THE NEED FOR A COMPREHENSIVE APPROACH TO CAPITAL MARKETS REGULATION

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With the adoption of the Jumpstart Our Business Startups Act in 2012, Congress recognized the need to spur economic growth by facilitating access to the public market. However, certain pieces of that Act seem to have created opportunities for companies to stay private longer and enhanced optionality in the decision to go public. Now, in light of private market expansion, and as the steady decline of publicly listed firms from the late 1990s peak continues, it is time for Congress and the SEC to make a comprehensive accounting of market structure and market participation. This Article contextualizes changes to the securities laws over recent years, raises key issues and concerns related to the effects of private market growth on the public market, and gives recommendations regarding how the SEC should move forward in its attempts to expand investor eligibility in the private market. In addition, it calls for the commencement of a special study to examine the structural issues and recent changes in both markets and recommend coordinated reforms to the regulatory

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structure. We believe that a more comprehensive regulatory approach is needed to ensure the appropriate expansion of the private market while protecting the public market and investors at large.

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I. INTRODUCTION

The private securities market has experienced immense growth over the past decade, with an unprecedented amount of funds becoming available for private market investments. The number of private equity firms doubled during this time, and private market assets under management grew by 170% ($4 trillion).[1] The rapidly growing private market serves as an effective source of capital for small- and medium-sized enterprises, for whom access to the public market may be cost-prohibitive. But the increased availability of private capital has also enabled companies to fund more rounds of financing before going public, delaying the entry of large private firms into the public market. While the amount invested in the private market has grown, non-accredited retail investors have been excluded from investment opportunities in this market through regulations developed to promote investor protection. These investors are therefore limited to the public market. Although the overall size of the public market as judged by total market capitalization remains robust and has been increasing over the past decade,[2] the number of publicly listed firms has steadily declined—from its peak of 7,322 in the late 1990s to 3,671 in 2017.[3] The number of yearly initial public offerings (IPOs) has similarly decreased, from 486 IPOs in 1999 to only 176 IPOs in 2017.[4]

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[1] SARA BERNOW ET AL., MCKINSEY & CO., A NEW DECADE FOR PRIVATE MARKETS 2 (2020), https://www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/McKinseys%20Private%20Markets%20Annual%20Review/McKinsey-Global-Private-Markets-Review-2020-v4.pdf [https://perma.cc/4TVT-RR27].

[2] *Total Market Value of U.S. Stock Market*, SIBLIS RSCH., https://siblisresearch.com/data/us-stock-market-value/ [https://perma.cc/36M2-U8G7] (last visited Feb. 24, 2021).

[3] Jason M. Thomas, *Where Have All the Public Companies Gone?*, WALL ST. J. (Nov. 16, 2017, 7:10 PM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/where-have-all-the-public-companies-gone-1510869125.

[4] *Number of IPOs in the United States from 1999 to 2019*, STATISTA (on file with the Columbia Business Law Review), https://www.statista.com/statistics/270290/number-of-ipos-in-the-us-since-1999/ (last visited May 10,

The simultaneous growth of the private market and decline of the public market present a regulatory dilemma. On one hand, the growing investment opportunities in the private market weigh in favor of expanding the market to a wider class of investors. On the other hand, the public market provides crucial benefits and protections for investors that cannot be replicated in the private market without legislation and increased regulation. The robust mandatory disclosure and liability regimes in the public market protect retail investors who may lack the expertise to analyze investments. Conversely, the private market, with its more relaxed disclosure and liability regimes, poses significantly more risk for retail investors. These considerations weigh in favor of taking measures to preserve the public market by increasing firms' incentives to go public. The regulatory response of Congress and the Securities and Exchange Commission ("SEC" or "Commission") to this dilemma has been ad hoc, in that it has made changes in access to each market without assessing the impact of such changes on the other. Through the 2012 Jumpstart Our Business Startups Act (the "JOBS

2021). The years 1999 and 2000, seeing 486 and 429 IPOs respectively, are likely outliers as those years coincided with the "internet bubble." In the years since the last financial crisis, yearly IPOs from 2010 to 2019 in the U.S. have been between a low of 100 in 2016 and a high of 268 in 2014. *Id.* But there is evidence that 2020 may be a departure from this trend, given that over 235 companies have gone public this year. *See* Corrie Driebusch, *IPO Market Parties Like It's 1999*, WALL ST. J. (Sept. 25, 2020, 12:47 PM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/ipo-market-parties-like-its-1999-11601052419. Over 80% of these IPOs consisted of healthcare companies, technology companies, and special purpose acquisition vehicles (SPACs). *Id.* This increase has been facilitated by pandemic-induced market shifts, including decreased availability of private market funding after shutdowns, an influx of money from the federal government into the markets, the growth of SPACs after high-profile companies utilized them to go public, and the growth of the technology and healthcare sectors. *See id.* For further discussion of SPACs, see *infra* Parts III and IV. Additionally, as the number of IPOs has been declining since as early as 2000, there is evidence that this decline is driven at least in part by consolidation and economy of scale, apart from regulatory changes. *See, e.g.*, Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1667 (2013).

Act") and subsequent rules and amendments, Congress and the Commission laid out a framework that would, in theory, spur public market participation by permitting confidential filings and "testing-the-waters" to allow companies to gauge market interest in their offerings prior to incurring the cost of preparing and filing their registration statements. Thus far, evidence indicates that the JOBS Act has succeeded in attracting new entrants to the public market in certain industries, but its overall effectiveness is less clear.[5] At the same time, recent private market reforms have expanded the scope of offering exemptions and the pool of investors eligible to participate in private offerings.[6] The question remains whether such an expansion will be met with a proportionate increase in investor protection.

The public and private markets are interconnected. Therefore, addressing the dual goals of appropriately expanding investors' access to the private market while still preserving the public market will require a more coordinated regulatory approach. Moreover, public market participation cannot be increased without addressing structural issues that make it unattractive to many small- and medium-sized enterprises, as well as larger private firms. These issues remain largely unaddressed by recent reforms, and addressing them will require an in-depth study of the capital markets. The last such study was conducted over five decades ago and led to important and effective regulatory reforms.[7] Since then, the markets have changed significantly due to

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[5] *See infra* Section III.B.

[6] *See* Press Release, SEC, SEC Proposes Rule Changes To Harmonize, Simplify, and Improve the Exempt Offering Framework (Mar. 4, 2020), https://www.sec.gov/news/press-release/2020-55 [https://perma.cc/HHN3-MY2P]; *see also* Tom Zanki, *SEC Small Biz Panel Wants Limits Eased on Private Offerings*, LAW360 (May 8, 2020, 6:50 PM) (on file with the Columbia Business Law Review), https://www.law360.com/articles/1271699/sec-small-biz-panel-wants-limits-eased-on-private-offerings.

[7] *The New Special Study of the Securities Market*, COLUMBIA L. SCH.: THE PROGRAM IN THE L. & ECON. OF CAP. MKTS., https://capital-markets.law.columbia.edu/content/new-special-study-securities-markets [https://perma.cc/3WMB-RLVD] (last visited Feb. 24, 2021).

factors such as technological development, globalization, and regulatory reform.

This Article therefore recommends that Congress and the Commission undertake a comprehensive study to explore regulatory reforms that can address the substantive changes that have occurred in the capital markets. In the short term, this paper recommends further revisions to the accredited investor definition under Rule 501 of Regulation D (Reg D) in order to safely expand access to the private market.[8] In the long term, this paper calls for a special study that examines how to address structural concerns with the public market in light of recent technological innovation and identifies changes to be considered. Given the need to spur capital growth in response to the COVID-19 pandemic, the time is ripe for such a study. In addition to the issues discussed in this Article, the study should consider how to ensure that the small- and medium-sized businesses most affected by the pandemic can more easily access capital, as well as how non-accredited investors can safely take part in the economic growth that will hopefully come after the pandemic.

This Article proceeds as follows: Part II provides background on the U.S. securities laws and their role in shaping public and private markets; Part III discusses the policy considerations that should drive regulatory reform, including benefits of the public market, structural issues that may deter companies from going public, and concerns with unchecked expansion of the private market; finally, Part IV

[8] Until recently, the "accredited investor" definition for the purposes of Regulation D included investment companies, private business development companies, directors, executive directors or general partners of the issuer, and any individuals that met bright-line wealth or income requirements. 17 C.F.R. § 230.501(a) (2020). In August 2020, however, the SEC amended the definition to allow those holding certain professional certifications to qualify as accredited investors. Accredited Investor Definition, 85 Fed. Reg. 64,234, 64,237 (Oct. 9, 2020) (to be codified at 17 C.F.R. pts. 230, 240). It also qualifies directors, senior executives, and individuals who participate directly in investment activities of private funds (knowledgeable employees) to be accredited investors. *Id.* As discussed *infra* Part IV, we believe further changes are necessary in order to expand the private market to more investors while preserving investor protection.

concludes by suggesting revisions to the accredited investor definition to address short-term concerns regarding access to the private market and calling for a study to focus on longer-term structural concerns that may be stymying public market growth.

II. OVERVIEW OF CAPITAL MARKETS REGULATION

Current U.S. securities law distinguishes between public and private offerings. A publicly traded company must comply with the registration and disclosure framework established by the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") (collectively the "Acts"). This heightened disclosure and liability regime serves to protect both initial investors when companies seek to raise money in offerings to the general public and subsequent investors who trade in public companies' securities on national exchanges. Recognizing the need for private companies to raise capital as well, the Securities Act and subsequent legislation carved out several exemptions to allow certain individuals and entities to invest in private offerings. Private offerings—with a more relaxed disclosure and liability regime—are limited to a narrower category of sophisticated investors deemed to be able to fend for themselves. This Part will give a brief overview of public market regulation, explain the exemptions that apply to private offerings and helped to spur private market growth, and give an account of recent reforms and proposals to reform these exemptions.

A. Public Market Regulation

The Exchange Act established the SEC as an independent federal agency responsible for protecting investors, maintaining the fair and orderly functioning of the securities markets, and facilitating capital formation.[9] The SEC

[9] Securities Exchange Act of 1934 (Exchange Act), Pub. L. No. 73-290, § 4, 48 Stat. 881, 885 (codified as amended at 15 U.S.C. § 78d (2019)).

operates through an extensive disclosure regime, the creation of which was heavily influenced by Justice Louis Brandeis's regulatory philosophy that "[s]unlight is said to be the best of disinfectants."[10] The premise of the Securities Act was that "truth in securities" would create investor confidence in the securities market following the abuses and rampant speculation of the interwar era.[11] The regime was built on two basic notions: first, companies would eventually have to solicit money from the general public to operate and expand; second, the full disclosure required under the Acts would provide investors with sufficient information to make informed investment decisions without having any financial expertise or prior experience.[12]

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[10] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Frederick A. Stokes Co. 1914); *see also* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 6 (8th ed. 2017).

[11] HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES & FEDERAL CORPORATE LAW, Westlaw (database updated Dec. 2020) (preface); *see also* COX ET AL., *supra* note 10, at 6 (internal quotation marks omitted) (quoting H.R. REP. No. 73-85, at 2 (1933)) ("Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High pressure salesmanship rather than careful counsel was the rule in this most dangerous enterprise.").

[12] Interestingly, when the Securities Act was initially enacted, commentators pointed out that there was a logical issue with this underlying policy determination. For example, some "questioned whether many investors would benefit from the [Securities] Act's disclosure requirements. The highly technical information provided in registration would be 'small comfort' to those in need of investment guidance. The average investor has difficulty assimilating the vast amounts of information to make an informed investment decision." Elisabeth Keller & Gregory A. Gehlmann, Introductory Comment, *A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1943*, 49 OHIO ST. L.J. 329, 342–43 (1988) (footnotes omitted) (quoting William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 172 (1933)). As the efficient market hypothesis developed, however, it became evident that analysts with financial expertise would be able to discern pertinent information for the registration statements and ongoing disclosures in order to ensure that prices on market exchanges were a fair representation of the information available to the public. *See infra* Section IV.A.1.

Under section 5 of the Securities Act, any offering that is a "public offering," i.e., one that does not qualify for an exemption, must first be registered with the SEC.[13] The filed registration statement, along with the issuer's prospectus, are meant to provide investors with full and fair disclosure regarding the securities being offered.[14] A company may not offer a security for sale until it files its registration statement, and may not close a public offering until the registration statement is declared "effective" by the SEC.[15] Because of the initial structure of the Securities Act, an issuer would usually meet and hire an underwriter months before a planned IPO to begin preparing for the offering.[16] The typical "firm commitment" underwriter would purchase the underlying security from the issuer for resale to the public at a specific offering price.[17] However, neither the issuer nor the underwriter could meet with prospective investors until the registration statement was filed.[18] From the time of the decision to make an offering (the *pre-filing* period) to the time the registration statement was declared effective (the *post-effective* period), the SEC imposed many restrictions on the timing and types of communications issuers and underwriters could make.[19] Although recent changes known as "testing-the-waters" have allowed for broader communications among issuers, underwriters, and potential purchasers during the pre-filing and post-filing/pre-effective period, it generally remains the case that, unless an exemption applies, an issuer and underwriter may not offer to sell a security before filing the registration statement or consummate the offering until the registration statement is declared effective.[20] The result

[13] *See* 15 U.S.C. § 77e (2019).

[14] COX ET AL., *supra* note 10, at 6–7.

[15] *Id.* at 7.

[16] *Id.* at 108.

[17] *Id.* at 106.

[18] *Id.* at 139.

[19] *See* LATHAM & WATKINS LLP, US IPO GUIDE 15 (2020), https://www.lw.com/thoughtLeadership/lw-us-ipo-guide [https://perma.cc/G3AB-R9UU].

[20] *See id.* at 15–16.

is that the issuer must incur the significant costs associated with preparing the registration statement without knowing whether the offering will be positively received by investors.

Compliance with the strictures of the Securities Act is ensured through private and public remedies.[21] A private right of action is available under section 11 for materially false statements in the registration statement.[22] Under section 11, the registrant has absolute liability for any intentional misstatement or omission; there is no defense.[23] In addition, any person who signs the registration statement (including the directors, CEO, and CFO) without conducting a reasonable investigation into the accuracy of the disclosures can be held liable for any materially false statement contained therein.[24] Section 12 imposes civil "liability on any person who offers or sells a security by means of offering material or oral communication that contains a material misstatement or omission."[25] All individuals involved in the offering can also be held liable for misleading or inaccurate statements under the general antifraud provision of the Exchange Act (section 10(b) and Rule 10b-5) upon a showing that "the defendant acted recklessly or willfully and that the plaintiff relied" on the statements.[26]

Unlike the Securities Act, which only requires disclosure when securities are issued, the Exchange Act requires reporting companies to make certain ongoing disclosures.[27] A

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21 COX ET AL., *supra* note 10, at 7.

22 *Id.*

23 *See* 15 U.S.C. § 77k(a)–(c) (2019).

24 ADAM E. FLEISHER & SOPHIE GRAIS, CLEARY GOTTLIEB, GOING PUBLIC: A GUIDE TO U.S. IPOS FOR FOUNDERS, OFFICERS, DIRECTORS AND OTHER MARKET PARTICIPANTS 19 (2020), https://www.clearygottlieb.com/-/media/files/alert-memos-2020/going-public-a-guide-to-us-ipos-for-founders-officers-directors-and-other-market-participants-2020.pdf [https://perma.cc/E4BY-A2NP].

25 *Id.* Individuals that control a party primarily liable under section 11 or section 12 can be found secondarily liable for the material misrepresentations under section 15 of the Securities Act or section 20 of the Exchange Act. *Id.*

26 *Id.*

27 *See* 3 BLOOMENTHAL & WOLFF, *supra* note 11, § 1:60.

company qualifies as a "reporting company" for purposes of the Acts if it: (1) has securities listed on a national exchange, (2) has assets over $10 million and at least 2,000 record holders in a class of equity securities or 500 record holders who are not accredited investors, or (3) has filed a registration statement under the Securities Act which has become effective.[28] Reporting companies must comply with continuing financial disclosure requirements, including annual filings on Form 10-K, quarterly filings on Form 10-Q, and periodic filings on Form 8-K.[29] As these ongoing disclosures are often incorporated in subsequently filed registration statements, directors and officers are exposed to potential liability under the Securities Act for any misrepresentations in these periodic filings.[30] In addition to liability through incorporation of statements in Securities Act filings and the general antifraud provisions of section 10(b), section 18(a) of the Exchange Act provides a private right of action against companies and officials for investors who rely on false or misleading statements in reports filed with the SEC.[31]

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[28] COX ET AL., *supra* note 10, at 10.

[29] Syed Haq, Comment, *Revisiting the Accredited Investor Standard*, 59 MICH. BUS. & ENTREPRENEURIAL L. REV. 59, 64 (2015). While all reporting companies are generally required to file these forms, the SEC has divided issuers into four categories: large accelerated filers, accelerated filers, non-accelerated filers, and smaller reporting companies. Depending on which category the company falls into, the Exchange Act filings and filing deadlines will vary. MORRISON & FOERSTER LLP, FREQUENTLY ASKED QUESTIONS ABOUT PERIOD REPORTING REQUIREMENTS FOR U.S. ISSUERS—OVERVIEW 2–3 (last visited May 25, 2021), https://media2.mofo.com/documents/faq-periodic-reporting-requirements-for-us-issuers-overview.pdf [https://perma.cc/TWJ3-PUJY].

[30] MORRISON & FOERSTER LLP, *supra* note 29, at 12–13.

[31] *Id.* at 13. Under Exchange Act section 18(a), an individual who buys or sells securities relying on a false or misleading statement in a report filed with the SEC whose prices were affected by those statements has an express private right of action against the person who made the statement. 15 U.S.C. § 78r(a) (2019). This means that any insufficient disclosures in periodic reports filed with the SEC (other than Results of Operations and Financial Conditions and Regulation FD Disclosures in Form 8-K) can create a private cause of action against the company and its officials. *See id.*; Current Report (Form 8-K), at 2 (2021), https://www.sec.gov/files/form8-

Even though investors seek similar information in valuing securities at their issuance and in secondary transactions, the disclosure obligations promulgated under the Acts developed separately for much of the fifty years after they were enacted.[32] However, this trend began to change after the SEC implemented the recommendations of *The Special Study of the Securities Markets*, a comprehensive report headed by Milton Cohen and funded by Congress.[33] The *Special Study* was independent from and unaccountable to SEC leadership and conducted by a team of economists, lawyers, statisticians, and financial analysts.[34] The study made significant contributions to securities regulation by mapping and evaluating the changes to capital markets since the statutes were enacted, reviewing the structure of the regulatory regime, and questioning the overall institutional design.[35] The full report was over 3,000 pages and made over 175 recommendations, including the integration of the disclosures required by the Securities and Exchange Acts.[36] Though the *Special Study* was submitted to Congress in the early 1960s, meaningful changes to integrate the disclosure system did not occur until the 1980s, when the SEC adopted a process to allow

k.pdf [https://perma.cc/E6YU-HWCD] (instructing reporting companies on the exceptions to section 18(a) coverage).

32 A.C. Pritchard, *Revisiting "*Truth in Securities*"* Revisited*: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 999–1000 (2013). If an issuer sells a non-exempt security without registering it, purchasers may rescind their purchase for a full refund. 15 U.S.C. § 77*l*(a)(1).

33 Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, H.R. DOC. NO. 88-95, pt. 1 (1963); *see also* Stanley Sporkin, Commentary, *A Call for a New Special Study of the Securities and Financial Markets*, 46 MD. L. REV. 915, 916 (1987) (describing the impact of the report).

