

PRIMARY MARKETS AND THE SECURITIES LAWS: CAPITAL-RAISING AND SECONDARY TRADING

Donald C. Langevoort^{*}

This Chapter on the law of capital-raising and primary markets surveys a large swath of securities regulation—the domain commonly known as “corporation finance”—in search of an agenda for a new Special Study. This territory includes the entirety of the Securities Act of 1933, both in its positive mandate, the intricate regulation of registered public offerings, and its exemptive grace through either statutory or administrative forbearance from registration. Here we see the most direct connection to the goal of allocative capital market efficiency, as issuers ranging from small start-ups to well-known seasoned issuers compete for scarce investor capital. Here, too, we see the most obvious points of tension among the values of investor protection, efficiency, competition and capital formation. But we cannot stop this survey at the capital-raising transaction itself. Investors covet liquidity, the ability to resell what they have bought from issuers, which means that expectations as to secondary trading opportunities will always be integral to primary

^{*} Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center. Thanks to commentators and participants at the March 2017 New Special Study of the Securities Markets conference at Columbia Law School for helpful thoughts and suggestions, especially Jay Ritter and Bill Williams.

capital-raising choices and affect the cost of capital.¹ Most initial public offerings today are accompanied by an immediate listing on a national securities exchange. So this Chapter extends its scope to on-going disclosure for secondary market trading as well—the subject of much of the Securities Exchange Act of 1934—and the elaborate regulatory infrastructure designed to promote informational integrity throughout the life of a public company.

That is a lot on which to chew.² But this is not an occasion to offer concrete reform proposals or resolve any heated policy debates, rather just seek out important but still-unanswered questions that deserve further research via a new Study. My effort here will be to describe briefly the current state of the law and identify notable points of doubt or controversy in the eyes of legal scholars, practitioners and law-makers. In turn, the companion chapter by Kathleen Hanley focuses on the financial economics of primary capital-raising and secondary trading, giving us a better sense of what existing research already demonstrates and what kind of further empirical work could reasonably be sought in a new project.

The context for this effort to explore the regulatory world of corporation finance is very different from that prevailing in 1963, when the original Special Study of the Securities Markets was submitted to Congress. That was a time of

¹ See Merritt B. Fox, *Regulating Public Offerings of Truly New Securities: First Principles*, 66 Duke L.J. 673, 697-98 (2016).

² All the more so if we think of primary capital markets on a global scale. Because there is a separate chapter devoted to internationalization, this Chapter has a domestic focus.

contentment and faith in regulation.³ To be sure, there was recognition that securities regulation could be done differently and better, not permanently affixed to concerns and beliefs from the Great Depression and the New Deal. But in the early 60s, the United States had reached unmatched hegemony in the global capital markets, for a variety of reasons.⁴ Investor protection and the public interest were twinned, faith in which persisted well into the 1970s.⁵ Regulatory reform effectively meant regulatory expansion. As to corporate finance, the original Special Study prompted the 1964 Securities Law Amendments, enlarging the scope of mandated disclosure to larger issuers traded in the over-the-counter marketplace.⁶

³ For much more on the implicit beliefs and attitudes that support securities law-making then and now, see DONALD C. LANGEVOORT, *SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET AND THE DILEMMAS OF INVESTOR PROTECTION* (2016). Thorough historical coverage of the first Special Study can be found in JOEL SELIGMAN, *TRANSFORMING WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 295-305 (3d ed. 2003). The main focus of the 1963 study was on market structure and the balance between regulation and self-regulation as this played out in the exchange and over-the-counter marketplace. There may have been faith in regulation on the part of the Study's proponents and authors, but not necessarily in bureaucrats or, especially, self-regulators.

⁴ See Mark Roe, *Legal Origins and Modern Stock Markets*, 120 Harv. L. Rev. 460 (2006).

⁵ This was so even in the face of worries throughout this time period that the securities industry had too much control over regulation and the markets. To be clear, self-interest and rent-seeking have never been far below the surface of securities law-making, even in the New Deal era. See generally PAUL G. MAHONEY, *WASTING A CRISIS: WHY SECURITIES REGULATION FAILS* 49-76 (2015). Indeed, the first Special Study was instigated by new SEC Chair William Cary and allies in Congress who were suspicious of Wall Street domination over market structure and trading.

⁶ With Milton Cohen's prodding, a long project soon began to integrate the Securities Act and the Securities Exchange Act, eventually bearing much fruit but rethinking the legal foundations of corporate disclosure for seasoned issuers only at the margins, not fundamentally. Milton H. Cohen, *"Truth in Securities" Revisited*, 79 Harv. L. Rev. 1340 (1966). Cohen later addressed the agenda for a new Special Study, called for by Congress in 1988 but never funded. See Milton H. Cohen, *A Quarter Century of Market Developments—What Should a "Special Study" Study?*, 45 Bus. Law. 3 (1989).

