics-driven approaches instead scale the benefits and obligations associated with companies in various stages of publicness with greater uniformity based on quantifiable or observable attributes of their operations and activities.

The principal advantage of issuer-driven approaches is to give issuers greater control over when and to what degree they become subject to or able to withdraw from the public gaze. This flexibility not only permits issuers to conduct a more finely-tuned analysis of the trade-offs created by the applicable regulatory framework, but it also carves out a role for self-regulatory bodies and market intermediaries to perform a continuous cost-benefit analysis of the attendant privileges and obligations for both issuers and investors. By contrast, the advantage of metrics-based approaches is naturally to eliminate such discretion when issuers abuse it or fail to adapt to public expectations or to the practices of similarly situated companies.

Neither paradigm, of course, exclusively describes the current U.S. regulatory framework. Many companies exercise significant freedom over their public exposure today: whether to mount a public offering, whether to list on an exchange, and whether to go private or escape abroad.<sup>160</sup> At the same time, policy makers have whittled away at the amount of discretion that issuers and intermediaries enjoy to calibrate regulatory trade-offs within the different categories of publicness—to the point that the relevance of such decisions in public company regulation has become increasingly “anachronistic.”<sup>161</sup> As a result, while issuers retain choice, they lack flexibility.

This Part explores some of the promises and pitfalls of issuer-driven and metrics-driven approaches. Sections III.A and III.B consider the benefits and disadvantages of the issuer-driven paradigm in U.S. federal securities regulation, while Section III.C focuses on the difficulties posed by more recent metrics-based approaches to tiering publicness.

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160. See William J. Carney, *The Costs of Being Public After Sarbanes–Oxley: The Irony of “Going Private,”* 55 EMORY L.J. 141, 149–51 (2006) (highlighting the cost-benefit analysis that may lead to going private transactions); *id.* at 152–54 (contrasting alternatives, such as the decision to go private and the decision to list abroad).

161. See Langevoort & Thompson, *Publicness*, *supra* note 1, at 352 n.69, 353 (discussing the requirements of section 12(b)). See generally Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 2–3 (1993) [hereinafter Seligman, *New Corporate Law*] (discussing the displacement of state corporate governance norms by federal regulation).

### A. *The Issuer-Driven Paradigm*

The issuer-driven paradigm of public company regulation rests on three pillars. First, a statute, regulator, or self-regulatory body must divide the marketplace for securities into discrete tiers of regulation. Often, such tiers describe the relevant marketplace (e.g., global, national, regional, small cap, or microcap) or industry sector (e.g., high-tech or internet). Second, the law must identify the trade-offs issuers face at each transition, as described in Part II, with respect to liquidity, transparency, and compliance obligations.<sup>162</sup> Third, there must be an intermediary—such as an investment bank, broker–dealer, or exchange—that facilitates these transitions to calibrate and enforce the associated privileges and commitments on an ongoing basis.

The underwritten IPO and exchange listing are perhaps the best developed systems of issuer-driven regulation. Scholars have long recognized investment banks as the reputational intermediary that serves as a gateway to public markets, even as the SEC and SROs have assumed the role of setting baseline disclosure standards and offering practices for public companies.<sup>163</sup> Likewise, stock exchanges in the United States and around the world have used tiering of listed securities as a means of scaling the application of their corporate governance and disclosure rules to the needs and resources of individual issuers.<sup>164</sup> In particular, to the extent that an exchange is able to coordinate the interfaces among tiers, the exchange could substantially reduce the cost of transitioning from one regime to another.<sup>165</sup>

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162. See, e.g., Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACC. & ECON. 233, 260–61 (2005) (using an event study to document “firm-specific costs and benefits, as well as externalities, of disclosure regulation” for firms that are not in compliance, already in compliance, and newly in compliance with FINRA’s recently adopted Exchange Act reporting requirement for OTC BB firms).

163. See Black & Gilson, *Active Stock Market*, *supra* note 98, at 44; Gilson & Kraakman, *supra* note 64, at 613–21 (discussing the role of the investment banker); see *supra* text accompanying note 100.

164. See Steven M. Davidoff, *Regulating Listings in a Global Market*, 86 N.C. L. REV. 89, 145–48 (2007) (discussing incentives for issuers to list on various exchange tiers). For example, issuers trading in an exchange’s pre-public tier might be able to mount an initial public offering and launch public trading for retail investors with greater certainty as to pricing, liquidity, and institutional interest. See Pritchard, *supra* note 1, at 1019–22 (analogizing such a market to the “English Premier League”).

165. See Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355, 356–58 (2006) (discussing the benefits of a common trading platform both across borders and across products); see also Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435, 1476 (2008) (discussing the benefits of a common platform in facilitating the trading of securities across borders).

The use of exchange listing as a form of tiering has long played a particularly prominent role in cross-border offerings since issuers often view the listing rules of different national markets as stepping stones to higher, lower, or different levels of regulation.<sup>166</sup> Professor John Coffee suggests that many non-U.S. firms might have historically chosen to cross-list their securities in the United States, in part, based on the “higher likelihood of legal enforcement, the signal of profitable investment opportunities, the more credible promise of improved disclosure, contractual protections negotiated on entry into the U.S. market, [and] the enhanced analyst coverage” associated therewith.<sup>167</sup>

The “passporting” privileges conferred on listed issuers in the European Union (EU) likewise demonstrate the potential benefits of building tiered regulatory regimes within a single jurisdictional area. Under EU directives, issuers whose securities are listed or admitted to trading in a venue authorized as an EU regulated market may be offered and traded throughout the EU in reliance upon the issuer’s home country registration and periodic disclosure requirements.<sup>168</sup> Meanwhile, junior markets, such

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166. See Brummer, *supra* note 165, at 1477–78 (describing stock exchanges as “sellers of foreign law” consistent with the issuer-choice paradigm of securities regulation (emphasis omitted)); Davidoff, *supra* note 164, at 145–48 (discussing incentives for issuers to list on various exchange tiers).

167. 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, 1830 (2002). *But see* Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT’L L. 141, 160–62 (2003) (citing studies that suggest that cross-listing in the United States may allow foreign issuers to avoid more onerous corporate governance regulation in their home country). Markets such as London’s Alternative Investment Market, the Tel-Aviv Stock Exchange, and Frankfurt’s former Neuer Markt similarly cater to smaller businesses using a lower-tiered listing as a stepping-stone to broader capital-markets access. See Jose Miguel Mendoza, *Securities Regulation in Low-Tier Listing Venues: The Rise of the Alternative Investment Market*, 13 FORDHAM J. CORP. & FIN. L. 257, 285–89 (2008); Mendoza & Vermeulen, *supra* note 40, at 25–26; Mark Boslet, *Some Venture-Backed IPOs Look to London’s AIM as NASDAQ Cools*, WALL ST. J., Nov. 23, 2005, at B.4B.

168. Article 17 of the Prospectus Directive provides that “where an offer to the public or admission to trading on a regulated market is provided for,” a prospectus approved by the home member state of an issuer “shall be valid for the public offer or the admission to trading in any number of host Member States” with appropriate notification of the host member states’ competent regulatory authorities. Directive 2003/71, of the European Parliament and of the Council of 4 November 2003 on the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading and Amending Directive 2001/34/EC, 2003 O.J. (L 345) 64 (EC) (amended by Directive 2010/73, of the European Parliament and of the Council of 24 November 2010, 2010 O.J. (L 327) 1 (EU)). Similarly Article 3(2) of the Transparency Directive provides that a host member state (a state in which issuers admit securities to trading on a regulated market) may not, as regards the admission of securities to a regulated market in its territory, impose disclosure requirements more stringent than those in “this Directive or in Article 6 of Directive 2003/6/EC” or on shareholders or other persons or entities. Directive 2004/109, of the European Parliament and of the Council of 15 December 2004 on the Harmonisation of Transparency Requirements in Relation to

as London's Alternative Investment Market (AIM), admit issuers without requiring compliance with EU directives.<sup>169</sup> More recently, the EU has laid the groundwork for multilateral trading facilities that serve the small and medium enterprise (SME) growth market to “raise their visibility and profile and aid the development of common regulatory standards in the Union for those markets.”<sup>170</sup>

Several academic and industry proposals to tier levels of regulation in the United States rely on the assumption that regulators can restrict participation in opaque markets to sufficiently sophisticated market participants.<sup>171</sup> Under such approaches, private secondary markets could assume responsibility for screening admission to trading by vetting investors' sophistication and capacity to absorb risk, as well as the degree of access to information they provide.<sup>172</sup> However, an implicit premise of this structure is that trading venues, dealers, and other intermediaries can create market tiers or categories that supply enough liquidity from qualified investors to sustain trading until issuers are able to achieve different stages of publicness. Others suggest that public investors should be able to participate in lower-tiered markets, although firms might be timed out of such lower tiers (much as “emerging growth companies” are phased into Exchange Act compliance under the JOBS Act).<sup>173</sup>

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Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, 2004 O.J. (L 390) 38 (EC) (amended by Directive 2013/50, of the European Parliament and of the Council of 22 October 2013, 2013 O.J. (L 294) 13 (EU)).