34 Michael S. Piwowar, Acting Chairman, U.S. Sec. & Exch. Comm'n, New Special Study of the Securities Markets: Keynote Address (Mar. 23, 2017), https://www.sec.gov/news/speech/piwowar-keynote-columbia-university-032317 [https://perma.cc/8LEU-GMB8].

35 James D. Cox & Randall S. Thomas, *Revolving Elites: The Unexplored Risk of Capturing the SEC*, 107 GEO L.J. 845, 874–75 (2019).

36 Piwowar, *supra* note 34; Sporkin, *supra* note 33, at 916 (discussing the *Special Study*'s influence on integration).

companies registering securities under the Securities Act to fulfill many of their disclosure obligations by incorporating their Exchange Act filings.[37] This developed into the adoption of shelf registration[38] and the subsequent 2005 adoption of "automatic shelf registration" for well-known seasoned issuers.[39] The integrated disclosure regime, including the shelf registration process, has played an important role in reducing the registration burdens of seasoned issuers by increasing the efficiency of offerings, lowering the costs associated with registering new issuances of securities, and substantially reducing the delay between the registration and sale of securities.[40]

For the first seventy years after the Acts were enacted, the focus of securities regulation, as promulgated by the SEC, was on investor protection through disclosure.[41] In 2002, Congress deviated from this historical focus in response to the high-profile Enron and WorldCom scandals by passing the Sarbanes-Oxley Act (SOX).[42] Among other things, SOX prescribed regulations related to corporate governance. This broadened the SEC's purview and introduced further procedural and substantive requirements on public companies to add safeguards beyond financial disclosures.[43] These

[37] COX ET AL., *supra* note 10, at 11.

[38] Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 135–36 (1984). Shelf registration is the process by which eligible issuers are able to file registration statement for a public offering with the SEC with "no present intention to immediately sell all the securities being registered," allowing the issuer to take the securities "off the shelf" when they want to offer them to the public. LLOYD S. HARMETZ & BRADLEY BERMAN, MORRISON & FOERSTER LLP, FREQUENTLY ASKED QUESTIONS ABOUT SHELF OFFERINGS 1 (2017), https://media2.mofo.com/documents/faqshelfofferings.pdf [https://perma.cc/G2MN-CW46].

[39] Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U. L. REV. 561, 590–91 (2007).

[40] COX ET AL., *supra* note 10, at 11.

[41] See *id.* at 7–12 (discussing the disclosure regime).

[42] *Id.* at 12; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

[43] COX ET AL., *supra* note 10, at 13.

features apply to all publicly traded companies and include making CEOs and CFOs directly responsible for the accuracy of financial reports and requiring the creation and maintenance of internal controls, formal data security policies, and records documenting compliance with, and continuous monitoring of, SOX objectives.[44]

Subsequent legislation has also imposed disclosure requirements that do not deal directly with investor education or protection, but rather with social issues. For example, the 2010 Dodd-Frank Act instructed the SEC to issue rules that would require "issuers that use 'conflict minerals' to disclose annually whether any such minerals originated in the Democratic Republic of Congo . . . or in an adjoining country."[45] In addition, Dodd-Frank requires certain disclosures related to executive compensation in a company's annual proxy statements and shareholder votes on certain executives' compensations ("say-on-pay").[46] Throughout the 2000s, stressing the importance of social disclosures, some investors have called for increased requirements in the area of environmental, social, and governance (ESG) matters.[47] Within the SEC, the call for ESG-related disclosure became evident in 2010 when the Commission issued guidance identifying areas in company reporting that may require

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44 Jeff Petters, *What Is SOX Compliance? Everything You Need To Know in 2019*, VARONIS, https://www.varonis.com/blog/sox-compliance/ [https://perma.cc/G5MS-98VX] (last updated Sept. 23, 2020).

45 BLOOMENTHAL & WOLFF, *supra* note 11, § 1:479 (citing Specialized Disclosure Report (Form SD), at 2 (2020), https://www.sec.gov/files/formsd.pdf [https://perma.cc/73PU-PF2G]). The SEC promulgated these rules under section 13(p) of the Exchange Act. *Id.*

46 David S. Huntington, *Summary of Dodd-Frank Financial Regulation Legislation*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 7, 2010), https://corpgov.law.harvard.edu/2010/07/07/summary-of-dodd-frank-financial-regulation-legislation/ [https://perma.cc/FB8C-UH8P].

47 *See* Letter from Cynthia A. Williams, Osler Chair in Bus. L., York Univ. & Jill E. Fisch, Saul A. Fox Distinguished Professor of Bus. L., Univ. of Pennsylvania L. Sch., to Brent J. Fields, Sec'y, U.S. Sec. & Exch. Comm'n 1 (Oct. 1, 2018), https://www.sec.gov/rules/petitions/2018/petn4-730.pdf [https://perma.cc/J2NA-XQYA].

disclosure related to climate change.[48] Recently, there have been questions about whether this guidance, issued a decade ago, satisfies investors' desires for full disclosure on environmental issues and risks.[49] However, the SEC has yet to require more specific ESG-focused disclosures as of 2020, and has indicated that it will remain focused on disclosures based on materiality.[50]

In addition to regulating companies through the registration requirements of the Securities Act and reporting companies through the ongoing disclosure requirements of the Exchange Act, the SEC has also permitted limited fundraising through Regulation A (Reg A), subsequently amended in the

[48] *See generally* Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6,290 (Feb. 8, 2010). In that guidance, the SEC noted that ESG-related disclosure may be required concerning the "description of the business, legal proceedings, risk factors, and [the] management's discussion and analysis of financial condition and" resulting operations. Press Release, Allison Herren Lee, Comm'r, U.S. Sec. & Exch. Comm'n, "Modernizing" Regulation S-K: Ignoring the Elephant in the Room (Jan. 30, 2020), https://www.sec.gov/news/public-statement/lee-mda-2020-01-30 [https://perma.cc/8LYP-J9T2].

[49] *See* Lee, *supra* note 48. ("[I]nvestors are overwhelmingly telling us, through comment letters and petitions for rulemaking, that they need consistent, reliable, and comparable disclosures of the risks and opportunities to sustainability measures, particularly climate risk.").

[50] Donna Mussio, Mary Beth Houlihan & Taylor Souter, *To Lead or Not To Lead: Contrasting Recent Statements by SEC and ESMA Chairs on ESG Disclosure*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 16, 2020), https://corpgov.law.harvard.edu/2020/03/16/to-lead-or-not-to-lead-contrasting-recent-statements-by-sec-and-esma-chairs-on-esg-disclosure [https://perma.cc/LN47-UKKX]. Interestingly, outside of the U.S. public market, there does seem to be a push for more ESG-related disclosures. For example, the Chair of the European Securities and Markets Authority has "indicated that it is time for the public sector to step in to promote reliable, relevant and comparable ESG information." *Id.* And major private market investors, such as BlackRock, have focused on ESG-related issues in their portfolio companies. Letter from Larry Fink, Chairman & CEO, BlackRock, to CEOs (2020), https://www.blackrock.com/us/individual/larry-fink-ceo-letter [https://perma.cc/63ZS-NVND].

JOBS Act to form "Regulation A+" (Reg A+)[51] and Regulation Crowdfunding. Both of these types of offerings limit the amount of capital a company can raise in order to be eligible for reduced registration and ongoing disclosure requirements.[52]

Reg A+ offerings, which are sometimes referred to as mini-IPOs, allow for two tiers of offerings in a twelve-month period: a $20 million Tier 1 offering and a $75 million Tier 2 offering.[53] Because of these size limits, Reg A+ offerings are mainly utilized by small- and medium-sized businesses that are not subject to the Exchange Act's ongoing reporting requirements.[54] Reg A+ requires filing an offering statement with the SEC[55] but imposes less stringent disclosure requirements than section 5 public offerings. Reg A+ offerings are still subject to some ongoing reporting requirements: Tier 1 issuers are required to file an exit report, and Tier 2 issuers must file certain annual and semi-annual reports.[56] In this manner, Reg A+ "mini-IPOs" protect investors by limiting the size of the offering (thus limiting the total possible downside

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51 *See Reg A+ Bombshell: $50M Equity Crowdfunding Under Regulation A*, SEEDINVEST (Sept. 7, 2016), https://www.seedinvest.com/blog/regulation-a-equity-crowdfunding-rules [https://perma.cc/M835-8TNY].

52 *See* MORGAN, LEWIS & BOCKIUS LLP, SEC ADOPTS FINAL RULES ON REGULATION A+, at 2–3 (2015), https://www.law.umich.edu/clinical/internationaltransactionclinic/Documents/May%2011%20Conference%20Docs/Final%20Rules%20on%20Regulation%20A+.pdf [https://perma.cc/3A8G-Y9G5] (discussing Reg A+); 17 C.F.R. § 227.100(a)(1) (2020) (Regulation Crowdfunding).

53 Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,496, 3,498 tbl.1 (Jan. 14, 2021) (codified in scattered parts of 17 C.F.R.). Previously, the Tier 2 cap was $50 million. 17 C.F.R. § 230.251(a)(2).

54 MORGAN, LEWIS & BOCKIUS LLP, *supra* note 52, at 8 (noting however, that such issuers may still use Regulation D exemptions instead); *see also* U.S. SEC. & EXCH. COMM'N, REPORT TO THE COMMISSION: REGULATION A LOOKBACK STUDY AND OFFERING LIMIT REVIEW ANALYSIS 14 (2020), https://www.sec.gov/files/regulationa-2020.pdf [https://perma.cc/NT2Q-HMY4].

55 *See* 17 C.F.R. § 230.252.

56 *Id.* § 230.257(a)–(b).

loss) while also requiring a minimum amount of disclosure to ensure some protection through sunlight. Unlike private offerings, discussed in Section II.B, Reg A+ offerings are unregistered public offerings. Unregistered public offerings allow for the solicitation of non-accredited investors,[57] and any securities issued are not "restricted securities" under Rule 144.[58] In addition to liability under the general antifraud provisions of section 10(b) of the Exchange Act, companies that complete a Reg A+ offering can be found civilly liable under section 12(a)(2) of the Securities Act for offers or sales made pursuant to any offering materials or oral communications containing materially misleading statements or facts.[59]

Crowdfunding was envisioned as a medium through which startup companies could raise money without the burdens of the rigorous disclosure framework. The JOBS Act and Regulation Crowdfunding allow companies to raise an aggregate amount of $5 million over a twelve-month period[60] and place limitations on the amount each investor can contribute in a twelve-month period. These investor restrictions are based on much more inclusive income and net worth metrics than the accredited investor definition.[61] The crowdfunding exemption from section 5's registration

[57] There are, however, certain limitations on the amount of money a non-accredited investor can invest in a Tier 2 offering based on the investor's net worth. *See Updated Investor Bulletin: Regulation A*, U.S. Sec. & Exch. Comm'n (May 24, 2019), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_regulationa.html [https://perma.cc/8F93-D9W2].

[58] MORGAN, LEWIS & BOCKIUS LLP, *supra* note 52, at 2. On restricted securities, *see infra* notes 93–101 and accompanying text.

[59] MORGAN, LEWIS & BOCKIUS LLP, *supra* note 52 at 7.

[60] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,496, 3538 (Jan.14, 2021) (codified in scattered parts of 17 C.F.R.). Previously, the cap was $1.07 million. 17 C.F.R. § 227.100(a)(1).

[61] *Id.* § 227.100(a)(2). Investors with a net worth or annual income of less than $107,000 are not permitted to invest more than the greater of $2,200 or five percent of their annual income. *Id.* § 227.100(a)(2)(i). Investors with an annual income or net worth greater than or equal to $107,000 are not permitted to invest more than ten percent of the lesser of the investor's annual income or net worth. *Id.* § 227.100(a)(2)(ii).

requirements was meant to provide an efficient and open public securities market by creating a low-cost method for raising capital open to all entrepreneurs.[62] In a crowdfunding offering, the issuer conducts the offering through a registered broker or "funding portal," which is an intermediary (generally known as a crowdfunding platform) that is involved in the offer and sale of the security. The portal does not qualify as a broker because it offers no investment advice, but it is subject to other limitations.[63] Unlike a security issued in a public offering, a security issued through Regulation Crowdfunding is subject to resale limitations—it may not be resold for a one-year period unless it is sold to the issuer, an accredited investor (a term to be described further in Section II.B), a family member, or as part of a registered offering.[64] Section 302(b) of the JOBS Act provides an express private right of action against the issuer of an offering made pursuant to Regulation Crowdfunding.[65] Under this private right of action, the issuer (including the issuer's officers, directors, and potentially the intermediaries, i.e., funding portals)[66] can

[62] *See* Andrew A. Schwartz, *The Gatekeepers of Crowdfunding*, 75 WASH. & LEE L. REV 885, 898, 903 (2018). While inclusivity was a goal of securities crowdfunding, when the SEC promulgated crowdfunding rules in Regulation Crowdfunding, there were some limits to its inclusivity. *Id.* at 913. For example, Regulation Crowdfunding does allow crowdfunding platforms to "screen and reject companies they do not want to list" on their sites. *Id.* Thus, not all entrepreneurs who have an idea can seek financing through the crowd. *See id.* at 912–13.

[63] 3 BLOOMENTHAL & WOLFF, *supra* note 11, § 1:533.02. A "funding portal" is required to register with the SEC on the Form Funding Portal, cannot offer investment advice, solicit purchases, compensate employees for solicitation or sales, or hold, manage, or handle investor securities. *Registration of Funding Portals*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/divisions/marketreg/tmcompliance/fpregistrationguide.htm [https://perma.cc/234K-266D] (last modified Jan. 18, 2017). If a funding portal partakes in any of the above activities, it must register as a broker-dealer. *Id.*

[64] 3 BLOOMENTHAL & WOLFF, *supra* note 11, § 1:533.02.

[65] *Id.* (citing Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 318–19 (2012)).

[66] Jo Won, *Jumpstart Regulation Crowdfunding: What Is Wrong and How To Fix It*, 22 LEWIS & CLARK L. REV. 1393, 1419 (2018) (first citing 15

be held liable for any untrue or misleading statements of material fact, or omissions of material fact, contained in written or oral communications in the offering of the security.[67] While both Reg A+ and Regulation Crowdfunding offer ways for small- and medium-sized businesses to raise capped amounts of money from a fairly wide pool of investors, neither has been utilized to a large extent.[68]

B. Private Market Exemptions

Reporting companies are subject to extensive regulations and disclosures, but the Securities Act and subsequent legislation carve out several exemptions that permit firms to raise capital in the private market without becoming reporting companies. In exchange for a more relaxed disclosure and liability regime, however, private offerings were traditionally limited to a narrower base of "sophisticated" investors and, in certain cases, subject to restrictions on the amount of capital that could be raised. The primary exemptions utilized by non-reporting companies include those under section 4(a)(2) of the Securities Act—most importantly, Regulation D offerings.

U.S.C. § 77d-1(c)(2) (2018); then citing *id.* § 77d-1(c)(1)(A); and then citing Crowdfunding, 80 Fed. Reg. 71,387, 71,478 (Nov. 16, 2015) (codified as amended in scattered parts of 17 C.F.R.)). Regulation Crowdfunding specifically created a remedy against issuers, and the SEC refused to exempt intermediaries from such liability. *Id.* In their final rules on Regulation Crowdfunding, the SEC explained that potential liability for intermediaries "may encourage [them] to develop adequate procedures to fully assess whether reliance on an issuer's representation is reasonable." Crowdfunding, 80 Fed. Reg. at 71,433 n.643. Furthermore, "Congress provided a defense to any such liability if an intermediary did not know, and in the exercise of reasonable care could not have known, of the untruth or omission." *Id.*

[67] 3 BLOOMENTHAL & WOLFF, *supra* note 11, § 1:533.02 (citing JOBS Act § 302(b)).

[68] Reg A+ and Regulation Crowdfunding offerings combined to raise about $1.104 billion in 2019 compared to an estimated $1,492 billion raised using Reg D's Rule 506(b) exemption. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17,956, 17,958 tbl.1 (proposed Mar. 31, 2020) (to be codified in scattered parts of 17 C.F.R.).

Section 4(a)(2) of the Securities Act exempts transactions that do not involve a "public offering" from section 5's registration requirements.[69] Congress included this exemption because it determined that it was unnecessary to impose such extensive disclosure requirements where "'there [was] no practical need for [their] application or where the public benefits [were] too remote.'"[70] While Congress did not define the term "public offering," the Supreme Court interpreted the provision in the seminal case *SEC v. Ralston Purina Co.*[71] There, the Court explained that the applicability of section 4(a)(2) turns on whether the investor "needs the protection of the Act" or is "shown to be able to fend for themselves." [72] In other words, the question is whether the investor is *sophisticated*.

The SEC codified the *Ralston Purina* decision in 1974 by adopting "Rule 146, which required that investors be financially sophisticated enough to be offered private placements based on their knowledge and experience, capability of evaluating the risks and merits, and ability to bear the economic risk of the investment."[73] Rule 146 created an unlimited exemption from section 5's registration requirements, but included requirements that "were so burdensome and expensive that the exemption was often practically unavailable, especially for small offerings by small issuers."[74] Additionally, the ambiguity around whether an

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[69] 15 U.S.C. § 77d(a)(2) (2019).

[70] Haq, *supra* note 29, at 61 (alteration in original) (quoting H.R. REP. NO. 73-85, at 5 (1933)).

[71] 346 U.S. 119, 124–25 (1953); *see also* Haq, *supra* note 29, at 61.

[72] *Ralston Purina*, 346 U.S. at 125; *see also* Haq, *supra* note 29, at 62.

[73] Haq, *supra* note 29, at 62 (citing A. NICOLE CLOWERS ET AL., U.S. GOV'T ACCOUNTABILITY OFF., GAO-13-640, SECURITIES AND EXCHANGE COMMISSION: ALTERNATIVE CRITERIA OR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED 8 (2013), https://www.gao.gov/assets/gao-13-640.pdf [https://perma.cc/TDV7-8M54]).

[74] 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, 923–24 (2011).

investor fell within the exemption proved difficult for issuers to navigate.[75]

Learning from its failures, the SEC replaced Rule 146 and similar exemptions (Rule 240, an exemption for small issuers, and Rule 242, an exemption for offerings up to $500,000) with Reg D in 1982.[76] Reg D introduced a bright-line rule clarifying which investors could participate ("accredited investors") and exempted offerings based on the number of investors and the size of the offering. Reg D now provides two exemptions from section 5's registration requirement: Rule 504, which is limited to offerings of $10 million,[77] and Rule 506, which allows for unlimited funds to be raised, but (1) caps the number of non-accredited purchasers at thirty-five when no general solicitations are allowed (Rule 506(b)) or (2) allows for general solicitations so long as the issuer takes steps to ensure

[75] Rutheford B. Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139, 1143–44 (1977) (discussing how the ambiguity around when a purchaser had "access" to information about the issuer and when a purchaser was sophisticated was difficult to navigate); *see also* Transactions by an Issuer Deemed Not To Involve Any Public Offering, 39 Fed. Reg. 15,261, 15,267 (May 2, 1974) (stating that the issuer can only offer or sell securities under the Rule 146 exemption to persons that the issuer "ha[s] reasonable grounds to believe and shall believe" that the offeree has experience in financial and business matters and can bear the economic risk of the investment.), *repealed by* Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982) (codified as amended at 17 C.F.R. pts. 230, 239).

[76] Campbell, *supra* note 74, at 924.