Today, as we contemplate launching a new Special Study, no comparable confidence can be taken for granted.⁷ American capital market hegemony is no longer, and with that the recognition that global competition (and arbitrage) undermines any one country's effort to impose either regulatory philosophy or regulatory will. The very idea of public offerings and public companies as dominant solutions to the needs of corporate finance is in doubt,⁸ especially as the rapid institutionalization of the holding of both debt and equity enables alternative arrangements for supplying the capital needs of enterprises of all sizes and stages of development without the glaring transparency, short-term pressures and accountability of publicness.⁹ Numerous forms of regulation are said to hurt capital-raising, not help. The politics have become self-serving, ideological and often ill-informed.

Before we get to the substance of this Chapter, a word about its organization. The Securities Act focuses on the public offering of securities, and the Securities Exchange Act on public trading in the secondary markets. But public status is

⁷ E.g., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION, Nov. 30, 2006, available at <http://www.capmksreg.org/wp-content/uploads/2016/10/Committees-November-2006-Interim-Report.pdf>.

⁸ See Xiaohui Gao, Jay Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. Fin. & Quant. Analysis 1663 (2013); Jerold Zimmerman, *The Role of Accounting in the 21st Century Firm*, 45 Acct'g & Bus. Res. 485 (2015). Importantly, this cautions against assuming that drops in public offerings or public listings are mainly caused by regulatory excess, as opposed to these other incentives. An interesting Canadian study traces the comparable drop there even though the regulation of IPOs is less burdensome. Bryce Tingle et al., *The IPO Market in Canada: What a Comparison with the United States Tells Us About a Global Problem*, 54 Canadian Bus. L.J. 321 (2013).

⁹ See Donald C. Langevoort & Robert B. Thompson, "*Publicness*" in *Contemporary Securities Regulation After the JOBS Act*, 101 Geo. L.J. 337 (2013); see also Hillary A. Sale, *J.P. Morgan: An Anatomy of Corporate Publicness*, 79 Brook. L. Rev. 1629 (2014).

potentially attractive and available to a relatively small (and apparently shrinking) number of firms of considerable size and salience. Arguably, a more realistic survey of the law relating to capital-raising should begin with the options fairly available to start-ups and small businesses, and ascend from there. But because this is a legal discussion, and the non-public capital-raising options under the Securities Act are defined as exemptions from the public offering presumption, we will take the conventional route. Readers should keep in mind, however, that taking publicness as a starting point distorts the reality of what most firms face in the pursuit of needed capital.

I. INITIAL PUBLIC OFFERINGS

The original Special Study understood that the issuance of “truly new securities”¹⁰ poses the quintessential test for the regulation of capital-raising transactions. Almost by definition, a lighter touch is warranted for public offerings by issuers with which the market is already more familiar. So we start with the IPO.

The Securities Act is above all a disclosure statute, famously rejecting the sort of “merit regulation” whereby state securities regulators had passed judgment (and to an extent still do) on the quality of the investment being publicly offered. In that regard, the IPO triggers extensive disclosure obligations, which place a great deal of stress on the ability of potential investors to process the information

¹⁰ Fox, *supra*.

intelligently. When the Act was passed there was an assumption that most purchasers in public offerings were ordinary folk, needing the assistance of disclosure—thereby begging the question of how likely they would be, if indeed so unsophisticated, to make good use of the disclosure.¹¹ Today, by contrast, initial purchasers are mainly large institutional investors, just one of many changes that justify a hard look at the contemporary efficacy of the statute.

A. The Securities Act's Investor Protection Strategies

Although there is little evidence that the drafters of the Securities Act thought in these terms, entrepreneurial capital-raising poses a classic “lemons problem” that arises when rational investors face multiple investment opportunities and the promoters have private information about the quality of their ventures. The cost of capital goes up for all ventures, perhaps prohibitively, unless the investors have some reliable mechanism for telling the difference between the sour lemons and the sweeter fruit. As noted, the Securities Act tries to solve this problem in public offerings via mandatory, credible disclosure.