169. See EUROPEAN CAPITAL MARKETS LAW 78 (Rüdiger Veil ed., Rebecca Ahmling trans., 2013).

170. Directive 2014/65, of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments and Amending Directive 2002/92/EC and Directive 2011/61/EU, 2014 O.J. (L 173) 349 (EU), ¶ 132, at 369 [hereinafter MiFID 2].

171. See, e.g., Mendoza, *supra* note 167, at 297 (describing AIM as a “junior” market for predominantly “senior” investors, though AIM does seek to attract retail investors through tax and other incentives). Several scholars have floated approaches to eliminating statutory obstacles to trading among accredited or other sophisticated investors. See, e.g., Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules That Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151, 208–11 (2013) (suggesting restrictions on tradability of shares and compliance with alternative disclosure regimes as conditions for a contingent exemption from periodic disclosure requirements for firms that meet the author's proposed size and numerosity thresholds); Pritchard, *supra* note 1, at 1019–20 (restricting access to the “English Premier League” companies to accredited investors); Sjostrom, *Carving a New Path*, *supra* note 58, at 664 (suggesting revisions to Rule 144 to promote an active resale market among sophisticated investors so that an issuer can obtain liquidity without going public).

172. The revisions to Rule 506(c) under Regulation D expressly contemplate such delegation. See *supra* note 38 and accompanying text. Other proposals have contemplated more aggressive self-certification regimes in which investors would qualify themselves to participate in comparatively less-regulated market centers. See, e.g., Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 280 (2000).

173. Schwartz, *Twilight of Equity*, *supra* note 14, at 580–92 (describing the contours of an “emerging-firm market”).

## B. *The Difficulty of Maintaining Issuer-Driven Tiers*

While multi-tiered exchange listing may hold promise as a tool of issuer-driven regulation, it has lost much of its effectiveness in the United States despite decades of experimentation. In some respects, lower-tiered markets have always struggled at attracting liquidity for small to medium-sized enterprises, regardless of how much energy regulators and market operators devote to promoting investor interest. In the United States, a variety of additional forces are at work: some commentators cite the federalization of corporate governance and disclosure policy as hampering the flexibility afforded to exchanges and market centers to develop and promote such tiers, while others focus on the laxity in enforcement of listing standards as exchanges increasingly compete for trading volume and listings.

### 1. Creeping Federalization of Standards

Scholars often cite the creeping federalization of corporate governance and disclosure policy as a prime factor in the erosion of the self-regulatory authority of exchanges.<sup>174</sup> Congress initially limited application of the Exchange Act's periodic reporting, proxy solicitation, and insider reporting and trading provisions to exchange-listed firms.<sup>175</sup> Frustration with larger firms that refused to list on exchanges led Congress to extend Exchange Act reporting to a broader swath of over-the-counter firms in 1964.<sup>176</sup> Similarly, as the SEC has expanded and reformed Exchange Act disclosure requirements during the past four decades, the marginal value of voluntary disclosures encouraged or mandated by listing rules has arguably diminished.<sup>177</sup>

While exchanges retain some incentives and discretion to promulgate qualitative governance rules and standards that are stricter than SEC requirements,<sup>178</sup> the SEC has often viewed exchange rule making and

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174. See Seligman, *New Corporate Law*, *supra* note 161, at 1–3 (discussing the displacement of state corporate governance norms by federal regulation); see also Dombalagian, *Identity Crisis*, *supra* note 9, at 324–28.

175. Dombalagian, *Identity Crisis*, *supra* note 9, at 324 n.24.

176. See Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565, 565–68 (amending the Exchange Act to extend “disclosure requirements to the issuers of additional publicly traded securities” by adding section 12(g) thereto); REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 3, at 7–17; Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17, 29–30 (1986).

177. See SELIGMAN, *supra* note 8, at 562–68.

178. See Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 329–30 (2001) [hereinafter Karmel, *Future of Corporate Governance*] (“Even after the promulgation of the Exchange Act, the NYSE was still concerned with the practices of its listed companies.”). In addition to the quantitative requirements for listing eligibility, the NYSE has

enforcement in the area of corporate governance as a means of circumventing statutory limitations on its own authority.<sup>179</sup> Following the SEC's failed attempt to regulate corporate governance listing standards in the 1990s,<sup>180</sup> advocates of corporate governance reform understandably turned to federal legislation.<sup>181</sup> Congress's unprecedented involvement in the composition and operation of corporate boards of listed companies over the past decade,<sup>182</sup> however justified, threatens to leave increasingly little room for exchanges to differentiate listed firms in terms of quality.<sup>183</sup>

At the same time, federal policy makers have made only lukewarm efforts to recognize privileges or provide other benefits for companies that choose to list. Some privileges have endured even as the signaling effect of a listing has diminished. The Federal Reserve Board's margin regulations

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historically imposed qualitative obligations, such as real-time disclosure of certain material information during volatile market conditions, and qualitative corporate governance rules respecting the independence of auditors, directors, and audit committees. *See* NYSE MANUAL, *supra* note 67, §§ 202.03, 303A.00 (2006). NYSE listing agreements also continue to provide important protections for investors in exchange-listed securities by restricting the dilution of their voting rights in various corporate finance transactions. *Id.* § 313.00(A).

179. *See* Karmel, *Future of Corporate Governance*, *supra* note 178, at 352; Robert Todd Lang et al., *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1490 (2002). Prominent examples are the SEC's efforts to require the NYSE to enforce its rule against dual class recapitalizations after its own Exchange Act Rule 19c-4 was vacated in *Bus. Roundtable v. SEC*, 905 F.2d 406, 417 (D.C. Cir. 1990), and to require exchanges to adopt rules governing auditor independence in the late 1990s. *See, e.g.*, Ira M. Millstein, *Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1057, 1063 (1999); *see also supra* note 70 and accompanying text.

180. *See, e.g.*, *Bus. Roundtable*, 905 F.2d at 407 (finding that the SEC exceeded its authority to amend exchange listing standards in adopting Rule 19c-4, which prohibited exchanges from listing stock of a corporation that takes any corporate action "with the effect of nullifying, restricting or disparately reducing the per share voting rights" of existing common stockholders because the rule "directly controls the substantive allocation of powers among classes of shareholders" (internal quotation marks omitted)).

181. *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 92–94, 121–23 (2005) [hereinafter Karmel, *Dream*] (discussing the federalization of stock exchange rules).

182. *See id.* at 123 (characterizing Sarbanes–Oxley's directive to the SEC as a "sub-delegation of delegated authority, which is troubling as a federal law making methodology"); *supra* notes 72–73 and accompanying text (describing the audit committee requirements of Sarbanes–Oxley and the compensation committee requirements of Dodd–Frank). Congress has previously looked to the independence of boards and board committees when considering the legitimacy of certain corporate actions in other contexts. *See, e.g.*, 26 U.S.C. § 162(m)(4)(C) (2012) (permitting corporations to deduct certain incentive-based compensation approved by an independent compensation committee).

183. *See* Karmel, *Dream*, *supra* note 181, at 121–23 (describing the NYSE's decision to adopt various listing standards relating to corporate governance in the wake of Sarbanes–Oxley).

have historically treated listed and unlisted equity securities differently because of the differing expectations as to the liquidity of those securities and the efficiency of the markets in which they trade.<sup>184</sup> Likewise, federal and state law may still steer U.S. institutional investors toward investments in listed securities due to historical restrictions on institutional participation in control.<sup>185</sup>

Even when policy makers attempt to create privileges for exchange-listed companies, it may be difficult to use those privileges as organizing principles for reinforcing a system of tiered listing. For example, Congress sought to preempt the application of state registration requirements to top-tiered, exchange-listed securities as part of the National Securities Markets Improvements Act of 1996 (NSMIA), thereby codifying exemptions for exchange-listed companies that largely permeated blue-sky laws at the time.<sup>186</sup> Because Congress later extended the same privilege to privately placed securities under Rule 506, however, the NSMIA exemption effectively undermines a nontrivial incentive to develop a progressive listing regime.<sup>187</sup>

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184. Generally speaking, broker-dealers may not extend credit against any “[n]onmargin, nonexempted equity security” because there is little guarantee that a broker-dealer will be able to liquidate the securities at a price reasonably related to market value after a customer default. 12 C.F.R. § 220.12(e) (2014); *see also id.* § 220.7 (setting maximum loan value of nonmargin stock and all other collateral for extensions of credit by banks and other lenders at their “good faith” loan value). Under Federal Reserve Board Regulations T and U, broker-dealers, banks, and non-bank lenders may lend customers up to 50% of the market value of any margin equity security (i.e., the customer must maintain equity, or “required margin,” of the remaining 50% of the purchase price) and require “good faith” margin for debt securities. *Id.* §§ 220.12(a), 221.7(a). SRO rules permit customers to finance securities purchases as long as they generally maintain minimum equity (or “maintenance margin”) in both equity and debt securities. *See, e.g.*, NYSE RULE 431.