[77] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,496, 3,570 (Jan. 14, 2021) (to be codified at 17 C.F.R. § 230.504). Previously the cap was $5 million. 17 C.F.R. § 230.504(b)(2) (2020). Rule 504 offerings are exempt pursuant to section 3(b), and are generally not considered a "private offering". ROBERT B. ROBBINS, PILLSBURY WINTHROP SHAW PITTMAN LLP, DUE DILIGENCE IN PRIVATE PLACEMENT OFFERINGS 9 (2013), https://www.pillsburylaw.com/images/content/4/6/v2/468/RobbinsDueDiligence2013.pdf [https://perma.cc/R8QL-2UGL]. Generally, Rule 504(c) offerings do not permit general solicitations and general advertisements unless the sales are only made to accredited investors. 17 C.F.R. § 230.504(b)(1)(iii).

that all purchasers are accredited investors (Rule 506(c)).[78] Of these options, Rule 506(b) is far and away the most utilized private placement exemption.[79]

Until August 2020, Reg D "accredited investors" effectively only included investment companies, private business development companies, directors, executive directors, or general partners of the issuer, and any individuals that met

[78] *See* 17 C.F.R. § 230.506(a)–(c). In theory, the SEC permits participation of non-accredited investors in a Rule 506(b) offering because they are, or should be, protected by the negotiations of the "sophisticated" accredited investors who bargain with the issuer for certain disclosures. When a non-accredited investor purchases a security in a Rule 506(b) offering, the issuer must provide that purchaser with a description of all information supplied to any accredited investor. *See id.* § 230.502(b)(2)(iv). Although Rule 506(b) permits the issuer to raise money from non-accredited investors, companies advising startup companies generally suggest that the issuer should not raise money from any non-accredited investors. *See, e.g.*, Derek Colla, *Can You Raise Money from Investors who Are Not "Accredited Investors?"*, COOLEY GO, https://www.cooleygo.com/can-you-raise-money-from-unaccredited-investors/ [https://perma.cc/P6KM-MFVT] (last visited Mar. 4, 2021) ("The easy answers are 'you shouldn't' or 'technically you can but it's not worth it because of the hoops you have to jump through[.]'"); James Graves, *Why It Is So Difficult To Take Investment from Non-Accredited Investors*, THE STARTUP L. BLOG (July 21, 2020), https://thestartuplawblog.com/why-it-is-so-difficult-to-take-investment-from-non-accredited-investors/ [https://perma.cc/K66Z-4GCJ] ("[I]f you want to take funds from even one non-accredited investor, your disclosure obligations do not scale—they skyrocket"); Matthew W. Bower, *Reasons To Include Only Accredited Investors in Your Rule 506(b) Private Offering*, VARNUM (Sept. 6, 2018), https://www.varnumlaw.com/newsroom-publications-reasons-to-include-only-accredited-investors-in-your-rule-506b-private-offering [https://perma.cc/C5EP-SPMZ] ("[T]he amount of capital that can be raised from non-accredited investors . . . is rarely enough to justify the expense of providing the information required under Rule 502(b)(2). In fact, the combined legal and accounting costs for Rule 502(b)(2) compliance could easily exceed $50,000.").

[79] An estimated $1,492 billion was raised using Reg D's Rule 506(b) exemption in 2019, compared with an estimated $66 billion raised using Rule 506(c), $0.228 billion using Rule 504, $1.042 billion using the two tiers of Reg A, and $0.062 billion raised using Regulation Crowdfunding. Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17,956, 17,958 tbl.1 (proposed Mar. 31, 2020) (to be codified in scattered parts of 17 C.F.R.).

bright-line wealth or income requirements.[80] This definition relied on an investor's wealth and income as the sole proxies for whether the investor was sophisticated enough to be able to "fend for themselves," and qualified those with (1) a net worth (or joint net worth with their spouse) exceeding $1 million (excluding the value of their primary residence) or (2) an individual income for the past two years of over $200,000 per year (or joint income with their spouse of over $300,000 per year).[81] In August 2020, however, the SEC amended the accredited investor definition for the first time in thirty-five years.[82] Under the new definition, the SEC can designate certain professional certifications to qualify the holders of such certifications as accredited investors.[83] It also qualifies directors, senior executives, and individuals who participate directly in the investment activities of private funds (knowledgeable employees) as accredited investors, theorizing that these individuals are financially sophisticated regardless of their net worth.[84] The amendment, which went into effect in the fall of 2020, is "intended to improve the definition to identify more effectively institutional and individual investors that have the knowledge and expertise to participate in private capital markets without the additional protections of registration under the Securities Act."[85]

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[80] *See* 17 C.F.R. § 230.501(a).

[81] *Id.* § 230. 501(a)(5)–(6). These wealth cutoffs, however, have not be adjusted for inflation. Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 467 (2017).

[82] SULLIVAN & CROMWELL LLP, SEC FINALIZES AMENDMENTS TO "ACCREDITED INVESTOR" DEFINITION 1 (2020), https://www.sullcrom.com/files/upload/sc-publication-sec-finalizes-amendments-accredited-investor-definition.pdf [https://perma.cc/244F-HGXW]; *see also generally* Accredited Investor Definition, 85 Fed. Reg. 64,234 (Oct. 9, 2020) (to be codified at 17 C.F.R. pts. 230, 240) (announcing the changes).

[83] SULLIVAN & CROMWELL, *supra* note 82, at 2.

[84] *Id.* In addition, the definitional change expands the list of entities that qualify as accredited investors and allows spousal equivalents to pool their income or net worth to qualify as accredited investors. *Id.* at 3.

[85] *Id.* at 1–2. The amendment applied to new offerings starting in early November 2020. Larry W. Nishnick et al., *SEC Adopts Changes to*

Though Rule 506 offerings are not subject to section 5's onerous registration requirements, Reg D private placement issuers must still furnish specific materials to non-accredited investors, including certain non-financial and financial information.[86] While non-reporting issuers are not required to furnish any specific information to accredited investors, they typically do provide such investors with a private placement memorandum (PPM).[87] The PPM usually gives a description of the issuer and the securities being offered.[88] Importantly, the information provided is typically not reviewed or filed with the SEC.[89] Because a registration statement and prospectus are not filed in a Reg D private placement under Rule 506, such offerings are exempt from sections 11 and 12 of the Securities Act.[90] Consequently, liability for material misrepresentations or misleading omissions made during these offerings can only be pursued under section 10(b) of the Exchange Act.[91] As section 10(b) and Rule 10b-5 are applicable only for intentional misrepresentations or ones made with "reckless disregard for the accuracy of the

"Accredited Investor" Definition, DLA PIPER (Sept. 1, 2020), https://www.dlapiper.com/en/us/insights/publications/2020/09/sec-adopts-changes-to-accredited-investor-definition/ [https://perma.cc/642H-LQAP].

86 *See* 17 C.F.R. § 230.502(b)(2).

87 *Investor Bulletin: Private Placements Under Regulation D*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html [https://perma.cc/Z5A9-ZYG4] (last modified Feb. 6, 2017).

88 *Id.* Any information provided to an accredited investor must also be made available to any non-accredited investor. 17 C.F.R. § 230.502(b)(2)(iv).

89 *Investor Bulletin: Private Placements Under Regulation D*, *supra* note 87. The issuer does, however, file Form D, which "include[s] brief information about the issuer, its management and promoters, and the offering itself." *Id.*

90 ROBBINS, *supra* note 77, at 2, 8–10. Note, however, that placements offered pursuant to Rule 504 are not exempt from section 12 liability because securities issued pursuant to section 3 exemptions are specifically referred to in section 12's liability regime. *Id.* at 9; *see also* 15 U.S.C. § 77*l*(a)(2) (2019).

91 ROBBINS, *supra* note 77, at 10.

disclosures," purchasers are not able to recover for negligent misstatements or omissions.[92]

Unlike securities sold in a public offering, securities issued under Reg D are "restricted" to ensure that they come to rest instead of being sold so quickly that they are deemed to be part of a public offering.[93] Purchasers in Reg D offerings must hold their securities for at least one year before selling unless they can rely on a separate exemption.[94] Generally speaking, an individual holder of a restricted security issued in a Reg D private placement will rely on a derivation of section 4(a)(1)'s exemption (Rule 144, "section 4(a)(1½)," or section 4(a)(7)) with respect to resale. Section 4(a)(1) exempts "transactions by any person other than an issuer, underwriter, or dealer" from section 5's registration requirements.[95] Rule 144 clarifies section 4(a)(1) by explaining that an individual who receives the security directly from the issuer will not be deemed an "underwriter" if he or she holds the security for one year, after which the restricted security can be sold to anyone.[96] "Section 4(a)(1½)"[97] was developed through case law to permit the resale of restricted securities to accredited investors who are acquiring the security for investment purposes rather than with the intent to distribute.[98] Section 4(a)(7) codifies parts of

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[92] *Id.*

[93] *See* 17 C.F.R. § 230.502(d); *Investor Bulletin: Private Placements Under Regulation D*, *supra* note 87; *see also* ROBERT B. ROBBINS, PILLSBURY WINTHROP SHAW PITTMAN LLP, OFFERS, SALES AND RESALES OF SECURITIES UNDER SECTION 4[A](1-1/2) AND RULE 144A, at 2–3 (2013), https://www.pillsburylaw.com/images/content/4/8/v2/481/RobbinsSalesand Resalesunder4112andRule144A2013.pdf [https://perma.cc/M3D9-3BWQ].

[94] 17 C.F.R. 230.144(d)(1)(ii) (stating the general rule for non-reporting issuers); *Investor Bulletin: Private Placements Under Regulation D*, *supra* note 87.

[95] 15 U.S.C. § 77d(a)(1).

[96] *Securities Laws for Reselling Shares: How Section 4(a)(7) Compares to Other Available Securities Exemptions*, SPRINGMEYER L., http://www.calstartuplawfirm.com/business-lawyer-blog/section-4a7-Fast-Act-resales.php [https://perma.cc/7GBR-4ZYY] (last visited May 10, 2021).

[97] This is not a statutory provision or a codified rule and therefore is often referred to with quotation marks. *See id.*

[98] Bradley Berman & Steven J Bleiberg, *Restricted Securities vs. Control Securities: What Are the Differences?,* THE CLS BLUE SKY BLOG (Jan.

"section 4(a)(1½)" to more clearly permit the resale of restricted securities to accredited investors.[99] Although restricted securities are not nearly as liquid as public market securities, these resale exemptions provide multiple avenues for both accredited investors and Qualified Institutional Buyers (QIBs) to liquidate their private market investments.

Rule 144A is likely the most significant exception to the resale restriction, but it is only applicable to certain entities. While securities issued under Reg D are typically equity securities, Rule 144A transactions almost exclusively involve debt securities.[100] Under Rule 144A, any person other than the issuer or a dealer may freely resell restricted securities to investors that sellers or their agents reasonably believe to be

14, 2014), https://clsbluesky.law.columbia.edu/2014/01/14/restricted-securities-vs-control-securities-what-are-the-differences/ [https://perma.cc/UZ7Z-C66B].

[99] *See* 15 U.S.C. § 77d(a)(7). The new section 4(a)(7) exemption provides private sellers (persons and entities other than the issuer or their subsidiaries) to resell securities to accredited investors. SIDLEY AUSTIN LLP, THE FAST ACT'S AMENDMENTS TO THE SECURITIES ACT: PRACTICAL IMPLICATIONS FOR ISSUES AND UNDERWRITERS 4 (2016), https://www.sidley.com/~/media/update-pdfs/2016/03/practice-note—the-fast-acts-amendments-to-the-securities-act.pdf [https://perma.cc/4ECA-KNLU]. The theory of allowing these private sales, like those in the uncodified "section 4(a)(1½)" exemption, is that the private nature of the sale means that there is no distribution of the securities and that the seller is not acting as an underwriter. *Id.* Because there is no distribution or underwriting, the sale need not be registered. *Id.* Under the 4(a)(7) exemption, general solicitation by the seller is not permitted, and if the securities were originally issued from a non-reporting company, the seller "must provide specified disclosure[s], including financial information, about the company." *Id.* A requirement to provide information about the non-reporting company differentiates a section 4(a)(7) resale from one previously relying on "section 4(a)(1½)," and likely lessens its usefulness because "the company's cooperation will be necessary to make the exemption available." *Id.*

[100] John Armour, Martin Bengtzen & Lucas Enriques, *Globalization*, *in* SECURITIES MARKET ISSUES FOR THE 21ST CENTURY 385, 424–25 (Merritt B. Fox et al. eds., 2018).

QIBs.[101] Rule 144A allows dealers or investment banks to purchase and immediately resell blocks of securities to QIBs in "underwritten private placements."[102] While an issuer cannot directly issue securities under Rule 144A, it can sell securities to a financial intermediary (similar to an underwriter in an traditional IPO) who can then "resell them to an unlimited number of QIBs."[103] Thus, Rule 144A facilitates the resale of unregistered securities to create "an institutional trading market for unregistered securities."[104] Individual investors—even accredited investors—are not permitted to participate directly in Rule 144A "offerings"; they may only participate indirectly through accounts with a QIB.[105] In the aggregate, by reducing holding periods and transaction costs, Rule 144A has increased liquidity, efficiency, and access to the private placement markets.[106]

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[101] Robert B. Robbins, *Offers, Sales and Resales of Securities and General Solicitation Under Section 4(a)(1-1/2), Rule 144A, and the New Section 4(a)(7)*, PRAC. LAW., Oct. 2016, at 49, 50–52. A QIB is defined

> as an institution with a portfolio of securities valued (at cost) (determined on a fiscal year-end basis) at more than $100 million either owned or under its management, a registered broker-dealer with at least $10 million in securities owned or managed, and a bank or savings and loan that both (i) owns, or invests on a discretionary basis in, at least $100 million in third-party securities and (ii) has an audited net worth of at least $25 million.

Id.

[102] *Id.* Nasdaq operates a web-based platform, Private Offerings, Resales, and Trading through Automated Linkages (PORTAL), to facilitate private placements and the resale of private placements between QIBs. Press Release, NASDAQ, NASDAQ Announces Approval of the PORTAL Market Trading System (Aug. 1, 2007), http://www.nasdaqtrader.com/Content/NewsAlerts/2007/headtraderalerts/hta2007-158.pdf [https://perma.cc/5TS7-L9H8].

[103] Kathleen Weiss Hanley, *The Economics of Primary Markets*, *in* SECURITIES MARKET ISSUES FOR THE 21ST CENTURY, *supra* note 100, at 34, 91.

[104] COX ET AL., *supra* note 10, at 379.

[105] *See* Robbins, *supra* note 101, at 51 ("Securities eligble for the Rule 144A safe harbor may be offered or sold only to a [QIB].").

[106] Robbins, *supra* note 101, at 51.

Domestically, the usefulness of Rule 144A is limited for firms attempting to make an exempt offering of private securities because Rule 144A securities "must not be fungible with securities listed on a U.S. exchange."[107] Thus, U.S. private companies issue their equity securities in private placements under Reg D, with QIBs subsequently trading the securities under Rule 144A.[108] However, foreign issuers are able to utilize Rule 144A to resell securities issued under Regulation S, which "provides a safe harbor . . . for offshore offerings where the *sale* occurs outside the U.S., without any prior directed selling efforts in the U.S."[109] In effect, by structuring their offerings in accordance with Regulation S, foreign issuers can "sell to an initial purchaser outside the United States . . . even though the initial purchaser contemplates the immediate resale to QIBs in reliance on Rule 144A."[110] Thus, a foreign issuer may gain substantial access to the U.S. market through 144A resales to QIBs while remaining exempt from SEC reporting requirements and more stringent liability standards. The result is that only

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[107] Armour et al., *supra* note 100, at 424–25. Rule 144A prevents "side by side" sales of securities in the public and private markets by excluding the

> sale of (i) "fungible" securities that, when originally issued, were of the same class as securities listed on a national securities exchange or quoted in an automated inter-dealer quotation system (*not* including "pink sheet" quotations) or (ii) securities of open-end investment companies, unit trusts, and face-amount certificate companies registered or required to register under the Investment Company Act of 1940. Eligibility for resale is determined at the time of issuance, thereby retaining the eligibility of securities privately placed before an issuer went public.

Robbins, *supra* note 101, at 52; *see also* 17 C.F.R. § 230.144A(d)(3) (2020).

[108] Conversely, for U.S. issuers Rule 144A "offerings" are used to sell billions of dollars of investment grade debt annually. Robbins, *supra* note 101, at 51 & n.4.

[109] Armour et al., *supra* note 100, at 425; *see also* 17 C.F.R. § 230.903.

[110] MORRISON & FOERSTER LLP, FREQUENTLY ASKED QUESTIONS ABOUT RULE 144A, at 2 (2018), https://media2.mofo.com/documents/faqrule144a.pdf [https://perma.cc/P5AM-Z9BN].

QIBs, and not accredited or non-accredited investors, are able to invest in the foreign issuer's securities—despite the fact that the issuer is likely a reporting company in its domestic market.

C. SEC Responses to Private Market Growth

Despite a decade-long surge in the public market's market capitalization, the number of publicly traded companies and IPOs in the U.S. has steadily declined since the late 1990s.[111] In 1996, there were around 8,000 publicly traded companies; by 2015, there were only about 4,300.[112] In contrast, the private market has seen extraordinary growth,[113] even surpassing the public market in terms of total offering size.[114] In 2014, private market offerings accounted for $2.1 trillion, compared to $1.35 trillion raised in the public market.[115] The use of the offering exemptions discussed *supra* Part II.B—especially Rule 506(b)—has spurred this private market expansion.

The private market's growth may undermine a fundamental assumption on which the securities laws were based: that when companies eventually need to raise large amounts of money, they will have to do so through a general public offering.[116] As described above, public offerings subject companies to enhanced disclosure requirements, which promote efficient markets through access to material information and allow Congress and the SEC to promote standards of corporate governance through SOX

111 Gao et al., *supra* note 4, at 1663.

112 Louise Lee, *The Decline of the IPO*, STANFORD GRADUATE SCH. OF BUS. (Apr. 12, 2018), https://www.gsb.stanford.edu/insights/decline-ipo [https://perma.cc/BZS4-K28X].

113 The private market assets under management has grown by $4 trillion in the last decade. BERNOW ET AL., *supra* note 1, at 2.

114 H.R. REP. NO. 115-375, at 3 (2017).

115 *Id*. Of the $2.1 trillion raised in private offerings in 2014, $1.3 trillion (sixty-two percent) was raised through Reg D offerings. *Id*.

116 On the traditional funding process, see *infra* text accompanying notes 202–206.

disclosures.[117] However, with access to greater amounts of capital in the private market, companies are able to delay entering the public market for longer periods of time. Additionally, a large number of private firms are being acquired by other firms instead of pursuing the IPO route,[118] further reducing the number of public companies and allowing acquired companies to avoid enhanced disclosures throughout their life-cycles as independent companies. These market changes require responses from Congress and the SEC to help promote public market growth.

The regulatory response to these market changes began in earnest in 2012, when Congress introduced sweeping changes to the securities laws through the JOBS Act. The JOBS Act implemented "initiatives designed to facilitate access to the capital markets while lessening the regulatory burdens of traditional IPOs."[119] These initiatives were mainly aimed at emerging growth companies (EGCs) (companies with annual gross revenue of less than $1 billion),[120] and allowed them to: (1) confidentially file initial registration statements, enabling secrecy around IPO plans until later in the process; (2) "partake in 'test-the-water' communications with certain potential investors"; (3) file "only two years of audited financial statements" in their registration statements rather than three; and (4) be exempted from certain corporate governance requirements of SOX.[121] These reforms were meant to reduce the burdens associated with going public, including subsequent reporting requirements. In 2017, the SEC expanded on the JOBS Act to allow "*all* companies to

117 *See supra* Section II.A.