185. *See, e.g.*, Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 306–15 (2007) (describing rules that restrict mutual funds and pension funds from engaging in certain types of investments). *See generally* ROE, *supra* note 20 (providing historical evidence that banks, insurers, mutual funds, and other institutional investors in the United States—unlike Germany, Japan, and other jurisdictions—have been actively discouraged from exercising a controlling interest in U.S. companies due to historical circumstance); *infra* note 279 and accompanying text.

186. *See* National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, § 18(a), 110 Stat. 3416, 3417–18 (codified at 15 U.S.C. § 77r(b)(1)(A) (2012)) (preempting state law registration and qualification requirements for “covered securit[ies],” including securities “listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the Nasdaq Stock Market (or any successor to such entities)”).

187. *See* Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 188–96 (2010) (criticizing the regulatory no-man’s land for privately placed securities resulting from the extension of section 18 of the Securities Act to Rule 506 offerings). The SEC has proposed to extend state law preemption to Regulation A+ offerings as well. *See supra* note 34 and accompanying text.

## 2. Competition Among Exchanges

Competition among exchanges and market centers is also frequently blamed for eroding much of the freedom that exchanges traditionally enjoyed in maintaining higher listing standards. Primary exchanges—such as the NYSE, NASDAQ, and the former American Stock Exchange (AMEX)<sup>188</sup>—have long competed for listing and trading revenues.<sup>189</sup> While these exchanges have remained successful at preserving the prestige of a primary listing, regional exchanges and alternative trading systems have succeeded in diverting substantial trading volume away from the trading facilities of the listing exchanges.<sup>190</sup> Meanwhile, foreign exchanges have gained ground on the NYSE and NASDAQ in attracting primary listings.<sup>191</sup>

To be fair, one may attribute much of the increase in competition to the SEC's efforts to deregulate exchange rules. Over the past several decades, the SEC has labored to eliminate many of the anticompetitive privileges once enjoyed by exchanges regarding listing and trading: not only has the SEC made it easier to trade securities off of an exchange, but it has pressured the exchanges to make it easier for issuers to delist as well.<sup>192</sup> Other elements of regulatory policy conversely squeeze the profitability of trading to the point that the liquidity commitments of listing exchanges may become increasingly desirable. For example, some commentators have

188. See, e.g., 15 U.S.C. § 77r(b)(1)(A) (recognizing the listing standards of the NYSE, AMEX, and the top tier of NASDAQ as the standard for preemption of state registration requirements). AMEX is now known as NYSE MKT. News Release, NYSE, NYSE Amex LLC to Be Renamed NYSE MKT LLC (May 10, 2012), available at <http://www1.nyse.com/press/1336646911531.html>.

189. See, e.g., Lang et al., *supra* note 179, at 1491 (“[B]oth the American Stock Exchange LLC (Amex) and Nasdaq have adopted less stringent corporate governance listing standards to compete with the NYSE for listings.”). Historically, exchanges derived their profits from three principal sources: listing fees, trading and market data fees, and membership fees. See Regulation of Market Information Fees and Revenues, Exchange Act Release No. 42208, 64 Fed. Reg. 70,613, 70,624–25 (Dec. 17, 1999).

190. See Maureen O’Hara & Mao Ye, *Is Market Fragmentation Harming Market Quality?*, 100 J. FIN. ECON. 459, 465–67 (2011) (analyzing the increase in market fragmentation as a result of the primary exchanges—the NYSE, NASDAQ, and AMEX—losing market share to alternative trading venues).

191. See Aaron Lucchetti, *U.S. Falls Behind in Stock Listings*, WALL ST. J. (May 26, 2011, 12:01 AM), <http://www.wsj.com/articles/SB10001424052748703421204576329400112880300> (paid subscription required) (illustrating the 43% decline in the number of U.S. listings from 1991–2011 and the concomitant rise of listings on foreign exchanges); see also *Cornerstone Study*, *supra* note 136, at 9 (noting the uptick in U.S. listings and IPO activity following the passage of the JOBS Act).

192. See Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. RICH. L. REV. 1069, 1122–33 (2005) [hereinafter Dombalagian, *Demythologizing*].

criticized the push to decimalization and the enhanced scrutiny of market-maker spreads under the Volcker Rule for reducing liquidity in the unlisted over-the-counter market.<sup>193</sup>

Whatever the cause, primary exchanges have a strong incentive to keep their listing standards sufficiently flexible to attract and retain issuers, whether for good or for ill.<sup>194</sup> Commentators have noted the tendency of exchanges to waive corporate governance rules for foreign issuers who are not subject to comparable rules in their home country or to delay involuntary delisting proceedings for larger companies that fail to meet qualitative listing requirements.<sup>195</sup> Skeptics argue that Congress and the SEC should strip exchange listing of its remaining significance in federal securities law rather than use the listing process as a focal point for coordinating federal and SRO policy.<sup>196</sup>

While this argument has some appeal, there are significant legal and historical differences between exchange listing and other certification mechanisms. First, the SEC must approve material changes to listing standards. Even in the muddy waters of a principles-based system of self-regulation, exchanges cannot unilaterally water down their listing standards without the SEC's assent.<sup>197</sup> Shifting certain aspects of public company regulation out of the SEC and onto self-regulatory bodies, moreover, insulates them from political scrutiny without a loss of SEC oversight.<sup>198</sup> In

193. See, e.g., 15 U.S.C. § 78k-1(c)(6) (requiring the SEC to “examine the impact that decimalization has had on the number of initial public offerings since its implementation” as well as “on liquidity for small and middle capitalization company securities and whether there is sufficient economic incentive to support trading operations in these securities in penny increments”); Order Directing the Exchanges and the Financial Industry Regulatory Authority to Submit a Tick Size Pilot Plan, Exchange Act Release No. 72460, 79 Fed. Reg. 36,840 (June 30, 2014) (ordering U.S. stock exchanges and FINRA to develop and implement a pilot program to widen quoting increments for certain small capitalization stocks); see also Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5579 & n.553 (Jan. 31, 2014) (discussing commentators’ concerns that a narrow exemption for market making under the Volcker Rule would reduce market-maker interest in the securities of small and midsized issuers and companies).

194. See, e.g., Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: “Are We There Yet?”*, 20 CARDOZO L. REV. 135, 221 & n. 413 (1998) (praising the flexibility of exchange listing standards relative to SEC rule making); NYSE Euronext, Annual Report (Form 10-K), at 23 (Feb. 26, 2013) (discussing the competitive pressures of exchange listing).

195. Lang et al., *supra* note 179, at 1514–15.

196. See, e.g., Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1462 (1992) (suggesting that exchange corporate governance standards are “marketing campaigns” that provide little substantive protection for shareholders).

197. See 15 U.S.C. § 78s(b)(2)(C)(i); see also 17 C.F.R. § 240.19b-4 (2014).

198. Aulana L. Peters, *Independent Agencies: Government’s Scourge or Salvation?*, 1988 DUKE L.J. 286, 291. *But see* Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A*

addition, exchanges cannot require their market makers to commit capital to firms that fail to draw sufficient trading interest or whose shares trade in such a sufficiently thin market that they run the risk of manipulation.<sup>199</sup>

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As with other regulatory functions formerly performed by national securities exchanges, listing may over time evolve into a self-funding regulatory function in the United States segregated financially and operationally from the trading operations of registered exchanges.<sup>200</sup> For example, as stock exchanges began to demutualize into for-profit companies, the member regulation arms of the NYSE and the National Association of Securities Dealers merged to establish FINRA as the single self-regulatory body for the securities industry.<sup>201</sup> While listing privileges in the United States are largely a duopoly enjoyed by the NYSE and NASDAQ (with other registered exchanges sharing in a sliver of the market share),<sup>202</sup> the proliferation of trading venues might counsel in favor of spinning off listing activity to a similarly constituted self-regulatory authority in the future.<sup>203</sup>

### C. *The Alternative of Metrics-Based Approaches*

Legislative and regulatory attempts to exclude or minimize issuer choice in regulation default to quantitative criteria. To be effective, such metrics must generally be both quantifiable and verifiable: the long-standing “financial milestones” employed in tiering registration and

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*Survey*, 80 S. CALIF. L. REV. 1239, 1253–56 (2007) (noting the criticism that regulatory oversight may be insufficient to counter the effects of political insulation).

199. See Jonathan Macey et al., *Down and out in the Stock Market: The Law and Economics of the Delisting Process*, 51 J.L. & ECON. 683, 709–10 (2008) (suggesting that “[a]n optimal listing policy [hypothetically] should provide optimal liquidity for a stock consistent with the exchange’s interest of making, or at least not losing, money while protecting both current and future investors in the company”).

200. See, e.g., Gadinis & Jackson, *supra* note 198, at 1294 (noting the trend to segregate the regulatory functions of exchanges and other SROs from activities in jurisdictions that rely on “cooperation” between SROs and administrative agencies that oversee them).

201. HAZEN, *supra* note 31, § 14.3[3], at 119–21 (describing the creation of FINRA).

202. See generally Daniel M. Gray, *The Essential Role of Regulation in Promoting Equity Market Competition*, 1 BROOKLYN J. CORP. FIN. & COM. L. 395, 398–99 (2006) (noting market participants’ concerns regarding the duopoly between the NYSE and NASDAQ).