118 Thomas Chemmanur et al., The Disappearing IPO Puzzle: New Insights from Proprietary U.S. Census Data on Private Firms 1 (Oct. 2020) (unpublished manuscript) (on file with the Columbia Business Law Review), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3556993.

119 1 BRENT A. OLSON, PUBLICLY TRADED CORPORATIONS HANDBOOK § 8.46, Westlaw (database updated Oct. 2020).

120 15 U.S.C. § 77b(a)(19) (2019).

121 Patrick J. Gallagher, Note, *Going Public Secretly: The SEC's Unavailing Effort To Increase Initial Public Offerings Through Confidential Registration,* 2019 COLUM. BUS. L. REV. 305, 322–23; 1 OLSON, *supra* note 119, § 8.46 (mentioning the SOX exemption).

submit draft registration statements relating to initial public offerings for review on a non-public basis."[122] The rationale behind the confidential filing process was to encourage more companies to pursue IPOs. By ensuring that companies could file their initial registration statements and respond to SEC comments without alerting the public or their competitors to any existing issues, the process enabled companies to withdraw their registration statements without public embarrassment.[123]

In 2019, the SEC again expanded upon the JOBS Act by adopting a rule permitting all companies to use "test-the-waters" communications.[124] "Testing-the-waters" gives issuers the ability to evaluate market interest in advance by allowing them to communicate with potential investors prior to filing a registration statement so long as those investors are (or the issuer reasonably believes them to be) QIBs or institutional accredited investors.[125] Given the expansion of confidential registration statements, allowing all companies to "test-the-waters" was a logical step for the SEC to take, as insufficient market interest would similarly discourage companies from moving forward with an IPO.[126] With the expansion of "testing-the-waters," companies could take full advantage of the optionality provided by the confidential filing process, as they could begin book building earlier in the process and withdraw the offering if there were issues with

[122] Press Release, U.S. Sec. & Exch. Comm'n, SEC's Division of Corporation Finance Expands Popular JOBS Act Benefit to All Companies (June 29, 2017) (emphasis added), https://www.sec.gov/news/press-release/2017-121 [https://perma.cc/6ZXB-F8R2].

[123] Gallagher, *supra* note 121, at 308, 322.

[124] Michael Zeidel, Andrew J. Brady & Ryan J. Adams, *SEC Expansion of "Testing-the-Waters" Communications to All Issuers*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 4, 2019), https://corpgov.law.harvard.edu/2019/10/04/sec-expansion-of-testing-the-waters-communications-to-all-issuers/ [https://perma.cc/2LTX-T5C2].

[125] *Id.*

[126] *See* Tom Zanki, *SEC's 'Test The Waters' Expansion Could Spur More Offerings*, LAW360 (Oct. 11, 2019, 12:03 PM), https://www.cov.com/-/media/files/corporate/publications/2019/10/secs-test-the-waters-expansion-could-spur-more-offerings.pdf [https://perma.cc/8MTY-WLKC].

either the registration statement or the offering being undersubscribed.[127] This expansion of "testing-the-waters" enabled all companies, whether for an initial offering or a follow-on offering, "to gauge sentiment from institutional investors regarding the potential offering" and "gain a better sense of whether the market will support their offerings."[128] Therefore, companies could assess whether their offerings would be successful *before* incurring the significant costs associated with filing a registration statement.[129]

Although confidential filing and "testing-the-waters" aimed to promote IPOs, other provisions in the JOBS Act and subsequent proposals likely encouraged private market growth by loosening the rules around private offerings and increasing the number of investors a company can have before being deemed a reporting company under the Exchange Act.[130] For example, the JOBS Act amended Reg D to permit general advertising and the solicitation of accredited investors in Rule 506(c) private placement offerings.[131] Like "testing-

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127 *See id.*

128 *Id.*

129 Companies like Uber and Lyft had drops in share price following their IPOs, and WeWork cancelled its IPO in a very public fashion. Some note that if "testing-the-waters" had been in effect for non-ECGs, such companies could have benefited from "testing-the-waters" to either more successfully price their IPOs or to gauge potential downfalls of an IPO before communicating it publicly. *Id.*

130 *See* ANNA T. PINEDO & DAVID LYNN, A QUICK GUIDE TO THE JOBS ACT 1, 4 tbl.Exchange Act Thresholds (2012), https://media2.mofo.com/documents/120416-pli-quick-guide-jobs-act.pdf [https://perma.cc/7ZM6-N6XC]. In order to be permitted to make general solicitations, however, the issuer must verify that purchasers (not offerees) are all accredited investors. *Id*. at 5.

131 *Id.*; *see also* RAFFI GARNIGHIAN, GONZALO GO & ANNA PINEDO, MAYER BROWN, GENERAL SOLICITATION AND GENERAL ADVERTISING 1 (2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/08/on-point—general-solicitation.pdf [https://perma.cc/GKU2-WK4S]. Neither the Commission nor the JOBS Act define what constitutes general solicitation. *Id*. However, Rule 502(c) provides that the following may constitute general solicitation: "(1) 'any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio'

the-waters," this development allowed issuers to gauge interest in offerings before significant expenses were incurred, a feat that was not previously possible.[132] Issuers have likely taken advantage of this provision by utilizing the internet to further expand their ability to reach investors and gauge interest.[133]

After lobbying from tech companies, the JOBS Act also increased the cap on the number of shareholders that would automatically push an issuer into becoming a reporting company.[134] Previously, private companies with assets of over $10 million became reporting companies once they had over 500 shareholders on record. The JOBS Act adjusted this number upwards to 2,000 holders of record or 500 non-accredited investors, enabling companies to delay IPOs for longer periods of time before creeping public.[135]

More recently, on November 2, 2020, the SEC announced a set of amendments to "harmonize, simplify, and improve the multilayer and overly complex exempt offering framework."[136] An overarching goal of the proposal, since adopted

and (2) 'any seminar or meetings whose attendees have been invited by any general solicitation or general advertising.'" *Id.* (quoting 17 C.F.R. 230.502(c) (2019)). The Commission has provided additional guidance through no-action letters over the past 40 years. *Id.*

[132] *Cf.* GARNIGHIAN ET AL., *supra* note 131, at 1 (describing the capital formation goals of the reform).

[133] *See id.* at 3, 6–7. The Commission has confirmed that electronic media may be used to gauge investor suitability before presenting an investment opportunity. *Id.* at 7.

[134] *See* Paul Sloan, *Three Reasons Facebook Has To Go Public*, CNET (Jan. 31, 2012, 7:07 AM), https://www.cnet.com/news/three-reasons-facebook-has-to-go-public/ [https://perma.cc/B5N2-JTHN].

[135] Susan Beblavi, Note, *JOBS Act Title V: Raising Threshold for Registration*, 90 DENVER L. REV. ONLINE 63, 65–68 (2013).

[136] Press Release, U.S. Sec. & Exch. Comm'n, SEC Harmonizes and Improves "Patchwork" Exempt Offering Framework (Nov. 2, 2020), https://www.sec.gov/news/press-release/2020-273 [https://perma.cc/KQ9W-3T2C]. The amendments follow changes previously proposed in March 2020. *Id.*

"substantially as proposed,"[137] is to reduce the complexity of the current framework, "mak[ing] certain unregistered private offerings . . . more appealing" for small companies.[138] This proposal raises the amount of capital a company is permitted to raise under various exemptions—specifically, from $5 million to $10 million for Rule 504 of Reg D, from $50 million to $75 million for Tier 2 of Reg A, and from $1.07 million to $5 million for Regulation Crowdfunding.[139] It also permits Regulation Crowdfunding issuers to "test-the-waters" prior to filing with the SEC[140] and amends eligibility restrictions on Reg A+ and Regulation Crowdfunding. Specifically, it allows special purpose vehicles to be used when investing in Regulation Crowdfunding issuers[141] and restricts companies that have failed to file section 13 or 15(d) reports under the Exchange Act for two years from Reg A issuances.[142]

Additionally, the amendments create Rule 241, a new exemption permitting the use of "generic solicitation of interest materials" about an offer of securities to allow an issuer to gauge market interest in its exempt offering "prior to incurring the expense of preparing and conducting an offering."[143] However, "depending on the method of

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137 Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. 3,496, 3521 (Jan.14, 2021) (codified in scattered parts of 17 C.F.R.).

138 Zanki, *supra* note 6.

139 Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 136; *see also* Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3,498 tbl.1.

140 Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3,523–24.

141 *Id.* at 3,544.

142 *Id*. at 3,548–49.

143 *See id.* at 3,520. The generic solicitations under the proposed Rule 241 would be deemed offers to sell a security for the purposes of the general antifraud provisions. *Id.* at 3,521. Any materials an issuer sends to potential investors under the new rule would be required to include disclaimers about the limitations of the solicitation. *Id.* at 3,522.

dissemination of the information, such offers may be considered a general solicitation."[144] If the issuer's use of interest materials is deemed to be a general solicitation, the issuer may be foreclosed from ultimately deciding to conduct an unregistered offering that does not permit general solicitations, such as a Rule 506(b) offering.[145]

As it relates to Rule 506(c) offerings, the SEC proposed allowing issuers to assume that an accredited investor from a previous issuance remains an accredited investor without taking additional steps to verify their status so long as the investor submits a writing to that effect.[146] In addition to harmonizing the exempt offerings, the new amendments aim "to enable . . . issuers to optimize their financing strategy and reduce their financing costs" by affording them increased flexibility.[147] It does nothing, however, to promote public offerings.

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[144] *Id.* at 3,521.

[145] *Id.* at 3,522. Thus, if an issuer uses a generic indication of interest solicitation that is deemed a general solicitation but subsequently decides to engage in an unregistered offering as opposed to an exempt Regulation A or Regulation Crowdfunding offering, that issuer's only option may be to rely on Rule 506(c) instead of Rule 506(b), which allows for general solicitations but requires the issuer to take the extra step of verifying all purchasers are accredited investors. *See supra* note 78 and accompanying text (discussing Rule 506 offerings). In these cases, the issuer would only be able to rely on a Rule 506(b) offering if it

> has a reasonable belief, based on the facts and circumstances, with respect to each purchaser in the exempt offering prohibiting general solicitation, that the issuer (or any person acting on the issuer's behalf) either did not solicit such purchaser through the use of general solicitation or established a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation.

Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3,522.

[146] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 86 Fed. Reg. at 3,527.

[147] *Id.* at 3,551.

III. POLICY FACTORS AND UNRESPONSIVE REFORMS

Elements of the JOBS Act, subsequent rules, and recent proposals evidence the SEC's attempts to facilitate access to the public market. In many instances, however, these efforts have instead created greater optionality for companies to stay in the private market, leading to increased growth in the private market. The rise of the private market and shrinkage of the public market have raised debate as to whether the private market should be expanded to a wider class of investors, and how such expansion would affect the already declining public market. By attempting to address the issues presented by each market separately, however, recent reform efforts appear to have fallen short of their goals, potentially working against each other. This Part examines some of the policy considerations for preserving the public market, structural issues with the public market that have not been properly addressed through recent reform efforts, arguments for expanding access to the private market, and the effect of recent and proposed reform efforts.

A. Policy Factors That Should Drive Regulation

1. Benefits of the Public Market

The public market provides a wide array of benefits and protections that are largely absent from, and difficult to replicate in, the private market. If the number of public companies continues to decline, and the set of available public market investments decreases as a result, investors may be deprived of these benefits. The regulatory scheme in the public market facilitates transparent and efficient securities pricing. Companies that wish to raise capital from the general public are subject to significant disclosure requirements geared towards protecting smaller and unsophisticated investors.[148] The informational efficiency and price transparency created by the mandatory disclosure regime are

[148] *See supra* Section II.A.

further enhanced by the wide range of public and private remedies for fraud and the insider trading laws.[149] By standardizing information available to investors, this oversight and mandatory disclosure regime also plays a crucial role in leveling the playing field for smaller investors.[150]

Rather than depending on individual financial sophistication, public market participants can rely on the efficient market hypothesis to ensure efficient pricing for both retail and sophisticated investors.[151] Under the semi-strong form of the efficient market hypothesis, all publicly available information is nearly immediately reflected in a security's publicly traded price as investment analysts continuously evaluate and adjust prices to reflect any new information.[152] In the liquid public securities market, individuals can feel confident that the prices on exchanges fairly reflect the present value of expected future cash flows based on the significant amount of publicly available information without having to individually process new information as it comes in.[153] In contrast, individuals cannot be certain that the prices for private market securities are "fair" at any given point because the lack of mandatory public disclosures and comparatively illiquid nature of private market securities make it difficult to assess an accurate "market price" for such securities. Moreover, antifraud protections and insider trading laws are difficult to enforce outside the public market.[154] The public market's informational efficiency and price transparency are thus difficult to replicate in the private market. As a result of these characteristics, the public market

149 *See* Elisabeth D. de Fontenay, Professor of L., Duke Univ. Sch. of L., et al., Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions 3–4 (Sept. 24, 2019), https://scholar.law.colorado.edu/cgi/viewcontent.cgi?article=1010&context=research-data [https://perma.cc/8BCC-FDAB].

150 *See id.* at 3.

151 Haq, *supra* note 29, at 65–66.

152 *Id*. at 66.

153 *See id.*

154 de Fontenay et al., *supra* note 149, at 9.

often serves as a benchmark for the private market. For example, the private market frequently relies on public market prices as indicators of fair pricing.[155] The transparent and efficient nature of public market securities also enables them to serve as reliable collateral for other financial transactions.[156]

Public market securities are also highly liquid. This allows retail investors to pay lower commissions, to acquire the best execution prices for their trades, and to quickly meet their cash needs by selling their public market investments.[157] The ease of exit and the corporate governance procedures in public companies also serve as tools for investors to discipline underperforming or mismanaged companies.[158] In contrast, private market securities are more thinly traded, and investors have difficulty unwinding their positions—in fact, individuals are generally unable to trade many restricted securities for at least one year.[159] This poses significant liquidity risks for retail investors, who are more likely to "have liquidity needs that institutional investors typically do not."[160] Additionally, given the lack of liquidity and governance procedures in the private market, it is generally the case that only investors with substantial bargaining power and financial sophistication are able to discipline underperforming private companies.[161]

In addition to eroding the pricing and liquidity benefits of the public market, allowing the size of the public market to shrink significantly could decrease returns and increase risk for retail and institutional investors alike. First, the public market enables retail investors to diversify and therefore

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[155] *Id.* at 3.

[156] *Id.*

[157] *See id.* at 4.

[158] *Id*. The corporate governance procedures for public companies include independent audit committees, the proxy process, and stock exchange listing standards. *Id.*

[159] *See supra* text accompanying note 94.

[160] de Fontenay et al., *supra* note 149, at 8.

[161] *Id.* at 9.

reduce risks through index funds.[162] As the private market does not provide meaningful diversification opportunities to individual investors without significant funds, materially decreasing the size of the public market will increase risks for such investors.[163] The public market also provides valuable diversification opportunities for institutional investors with sufficient capital, given that private equity funds, whose investments are largely in the private market, are less than perfectly correlated with the S&P 500.[164] Therefore, shrinking the number of firms in the public market arguably decreases diversification opportunities for institutional investors as well.

[162] *Id.* at 3.

[163] *See* Interview by the Columbia Program in L. & Econ. of Cap. Mkts. with Anonymous Interviewees (2019) [*hereinafter* Special Study Interview]; *cf. also* de Fontenay et al., *supra* note 149, at 6 (asserting that high-net-worth investors have already flooded the private markets and that the remaining investments are ill-suited to retail investors). For a discussion of the interviews referenced in this Article, see Merritt B. Fox et al., *Distributed Ledger Technology and the Securities Markets of the Future: A Stakeholder Survey*, 2021 COLUM. BUS. L. REV. 652.

Defined benefit plans, i.e., pension plans, are significant investors in private markets and private funds. Thus, individuals who may not have the benefit to invest in a private placement or private fund based on their status as accredited investors can gain some diversification benefit based on their pension plans. However, most retail investors do not gain this diversification benefit through defined contribution plans, i.e., 401(k) plans. *See* Michael Doherty, Partner, Ropes & Gray LLP, et al., Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions 6 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6190355-192429.pdf [https://perma.cc/83YQ-BY3M]. Though these plans are not prohibited from investing in private funds, the actual investment in private funds is limited because, in exercising its fiduciary duties, the defined contribution plan fiduciaries must take into account the liquidity of the investments. *See id.* at 6–7.

[164] de Fontenay et al., *supra* note 149, at 11–12; Miriam Gottfried, *Private-Equity Firms Are Raising Bigger and Bigger Funds. They Often Don't Deliver*, WALL ST. J. (June 18, 2019, 8:00 AM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/private-equity-firms-are-raising-bigger-and-bigger-funds-they-often-dont-deliver-11560859200 (noting that private equity funds with $10 billion or more have a 0.62 correlation with the S&P 500 while funds with less than $350 million have a correlation of just 0.38).

Second, as discussed further in Section III.A.3 below, the private market offers high returns from companies' early-stage growth, and retail investors are currently excluded from these returns. However, these returns are generally achieved by taking on higher risk and are often driven by the operational and financial sophistication of institutional investors.[165] For investors who lack financial sophistication and proper advice, the risks of investing in private markets can be "exponentially higher," and the expected returns are significantly decreased.[166] Finally, the lack of disclosure in the private market likely affects retail investors significantly more than institutional investors, who generally have the financial sophistication and bargaining power to obtain necessary information.

Due to this information asymmetry between retail and institutional investors in the private market, allowing individuals—even accredited investors—to directly invest in the private market likely creates a "lemons" problem. In other words, the worthiest private market investments would go to institutional investors, leaving individual investors with the least promising opportunities.[167] Because these investments are likely to be promoted by unregulated parties, retail investors may be offered opportunities that do not satisfy FINRA's suitability standard or Regulation Best Interest.[168] Given the lack of data, this issue would prove difficult to resolve. Though FINRA requires brokers to file private placement offerings for investments offered to individuals, such disclosures are unlikely to provide a complete view of the

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[165] *See* Special Study Interview, *supra* note 163.

[166] *Id.* For a discussion of how to expand access to the private market for retail investors while accounting for the lack of operational and financial sophistication of these investors, see *infra* Section IV.B.

[167] *See* de Fontenay et al., *supra* note 149, at 6.

[168] *Id.* at 7. For the suitability rule, see FINRA R. 2111 (Fin. Indus. Regul. Auth., Inc. 2020). For Regulation Best Interest, see 17 C.F.R. § 240.15*l*-1 (2020).

nature of the private market investments offered to individuals.[169]

Through the disclosure regime, the possibility of enforcement for failures to abide by that regime, and the reliance on the efficient market hypothesis, the public market ensures that investors can be confident in the accuracy of securities prices, limit their liquidity risks, and be protected from mismanaged companies. Regulatory reforms that diminish the public market would not only erode these crucial protections, but would likely also adversely affect other markets.[170] Consequently, private market reforms should take into account the potential adverse effects on the public market.

2. Structural Issues with the Public Market as Deterrents to Entry

Despite the importance of the public market and the compelling arguments to preserve it, recent reforms have been unresponsive to fundamental structural issues with the public market. As companies are able to raise significant funds in the private market, these structural issues may deter them from "going public." As discussed below in Part IV, these structural concerns should be addressed to ensure the preservation of the public market and encourage firms to go public. The structural issues highlighted in this Section are the high costs incurred by public companies and the pressure to focus on short-term earnings at the expense of long-term growth.

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[169] Special Study Interview, *supra* note 163. Only around one-fifth of PPOs are offered through broker dealers, and these tend to be niche investments. *See, e.g.*, MARY M. DUNBAR, DLA PIPER, FINRA ISSUES GUIDANCE ON PRIVATE PLACEMENT RETAIL COMMUNICATIONS 2 (2020) (reporting that broker-dealers participate in roughly one-fifth of all Reg D offerings), http://pdf.dlapiper.com/pdfrenderer.svc/v1/ABCpdf9/GetRenderedPdfByUrl//FINRA%20issues%20guidance%20on%20private%20placement%20retail%20communications.pdf/?url=https://www.dlapiper.com:443%2Fen%2Fus%2Finsights%2Fpublications%2F2020%2F07%2Ffinra-issues-guidance-on-private-placement-retail-communications%2F%3F%26pdf%3D1&attachment=false [https://perma.cc/ZHM5-3DVP].

[170] de Fontenay et al., *supra* note 149, at 3.

The cost of going public is high, and the prospect of an IPO, as opposed to raising private capital, can be cost prohibitive.[171] In the IPO process, for example, a company is required to expend significant amounts of time and money in filing its registration statement. In a traditional offering, an issuer must hire an underwriter to purchase the issuer's securities at a discount[172] and then "build the book" to garner interest for the securities when they are sold from the underwriter to the offering's initial purchasers.[173] While recent reforms[174] aim to reduce the costs of going public, they may only be delaying these costs rather than reducing them. For example, the extension of "testing-the-waters" to all issuers does not necessarily make it less expensive to go public. When the issuer decides to undertake a public offering, it will still be required to pay the legal and underwriting fees associated with the offering. Thus, the reform simply delays the costs. An issuer who realizes that the offering will not be successful after "testing-the-waters" will certainly save money in the short term, but if they eventually decide to conduct an IPO, there will still be a similar outlay. This is likely an important reason why the reforms have not resulted in an increased number of IPOs.[175]

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[171] If the benefits of going public, e.g., increased liquidity for early investors, do not outweigh the costs of the registration and on-going disclosure requirements, a firm may decide to continue relying on private fundraising.

[172] This discount, or "spread," explicitly paid to the underwriters is on average seven percent of the total proceeds of an IPO. *See* Susan Chaplinsky, Kathleen Weiss Hanley & S. Katie Moon, *The JOBS Act and the Costs of Going Public*, 55 J. ACCT. RSCH. 795, 807 tbl.2 (2017). This is in addition to two percent of the proceeds paid to accountants, lawyers, and other intermediaries, as well as an implicit cost of thirteen percent to fourteen percent of the proceeds from underpricing (underwriters pricing the IPO low, which effectively transfers part of the proceeds from the issuer to a group of institutional investors selected by the underwriter). *Id.*

[173] *See* Frederick A. Elmore IV, *When, as, and if: How an Obscure Security Could Make Initial Public Offerings More Efficient*, 14 VA. L. & BUS. REV. 1, 10 (2020).

[174] For a summary of these reforms, see *supra* Section II.C.

[175] For a discussion of the empirical research, see *infra* notes 217–223 and accompanying text.

While the SEC attempts to reduce the costs of going public through reforms, market participants have resorted to alternative measures to address this cost. Two recent trends in the public market both seek to reduce the cost of going public: direct listings and Special Purpose Acquisition Companies (SPACs). A direct listing is a way for a company to go public "without selling its shares directly to the public and without the traditional underwriting assistance of investment bankers."[176] Former unicorns Spotify and Slack both opted for direct listings when they publicly listed in 2018 and 2019, respectively.[177] Unlike an IPO, a direct listing is not a capital raising event; it is an opportunity for existing employees and investors to sell their stock to the public.[178] However, as discussed in Section IV.B.1.ii *infra*, the SEC has approved proposals by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations (NASDAQ) to allow certain companies to simultaneously conduct a direct listing and offer new stock to raise capital.

A SPAC is a company formed by a sponsor that raises capital on an exchange through an IPO in order to acquire a company—typically a private company.[179] If the "blank check company" does not make an acquisition within a set time period after its IPO—usually two years—all funds raised are returned the investors.[180] During that two-year period, a

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[176] *The Rise of Direct Listings: Understanding the Trend, Separating Fact from Fiction*, FENWICK (Dec. 5, 2019), https://www.fenwick.com/insights/publications/the-rise-of-direct-listings-understanding-the-trend-separating-fact-from-fiction [https://perma.cc/RA85-XFGZ].

[177] Bob Pisani, *Slack Going Public in a Red-Hot IPO Market, with a Twist*, CNBC, https://www.cnbc.com/2019/06/20/slack-going-public-in-a-red-hot-ipo-market-with-a-twist.html [https://perma.cc/XNB8-TYEA] (last updated July 16, 2019, 3:33 PM).

[178] *Direct Listing*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/direct-listing/ [https://perma.cc/S2LW-9JFP] (last visited Mar. 6, 2021).

[179] Kevin LaCroix, *Rain on the SPAC Parade?*, THE D&O DIARY (Oct. 12, 2020), https://www.dandodiary.com/2020/10/articles/director-and-officer-liability/rain-on-the-spac-parade/ [https://perma.cc/5C6L-ZL25].

[180] *Id.*

SPAC will typically acquire a private company in a reverse merger where the surviving entity is the formerly-private operating company, which becomes publicly traded through the "de-SPAC" transaction.[181] SPAC IPOs have become increasingly popular recently, with some dubbing 2020 the "year of the SPAC."[182] SPACs accounted for sixty-six percent of all IPOs completed in 2020 as of October.[183] The efficacy of each of these trends in reducing the costs of going public is discussed in Section IV.B.1.

In addition to the significant costs of going public, the costs of staying public may also serve as a deterrent. Reporting companies face significant costs through the mandatory disclosure requirements and the potential threat of litigation related to these disclosures. A PricewaterhouseCoopers study estimated the average annual cost of being public to be between $1 million and $1.9 million.[184] With these costs, companies may have an incentive to stay private.[185] The cost of compliance has substantially increased with the passage of SOX, and a significant proportion of reporting costs relate to compliance with SOX disclosures. The incremental cost of SOX compliance ranges anywhere from under $100,000 to over $2 million annually, depending on the size of the

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181 *Id.*

182 James Dunne, *2020: The Year of the SPAC*, YAHOO!: ENT. (Jan. 5, 2021), https://www.yahoo.com/entertainment/2020-spac-194704978.html [https://perma.cc/P48A-QFR4]; *see also* Dave Michaels & Alexander Osipovich, *Blank-Check Firms Offering IPO Alternative Are Under Regulatory Scrutiny*, WALL ST. J. (Sept. 24, 2020, 4:34 PM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/blank-check-firms-offering-ipo-alternative-are-under-regulatory-scrutiny-11600979237.

183 LaCroix, *supra* note 179.

184 STEPHANIE REVERING ET AL., PRICEWATERHOUSECOOPERS, CONSIDERING AN IPO TO FUEL YOUR COMPANY'S FUTURE?: INSIGHTS INTO THE COSTS OF GOING PUBLIC AND BEING PUBLIC 14 (2017), https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf [https://perma.cc/ND9V-KTAR] (reporting the range offered by two-thirds of surveyed CFOs).

185 *See id.*

company.[186] As a matter of investor protection, SOX has improved internal controls over financial reporting, and some organizations have recognized positive effects throughout their companies as a result.[187] Yet, for private companies considering going public, these significant costs may have a deterrent effect. Some of this deterrent effect was likely mitigated for EGCs by the exemptions from SOX disclosures for EGCs promulgated under the JOBS Act.[188] In fact, there is evidence that SOX compliance cost is not the major cause of small companies avoiding IPOs[189] or performing badly after IPOs.[190] However, non-EGC private companies, like the tech unicorns (companies valued over $1 billion) and decacorns (companies valued over $10 billion)[191] that have remained private recently, would immediately be subject to all of SOX's disclosure requirements upon going public, without the assistance of the on-ramp afforded to EGCs under the JOBS Act.

Another important structural factor that may be deterring companies from going public is the heightened pressure from investors that public firms are subject to. Market participants have commented that the public market rewards short-term profits rather than long-term performance and strategies.[192]

[186] Reports indicate that about one-third of organizations spend $500,000 or less annually on SOX compliance, while "just under half spend less than $1 million." PROTIVITI, UNDERSTANDING THE COSTS AND BENEFITS OF SOX COMPLIANCE 1 (2016), https://www.protiviti.com/sites/default/files/united_states/insights/2016-sox-survey-protiviti.pdf [https://perma.cc/Z9DK-KRV3]. However, "[a] significant number of large companies" spend over $2 million per year. *Id.*

[187] *Id.* at 29.

[188] On the JOBS Act and its exemptions, see *supra* notes 119–121 and accompanying text.

[189] *See* John C. Coates & Suraj Srinivasan, *SOX After Ten Years: A Multidisciplinary Review*, 28 ACCT. HORIZONS 627, 638 (2014).

[190] *See* Gao et al., *supra* note 4, at 1690.

[191] Begum Erdogan et al., *Grow Fast or Die Slow: Why Unicorns Are Staying Private*, MCKINSEY & CO. (May 11, 2016), https://www.mckinsey.com/industries/technology-media-and-telecommunications/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private [https://perma.cc/2SL8-NK4X].

[192] *See* Special Study Interview, *supra* note 163.

This can be particularly detrimental for retail investors, who tend to hold long-term positions through index funds rather than use short-term strategies implemented by algorithmic trading.[193]

This focus on short-term profits may be driven by a number of causes. For one, public companies that perform poorly in the short term could be subject to attack by activist investors who may prompt the board to enact divestitures or implement cost reductions to promote short-term earnings growth.[194] Second, the quarterly reporting system promulgated under the Exchange Act may be promoting short-termism.[195] Quarterly reporting likely adds to price efficiency by giving the market information at regular intervals, and may aid in investor protection by shedding light on companies' financial health. In fact, some insist that quarterly reporting is an important mechanism for transparency so that investors and regulators have access to the information necessary to make investment and regulatory decisions.[196] Yet, others argue that the pressure to meet short-term earnings estimates under the quarterly reporting system may be creating a "lemons" problem by discouraging companies with longer-term visions from going public, "depriving the economy of innovation and opportunity."[197] With no specific reporting requirements and,

[193] *See id.*

[194] For a discussion of short-termism, see, for example, John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 573–81 (2016). The topic has attracted considerable debate.

[195] *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Solicits Public Comments on Earnings Releases and Quarterly Reports (Dec. 18, 2018), https://www.sec.gov/news/press-release/2018-287 [https://perma.cc/FL2A-JMZU].

[196] *See* Michael Posner, *Why Quarterly Reporting from Business Makes Sense*, FORBES (Aug. 17, 2018, 1:46 PM), https://www.forbes.com/sites/michaelposner/2018/08/17/why-quarterly-reporting-from-business-makes-sense/ [https://perma.cc/CY74-XNJ7].

[197] Jamie Dimon & Warren E. Buffett, *Short-Termism Is Harming the Economy*, WALL ST. J. (June 6, 2018, 10:00 PM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801.

therefore, no quarterly earnings pressures, private firms may have more freedom to pursue their long-term goals and idiosyncratic visions. Additionally, twenty-first century firms may need the privacy and governance flexibility of private equity markets to be nimble and more consistently innovative.[198]

Each of these structural issues may have the individual or aggregate effect of causing a company to raise money in the private market as opposed to raising money through an IPO when the benefits of the public market (i.e., liquidity for early investors) do not outweigh the deterring costs and effects of going and remaining public.

3. Considerations in Expanding Access to the Private Market

Although the public market remains the "gold standard" for investor protection,[199] the private market offers promising investment opportunities that the vast majority of investors are currently precluded from because they are non-accredited investors.[200] While it is true that investor protection must be a chief concern of the SEC, allowing private companies to grow into behemoths without needing to access the public capital markets would effectively exclude non-accredited investors from participating directly in the growth of the most exciting companies, such as SpaceX or Instacart—two decacorns that

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[198] *See* Jerold L. Zimmerman, *The Role of Accounting in the Twenty-First Century Firm*, ACCT. & BUS. RSCH. 485, 499 (2015). Zimmerman explains that, as compared to nineteenth and twentieth century firms, which relied on large amounts of physical capital funded in liquid shares, "[t]wenty-first century firms are . . . more knowledge-based, requiring human capital to generate their intangible assets." *Id.* at 487. Because these firms have fewer physical assets to use as debt collateral, they are more likely to turn to private markets than the public market to provide capital. *Id.*

[199] de Fontenay et al., *supra* note 149, at 2.

[200] *See* Accredited Investor Definition, 85 Fed. Reg. 64,234, 64,272 (Oct. 9, 2020) (to be codified at 17 C.F.R. pts. 230, 240). As a result of inflation, roughly thirteen percent of households in the United States qualify under the accredited investor criteria, as compared to two percent in 1983. *Id.*

remain privately held.[201] Of course, it was not always this way. The traditional growth trajectory of a startup involved multiple rounds of private financing and typically culminated in an IPO and public listing.[202] The rounds of financing would include initial startup money from friends and family, additional funding from angel investors to seed early growth, and then a series of venture capital financing to fund growth until investors would be able to liquidate through an IPO or an acquisition by a strategic investor.[203] The time between a venture investor's first investment and exit was typically seven years.[204] This seven-year cycle fits within the timeframe of most venture capital funds' terms, which are often limited to ten years.[205] After the seven years of private market growth, and upon the company's entry into the public market, the traditional retail investor could participate in the company's continued growth through direct investment in the company's stock or through holding a diversified index fund.[206]

By 2014, private companies, particularly technology companies, were staying private longer. On average, these firms stayed private for eleven years, and private funding was

201 *See The Complete List of Unicorn Companies*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies [https://perma.cc/7CLP-JY82] (last visited Mar. 2, 2021).

202 *See* Seth C. Oranburg, *Democratizing Startups*, 68 RUTGERS U. L. REV. 1013, 1032 (2016).

203 *See id.*

204 *See id.*

205 *See id.*

206 Frank Partnoy, *The Death of the IPO*, ATLANTIC (Nov. 2018), https://www.theatlantic.com/magazine/archive/2018/11/private-inequity/570808/ [https://perma.cc/8ZNL-RV4S]. It should be noted that retail investors do have the opportunity to invest in private companies through mutual funds. However, under Rule 22e-4 of the Investment Company Act of 1940, registered open-ended investment funds can only invest up to fifteen percent of their assets in illiquid investments (i.e., private investments) to ensure funds are available for daily redemptions. 17 C.F.R. § 270.22e-4(b)(1)(iv) (2020). The SEC has also applied the fifteen percent limitation to registered closed-end funds unless the fund is limited to accredited investors. *See* Doherty et al., *supra* note 163, at 9 & n.54, 10 & n.55.

producing an increasing number of unicorns and decacorns.[207] With companies staying private longer, non-accredited investors missed out on the fastest stages of growth.[208] In fact, from 2017 to 2019, companies that conducted IPOs declined in value by an average of eight percent, whereas the S&P 500 was up twelve percent.[209] As firms stay private longer, the early stage growth of such companies will increasingly be realized only by the wealthiest investors. These investors can invest in venture funds or directly in Reg D offerings and "cash out" in highly-valued IPOs.[210] Delaying opportunities for retail investors to invest in high-growth private companies likely increases the wealth inequalities that securities laws may already be exacerbating.[211] Non-accredited investors are unable to invest in hedge funds, private equity funds, or venture capital funds, and thus miss out on the opportunity to invest in vehicles that can earn higher average returns when compared to public equity.[212] Restricting non-accredited investors from investing in private placements and potentially high-growth vehicles "has permitted the[] investing elite to become even wealthier relative to the middle class."[213] As the private market continues to grow, maintaining the broad

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[207] Erdogan et al., *supra* note 191.

[208] *See* Matt Phillips & Erin Griffith, *In This Tech I.P.O. Wave, Big Investors Grab More of the Gains*, N.Y. TIMES (Mar. 28, 2019), https://www.nytimes.com/2019/03/28/business/startups-ipo.html [https://perma.cc/EM2C-KYV8].

[209] *Id*. This indicates that the companies that went public were overvalued at the time of their public offerings, depriving retail investors of the benefit of their high-growth periods. However, the statistic should be taken with a grain of salt—simply being on the S&P 500 gives an indication that the company is a well-performing company, and since companies are added to and removed from the S&P 500 each month, using this index as a baseline can create selection bias.

[210] *See* Partnoy, *supra* note 206.

[211] *See* Kevin G. Bender, *Giving the Average Investor the Keys to the Kingdom: How the Federal Securities Laws Facilitate Wealth Inequality*, J. BUS. & SEC. L., Spring 2016, at 1, 26–28.

[212] *See id*. at 26.

[213] *Id*. at 36.

exclusion of non-accredited investors from private market opportunities will likely exacerbate this effect.

B. Piecemeal Reforms Have Been Unresponsive to the Policy Considerations

As indicated by the foregoing discussion, the public and private markets have presented competing policy considerations, and, thus far, regulators have attempted to address these issues in an ad hoc manner. Legislation and rulemaking over the past decade have attempted to preserve the public market by incentivizing companies to go public through the JOBS Act and subsequent rules.[214] However, evidence indicates that these initiatives were met with limited success. And, more recently, the promising early stage growth returns in the private market have led to efforts to expand the exempt offering framework.[215] In the aggregate, public and private market reforms appear to be increasing the ability of firms to remain private without providing the right balance of incentives towards pushing companies public.

The JOBS Act aimed to encourage EGCs towards the public market by reducing the burdens around the IPO process and scaling back certain ongoing disclosure and corporate governance requirements.[216] However, the evidence is mixed as to whether these changes meaningfully increased EGC IPOs.[217] In some industries, specifically among biotechnology firms, there is evidence that the JOBS Act has

[214] *See supra* Section II.C.

[215] *See supra* text accompanying notes 136–47.

[216] *See supra* Section II.C.

[217] Gallagher, *supra* note 121, at 329–30. For example, one study found that IPO volume increased by fifty percent in the two years following the JOBS Act, but another study found that the number of IPOs by smaller companies (i.e., the companies targeted by the JOBS Act) did not significantly increase. *See id.* at 327–28 (first citing Michael Dambra, Laura Casares Field & Matthew T. Gustafson, *The JOBS Act and IPO Volume: Evidence that Disclosure Costs Affect the IPO Decision*, 116 J. FIN. ECON. 121, 122 (2015); and then citing Carlos Berdejó, *Going Public After the JOBS Act*, 76 OHIO ST. L.J. 1, 35 (2015)).

had a meaningful impact on increasing IPOs.[218] A recent study found "a 219% increase in biotech IPO volume during the six-year period after the JOBS Act."[219] The study theorizes that the reduced compliance costs for EGCs under the JOBS Act are significantly important for biotech firms, which must expend substantial amounts on R&D prior to obtaining approval from the Food and Drug Administration.[220] These capital-related costs in the biotech industry make the firms prime candidates for IPOs. With reduced post-IPO compliance costs, biotech firms are able to raise more money from the public pre-revenue and focus their capital on R&D rather than on the heightened disclosure requirements typically imposed on public companies.[221] Importantly, this study found "no evidence of a decline in the quality of" biotech firms going public.[222] However, studies focusing more broadly on EGCs as a whole have found less favorable results with respect to the quality of companies going public.[223]

While some recent data indicate that the JOBS Act has increased the *quantity* of EGC IPOs, it appears that the reduced disclosure requirements may have lowered the *quality* of the companies going public.[224] Forty-six percent of

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[218] *See* Craig M. Lewis & Joshua T. White, Deregulating Innovation Capital: The Effects of the JOBS Act on Biotech Startups 2 (Aug. 21, 2020) (unpublished manuscript) (on file with the Columbia Business Law Review), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3640852.