203. See Macey et al., *supra* note 199, at 712 (providing an example of Canada’s Market Regulatory Service as an independent regulatory body responsible for upholding Universal Market Integrity Rules in Canadian markets and delisting noncompliant firms). FINRA performs a similar function in the United States with respect to the enforcement of business conduct rules by agreement with virtually all major U.S. securities exchanges. See HAZEN, *supra* note 31, § 14.3[3], at 119–21.

periodic disclosure obligations have historically included size as well as numerosity, age, or seasoning.<sup>204</sup> Moreover, a system of metrics-based regulation should ensure a reasonable scaling of regulatory obligations to individual tiers and provide an efficient mechanism for issuers to migrate from one tier to another and back.

### 1. Identifying Criteria and Metrics

The most difficult task in quantifying an issuer's progression down the pathway to publicness is to identify relevant criteria and apply appropriate metrics to monitor and enforce the issuer's progress. Policy makers often justify imposing higher disclosure or governance standards on larger issuers because larger issuers engage in more regulated conduct, generate more significant positive and negative spillover effects, or are simply better able to afford the necessary controls.<sup>205</sup> The numerosity of shareholders captures the intuition that legal requirements should vary based on the number of individuals who benefit and the difficulty of promoting collective action.<sup>206</sup> Age and seasoning are also factors that have become increasingly important, though scholars offer different theories as to why the relative age of a firm should justify more or less regulation.<sup>207</sup>

However relevant these milestones may be, the metrics used to measure them may be archaic, outmoded, or susceptible to abuse. Issuers may game their capital structure to avoid triggering metrics for monitoring numerosity, as discussed above, by reducing the fungibility of securities or aggressively exploiting the gap between record and beneficial ownership.<sup>208</sup> Creating new metrics, nevertheless, requires consideration of

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204. See Schwartz, *Law and Economics*, *supra* note 10, at 349–50 (discussing the academic attention that the issue of scaling disclosure requirements by measures of size and seasoning has drawn). Professors Langevoort and Thompson have proposed extending such metrics to calibrate the application of social disclosures as well. See, e.g., Langevoort & Thompson, *Publicness*, *supra* note 1, at 379–80 (recommending a \$700 million threshold consisting of “the top 20% to 30% of all registered companies” for the application of enhanced public disclosure requirements).

205. See, e.g., Schwartz, *Law and Economics*, *supra* note 10, at 367–69, 381–83, 387–89 (citing these and other commentators' arguments in favor of higher disclosure standards for larger issuers). One might measure size in a variety of ways, either by market capitalization for companies that have a public trading price or various measures of accounting assets (total assets or net worth) as calculated under generally accepted accounting principles. See *id.* at 368 & n.119.

206. In recommending legislation to Congress, the SEC considered, among other alternatives, whether transfers of stock, concentrations of holdings, or trading interest in interdealer markets might serve as alternative measures of public interest. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 3, at 18 (1963). The number of shareholders was ultimately adopted, “perhaps not surprisingly, as the single most workable and most meaningful criterion” to trigger periodic disclosure requirements for unlisted securities. *Id.*

207. See *infra* text accompanying notes 215–217.

208. See *supra* note 54 and accompanying text.

the attendant compliance costs. Volume-based metrics, for example, may complement or supplement size and numerosity requirements without introducing significant additional operational costs<sup>209</sup> to the extent that systems are already in place for collecting relevant trading data.<sup>210</sup> Other metrics, particularly those better linked with social disclosures, might be more challenging. For example, it may be more appropriate to target social disclosures through measures of economic footprint such as sales volume, earnings, market share, size of payroll, number of employees, and other factors.<sup>211</sup> However, building systems for standardizing such data might be excessively costly in light of the benefits.<sup>212</sup>

## 2. Monotonicity of Regulation

A second concern with metrics-based approaches is the delicacy with which policy makers can scale the scope of regulation to metrics. A recurrent theme of regulatory reform proposals is that issuers should enjoy reduced disclosure and substantive obligations in successively lower tiers

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209. See, e.g., Langevoort & Thompson, *Publicness*, *supra* note 1, at 341 (supporting volume-based thresholds). But see Guttentag, *supra* note 171, at 199–200 (suggesting that not enough empirical evidence exists to select volume-based thresholds for regulating disclosure). For example, the SEC has endorsed using U.S. trading volume for purposes of determining whether to require foreign issuers to register under the Exchange Act. See 17 C.F.R. § 240.12g3-2(b) & note 1 (2014) (exempting foreign private issuers from Exchange Act registration and reporting obligations under section 12(g) of the Exchange Act if, *inter alia*, “at least 55 percent of the trading in the subject class of securities on a worldwide basis took place in, on or through the facilities” of securities markets in the foreign jurisdiction where it is listed).

210. Quotation and transaction information about exchange-listed securities in the United States is collected through national market system plans overseen by the SEC. FINRA’s OTC Bulletin Board Service collects transaction information about shares in certain Exchange Act reporting companies, while its OTC Reporting Facility collects information with respect to all other equity securities traded otherwise than on an exchange in the United States. FINRA MANUAL, *supra* note 50, R. 6520–30, 6610. Various vendors provide electronic interdealer quotation systems for unlisted equity securities as well. See OTC MARKETS, <http://www.otcmarkets.com> (last visited Mar. 14, 2015); *OTC Bulletin Board*, FINRA, <http://www.finra.org/industry/otcbb/otc-bulletin-board-otcbb> (last visited Mar. 14, 2015); Macey et al., *supra* note 199, at 698–709 (observing that some delisted firms may enjoy substantial trading volume in such unlisted markets, including the former Pink Sheets market, and in some cases are superior to that of listed exchanges to the extent that unlisted markets are not subject to restrictions on tick size or affirmative market making obligations).

211. See, e.g., CAL. CORP. CODE § 2115(a)–(b) (West 2014) (purporting to regulate aspects of corporate governance based on certain predominating contacts with the forum state such as property holdings, payroll, sales, and other factors).

212. See, e.g., Pay Ratio Disclosure, Securities Act Release No. 70443, Exchange Act Release Nos. 9452, 78 Fed. Reg. 60,560, 60,569–73 (Oct. 1, 2013) (discussing the complexities of calculation and alternative methodologies in light of the fact that many companies simply do not keep track of the information necessary to perform the “total compensation” calculations required by the Exchange Act).

of trading, both to reduce the cost of regulation for smaller firms and because of the regulatory restrictions or natural limitations on the number, type, and sophistication of investors eligible to participate in them.<sup>213</sup> Advocates of tiered market structures thus typically begin with the assumption that policy makers will set a baseline for paradigmatically public companies and selectively whittle away disclosure requirements, governance standards, compliance burdens, and other regulatory elements to craft “less regulated” tiers.<sup>214</sup>

The implicit assumption of monotonicity in regulation is questionable for a variety of reasons. One may view some aspects of regulation as complementary rather than supplementary. For example, regulators need not decrease compliance costs and litigation risk for smaller issuers in tandem; instead, they may choose to treat them as alternatives for investor protection. In other cases, the implications of a metric (such as age) may not be clear.<sup>215</sup> One could argue, depending on one’s perspective, that seasoned companies should enjoy reduced compliance costs on the theory that they will have developed a following of outside analysts after a number of years,<sup>216</sup> or conversely, that unseasoned companies should enjoy reduced compliance costs to encourage them to go public sooner.<sup>217</sup>

The administrative process makes such fine-tuning difficult. If one assumes that a regulatory or self-regulatory authority should have some discretion to tinker with regulatory burdens as market conditions change, it is far easier to deregulate than to impose additional regulation. Defenders of the SEC note that the SEC has extensive experience with granting both general and individualized relief tailored to specific securities marketing or

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213. See, e.g., H.R. REP. NO. 112-406, at 6 (2012) (noting that the JOBS Act “provides temporary regulatory relief to small companies, which encourages them to go public, yet ensures their eventual compliance with regulatory requirements as they grow larger”).

214. See, e.g., Langevoort & Thompson, *Publicness*, *supra* note 1, at 352–53.

215. See, e.g., *id.* at 383–84 (expressing doubts about “on ramp” by time rather than size).

216. The SEC uses size and seasoning as a metric for relieving firms of the burden of producing duplicative information under Form S-3. See, e.g., Revisions to the Eligibility Requirements for Primary Securities Offerings on Forms S-3 and F-3, Exchange Act Release No. 8878, 72 Fed. Reg. 73,534, 73,536 (Dec. 27, 2007) (noting that “[p]ublic float has for many years been used as an approximate measure of a stock’s market following and, consequently, the degree of efficiency with which the market absorbs information and reflects it in the price of a security”).

217. See Mendoza & Vermeulen, *supra* note 40, at 8 (intimating that the difficulty of reversing the process of going public stalls the IPO decision); see also *infra* note 230 (discussing strategies for companies going private). Reversibility may be particularly important given the unpredictability of market conditions in the years following an IPO. For example, the five-year survival rate for companies after their IPO stood at 52% for IPOs during the period from 1996 to 2000, 66.7% from 2001 to 2008, and 89.8% from 2009 to 2013. *Cornerstone Study*, *supra* note 136, at 25.

distribution strategies.<sup>218</sup> However, as courts more rigorously challenge agency discretion and cost-benefit determinations,<sup>219</sup> it is increasingly difficult for agencies to add new obligations without encountering the prospect of significant litigation.<sup>220</sup>

### 3. Lack of Flexibility

Finally, metrics-based approaches hamper the flexibility of issuers to calibrate the preferred degree of publicness in line with business conditions. As private equity firms have made it easier for firms to “go private,”<sup>221</sup> managers of public companies may find it beneficial to oscillate between privateness and publicness during the life of a business. For example, managers of a firm may find it desirable to temporarily escape the public gaze to implement a long-term vision or take aggressive measures at the expense of short-term profits.<sup>222</sup>

A transition from higher to lower levels of regulatory disclosure might nevertheless trap public investors in an informational black hole.<sup>223</sup> Absent

218. See John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 552, 580 (2001) (suggesting that the SEC's current approach is “highly tailored” and offers a great deal of private choice).

219. Cf. 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, 1835 (2012) (“In a contemporary legal and political climate that is defined by a rising skepticism of government and more particularly of regulation, the SEC (and for that matter all independent regulatory agencies) must accept that it cannot support its rule making only through generalized, undeveloped assertions of a proposed rule's impact on competition, efficiency, and capital formation.” (footnote omitted)).

220. See, e.g., *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1146 (D.C. Cir. 2011) (involving a challenge to Exchange Act Rule 14a-11); *Chamber of Commerce v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005) (reviewing a rule created by the SEC under the Investment Company Act of 1940); see also Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289, 290 (2013) (discussing these developments).

221. See Bartlett, *supra* note 130, at 11–12; Kent Greenfield, *The Impact of “Going Private” on Corporate Stakeholders*, 3 BROOKLYN J. CORP. FIN. & COM. L. 75, 76 (2008) (noting that these private equity firms “buy up companies and take them out of the public markets, allowing them to be shielded from public scrutiny”). In “going private” transactions, either the issuer or an outside bidder must effectively repurchase sufficient publicly traded equity securities through a cash-out merger, reverse stock split, or reverse tender offer to fall below the section 12(g) threshold for Exchange Act reporting. See *supra* note 54.

222. Shareholder wealth maximization—combined with the pressures of providing quarterly reports, earnings guidance, and other soft information—arguably might force managers of some public companies to behave myopically. See, e.g., Greenfield, *supra* note 221, at 80–81. But see Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 978–81 (2013) (challenging the “short-termist argument”).

223. See Macey et al., *supra* note 199, at 710 (asserting that the delisting of an issuer may protect prospective investors at the expense of existing shareholders insofar as delisting may adversely “affect[] the liquidity of . . . the informational environment surrounding” their investment).

a forced sale of shares, any remaining shareholders in a company that decides to go private must sell their securities at prices set in an illiquid or inefficient market or seek other relief.<sup>224</sup> Some commentators have suggested that, as long as there is sufficient purchasing interest among sophisticated investors, retail investors would not suffer significant harm if a public market suddenly went private.<sup>225</sup> Others, however, view the risks of inefficient pricing, manipulation, and incomplete reporting as too great to permit issuers to withdraw from public trading without buying out retail investors.<sup>226</sup>

As a result, the ease with which firms can elect to transition back and forth among various tiers of publicness is an important consideration in the design of any regulatory scheme. Professor Robert Bartlett's study of the reporting practices of firms that have gone private suggests the appeal of a regulatory regime that offers issuers some flexibility in downgrading their level of publicness while continuing to supply information to key stakeholder constituencies on par with the Exchange Act.<sup>227</sup> Similarly, David Pompilio and Professors Jonathan Macey and Maureen O'Hara suggest that the delisting of larger companies should turn on a balancing of the economic interests of issuers, investors, and exchanges.<sup>228</sup>

While issuer-driven decisions to switch status may be prone to abuse, metrics-based regulation can force issuers to pursue unwieldy strategies to recalibrate their degree of publicness. Prior to the 1964 Securities Act Amendments, an issuer could in theory (with the consent of its shareholders) simply delist to avoid Exchange Act reporting rules.<sup>229</sup>

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224. Cf. Marco Ventrizzo, *Freeze-Outs: Transcontinental Analysis and Reform Proposals*, 50 VA. J. INT'L L. 841, 883–84 (2010) (discussing the availability of appraisal rights for delisting in various EU member states).

225. See Pritchard, *supra* note 1, at 1023–24.

226. See Schwartz, *Twilight of Equity*, *supra* note 14, at 564–76.

227. See Bartlett, *supra* note 130, at 43–44 (discussing the result of the exercise of registration rights, a private equity exit, or other transaction). According to Professor Bartlett, smaller firms were more likely to resort to “SOX-free forms of financing,” such as leveraged loans, to escape Exchange Act disclosure permanently. *Id.*

228. See Macey et al., *supra* note 199, at 710.

229. Most U.S. exchanges historically discouraged delistings by requiring audit committee approval or a supermajority vote of the shareholders, ostensibly to protect shareholders against a loss of liquidity resulting from delisting; critics nevertheless contended that such measures represented efforts by primary exchanges such as the NYSE to prevent competition for listings. See, e.g., Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. Repealing Exchange Rule 500 and Amending Section 806 of the Listed Company Manual, Exchange Act Release No. 48720, 68 Fed. Reg. 62,645, 62,646 (Nov. 5, 2003) (approving the repeal of former NYSE Rule 500); Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Relating to Voluntary Delistings by Listed Companies, Exchange Act Release No. 41634, 64 Fed. Reg. 40,633 (July 27, 1999) (approving elimination of

Today, firms must buy out their public shareholders in “going private” transactions<sup>230</sup> or otherwise engineer a reduction below the Exchange Act’s 300-shareholder floor<sup>231</sup> to avoid compliance with the Exchange Act’s reporting and monitoring requirements. Because such transactions often require a significant financial commitment from outside equity as well as concomitant returns, they run the risk that management will collude with bidders to manipulate the company’s share price.<sup>232</sup>

#### IV. PRINCIPLED TIERS OF PUBLIC COMPANY REGULATION

An issuer’s decision to become more or less public should ideally integrate its interests with objective determinations: there is little point in subjecting an issuer and its management to heightened levels of public scrutiny if the issuer is neither willing nor able to withstand the public gaze. A hierarchy of principles structured in the form of increasing regulatory privileges and obligations might create the appropriate incentives for issuers to progress through stages of publicness as they reach critical milestones, while preserving some room for negotiation with regulators and intermediaries at or near inflection points between tiers of regulation.

Consider, for example, how regulatory concepts such as suitability, efficiency, and perhaps representativeness, already inform the understanding of what it means to be public. Suitability ties the offer of securities to the adequacy of information available to brokers and the financial circumstances of the investor.<sup>233</sup> At the lower end of the spectrum

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the Rule 500 shareholder vote); *see also* Dombalagian, *Demythologizing*, *supra* note 192, at 1128–29. Today, an issuer may delist from the NYSE upon approval of the issuer’s board and compliance with the requirements of SEC Rule 12d2-2(c). *See* NYSE MANUAL, *supra* note 67, § 806.02.

230. *See supra* note 221.

231. 15 U.S.C. § 78l(g)(4) (2012). Issuers have engaged in questionable practices to achieve this objective. *See supra* note 54. Professor Jesse M. Fried has proposed requiring a shareholder vote, similar to the delisting requirement under former NYSE Rule 500 to effect a transaction that would result in a firm “going dark.” *See* Fried, *supra* note 54, at 157–60.

232. *See, e.g.*, Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 55–59 (2008) (discussing regulatory constraints on private equity transactions).

233. *See* Therese H. Maynard, *The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933*, 69 NOTRE DAME L. REV. 57, 123 (1993) (“[T]he suitability doctrine has been interpreted to require the broker–dealer to undertake an affirmative investigation into her client’s background so as to ascertain the information necessary to formulate appropriate recommendations.”); Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1557 (1999) (“The suitability doctrine, always somewhat nebulous and amorphous with respect to its content and parameters, may be broadly defined as a duty on the part of the broker to recommend to a customer only those securities which are suitable to the investment objectives and peculiar needs of that particular customer. The suitability doctrine entails the matching of two elements: (i) the investment objectives, peculiar needs, and other investments of the particular customer with (ii) the characteristics of the security which is being

of publicness, it may be appropriate to view suitability as a filter through which to regulate the diffusion of securities.<sup>234</sup> Similarly, efficiency ties the perceived integrity of market prices to the accuracy and continuity of mechanisms for collecting and disseminating inside and outside information. An even more rarified principle of representativeness might link the macroeconomic significance of a particular issuer to the issuer's power to shape business practices in a given industry.

Accordingly, one might classify the regulatory privileges and obligations of issuers at various stages of publicness based on the extent to which issuers, their securities, and the markets in which they trade resonate with these principles. For example:

- Suitability may serve as a principle for restricting the diffusion of securities until an issuer is prepared to generate adequate public disclosure about and attract adequate public diligence into its securities.
- Efficiency may serve as a principle for coordinating regulatory privileges and obligations designed to elicit soft information and improve price accuracy, such as enhanced controls, governance, and protocols for the dissemination of real-time, material information.
- Representativeness may serve as a principle for fostering better corporate governance and greater social responsibility among firms that seek recognition as macroeconomic benchmarks.