[219] *Id.*

[220] *See id.* at 2–3

[221] *See id.*

[222] *See id.* at 33.

[223] *See The JOBS Act at Five: Examining Its Impact and Ensuring the Competitiveness of the U.S. Capital Markets: Hearing on the Jumpstart Our Business Startups Act (JOBS Act), Pub. L. No. 112-106, 126 Stat. 306 (2012) Before the H. Subcomm. on Cap. Mkts., Sec. & Inv. of the H. Comm. on Fin. Servs.*, 115th Cong. 8 (2017) [hereinafter *JOBS Act Hearing*] (statement of Andy Green, Managing Director of Economic Policy, Ctr. for Am. Progress).

[224] *See id.* at 8–9. In a version of his testimony that he did not deliver orally, Green noted that eighty-seven percent of the IPOs since the JOBS Act were conducted by EGC filers who were able to take advantage of the lighter regulatory standards applicable to those companies. ANDY GREEN, CTR. FOR AM. PROGRESS, THE JOBS ACT AT FIVE: EXAMINING ITS IMPACT AND

EGC filers that provided management reports on internal controls reported material weaknesses in corporate governance,[225] and exchange-listed EGCs reported twice the number of material control weaknesses compared to exchange-listed non-EGCs.[226] "This suggests that the JOBS Act provisions eliminating Sarbanes-Oxley auditor attestation for EGCs is having a negative impact on offering quality."[227] A 2017 study found that EGCs averaged 10.6% lower than non-EGCs with respect to returns on assets prior to the JOBS Act, but that this spread had increased to 21.8% in the first four years after the Act was passed.[228] Finally, an

ENSURING THE COMPETITIVENESS OF THE U.S. CAPITAL MARKETS: TESTIMONY BEFORE THE U.S. HOUSE OF REPRESENTATIVES SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND INVESTMENT 3 (2017) (citing EY, UPDATE ON EMERGING GROWTH COMPANIES AND THE JOBS ACT (2016), http://www.ey.com/Publication/vwLUAssets/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016/$FILE/ey-update-on-emerging-growth-companies-and-the-jobs-act-november-2016.pdf), https://docs.house.gov/meetings/BA/BA16/20170322/105717/HHRG-115-BA16-Wstate-GreenA-20170322.pdf [https://perma.cc/87V5-XP7X]. However, the EGC-label is simply an indication of size, not a statement on whether the firm is "exciting or innovative." *Id.* In fact, a plurality of EGC filers by asset "were real estate investment trusts, state and federally-chartered commercial and savings banks, and pharmaceutical preparations," not the type of firms one would colloquially refer to as "growth" companies. *See id.* (citing KEVIN MURPHY, TOSHA WILLIAMS & HARSHA SAMARAWEERA, WHITE PAPER ON CHARACTERISTICS OF EMERGING GROWTH COMPANIES AS OF MAY 15, 2016, at 12 (2016), https://pcaobus.org/EconomicAndRiskAnalysis/ORA/Documents/White-Paper-on-Characteristics-of-Emerging-Growth-Companies-May-2016.pdf [https://perma.cc/DUV2-STDE]).

[225] *JOBS Act Hearing*, *supra* note 223, at 8 (statement of Andy Green, Managing Director of Economic Policy, Ctr. for Am. Progress).

[226] GREEN, *supra* note 224, at 4.

[227] *Id.*

[228] Kai Lu, The JOBS Act and Post IPO Performance of EGC Firms 20 (Feb. 1, 2017) (unpublished manuscript) (on file with the Columbia Business Law Review), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2927722. While returns for EGCs post-JOBS Act may be lower than for non-EGCs, it should be noted that the quality of the company may not be the only reason for this discrepancy. EGCs are smaller and newer than non-EGCs, so it may be expected that these companies may not perform as well as larger and more well-established non-EGC filers. Thus, isolating the

empirical study conducted by Chaplinsky, Hanley, and Moon suggests that while the JOBS Act can reduce the costs of going public, such reduction may be at the expense of capital formation and stock liquidity.[229] The study found that EGC issuers faced a 76% increase in underpricing compared to similarly-sized firms that underwent IPOs prior to the JOBS Act, and concluded that this was likely due to the reduced amount of issuer information available to investors, who are not willing to pay as much for stocks they cannot fully assess.[230] On average, this underpricing translates into a roughly 3% reduction in post-IPO market value for EGC issuers covered by the JOBS Act's reduced disclosure requirements.[231]

The overall effect of expanding the confidential filing and "test-the-waters" advantages to non-EGCs in 2017 and 2019 remains to be seen. One study analyzing the effects of the confidential filing expansion found that neither the number of non-EGC IPOs nor the proportion of non-EGC IPOs in the market increased in the year following the SEC's expansion in 2017.[232] Now that non-EGCs are also able to "test-the-waters," it is possible that more of them will begin the IPO process. However, given that this change only recently took place in September 2019, and in light of the market turmoil during the first half of 2020, the impact of this expansion on public market growth is still unclear.

The limited success of the JOBS Act in attracting firms to the public market can be attributed to its failure to address the driving forces behind the continuing decline in public companies. Changes in market structure combined with regulatory choices in recent decades have altered the cost-benefit analysis in the decision to go public. Historically,

different disclosure requirements as the cause of the differing performance may be inappropriate.

229 *See* Chaplinsky et al., *supra* note 172, at 799.

230 *See id.* at 797–99. EGCs may limit financial and executive compensation disclosures in the IPO filing. *See id.* at 796–97.

231 *See id.* at 800.

232 *See* Gallagher, *supra* note 121, at 348 tbl.7 (showing similar proportions from 2015 through 2017).

companies bore the cost of going public in exchange for access to a wider investor base—the general public.[233] However, as discussed above in Section III.A.2, regulations over the years have markedly increased the costs of going and staying public. Meanwhile, recent reforms have increased the benefits of staying private. These reforms have enabled companies to stay private longer and widened the class of investors able to invest in the private market, thereby increasing the amount of privately available capital.[234]

The JOBS Act has permitted even the largest of companies to forego becoming public for longer periods of time by increasing the number of shareholders on record a company can have before being deemed a reporting company.[235] Facebook, one of the companies that lobbied for the increase, serves as an illustrative example.[236] In 2011, Facebook reached the previous threshold of 500 shareholders shortly after closing a private round of financing with a valuation of $50 billion.[237] As the JOBS Act had not yet been signed into

233 *See* de Fontenay, *supra* note 81, at 466.

234 *See supra* Sections II.B.–C.

235 *Supra* text accompanying notes 134–35.

236 *See* Sloan, *supra* note 134.

237 *See id*. That fundraising drew much scrutiny from the SEC for its structure and its potential violations of solicitation and communication rules. *See* Michael J. de la Merced, *Facebook Completes $1.5 Billion Fund-Raising Round*, N.Y. TIMES: DEALBOOK (Jan. 21, 2011, 4:50 PM), https://dealbook.nytimes.com/2011/01/21/facebook-completes-1-5-billion-fundraising-round/ [https://perma.cc/RZ2P-R7SX]. The deal was initially to be structured with Goldman Sachs investing $450 million of its own money as part of a $1.5 billion fundraise from Goldman's clients who would invest in a special purpose vehicle created solely for the purpose of this investment. *See The Goldman Sachs Facebook Deal: Is this Business as Usual?*, KNOWLEDGE@WHARTON (Jan. 19, 2011), https://knowledge.wharton.upenn.edu/article/the-goldman-sachs-facebook-deal-is-this-business-as-usual/ [https://perma.cc/89F8-QXJ2]. This fund would count as a single investor to ensure that Facebook would not exceed the 499-shareholder limit. *Id.* According to David Wessels, a finance professor at Wharton, this structure "might follow the letter of the law but it certainly doesn't follow the spirit of the law." *Id.* (internal quotation marks omitted). However, because news of the fundraise leaked and created widespread media attention, there was concern that the offering would run afoul of SEC communication

law, this essentially forced the tech giant to become a reporting company.[238] Had the JOBS Act been effective before 2012, Facebook would have been able to delay its entrance into the public market until the number of its shareholders had quadrupled in size.

Moreover, Regulation Crowdfunding, which in and of itself can be seen as an ad hoc regulatory response to the desire to allow equity investment in startup firms, enabled investors *below* certain net worth or annual income caps to make limited investments.[239] More significantly, as will be discussed in Section IV.A below, the SEC's decision to expand the accredited investor definition[240] without indexing the wealth thresholds for inflation will further expand the number of investors able to invest in the private market. Finally, the Commission's new rules, finalized in January 2021,[241] increase the amount of capital that can be raised across various exemptions. Cumulatively, we believe these reforms do not strike the right balance between encouraging public market entry and addressing private market growth.

IV. RECOMMENDATIONS AND PERSPECTIVES FROM THE COLUMBIA SPECIAL STUDY

Thus far, the piecemeal reforms since the JOBS Act have failed to meaningfully increase the number of firms going public while creating even greater optionality for firms to stay private. Striking the right balance between encouraging companies towards the public market and expanding access to the private market will require a more coordinated approach that considers the impact of proposed changes to both markets at the same time. Part of this approach entails ensuring that the private market is only expanded to investors who can

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prohibitions. *Id.* In the end, Goldman still invested its $450 million but limited outside investment to foreigners to ensure no rules were violated. *Id.*

[238] *See* Sloan, *supra* note 134.

[239] *See supra* notes 60–61 and accompanying text.

[240] *See supra* note 8.

[241] *See supra* notes 136–47 and accompanying text.

adequately protect themselves from the risks. To this end, in the short term, we recommend indexing the accredited investor definition for inflation and amending it to include investors that are advised by fiduciaries.

However, remedying the declining number of firms in the public market will require an in-depth examination of its structural issues. In light of the significant changes to both markets, the time is ripe for a comprehensive review of the market structure as a whole. Due to fundamental changes, including technological development and financial innovation, the markets of today differ dramatically from those of prior decades. In order to effectively reform the regulatory approach, it is necessary to holistically examine the drivers behind these changes. Therefore, in the long term we call for the funding of a special study as advocated by the chairs of the Law and Economics program at Columbia University.

A. Make Additional Amendments to the Accredited Investor Definition

Given that the private market can provide significant benefits to knowledgeable investors, the optimal strategy would be to expand the private market to investors that are either financially sophisticated or properly advised. The accredited investor definition is perhaps the most important tool for achieving this objective.[242] In light of *Ralston Purina*,[243] we believe that securities law should create a sliding scale balancing the sophistication of the investor with investor protection, disclosure, and liability. The SEC's expansion of the accredited investor definition moves somewhat in this direction by expanding the definition to cover individuals who meet certain certification standards.[244]

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[242] *See* Press Release, Allison Herren Lee, Comm'r, U.S. Sec. & Exch. Comm'n & Caroline Crenshaw, Comm'r, U.S. Sec. & Exch. Comm'n, Joint Statement on the Failure To Modernize the Accredited Investor Definition (Aug. 26, 2020), https://www.sec.gov/news/public-statement/lee-crenshaw-accredited-investor-2020-08-26#_ftn1 [https://perma.cc/V97D-AYF6].

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

[244] Accredited Investor Definition, 85 Fed. Reg. 64,234, 64,241 (Oct. 9, 2020) (to be codified at 17 C.F.R. pts. 230, 240)

However, the amendment fails to address some of the most pressing issues with the definition. Namely, the amended definition fails to index for inflation[245]—which means that more individuals can qualify as accredited investors each year—or to otherwise protect the most vulnerable investors. To better balance investor protection with the expansion of access to the private market, we recommend indexing the accredited investor definition for inflation and amending it to include investors advised by a fiduciary.[246]

A diverse range of groups, including academics, regulators, investors, and industry organizations, have expressed support for indexing the wealth thresholds in the accredited investor definition for inflation.[247] Indeed, the failure to index for inflation has led to a 550% increase in qualifying households since 1983,[248] an expansion entirely unrelated to investor sophistication. The Commission's rationale for its decision is that indexing would reduce the capital supply in the private market, and that indexing is unnecessary because investors today have more access to information due to the advent of the internet.[249] However, the SEC's approach to Regulation Crowdfunding investments undermines this rationale. Crowdfunding investors tend to have a smaller capital supply and receive relatively limited information, but both the

[245] *See id.* at 64,254.

[246] In 2017, the Treasury issued a report recommending broadening the accredited investor definition to include investors advised by a fiduciary. STEVEN T. MNUCHIN ET AL., U.S. DEP'T OF TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS 44 (2017), https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf [https://perma.cc/BH3G-22R3].

[247] Press Release, Lee & Crenshaw, *supra* note 242.

[248] *Id.*

[249] *Id.* (quoting Amending the "Accredited Investor" Definition, Securities Act Release No. 10,824, at 79, 145 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10824.pdf [https://perma.cc/H5FR-QW7B]). The SEC's justification that investors today have more access to information due to the advent of the internet is weak. Simply having access to more information on the internet is irrelevant to whether an investor can "fend for themselves" or is sophisticated enough to analyze the sometimes-limited information publicly accessible about private firms. *Id.*

investment limit and wealth thresholds are adjusted for inflation.[250] Moreover, the private market accounted for seventy percent of new capital raised in 2019.[251] Therefore, though indexing will likely have a negative effect on the capital available in the private market, this concern does not appear to outweigh the need to ensure that only investors who can understand and bear private market risks can invest in it.[252] Additionally, there remains a dearth of information on the private market, including how many offerings take place, how investors fare in terms of return on investments or exposure to fraud, what proportion of investors are individuals, and how many investors will be accredited as a result of the amended definition.[253] This information could help shape a more responsive redefinition of "accredited investor."

The recently amended definition also fails to mitigate the number of investors potentially exposed to fraud in the private market.[254] Private market investments generally lack disclosure and liquidity and expose investors to a greater risk of fraud.[255] Though the Commission correctly notes that the

[250] EDWARD JOHN GRATTAN II, BUCHANAN INGERSOLL & ROONEY PC, THE SEC ADOPTS INFLATION ADJUSTMENTS AND OTHER TECHNICAL AMENDMENTS UNDER THE JOBS ACT 1 (2017), https://www.bipc.com/assets/PDFs/Insights/The%20SEC%20Adopts%20Inflation%20Adjustments%20and%20Other%20Technical%20Amendments%20Under%20the%20JOBS%20Act.pdf [https://perma.cc/ZL4U-BSJB].

[251] Press Release, Lee & Crenshaw, *supra* note 242 (citing Amending the "Accredited Investor" Definition, Securities Act Release No. 10,824, at 5).

[252] *Cf. id.* (emphasizing the importance of protecting unsophisticated investors from risks in the private market).

[253] *Id.* (quoting Amending the "Accredited Investor" Definition, Securities Act Release No. 10,824, at 102, 104, 110).

[254] *Id.*

[255] *Id.* Elderly investors are particularly susceptible to such fraud. The elderly accumulate wealth over time rather than due to financial sophistication, and wealth is increasingly concentrated in older households. As a result, unregistered offerings are consistently used to defraud elderly investors. *See* RACHITA GULLAPALLI, MISCONDUCT AND FRAUD IN UNREGISTERED OFFERINGS: AN EMPIRICAL ANALYSIS OF SELECT SEC ENFORCEMENT ACTIONS 4, 19 (2020), https://www.sec.gov/files/Misconduct

wealth thresholds in the accredited investor definition do not directly contribute to such fraud, they can indirectly do so by allowing more unsophisticated investors into the private market.[256] Amending the accredited investor definition to include investors guided by advisers held to a fiduciary standard will better address this risk than the current amendment.[257] By requiring that private market investors be advised by a fiduciary, the proposal ensures that non-institutional investors are—at a minimum—aware of the unique risks of the private market. A fiduciary adviser has a legal obligation to act in the client's best interest at all times.[258] As such, a fiduciary investment adviser or broker-dealer has a legal obligation to recommend a private market investment only if that investment is in the best interest of the client. Therefore, investors advised by qualified fiduciary advisers can "fend for themselves" such that they should have the opportunity to invest in the private market. Moreover, a fiduciary adviser that fails in its fiduciary responsibility is liable for civil damages to the client.[259] In addition to the fiduciary duty standard, a competitive market for clients is expected to increase the standard of care of broker-dealers and investment advisers, whose business models are reliant on reputation and continued client patronage. Thus, market

%20And%20Fraud%20In%20Unregistered%20Offerings.pdf [https://perma.cc/5JKD-UWC8]

[256] Press Release, Lee & Crenshaw, *supra* note 242.

[257] Additionally, an adviser-based accredited investor definition would ensure that previously-accredited investors who may no longer qualify as accredited investors based on their net worth after the net worth threshold is adjusted for inflation will be able to continue to invest in the private market through an adviser.

[258] *Information for Newly-Registered Investment Advisers*, U.S. SEC. & EXCH. COMM'N (Nov. 23, 2010), https://www.sec.gov/divisions/investment/advoverview.htm [Q9VG-8VFP].

[259] *See* Jonathan N. Eisenberg, *The Year in Review: SEC Enforcement Actions Against Investment Advisers*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 19, 2016), https://corpgov.law.harvard.edu/2016/12/19/the-year-in-review-sec-enforcement-actions-against-investment-advisers/ [https://perma.cc/NWD6-ZY6F].

forces should supplement the fiduciary duty standard to ensure that advisers supply quality investment advice.

Requiring non-institution-based investors who do not meet certain knowledge criteria to be advised by a fiduciary would also mitigate the risks stemming from limited disclosure in the private market. Many private "investments would be highly unlikely to meet FINRA's 'suitability' standard and the SEC's recently adopted Regulation Best Interest"—both of which are less stringent than the fiduciary standard.[260] A fiduciary adviser would advise the investor of these risks, likely recommend against such risky investments, and may even enable the investor to access the more promising investments available to institutional investors. This would likely mitigate the information asymmetry retail investors currently face in the private market.[261] As a corollary, the proposed definition would also limit the risk of loss retail investors potentially face in the private market. Finally, the proposed change would minimize uninformed investments, or if the adviser is skilled at fundamental value analysis, result in more informed investments. This would improve price accuracy, which would in turn facilitate capital creation. If combined with measures to make the public market more attractive, we believe that the proposed amendment would result in more efficient capital allocation in the private market with minimal adverse impacts on the public market.

When expanding the accredited investor definition, the SEC should also consider adjusting the liability standard in the private market. As previously discussed, the liability standard in the private market is much lower than that of the public market.[262] In the public market, directors and officers face absolute liability for any material misstatements in their registration statements or ongoing disclosures. Conversely, private company directors and officers will only be held liable under the general antifraud standards of the Exchange Act for reckless misstatements that investors rely upon. While it is

[260] de Fontenay et al., *supra* note 149, at 7.

[261] On this asymmetry, see *supra* text accompanying notes 167–69.

[262] For this discussion, see *supra* text accompanying notes 21–26, 90–92.

certainly true that companies have been held liable under this standard,[263] it is still far less stringent than the standard to which public companies are held. Therefore, if the investor pool of the private markets is to be expanded without putting additional measures of investor protection in place, the Commission should consider recommending that Congress change the liability regime in the private market from a fraudulence standard to a negligence standard in order to better protect investors.

The amendments to the accredited investor definition proposed above—indexing the wealth standard for inflation and including individual investors advised by a fiduciary—could decrease the number of individuals able to make investments in the private market. To mitigate the effects of these changes and to safely expand access to the private market for non-accredited investors, the SEC should also consider allowing non-accredited investors to invest in publicly traded funds which in turn invest in the private market.[264] Allowing retail investors to invest in either open- or closed-end publicly traded mutual funds that invest in the private market would enhance retail investors' diversification opportunities while also ensuring investor liquidity.[265] In addition, employer-sponsored defined contribution plans, i.e., 401(k) plans, could be the vehicle non-accredited investors

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[263] *See, e.g.*, Erika L. Robinson, Rosemary G. Reilly & Yoon-Young Lee, *SEC Reaffirms the Broad Reach of Rule 10b-5 to Private Companies*, WILMERHALE (Dec. 22, 2011), https://www.wilmerhale.com/en/insights/publications/sec-reaffirms-the-broad-reach-of-rule-10b-5-to-private-companies-december-22-2011 [https://perma.cc/WUV9-HEKW].

[264] *See* John Finley, Expanding Retail Access to Private Markets 10 (Nov. 2019), https://www.sec.gov/spotlight/sbcfac/expanding-retail-access-to-private-markets-finley.pdf [https://perma.cc/2TPK-PARR].

[265] Of course, to allow this would require revising the 1940 Act limitation on open-end funds' ability to invest in illiquid assets. *See* Doherty et al., *supra* note 163, at 9 & n.54, 10. Such a proposal, however, could create liquidity problems for an open-end fund. If the fund is invested in a significant number of illiquid private companies and there is a run on the fund, there could be an issue in redemptions. *Id.* at 9 n.54 Unlike a mutual fund that invests only in publicly traded securities that could be offloaded in the market, a fund invested in restricted securities would likely have to sell those securities in an exempted resale in the case of a run on the fund.

utilize to invest in the private market. Although ERISA does not prohibit defined contribution plans from investing in private funds, such investments are not prevalent because of the limited liquidity of the shares in private funds and the litigation risk that plan advisers face as fiduciaries.[266] To promote investment in private market funds through 401(k) plans, the Department of Labor should (1) give clear guidance as to the totality of factors a fiduciary may consider in making its investment decisions consistent with its fiduciary duties and (2) "expand[] the safe harbor [from litigation] for plan fiduciaries who are making good faith efforts, well informed by expertise on long-term retirement investing."[267]

Either adopting a fiduciary-based accredited investor definition or allowing non-accredited investors to invest through funds would significantly decrease the marginal costs of making Rule 506(b) offerings to non-accredited investors. To make Rule 506(b) offerings to non-accredited investors, issuers currently must provide such investors with a description of all the information supplied to any accredited

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266 *See id.* at 12.

267 *Id.* at 12–13. Of note, on June 3, 2020, the Department of Labor did issue some guidance on this matter; however, while the guidance may make litigation over an investment in a private fund by a 401(k) fiduciary harder to win, it does not completely "insulate [the] fiduciaries from liability." *See* Lydia Wheeler, *Private Equity Options for 401(k)s Bring Litigation Uncertainty*, BLOOMBERG: L. (June 4, 2020, 3:54 PM), https://news.bloomberglaw.com/employee-benefits/private-equity-options-for-401ks-bring-litigation-uncertainty [https://perma.cc/5ECM-4RGZ]. That guidance letter concluded that a fiduciary's duties would not be violated "solely because the fiduciary offers a professionally managed asset allocation fund with a private equity component." Letter from Louis J. Campagna, Chief, Div. of Fiduciary Interpretations, U.S. Dep't of Lab., to Jon W. Breyfogle, Groom Law Grp. 5 (June 3, 2020), https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/information-letters/06-03-2020.pdf [https://perma.cc/ZKP8-HX62]. But it also cautioned that the fiduciary must still "engage in an objective, thorough, and analytical process that compares the asset allocation fund with appropriate alternative funds that do not include a private equity component, anticipated opportunities for investment diversification and enhanced investment returns, as well as the complexities associated with the private equity component." *Id.* at 5–6.

investor.[268] The marginal costs of providing these additional disclosures is high enough that, in practice, it is generally inadvisable for issuers to make Rule 506(b) offerings to non-accredited investors.[269] However, a fiduciary adviser or a fund could be considered a single accredited investor. Thus, either (or both) solution(s) would make it much more cost-effective to make Rule 506(b) offerings to non-accredited investors while ensuring they are adequately protected.

The SEC recently finalized Regulation Best Interest—a new rule for broker-dealers providing investment advice.[270] Regulation Best Interest is a new standard of conduct that is higher than the current suitability standard but lower than the fiduciary duty standard to which investment advisers are subject.[271] It is unclear how Regulation Best Interest will be implemented in practice; therefore, we recommend that the SEC not expand the accredited investor definition to include investors advised by broker-dealers under the Regulation Best Interest standard at this time.

Despite the potential benefits, adopting the proposed changes to the accredited investor definition may enable private companies to use the definition as a loophole to become de facto public companies while remaining private. To prevent this from occurring, the SEC should review the rules applicable to platforms that trade securities issued in the private market as well as the consequences for private companies that wind up with a significant number of shareholders as a result of market activity. To this end, we suggest that the SEC consider revising section 12(g) of the Exchange Act to return to a 500-shareholder threshold before requiring a company to report.[272]

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[268] *See supra* note 78 and accompanying text.

[269] *See supra* note 78.

[270] 17 C.F.R. § 240.15*l*-1 (2020).

[271] *Compare id.* § 240.15*l*-1(a) (Regulation Best Interest), *with* FINRA R. 2111(a) (Fin. Indus. Regul. Auth., Inc. 2020) (suitability), *and Information for Newly-Registered Investment Advisers*, *supra* note 258 (fiduciary duty).

[272] For information on the change from this threshold, see *supra* text accompanying notes 134–36.

B. Address Structural Concerns Related to the Public Market Through a New Special Study

Although expanding the private market to investors through the methods suggested above would help protect retail investors from the risks of the private market, it would also make the private market even more attractive than the public market as it is currently structured and regulated. In order to research methods to preserve the public market, we support the continuation of, and increased funding for, the New Special Study advocated by the chairs of Columbia University's Program in the Law and Economics of Capital Markets. The study, which aims to promote a better understanding of "the relationships between market microstructure and regulatory reform," will consist of three stages.[273] Stage I, completed in Summer 2018, culminated in a book identifying the most pressing securities regulation issues today and determining which questions are already answered by existing literature and which require further empirical research.[274] Stage II builds on this work through a survey of securities regulators and private actors regarding the legal and economic issues that "are considered the most important," and a one-day conference to identify the effects of recent and anticipated technological changes.[275] Stage II will culminate in a prospectus that "outlines the final study and specifies" the research necessary to address the questions presented.[276] Finally, Stage III, set to begin in 2021 if funding is available, will implement the research identified in the prospectus.[277] The published report will be made available to Congress, relevant regulators, and the general public.[278]

This Part analyzes potential issues that might be further explored during Stage III of the study, many of which were

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273 *The New Special Study of the Securities Market*, *supra* note 7.

274 *See generally*, SECURITIES MARKET ISSUES FOR THE 21ST CENTURY, *supra* note 100.

275 *The New Special Study of the Securities Market*, *supra* note 7.

276 *Id.*

277 *Id.*

278 *Id.*

highlighted through the Stage II surveys. Specifically, areas commentators suggest the study should explore include how to: (1) make the process of going public more cost effective; (2) reduce ongoing reporting costs without reducing standards of investor protection; (3) ensure that companies are focused on long-term growth as opposed to short-term earnings reporting; and (4) leverage new technologies to benefit companies and investors. The following discussion is not intended as an exhaustive analysis of the public market's structural issues. Rather, it is intended to illustrate the aspects of the current market environment that significantly affect the decision to go public or stay private, but that require further study in order to identify appropriate regulatory reforms.

1. Making Public Market Entry More Cost Effective

The cost of going public has been a focus of the SEC's recent reforms, yet these reforms have done little to actually reduce costs.[279] To further address the costs issuers face in pursuing IPOs, the special study should consider three potential changes to the IPO process, each of which aim to reduce costs and ensure that issuers can use the money raised in their initial offerings to finance their growth. First is the trend of SPAC transactions; second is the NYSE's June 2020 proposal to modify the provisions relating to direct listings; and third is the concept of permitting a pre-IPO when-issued market to help reduce IPO underpricing.

i. Special Purpose Acquisition Company Transactions

As previously explained, a SPAC transaction involves a "blank check" company acquiring a private company through a reverse merger to effectively allow the previously-privately-traded company to "go public" without needing to go through

[279] *See supra* Section II.C.

the extensive registration process with the SEC.[280] The recent popularity of SPAC transactions is unprecedented: in 2020, SPACs raised as much money as they had in the previous decade;[281] as of mid-February 2021, there were roughly 400 SPACs looking to make acquisitions;[282] and as of mid-March 2021, eighty percent of the 302 IPOs that had occurred in 2021 were attributable to SPACs.[283] Some tout the SPAC IPO as an "instrument[] of financial democracy" that grants retail investors access to companies previously only accessible through private equity.[284] However, a recent study of forty-seven SPACs occurring between 2017 and 2019 indicates that this perception, at least in the current market, is misunderstood. That study found that SPACs do not provide "'poor man's private equity' to ordinary investors. . . . [SPACs] neither function like private equity nor service a clientele of ordinary investors."[285] Instead, there are typically two distinct groups of SPAC investors: the majority of pre-merger SPAC investors are large funds that purchase at the time of the SPAC IPO and redeem pre-merger, and then there is a group of investors in the post-merger operating company who

[280] For the earlier discussion of SPACs, see *supra* notes 179–183 and accompanying text.

[281] Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 19, 2020), https://corpgov.law.harvard.edu/2020/11/19/a-sober-look-at-spacs/ [https://perma.cc/N4S5-TS65].

[282] Kazi Ahmed, *Special Purpose Acquisition Companies Grow in Popularity on Wall Street During the Pandemic*, TICKER (Feb. 19, 2021), https://ticker.squarespace.com/ticker/2021/2/19/special-purpose-acquisition-companies-grow-in-popularity-on-wall-street-during-the-pandemic [https://perma.cc/G9T9-3YCB].

[283] Luisa Beltran, *The Booming IPO Market Shows No Signs of Slowing*, BARRON'S, https://www.barrons.com/articles/the-booming-ipo-market-shows-no-signs-of-slowing-what-investors-need-to-know-51615546800 [https://perma.cc/JGK8-WFWP] (last updated Mar. 15, 2021).

[284] *See* Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, YALE J. ON REGUL. (forthcoming) (manuscript at 3, 13) (on file with the Columbia Business Law Review), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919 (challenging this idea).

[285] *Id.* (manuscript at 54).

"bear the costs of the generous deal given to IPO-stage investors."[286] With this understanding in mind, and given such unprecedented popularity, a future in-depth analysis of SPACs is warranted to fully understand whether the transaction vehicles are a positive addition to the public market.

A common complaint of the traditional IPO process is the price increase that newly-public companies often see right after their IPOs and the underwriting fee paid to investment banks as part of the IPO process.[287] Some claim that SPACs respond to both of these issues. A significant advantage for target companies in SPAC transactions is that the target knows the price it will be receiving in the transaction at the signing of the merger agreement.[288] Conversely, in a traditional IPO, the company going public does not know what the price per share will be until investors weigh in[289] (an issue that may be partially solved by "testing-the-waters" communications). Thus, SPAC transactions may help solve one problem with the traditional IPO process—price discovery. However, it is not clear whether this means that the target is receiving its "true" market value. "[I]n fact some of the high-profile recent SPACs have essentially paid $10 a share for companies that immediately traded up to $20 or $30 per share, the sort of embarrassing IPO pop that venture capitalists love to complain about."[290] Additionally, a SPAC still must pay at least 5.5% of the money it raises to investment banks when it is formed as a shell company, and

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[286] *See id.* (manuscript at 5).

[287] Matt Levine, *SPACs Aren't Cheaper than IPOs Yet*, BLOOMBERG: OP. (July 27, 2020, 8:59 AM), https://www.bloomberg.com/opinion/articles/2020-07-27/spacs-aren-t-cheaper-than-ipos-yet [https://perma.cc/227B-DRT8].

[288] Matt Levine, *Bill Ackman Wants a Mature Unicorn*, BLOOMBERG (June 23, 2020, 11:59 AM), https://www.bloomberg.com/news/newsletters/2020-06-23/money-stuff-bill-ackman-wants-a-mature-unicorn?sref=1kJVNqnU [https://perma.cc/3WPB-J5AP].

[289] *Id.*

[290] Levine, *supra* note 287 ("Like an IPO, a SPAC will acquire its target company at a price that is *probably* too low; the SPAC is in business to get a good deal for its shareholders, so it wants to take the target public at a price that is below fair value.").

likely will pay additional investment banking fees when it acquires the target.[291] Thus, it is possible that SPAC acquisitions are at least as costly as traditional IPOs, with the costs just being "better disguised."[292]

Even if SPACs did resolve the underpricing of IPOs and the high underwriting cost associated with going public, they still raise legitimate concerns.[293] Commentators have observed and warned that SPAC transactions are ripe for potential fraud and litigation. As hedge fund manager Gabriel Grego explained, "[t]he [SPAC] structure itself seems engineered to attract fraud."[294] A prime example of such fraud is Akazoo, a company Grego shorted in 2019.[295] Akazoo was the operating company in a SPAC merger that was found to have falsified its "'books and records', including the due diligence materials" used by the SPAC when negotiating the deal.[296] The diligence that the SPAC and institutional investors undertake in the de-SPAC transaction has caught the eye of shareholder litigators and regulators;[297] but the

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291 *Id.*

292 *Id.*

293 *See, e.g., generally* NICOLAS GRABAR, ADAM BRENNEMAN & JARED GERBER, CLEARY GOTTLIEB STEEN & HAMILTON LLP, SPAC SPONSORS BEWARE: THE RISING THREAT OF SECURITIES LIABILITY (2020), https://www.clearygottlieb.com/-/media/files/alert-memos-2020/spac-sponsors-beware—the-rising-threat-of-securities-liability.pdf [https://perma.cc/7JTC-NSEU].

294 Ortenca Aliaj, Sujeet Indap & Miles Kruppa, *Can Spacs Shake off Their Bad Reputation?*, FIN. TIMES (Aug. 13, 2020) (internal quotation marks omitted), https://www.ft.com/content/6eb655a2-21f5-4313-b287-964a63dd88b3 [https://perma.cc/F8W9-BTJE].

295 *Id.*

296 *Id.*

297 In an interview with CNBC on October 20, 2020, when comparing de-SPAC transactions with the traditional IPO, SEC Chairman Jay Clayton noted that "there's something that happens in the IPO process that doesn't happen as much in the de-SPACing process, and that is institutional investors on your traditional road show kick the tires on the company. That doesn't happen to the same extent in the de-SPACing transaction." Interview by Bob Pisani with Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, at the CNBC Fin. Advisor Summit (Oct. 20, 2020), https://www.cnbc.com/2020/10/20/cnbc-transcript-cnbcs-bob-pisani-

popularity of SPACs has also caught the attention of insurers.[298] The Akazoo transaction resulted in a securities class action case against the operating company for the false and misleading statements that led to the allegedly artificially inflated prices.[299]

Some argue, however, that in light of the success of high-profile de-SPACs (such as DraftKings and Nikola) and the participation of more prominent investors (such as Bill Ackman and Billy Beane) in starting high-profile SPACs, they are no longer the "vehicle that shady financiers use to unload dodgy businesses on the unsuspecting masses."[300] Nonetheless, in addition to concerns about fraud, SPAC transactions will inevitably lead to other forms of litigation. For example, the SPAC can be liable for section 11 violations in its IPO registration statement as well as liable in typical

interviews-united-states-securities-and-exchange-commission-chairman-jay-clayton-from-the-cnbc-financial-advisor-summit-today.html [https://perma.cc/7RFA-44E2].

[298] In March 2021, Beazley launched "a directors' and officers' product suite designed specifically for" SPACs. Ryan Smith, *Beazley Launches D&O Coverage for SPACs*, INS. BUS. AM. (Mar. 10, 2021), https://www.insurancebusinessmag.com/us/news/professional-liability/beazley-launches-dando-coverage-for-spacs-248855.aspx [https://perma.cc/MQ4W-UPET]. A leader of the iniative stated: "These streamlined produces are specifically designed for SPACs and their officers and directors at a time when heightened regulatory scrutiny, media attention and an increasingly active plaintiff's bar make it critical that they have appropriate coverage and fully understand what that coverage is." *Id.* (internal quotation marks omitted).

[299] Priya Cherian Huskins, *Why More SPACs Could Lead to More Litigation (and How To Prepare)*, AM. BAR ASS'N (June 25, 2020), https://www.americanbar.org/groups/business_law/publications/blt/2020/07/spacs-litigation/ [https://perma.cc/6YES-W586].

[300] Aliaj et al., *supra* note 294. Apex Clearing Corp., a financial technology firm that provides services such as cryptocurrency solutions and clearing, went public with after merging with the SPAC Northern Star Investment Corp II, with the combined entity valued at $4.7 billion. *See Apex Clearing To Go Public via $4.7 Billion Deal with Ledecky's SPAC*, REUTERS (Feb. 11, 2021, 7:17 AM), https://www.reuters.com/article/us-apex-clearing-m-a-northern-star-in/apex-clearing-to-go-public-via-4-7-billion-deal-with-ledeckys-spac-idUSKBN2AM18D [https://perma.cc/6ZHE-KW6T].

M&A suits involving allegations of deficient proxy statements or litigation against the operating company if the target company performs poorly after the transaction is finalized.[301] As more SPAC IPOs proceed, more litigation is inevitable[302] and in fact may be the rational choice for investors to hedge their risk in response to the lesser disclosure required in de-SPAC transactions as compared to traditional IPOs.

Relatedly, some, most notably among them Acting Director of the SEC's Division of Corporation Finance John Coates, have also argued that the safe harbor from securities law liability under the Private Securities Litigation Reform Act (PSLRA) for forward-looking statements should not apply to de-SPAC transactions.[303] These commentators reason that the safe harbor does not apply to traditional IPOs because it is the first time investors see the business and financial information of the company and thus, "federal securities laws are typically most needed to overcome the information asymmetries."[304] Although a SPAC is already a public company, the de-SPAC transaction is effectively an IPO of the operating target company and thus, for similar reasons, the PSLRA safe harbor should not apply.[305] Thus, as currently formulated, SPACS do not seem to be a proper structure to increase the number of IPOs while protecting retail investors.

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[301] Huskins, *supra* note 299.

[302] *Id.*

[303] John Coates, Acting Dir., Div. of Corp. Fin., U.S. Sec. & Exch. Comm'n, SPACs, IPOs and Liability Risk Under the Securities Laws (Apr. 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws [https://perma.cc/YPX9-W2L3].