The goal of such principles-based tiers would be to calibrate both privileges and obligations in light of the ability and needs of the issuer and its investors. Commentators generally focus on the costs of increased publicness—heightened disclosure, monitoring, and accountability—and whether and when these costs should apply to particular issuers; less frequently discussed is the propriety of conferring regulatory privileges among such firms. While the primary benefit of publicness is access to deeper capital, calibrating privileges to obligations can both sharpen the incentives for becoming and staying public and reinforce a tiered system of public company regulation by better balancing costs and benefits.<sup>235</sup>

#### A. Tier 1: An Unsuitable Private Resale Market

As discussed above, a private resale market limited to accredited or sophisticated investors might best serve the needs of investors in emerging companies that are not yet ready to assume the risk and cost of ceding

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recommended.”(footnote omitted)).

234. *See supra* Subection II.A.2.ii.

235. Apart from modifications to the Exchange Act's reporting threshold, a self-regulatory body—preferably, a FINRA-like listing body unaffiliated with any trading market—could largely implement this Article's proposal through rules without replacing or conflicting with the Securities Act. *See supra* note 203.

control and information to the marketplace.<sup>236</sup> Given the lack of access and information attendant to such issuers, one approach to restricting the resale market is to consider their securities presumptively unsuitable for purchase by unaccredited investors.<sup>237</sup> Unaccredited investors would be able to purchase such shares on an unsolicited basis (whether in a direct offering or otherwise), but broker-dealers would bear the burden of proving suitability for any recommendations they make or any sales or resales they solicit. Courts or regulators might enforce such a presumption primarily through arbitration or litigation on the basis of the Rule 10b-5 implied cause of action.<sup>238</sup>

A market tier based on a presumption of unsuitability would allow unlimited transactions among accredited investors without the risk of more than minimal leakage to retail investors.<sup>239</sup> The presumption of unsuitability could be overcome in two ways: (1) if a broker-dealer takes “reasonable steps” to verify the accredited status of the investor;<sup>240</sup> or (2) if a broker-dealer can prove that it has undertaken independent diligence to obtain and provide sufficient information about the issuer and the security, in light of the investor’s ability to evaluate the merits and risks of the investment, such that the investor can make an informed investment decision.<sup>241</sup> This might allow for the possibility of “friends-and-family” resales or self-directed participation by certain sophisticated investors in resale markets.<sup>242</sup>

The advantage of a suitability principle is that it would allow the SEC to shift some of the more nettlesome elements of private placement regulation to SRO administration over time. The variety of factors that one could take into account in accrediting investors is institutionally better suited to an SRO such as FINRA (subject to SEC oversight and

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236. *See supra* note 171.

237. This presumption would thus place the burden of proof on the broker-dealer to demonstrate compliance with its “reasonable diligence” obligation under the suitability rule (similar to the Rule 506(c) verification requirement) rather than on enforcement officials or the investor in a private right of action. *See supra* note 38 and accompanying text.

238. *See supra* note 126 and accompanying text.

239. In effect, this Article’s proposal creates a private resale market similar to the structure that Professors A.C. Pritchard, William Sjoström, Michael Guttentag, and other commentators envision. *See supra* note 171.

240. *Cf.* 17 C.F.R. § 230.506(c)(2)(ii) (2014).

241. FINRA’s suitability rule for resales of OTC equity securities imposes additional diligence requirements on broker-dealers to “review[] the current financial statements of the issuer, current material business information about the issuer, and [make] a determination that such information, and any other information available, provides a reasonable basis under the circumstances for making the recommendation.” FINRA MANUAL, *supra* note 50, R. 2114.

242. *Cf.* 17 C.F.R. §§ 230.506(b)(2)(ii) (citing the sophistication requirement of SEC Rule 506(b)).

approval).<sup>243</sup> Moreover, to the extent that SEC rules restricting resales are necessarily interwoven with an analysis of the role of the issuer or intermediary in a “distribution,” an SRO-directed approach is more consistent with the authority of self-regulatory bodies to regulate secondary market operations under the Exchange Act.<sup>244</sup>

A second advantage is to gradually introduce issuers to the discipline of a regulated marketplace by conditioning the development of a secondary resale market on the provision of information to regulated intermediaries. Some commentators advocating recognition of private secondary markets assume that market operators will perform some vetting process with respect to both the issuer and its trading customers.<sup>245</sup> While an issuer-based system of verification may be reliable and cost effective for the initial placement of interests, it may be more troubling to permit the free

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243. A recent U.S. Government Accountability Office study on the definition of “accredited investor” surveyed a variety of alternative criteria relating to the investor’s understanding of financial risk to the relatively mechanistic criteria under Regulation D. 2013 AI Report, *supra* note 32, at 20–28. While most of the survey’s respondents felt that net worth was the best criterion for determining who is an accredited investor, a principal concern the study raised was that increasing the net worth and net income thresholds—through a periodic inflation adjustment—could unnecessarily shrink the pool of investors eligible to participate in Regulation D offerings. *Id.* at 12; *see also* Rodrigues, *supra* note 6, at 3422–25 (discussing the under- and over-inclusiveness of the accredited investor definition). Among the alternative standards related to an understanding of financial risk, commentators suggested that the definition should include the use of a registered investment adviser, a license and certification standard, an education standard, an examination requirement, or some sort of self-certification. 2013 AI Report, *supra* note 32, at 24–28. The Markets in Financial Instruments Directive similarly permits a more searching inquiry into the sophistication of an investor that opts to be classified as a “professional client.” MiFID 2, *supra* note 170, annex II, §§ I–II, at 484.

The administration of such rules is arguably better suited to the iterative supervision of a self-regulatory body like FINRA rather than the brute application of statutory thresholds or SEC rules. FINRA’s suitability rule requires a broker–dealer to have “a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities” to fulfill its suitability obligation to an institutional customer without further diligence into the security or the customer’s investment profile. FINRA MANUAL, *supra* note 50, R. 2111(b).

244. It is arguable that the current practice of regulating secondary market trading in restricted securities under section 4(a)(1) rather than SRO suitability rules allows for the possibility of issuer liability to downstream purchasers of securities sold in unregistered, nonexempt transactions. *See supra* note 35 (discussing the background of section 4(a)(1) of the Securities Act). To the extent that investors often have little recourse against issuers in failed offerings, such liability might not be as relevant as intermediary liability.

245. *Cf.* William K. Sjostrom, Jr., *Rebalancing Private Placement Regulation*, 36 SEATTLE L. REV. 1143, 1161–64 (2013) [hereinafter Sjostrom, *Rebalancing*] (proposing tailored civil liability for intermediaries in private placement transactions patterned after section 11 of the Securities Act). More saliently, private secondary market operators may come to appreciate that such vetting is necessary to create liquidity in the absence of direct relationships between prospective investors and issuers. *See supra* note 101 (discussing limitations on liquidity in private secondary markets).

resale of securities in a secondary market without some diligence or information-gathering obligation.<sup>246</sup>

### B. Tier 2: A Suitably Liquid Market for Publicly Traded Securities

The second tier comprises those securities that exhibit sufficient secondary market liquidity to warrant removing the presumption against suitability without imposing the full weight of Exchange Act reporting. While structuring such a tier is challenging, this Article envisions that Tier 2 would resemble a slow-motion IPO that provides issuers some breathing room to build secondary market liquidity and the disclosure and corporate governance mechanisms necessary to transition to a full-blown public secondary market.<sup>247</sup> Professors Jeff Schwartz and Adam Pritchard similarly envision an intermediary phase between private resales and an efficient public market for “emerging firms,” much as London’s AIM and the JOBS Act impose lower compliance obligations for smaller or “emerging growth” companies.<sup>248</sup>

The requirements of such a tier must therefore reflect a balancing of liquidity, disclosure, and verification. For example, part of the traditional appeal of an IPO is the commitment of the underwriter to stimulate secondary market demand for investors in an offering.<sup>249</sup> To the extent that building liquidity is a prerequisite to allowing broader retail investment, such issuers would need some liquidity commitment from an exchange, investment bank, or market makers to enter Tier 2. Alternatively, such issuers would need other evidence of sufficient trading interest to provide a reasonable expectation of liquidity for investors. Unlike a traditional IPO, the promotional efforts of the investment bank may evolve during the issuer’s time in Tier 2,<sup>250</sup> rather than around a carefully timed filing and effective date.<sup>251</sup>

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246. See, e.g., 17 C.F.R. § 240.15c2-11–15c2-12 (codifying provisions for OTC securities and municipal securities). The adequacy of those efforts may be of great reputational interest in the case of systems that cater to accredited investors and may be the subject of public enforcement, litigation, or arbitration in the case of broker-dealers that place securities with nonaccredited investors.

247. There is nothing to prevent an issuer from mounting a traditional IPO and moving into a higher tier more quickly. But this tier would give the issuer the option to assemble the components of the IPO more gradually.