[304] *Id.*

[305] *Id.* While a de-SPAC is not an IPO in the traditional sense and, therefore, ought to fall within the PLSRA safe harbor, Coates's theory rests on the fact that "the deSPAC transaction is the true introduction of the economically viable company to the market and therefore the safe harbor should not apply to statements about such a transaction." Corey Rogoff, *SEC Speaks out on SPACS, Highlights Legal Liability and Reporting Risk*, JD SUPRA (Apr. 19, 2021), https://www.jdsupra.com/legalnews/sec-speaks-out-on-spacs-highlights-9165295/ [https://perma.cc/FM3U-29ZH]. The argument is further bolstered by the fact that "the PSLRA does not define 'IPO.'" *Id.*

In light of the uptick in SPAC IPOs, the special study should explore ways that this alternative vehicle can be used to bring private companies public while ensuring that SPAC investors are properly protected.

ii. Direct Listing of Securities To Respond to Underwriting Costs

In June 2020, the NYSE proposed a rule change to permit a primary offering in connection with a direct listing.[306] The proposed amendment would allow a previously unlisted company to sell shares in an open auction on the first day of trading after the effectiveness of a registration statement in a primary direct floor listing.[307] This new primary direct floor listing option would only be available to companies with a market value of at least $100 million.[308] The valuation metrics proposed are significantly higher than the $40 million requirement for an underwritten IPO.[309] Requiring a higher valuation for the primary direct floor listings would help in ensuring there is enough stock in the public market to allow for liquid trading after the direct listing open auction process is completed.[310] To mitigate the price fluctuation concerns often associated with traditional direct listings, the NYSE proposal also requires the shares sold in the offering to be priced within a range specified in the company's registration statement.[311] If the offering is not fully satisfied, the listing

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[306] Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 2, To Amend Chapter One of the Listed Company Manual To Modify the Provisions Relating to Direct Listings, 85 Fed. Reg. 39,246, 39,246 (June 30, 2020).

[307] *Id.* at 39,246–47.

[308] *Id.* at 39,247. The valuation would be calculated by an independent valuation and the most recent trading price of the issuing company's stock in a private placement market. *Id.* Alternatively, if there has been no trading in a private placement market, a company would have to show that the value of its publicly held shares equal at least $250 million. *Id.*

[309] *Id.*

[310] *Id.*

[311] *Id.* at 39,248.

auction would not be able to proceed.[312] On August 26, 2020, the SEC approved the NYSE's rule change.[313] The adoption of the rule also indicates that the SEC recognizes "that a firm commitment underwriting is not necessary to provide adequate investor protection."[314]

However, on August 31, after an industry group of institutional investors objected to the rule, the SEC suspended its approval of the rule to undergo further review.[315] Those who object to the proposal contend that it offers fewer legal protections for investors because of the difficulty the investors may face in tracing their shares to a "misrepresented registration statement in order to support a meritorious claim."[316] The opponents are also concerned that the NYSE has offered no support for its argument that the offerings will be sufficiently large enough to give investors necessary liquidity.[317] Underlying the objections may be concerns related to the effect that removing the traditional underwriter would have on investor protections. In a traditional offering, investors can rely on the underwriter to negotiate the parameters of the listing with the issuer.[318] However, a direct listing would not grant these protections. In a traditional IPO, the underwriter faces liability and therefore will conduct due diligence in the offering process, which accords protection to the investors. Diminishing or

312 *Id.* at 39,250.

313 DAVIS POLK & WARDWELL LLP, PRIMARY DIRECT LISTINGS BY COMPANIES GAIN MOMENTUM 1 (2020), https://www.davispolk.com/sites/default/files/2020_08_28_direct_listings_by_companies_gain_momentum.pdf [https://perma.cc/55H3-DHDX]. Nasdaq also filed a similar direct listing rule. *Id*.

314 *Id*. at 2.

315 MORRISON & FOERSTER LLP, PE & VC EXITS: U.S. DIRECT LISTING RULES IN FLUX 1 (2020), https://www.mofo.com/resources/insights/200904-investor-exits.pdf [https://perma.cc/AF3L-KTEZ].

316 Letter from Jeffrey P. Mahoney, Gen. Couns., Council of Inst. Invs., to Sec'y, U.S. Sec. & Exch. Comm'n 3 (July 16, 2020), https://www.sec.gov/comments/sr-nyse-2019-67/srnyse201967-7435112-220582.pdf [https://perma.cc/KRS6-96PL].

317 *Id.* at 5.

318 MORRISON & FOERSTER LLP, *supra* note 315, at 4.

eliminating the role of the underwriter, however, could mean that investors need to be more directly involved in a direct offering process to garner similar protections.[319]

On December 22, 2020, the SEC again approved the NYSE's proposed direct listing rules.[320] The SEC determined that the proposal was consistent with the Exchange Act despite the dissent of two commissioners who were concerned that investor protection may suffer from, among other things, the "remov[al] [of] traditional underwriters from the listing process."[321] On May 19, 2021, the SEC approved a similar proposal by the NASDAQ.[322] These investor protection-related concerns are not unwarranted; however, because the adoption of the NYSE's rule may enable relatively large privately held companies to forego the costly process of hiring an underwriter and issuing securities with the underwriter, it may reduce the overall price of going public for these firms. Moreover, as secondary trading markets for private equity develop and leverage new technology to make pricing and trading information more widely available, private market price transparency will improve.[323] As a result, private companies will potentially be able to gain a better understanding of their trading price and valuations and will

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319 *See id.*

320 Order Setting Aside Action by Delegated Authority and Approving a Proposed Rule Change, as Modified by Amendment No. 2, To Amend Chapter One of the Listed Company Manual To Modify the Provisions Relating to Direct Listings, 85 Fed. Reg. 85,807, 85,807 (Dec. 29, 2020); *see also* Brian Hecht, Mark D. Wood & Mark J. Reyes, *SEC Again Approves NYSE's Direct Listing Rules*, NAT'L L. REV. (Jan. 8, 2021), https://www.natlawreview.com/article/sec-again-approves-nyse-s-direct-listing-rules#:~:text=On%20December%2022%2C%202020%2C%20the,sales%20of%20shares%20by%20existing [https://perma.cc/R6NL-JUH6].

321 Hecht et al., *supra* note 320.

322 Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Order Approving a Proposed Rule Change, as Modified by Amendment No. 2, to Allow Companies to List in Connection with a Direct Listing with a Primary Offering In Which the Company Will Sell Shares Itself In the Opening Auction on the First Day of Trading on Nasdaq and to Explain How the Opening Transaction for Such a Listing Will be Effected, Securities Act Release No. 34-91947 (May 19, 2021).

323 Special Study Interview, *supra* note 163.

therefore be more comfortable becoming public.[324] This will facilitate a more seamless transition to going public through direct listings.[325] The direct listing rules may also offer an attractive alternative for certain companies as compared to going public through a SPAC.[326] In early 2021, direct listing was again in the news when Coinbase joined the likes of Spotify and Palantir in eschewing the traditional IPO.[327] However, the practical effectiveness of direct listings remains to be seen.[328] As debate around the NYSE rule change and the corollary change at Nasdaq continues, the special study should examine the effects of these changes and explore other ways through which the SEC could reduce costs in the IPO process without decreasing investor protection. In connection with this, the special study should explore the role that intermediaries should play in the IPO and direct listing process, as well as the appropriate standard of conduct that should be applied in each of these contexts.

[324] *Id.*

[325] *Id.*

[326] Preston Brewer, *New Rules May Help Direct Listings Snack on SPACs*, BL (March 5, 2021, 4:18 AM) (on file with the Columbia Business Law Review), https://news.bloomberglaw.com/capital-markets/analysis-new-rules-may-help-direct-listings-snack-on-spacs.

[327] Taylor Tepper, *Coinbase IPO: Here's What You Need To Know*, FORBES: ADVISOR (Apr. 14, 2021, 10:20 AM), https://www.forbes.com/advisor/investing/coinbase-ipo-direct-listing/ [https://perma.cc/RPR9-BATK].

[328] Coinbase has been trading downward since going public through a direct listing on April 14, 2021. *See* Trefis Team & Great Speculations, *What's Happening With Coinbase Stock?* (May 6, 2021, 10:30 AM), https://www.forbes.com/sites/greatspeculations/2021/05/06/whats-happening-with-coinbase-stock/?sh=6f374b481901 [https://perma.cc/468E-AGXW]. Some have argued that the decline may be partly because direct listings, unlike traditional IPOs, do not have lock-up periods and allow insiders to sell shares immediately. *See id.* Similar downward trends were seen in the prices of Palantir and Asana, which also went public through direct listings. *Id.*

iii. Enhance Trading Opportunities To Respond to Underpricing

There is some empirical evidence of underpricing in the IPO markets, particularly since the advent of the JOBS Act.[329] Underpricing in firm commitment offerings is prevalent because the underwriter's incentive is to make sure all shares are sold as quickly as possible to ensure that it is not "stuck" with the shares left behind in an undersubscribed offering.[330] When an IPO is underpriced, the issuer raises less money than their stock may be worth, therefore creating inefficiency in the fundraising process.

If the SEC adopts the NYSE's direct listing proposal, underpricing for some IPOs will be addressed as issuers will not have to pay the four to seven percent underwriting fee.[331] However, underpricing can also be mitigated by improving price discovery. "Testing-the-waters" may address some underpricing concerns as the underwriter and issuer will be able to gauge market interests at certain prices. However, this may not fully address the issue. The fact that new IPOs often see an immediate jump in value indicates that testing-the-waters does not give a complete indication of the highest price issuers can offer their securities in their IPOs. To respond to this issue, at least one legal professional has proposed a when-issued market. "[W]hen-issued securities are conditional contracts for the delivery of a specified underlying security when, as, and if that security is issued."[332] If the underlying security is not issued on the specified date or at the specified price, the when-issued contract is void.[333] Studies of the German when-issued market have shown that the when-issued market "improve[s] estimates of aggregate demand for primary offerings" and improves price accuracy.[334]

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329 *See, e.g.*, Chaplinsky et al., *supra* note 172, at 822–24.

330 *See* Elmore, *supra* note 173, at 14–15 (summarizing explanations of underpricing).

331 On the costs of an underwritten offering, see *supra* note 172.

332 Elmore, *supra* note 173, at 17.

333 *Id.* at 17–18.

334 *Id.* at 33–35.

Congressional amendments to the Securities Act permitting a pre-IPO when-issued market could make the book building process—the process by which the underwriter finds institutional investors to purchase securities in an IPO—more accurate, reliable and fair,[335] thus reducing uncertainty for underwriters and, theoretically, allowing them to charge a higher price at the initial resale. This would allow issuers to price their IPOs more efficiently and receive more money in the IPO process, making the overall fundraising more efficient and cost effective for them.

Enhancements in price discovery could also be achieved without the development of a when-issued market. As discussed in Section II.B, securities issued in the private market are generally restricted. The restrictions make it difficult to trade the securities, thus making the secondary private market inefficient and leading to difficulty in pricing the securities. Newly emerging companies, however, are focusing on private market trading to help increase pre-public price discovery. One company, ClearList, hopes to create a more efficient secondary market for trading private company securities.[336] With a more efficient secondary market for private company securities, "[s]econdary trades conducted close to public listings could help companies get a better understanding of their current valuations."[337] If a more liquid market, with low fees, near-instant clearing and settling, and transparent pricing were created for trading private securities between early investors and accredited investors, companies would have a more recent picture of their valuation than the value assigned to them at their previous fundraising. This could help to better price the companies as they prepare for a SPAC acquisition or help to develop a reference price for direct listings.[338] Of course, a more liquid secondary market in private securities could also come at a cost to the public

[335] *Id.* at 18.

[336] Yuliya Chernova, *Secondary Market Trading Services Gain Steam*, CLEARLIST (Oct. 28, 2020), https://www.clearlist.com/2020/10/28/secondary-market-trading-services-gain-steam/ [https://perma.cc/3D9A-92XW].

[337] *Id.*

[338] *Id.*

market. If early investors and employees can easily liquidate and diversify their holdings in private companies, there could be less of an incentive for these individuals to push a private company public. Thus, the special study should consider whether a when-issued market or a more liquid secondary trading market in private securities should be developed to better address the issue of underpricing, and how the development of these markets could affect the public market.[339]

2. Reconsidering the Disclosure Requirements

Section III.C discussed ongoing costs related to disclosures as a structural concern in the public market that may deter private firms from going public. Thus far, the debate on public company disclosure requirements has focused on whether or not such requirements directly deter companies from going public. Proponents of the disclosure requirements often point to the lack of empirical evidence that these requirements actually make a meaningful difference in the decision to go public.[340] However, narrowing disclosure requirements can potentially mitigate another major deterrent of going public, namely litigation costs and exposure. Though private companies are not free of litigation risks, the probability and cost of potential litigation are much higher in the public market because of the potential for class action suits and the numerous disclosure requirements that may give rise to suits.[341] The wide breadth of disclosure requirements not only

[339] Of course, there are many other structural issues with the public market that may result in underpricing aside from the role of the underwriter in pricing the security to ensure they are not "stuck" with it in an undersubscribed offering. For example, an underwriter may attempt to compensate institutional investors for information production. Thus, the special study should take a comprehensive approach to addressing the issue of underpricing, considering the possible causes and solutions that may be tailored to certain issuers to ensure that IPO prices fairly and accurately reflect the market's view of the issuer.

[340] For an example of the ambiguous evidence, see *supra* text accompanying notes 216–23 (discussing the JOBS Act).

[341] Special Study Interview, *supra* note 163.

increases the expected costs of litigation, but also decreases a public company's ability to predict sources of litigation. Litigation exposure likely serves as a particularly poignant deterrent for smaller companies and foreign issuers.[342] Though the SEC cannot directly control the litigation public companies face, it can potentially decrease the sources of litigation by removing or refining disclosure requirements that are not significantly related to the company or investor protection. For example, ESG disclosure requirements could be adapted to account for the material issues present in each industry (or type of industry) rather than taking a "one size fits all" approach. Such an approach could better target the ESG disclosures that investors are actually interested in while removing superfluous ones. The special study should undertake a review of the costs and benefits of disclosure requirements, and potentially suggest reforms to refine disclosure requirements. The study could also analyze the effect of the increased pressure on public companies to address social issues on the decision to go public.

3. Addressing Public Market Short-Termism

Though there are certainly price efficiency arguments in support of the quarterly reporting system, further research should be conducted as to whether this system does in fact have a positive effect on efficiency, and whether that effect may be outweighed by the deterrence of long-term investments. In 2018, the SEC, possibly driven by President Trump tweeting in favor of an end to quarterly reporting, issued a request for comment on how quarterly reporting may be driving short-termism in the public market.[343] In furtherance of the SEC's concept release on the issue, we suggest that the special study explore the issue of short-termism in public markets to better understand whether quarterly reporting may be driving management decisions towards short-term benefits rather than long-term growth. In

[342] *Id.* (observing that litigation exposure may be among the biggest deterrents for foreign investors).

[343] *See* Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 195.

relation to this research, the special study should consider whether there are alternatives to the quarterly reporting system that allow for price and information efficiency without deterring long-term investment.[344]

4. Addressing the Effects of New Technology

Though not directly addressed in this paper, new technologies, including but not limited to distributed ledger technology and algorithmic trading, are raising important issues related to the securities market and its regulation. The potential benefits of these technologies include improved liquidity, pricing efficiency, and access to information. Distributed technology could enhance liquidity in both the public and the private markets by lowering the costs of clearing and settling.[345] The technology could also help persuade companies to go public by reducing costs associated with being public by, for example, decreasing costs associated with dividend distributions.[346] Additionally, distributed ledger technology could enhance pricing efficiency by allowing securities analysts continual and nearly instantaneous access to raw data from issuers, potentially without costing a great price.[347]

Like distributed ledger technology, algorithmic trading and high frequency trading (HFT) also potentially enhance liquidity. HFT traders are able to react faster to orders that

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[344] For example, the SEC could determine whether to mimic the European Union, which only requires semi-annual reporting. *See Trump's Pitch To End Quarterly Reports Would Follow EU, Australia*, REUTERS, https://www.reuters.com/article/us-usa-sec-trump-factbox/trumps-pitch-to-end-quarterly-reports-would-follow-eu-australia-idUSKCN1L51ZN [https://perma.cc/7QVM-9KQ6] (last updated Aug. 20, 2018, 3:53 PM).

[345] COLUMBIA-IBM CTR. FOR BLOCKCHAIN & DATA TRANSPARENCY, STAKEHOLDER SURVEY PRELIMINARY WHITE PAPER 18 (2020), https://capital-markets.law.columbia.edu/sites/default/files/content/7.25.20%20Program%20in%20the%20Law%20and%20Economics%20of%20Capital%20Markets%20-%20IBM%20-%20Stakeholder%20Survey%20-%20Preliminary%20White%20Paper.pdf [https://perma.cc/5AP2-6MJ4].

[346] *Id.* at 19.

[347] *Id.* at 19–20.

have not been updated for market movements, resulting in "adverse selection costs" for other market participants, including passive market makers that often attempt to mitigate these costs by widening bid-ask spreads.[348] Through increased speed and monitoring ability, HFT market makers can reduce these adverse selection costs and promote liquidity by narrowing bid-ask spreads.

While new technologies can be beneficial to the markets, they carry potential risks that should be studied and ultimately addressed. For example, although HFT and algorithmic trading can enhance liquidity, they are not obligated to provide liquidity and may consequently scale back from doing so during times of market turbulence.[349] Additionally, the effect of such technologies on investors, especially retail investors, is uncertain. On one hand, these technologies may enable faster and freer access to information that retail investors can capitalize upon. On the other hand, increased technology in the exchanges could further exacerbate the disadvantage retail investors already find themselves in.[350] At the same time, distributed ledger technology could further enhance AI-based investing, thus reducing costs of trading for retail investors. As a result, investing in exchange-traded funds would no longer be necessary: AI-based robo-investing could guide purchases.

To address the manner in which new technologies could affect the public market and investors, we suggest that the special study should further explore the role of distributed ledger technology and algorithmic trading in securities regulation. The study should also explore solutions recently discussed by the Commission, including imposing making and

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[348] U.S. SEC. & EXCH. COMM'N, STAFF REPORT ON ALGORITHMIC TRADING IN U.S. CAPITAL MARKETS 70, 71 & n.278 (2020), https://www.sec.gov/files/Algo_Trading_Report_2020.pdf [https://perma.cc/S9KQ-WWQT].

[349] *Id*. at 72–73.

[350] Because HFT companies and algorithmic traders can take advantage of this information long before a typical retail investor (especially one who invests through an adviser-managed fund, such as a closed-end mutual fund) can trade on it, retail investors have a speed to information disadvantage.

quoting obligations on HFTs to reduce the risk of reduced liquidity during market turmoil,[351] and examinations of firms' controls related to automated trading procedures.

In addition to exploring the effects of recent technologies, the study should explore the potential of moving all or a significant part of the IPO process online. Making registration statements and prospectuses available online would enhance access to information and decrease the cost of its dissemination. Among other efficiency enhancements, companies engaging in the IPO process would not have to wait until prospectuses are mailed to prospective investors to make an offering. Additionally, an online system under which investors can register as accredited investors would decrease the cost and time spent verifying accredited investor status. The study might conduct a survey of companies that have already implemented such portals and compare their marginal costs of making Rule 506(b) offerings to non-accredited investors to the costs for companies that have not yet implemented such a portal.[352]

V. CONCLUSION

The expansion of the private market and reduction of new entrants into the public market requires close attention and scrutiny from regulators. The public market remains the "gold standard" for investor protection, and regulators must continue to consider the structural reasons for the decline in new entrants to the market. However, as wealth accumulates in the private market, it is also important to ensure that all investors who wish to participate in that market are able to so long as they are properly protected.

This Article has examined the history of U.S. securities market regulation and the current issues facing the markets in order to propose recommendations not only for short-term

[351] *See supra* note 348 at 72–73.

[352] At least one company, EquityZen, has implemented a portal where investors can sign up and verify accredited investor status. Investor Page, EQUITYZEN, https://equityzen.com/investor/ [https://perma.cc/G3BV-RPV2] (last visited May 12, 2021).

solutions that the SEC can adopt to safely enhance investor participation in the private market, but also for long-term solutions to address structural concerns in the public and private markets. This paper, however, is only a beginning. The next crucial step is to commence a meaningful study to address the concerns raised here relating to the structural deficiencies of the public market.