248. See Schwartz, *Twilight of Equity*, *supra* note 14, at 580–90; Pritchard, *supra* note 1, at 1018–23. Professor Pritchard envisions that allowing companies to develop a reporting history and price discovery before permitting widespread retail investment in an at-the-market offering may obviate the negative features of IPOs. See *id.*

249. See Langevoort & Thompson, *IPOs*, *supra* note 7, at 911–12; see also Chen & Ritter, *supra* note 25, at 1116–19 (discussing the importance of commitment to ongoing analyst coverage in the pricing of IPOs).

250. See *supra* note 248 and accompanying text.

251. See generally Langevoort & Thompson, *IPOs*, *supra* note 7, at 895–909 (discussing the “devolution” of the Securities Act’s restraints on IPOs and marketing since 1933).

Eliminating the presumption against suitability, moreover, requires the availability of some public information vetted through collective external diligence. Listing markets may borrow specific disclosure requirements from any number of sources.<sup>252</sup> As Professor Jose Miguel Mendoza suggests, the threshold for minimum disclosure is not as critical as the freedom to provide enough information to attract trading interest by institutional and accredited investors and thereby to have access to the deeper liquidity provided by the addition of retail investors in subsequent tiers.<sup>253</sup> Such informal, unstructured information would eventually converge on the formal requirements of Exchange Act reporting in order to access such higher tiers.<sup>254</sup>

Because reliance on the accuracy of market prices is impossible in an inefficient market, market intermediaries (rather than self-certification of financial or disclosure controls by an issuer's management) should assume primary responsibility for regulating the quality of such disclosures. A number of commentators have suggested civil liability schemes that would require issuers to engage investment banks or other intermediaries to conduct disclosure audits and face civil liability for false or misleading statements.<sup>255</sup> In light of the reduced disclosure requirements for this tier, a heightened due diligence standard may be appropriate to hold the issuer or its sponsor accountable.<sup>256</sup>

The more difficult challenge is in developing a system of external diligence that balances costs and benefits. Stretching the due diligence requirements of the Securities Act over a multi-year period might pose undue risk to investment banks and intermediaries.<sup>257</sup> Nevertheless, such

252. Among other candidates for the minimum disclosure obligations discussed throughout this Article are those required by Rule 144A, those required by the quotation and suitability requirements applicable to broker-dealers with respect to OTC securities under Rule 15c2-11 and FINRA Rule 2114, those contained in standard disclosure covenants in public indentures, or those proposed for Tier 2 offerings under the SEC's proposed revisions to Regulation A. *See supra* notes 27, 57, 129, and 241 and accompanying text.

253. *See Mendoza, supra* note 167, at 296–97 (describing the customized compliance provided by AIM).

254. *Cf. Langevoort & Thompson, IPOs, supra* note 7, at 918–22 (discussing the information-filtering role of the informal preliminary prospectus in traditional IPOs under the Securities Act as compared to the retrospective “final prospectus” required by the Act).

255. *See, e.g., Fox, supra* note 135, at 913–17 (proposing an external certification regime for corporate disclosures); Mendoza, *supra* note 167, at 316–19 (describing the role of Nominated Advisers, or “Nomads,” in preserving the integrity of AIM and shepherding AIM issuers).

256. *See, e.g., Sjostrom, Rebalancing, supra* note 245, at 1162–66 (proposing a civil liability scheme for issuers, officers, directors, and placement agents in private placements with a “due diligence defense” similar to section 11 of the Securities Act).

257. With respect to shelf-registered offerings, underwriters assume ongoing due diligence obligations with respect to an issuer's periodic reporting as issuers take securities “off the shelf,” although the scope of section 11 liability in such cases is limited to direct purchasers. *See Joseph K.*

diligence risk may become more manageable if regulators limit diligence to annual reports and if issuers and sponsors benefit from good-faith safe harbors.<sup>258</sup> The risk may be blunted, moreover, by enforcing diligence requirements primarily through administrative sanctions<sup>259</sup> or requiring arbitration of claims.<sup>260</sup> Requiring one or more exchanges, investment banks, or market makers to publicly quote a security in this tier also introduces the issuer and its securities into the public price reporting mechanisms, which triggers a range of SRO surveillance mechanisms.<sup>261</sup>

An issuer that drops out of this tier—either because it ceases minimum disclosure reporting or because it loses market-maker coverage—would transition back to the first tier. As a result, the transition from Tier 1 to Tier 2 could not be taken lightly: firms must either jumpstart secondary market trading through a traditional IPO or generate enough institutional interest to persuade an exchange or market makers to enter this tier.<sup>262</sup> The reverse is true as well: firms and their intermediaries seeking to return to Tier 1 would have to anticipate the implications of withdrawing liquidity from unaccredited investors, particularly if such action might subject an issuer to

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Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After Worldcom*, 30 CARDOZO L. REV. 2001, 2005–07, 2014–16, 2027 (2009).

258. This Article envisions that such disclosures would be entitled to the protection covering forward-looking statements in Rule 175, 17 C.F.R. § 230.175 (2014), but not the more definitive safe harbor for Exchange Act reporting companies today. 15 U.S.C. § 78u-5(c) (2012).

259. For example, issuers that fail to meet their disclosure requirements may face delisting or lose their eligibility to advance to more liquid tiers, while sponsors that fail to meet their diligence obligations may face disqualification from sponsoring similar issuers. *Cf.* 17 C.F.R. § 230.506(d) (enumerating events that disqualify a “bad actor” from placing securities under Rule 506).

260. Professor Barbara Black has argued that the use of corporate charters and bylaws to require arbitration of securities law disputes are illegal under at least state law, if not federal law. Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar*, 2009 COLUM. BUS. L. REV. 802, 851. Nevertheless, recent Delaware cases have suggested an acceptance of forum-selection bylaws. *See, e.g.*, *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934, 938 (Del. Ch. 2013). The SEC and listing exchanges might deem such provisions inconsistent with the requirements for companies trading in Tier 3. To the extent that there is no expectation of public reliance on market prices under the *Basic* doctrine, courts will not likely recognize the availability of class actions in any event. *See supra* text accompanying note 76 (explaining the *Basic* doctrine).

261. While this Article’s proposal recognizes the link between OTC market making and involuntary reporting, neither the issuer nor the market maker can act alone. *See supra* text accompanying note 42. Under the proposal, issuers cannot be eligible for public trading and thus escape suitability constraints without a market maker to sponsor trading, and market makers may not quote prices in securities without the availability of minimum disclosures.

262. For well-connected firms, the flexibility to choose between tiers may be desirable. Venture capital and private equity firms, for example, might appreciate the freedom to negotiate an underwritten offering or a commitment to market making depending on the nature of the security and the degree of retail and institutional interest. For firms that do not qualify for the VC fast track, market makers and SROs that operate both private secondary markets and public over-the-counter markets would be free to devote resources toward helping issuers phase across platforms without incurring the expense and risk of an IPO.

liability for breach of fair dealing under state law or subject intermediaries to liability if they breach representations as to liquidity.

### C. Tier 3: An Efficient Market for Pricing Securities

The third tier encompasses firms that trade in a sufficiently efficient market to warrant application of higher compliance obligations. To qualify for this tier, an exchange would have to determine that the issuer's securities meet the exchange's criteria for price efficiency.<sup>263</sup> Such firms would thereafter undertake to comply with disclosure rules designed to ensure broad, continuous dissemination of information. These rules might include enhanced financial and disclosure reporting controls, audit committee requirements, selective disclosure prohibitions, and real-time disclosure requirements. Policy makers might also require such firms to comply with corporate governance requirements designed to improve reporting accuracy and accountability to shareholders.<sup>264</sup>

The function of this tier is essentially to reinvigorate the role of a traditional exchange listing in screening firms for liquidity and price efficiency. Since the *Basic* decision, courts have, for good or for ill, usurped this role from the exchanges.<sup>265</sup> The *Basic* test essentially supersedes the function of exchanges in identifying firms whose securities trade in a relatively efficient market based on largely quantitative and empirical factors.<sup>266</sup> Rather than relying on a judicial determination of efficiency in the context of an adversarial process (particularly one disfavored by courts), a regulatory or self-regulatory authority (such as a stock exchange's listing board) ought to make determinations of efficiency in accordance with an administrative process that weighs the costs and benefits of recognizing the market for a firm's securities as relatively efficient.

To the extent that federal securities law favors seasoned Exchange Act reporting companies in a variety of regulatory contexts,<sup>267</sup> only Tier 3 and Tier 4 companies would have access to these regulatory benefits under this Article's proposal. For example, there may be less need to regulate follow-

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263. This proposal would not prohibit exchanges from listing securities in lower tiers. Instead, as discussed above, this Article envisions that exchanges would establish national market tiers that correspond to the gradations of publicness this Part of the Article outlines.

264. Enhancing proxy solicitation rules, proxy expenditure rules, institutional nomination procedures, compensation oversight, and other corporate governance initiatives may only make sense in markets with a sufficient institutional participation to ensure their judicious use. To the extent that Congress has restricted the application of many of its enhanced corporate governance requirements to listed companies, the reservation of such requirements to Tier 3 is consistent with Congress's current policy.

265. See *supra* text accompanying notes 75–77.

266. See *supra* note 77 and accompanying text.

267. See *supra* note 78.

on offerings or affiliate resales in a market where professional trading interest, rather than managerial speculation, arguably sets prices.<sup>268</sup> Extensions of credit against securities collateral are likewise reasonable if publicly reported prices bear a fair relationship to the liquidation value of a security.<sup>269</sup> Antifraud laws may further limit liability for forward-looking statements and other soft information to the extent that professional traders are able to filter them critically.<sup>270</sup>

Meanwhile, the option to delist to Tier 2 instead of Tier 1 may mitigate the negative impact of voluntary and involuntary delisting from Tier 3. While some firms may prefer to avoid public markets altogether, the option to reduce the cost of disclosures and controls while retaining retail investors in Tier 2 may appeal to some firms, particularly those required to delist for failure to meet qualitative listing standards.<sup>271</sup> A negotiated transition from Tier 3 to Tier 2, with the prospect of relisting, may blunt the immediate outflow of institutional investors from delisted companies as well.<sup>272</sup>

#### D. Tier 4: A Market for Representative Issuers

The final tier might entice large firms that are representative of their industries' business practices to provide greater social disclosures as a condition of representation in nationally-recognized indices and the heightened liquidity available to the component securities of such indices.<sup>273</sup> Listed firms would opt into this tier by undertaking to comply with enhanced disclosures about their business operations and the impact they have on stakeholders other than shareholders. In return, policy makers would, as they do in some respects today, recognize national and sector indices comprised of such securities as suitable underlying instruments for listed index products.<sup>274</sup>

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268. See *supra* text accompanying note 35.

269. See *supra* note 184 and accompanying text.

270. 15 U.S.C. § 78u-5(c) (2012) (stating the safe harbor requirements for forward-looking statements under the Private Securities Litigation Reform Act); see also *supra* text accompanying notes 64–66.

271. Professor Macey and his co-authors observe that a significant percentage of regulatory delistings are due to the failure to meet quantitative criteria only loosely related to the reduced profitability of exchange trading. See Macey et al., *supra* note 199, at 692. They suggest that regulators should mandate delisting of otherwise solvent companies only in the case of “fraud or illegal activity,” while relaxing quantitative benchmarks if there is sufficient volume to sustain liquidity or an increase in listing fees to subsidize the provision of liquidity. *Id.* at 711–12.

272. See, e.g., *id.* at 698 (observing the high institutional trading volume that immediately follows delisting as institutional investors rebalance portfolios to offload such securities).

273. See Langevoort & Thompson, *Publicness*, *supra* note 1, at 375 (proposing “a distinct class of systemically significant public issuers” upon whom “[p]ublicly reactive regulation (and

One of the goals index providers strive to achieve in composing an index is to “clearly convey the economic realities of the underlying interest it seeks to measure to its users.”<sup>275</sup> Investors in broad-based indices, such as the S&P 500, seek exposure to systematic macroeconomic risks while canceling out industry- or firm-specific risks through diversification.<sup>276</sup> Investors in sector indices similarly seek exposure to a sector of the market, including the political, social, and economic factors affecting specific industries.<sup>277</sup> To the extent that the content of social policy disclosures relates to the business prospects of a firm, it is probably due to the systematic risk of legislation, regulation, or public pressure affecting all firms within an economic region or sector.<sup>278</sup> Disclosures by a handful of representative issuers might therefore suffice to establish a baseline understanding of how relevant industries operate.

Meanwhile, inclusion in an index gives issuers privileged access to a broader pool of passive investors. Index-linked funds have increasingly become investments of choice for individual retirement plans, mutual funds, and other forms of passive investment.<sup>279</sup> Trading activity in futures and options markets similarly fosters liquidity in the component securities underlying an index.<sup>280</sup> Regulators may also consider increasing net capital

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most of the inchoate social agenda) would presumably be concentrated,” in order to leave “small and mid-cap companies . . . free of the unintended burdens of publicness”).

274. Cf. 7 U.S.C. § 1a(35)(B)(i); 15 U.S.C. § 78c(a)(55)(C)(i)(III)(aa) (linking exclusion from the definition of “narrow-based security index” to the reporting status of an issuer under section 12 of the Exchange Act).

275. BD. OF INT’L ORG. OF SEC. COMM’N, FINANCIAL BENCHMARKS: CONSULTATION REPORT 10 (Jan. 2013), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD399.pdf>.

276. Shareholders that hold a diversified, leveraged portfolio may be largely indifferent to the risk-return ratio of individual portfolio companies. See RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 210 (7th ed. 2003) (asserting that “investors who can . . . borrow and lend at the risk-free rate of interest should choose the *best* common stock portfolio *regardless* of their attitudes to risk” under the capital asset pricing model).

277. See Patrick J. Collins, *Prudence*, 124 BANKING L.J. 29, 61 (2007) (discussing the benefits of sector diversification); William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 95 (2008) (discussing the dangers of index products targeted at highly specialized or narrow sectors).

278. Langevoort & Thompson, *Publicness*, *supra* note 1, at 372–74 (discussing the permeation of socio-political externalities in disclosure regulation).

279. See HARRIS, *supra* note 42, at 488 (describing the appeal of index funds to passive investors); Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 301 (2000) (proposing to “limit unsophisticated investors to investments in only passive index mutual funds”).

280. See HARRIS, *supra* note 42, at 489 (noting that program trading in index components accounts for a substantial percentage of trading on the NYSE). There is a significant literature debating whether inclusion in an index leads to a permanent increase in the market value of selected firms. See, e.g., Maria Kasch & Asani Sarkar, *Is There an S&P 500 Index Effect?* 1 (Mar. 2014) (unpublished manuscript), available at <http://dx.doi.org/10.2139/ssrn.2171235> (finding that,

haircuts, reducing margin requirements, and generally tying other regulatory privileges to the enhanced liquidity enjoyed by such securities.<sup>281</sup>

Although the Exchange Act does not directly regulate indices today, both U.S. and international regulatory developments are bringing index composition and calculation under increasing regulatory scrutiny, particularly with respect to the integrity of component securities.<sup>282</sup> Moreover, to the extent that most retail trading in derivatives products takes place on an exchange,<sup>283</sup> exchanges can easily impose disclosure requirements on component securities as a condition for listing broad-based and sector-based index products.<sup>284</sup> Large firms might of course forgo inclusion in an index if they believe the costs of enhanced disclosure exceed the reputational and commercial benefits. Even so, general principles of materiality may compel such firms to disclose deviations in their business practices from those of representative issuers.<sup>285</sup>

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contrary to the consensus in the literature, index inclusion has no permanent effect on value and comovement after accounting for the extraordinary preinclusion performance of component securities).

281. For example, the Basel Committee on Banking Supervision recognizes common equity shares included in a major stock index to be Level 2B “high-quality liquid assets” for purposes of calculating the liquidity coverage ratio for financial institutions. BANK FOR INT’L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, BASEL III: THE LIQUIDITY COVERAGE RATIO AND LIQUIDITY RISK MONITORING TOOLS ¶ 54(c) (Jan. 2013), *available at* <http://www.bis.org/publ/bcbs238.pdf>.

282. *See, e.g.*, Proposal for a Regulation of the European Parliament and of the Council on Indices Used as Benchmarks in Financial Instruments and Financial Contracts, art. 19, COM/2013/0641 Final (proposing to restrict the ability of certain supervised entities to use benchmarks that are not subject to EU or equivalent regulation); BD. OF INT’L ORG. OF SEC. COMM’N, PRINCIPLES FOR FINANCIAL BENCHMARKS: FINAL REPORT 20–22 (Feb. 2013), *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf> (proposing a framework for regulating standard benchmarks); Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise and Failure of Financial Indices*, 30 YALE J. ON REG. 1, 42–51 (2013) (discussing these developments).

283. *See, e.g.*, 7 U.S.C. § 6(a) (2012) (prohibiting trading in futures otherwise than by or through a designated contract market); HARRIS, *supra* note 42, at 50–58 (surveying trading markets for retail index options, futures, and other derivatives).

284. For example, for an issuer’s securities to be eligible for inclusion in an index, an exchange might require the issuer not only to agree to provide the exchange with all material information relevant to the individual firm and the market in which it competes, but also to provide additional information to Congress and the SEC via legislation or rule making relating specifically to their business practices.

285. Some firms may benefit from actual changes in regulatory policy that affect their competitors (and therefore have an incentive to disclose how their business practices deviate from the norm). Others may be disadvantaged by anticipated changes in regulatory policy (and therefore may face the risk of litigation if their disclosure practices fail materially to describe how changes in regulatory policy may affect their business).

### CONCLUSION

The privileges and obligations of public companies must evolve with the needs of markets. Regulators play a critical role in standardizing those privileges and obligations, but issuers, investors, and market intermediaries must ultimately make informed trade-offs based on evolving market conditions. A principles-based system of public company regulation may empower issuers and regulated intermediaries to make such calculations within an intuitive framework that is resilient in the face of shifting political winds and market cycles.