¹¹ Early SEC Chairman (and future Supreme Court justice) William O. Douglas made this point before his appointment in criticizing the adoption of the Securities Act. See Donald C. Langevoort, *The Politics of Entrepreneurial Capital Raising*, in D. GORDON SMITH & CHRISTINE HURT, EDS., *LAW AND ENTREPRENEURSHIP* (forthcoming, 2017). This point has been a critical theme ever since. E.g., HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* (1979). One answer to this comes via “filtration:” that the disclosure will at least influence those who play a role in advising or soliciting investors, and make the communications more useful and honest. See James D. Cox, *Premises for Reforming the Regulation of Public Offerings: An Essay*, 63 *Law & Contemp. Probs.* 11, 12-16 (2000).

The mandatory nature of disclosure follows from a number of insights. It elicits presumably useful information, although under the right bargaining conditions rational investors could (and often do) demand what they want and need as a condition for their investment. Issuers thus face disclosure incentives even in the absence of any regulatory mandate.¹² The Act's disclosure requirements are thus better understood to reflect some mix of (1) doubts about the opportunity to bargain and enforce effectively when offerees are unsophisticated and/or widely dispersed; (2) agency costs that arise when there are conflicting interests on the part of those in control of the issuer;¹³ (3) a desire to promote uniformity and comparability in presentation and content so as to facilitate comparison shopping; and (4) a recognition that disclosure generates positive externalities by enriching that capital-raising environment generally—offering information that aids in the valuation of other issuers beside the one making the disclosure (e.g., disclosing a product line with a competitive advantage also provides new information about the value of the securities of marketplace incumbents) and facilitating other healthy economic

¹² This is the starting point for a large volume of legal scholarship questioning (or defending) the mandatory disclosure system in light of the incentives for private ordering, whether in primary offerings or secondary trading. E.g., Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *Yale L.J.* 2359 (1998); John C. Coffee, Jr., *Market Failure and the Economic Case for Mandatory Disclosure*, 70 *Va. L. Rev.* 717 (1984); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 *Va. L. Rev.* 1335 (1999); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 *Duke L.J.* 711 (2006). Critics of regulation point out that the SEC might do more harm than good even if there is a strong theoretical case for mandates, and that empowering private standard-setters (or more competition in regulation) can better address the market failures that persist.

¹³ See Paul Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 *U. Chi. L. Rev.* 1047 (1995).

activity. There are many such positive externalities beyond the immediate value of the information for trading purposes, including better corporate governance.¹⁴

Disclosure content today is massively—perhaps unnecessarily¹⁵—complex, a product of accretion over nearly eighty-five years. The required disclosure on Form S-1 invokes a catalog of line-items found in Regulation S-K, a mix of both quantitative and narrative about the issuer and its business; the issuer’s capital structure; financial performance and risks; management, compensation and governance; and matters relating to the offering itself.

An especially difficult conceptual issue with respect to disclosure content has been with respect to forward-looking information. By and large, mandatory disclosure is a snapshot of the issuer as of the moment of its IPO, largely looking backwards. But the valuation decision made by rational investors is forward-looking: estimates and projections about future financial performance, adjusted for risk and discounted to present value. For many companies making an IPO—especially innovative ones—past performance is not a particularly useful indicator of the future, for better or worse. There have been moves toward some refocusing of attention, most notably in the Management Discussion & Analysis (Item 303) that

¹⁴ Fox, *supra*; see also Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 Duke L.J. 997 (1992); Urska Velikonja, *The Cost of Securities Fraud*, 54 Wm. & Mary L. Rev. 1887 (2013). Also, mandatory disclosure operates as a verification of information voluntarily disclosed previously, thereby constraining opportunism in voluntary disclosure practices.

¹⁵ The SEC is currently engaged in a project to assess the value of the line-item disclosure requirements. See *SEC Solicits Public Comments on Business and Financial Disclosure Requirements in Regulation S-K*, available at <https://www.sec.gov/news/pressrelease/2016-70.html> (April 15, 2016). Accretion leads to fear of information overload. E.g. Troy Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 Wash. U.L.Q. 717 (2003).

asks management to assess financial performance by reference to, among other things, those trends and uncertainties affecting reported performance that are known to management and reasonably likely to occur. There is also risk factor disclosure,¹⁶ disclosure of certain pending or threatened lawsuits, etc., plus the residual obligation to volunteer additional material information necessary to make what has been said not misleading. Still—presumably fearing revelation of secrets that could harm the issuer and deter innovation¹⁷—nothing in the required disclosure gives investors anything close to an inside view of the company’s future. This is particularly important in assessing the efficacy of the Securities Act, especially if we fear that some IPOs are timed to exploit investor attention before it shifts elsewhere.

Disclosure has no fundamental value unless it is timely, credible and accurate. To this end, the Securities Act uses a combination of four overlapping strategies.¹⁸ First, using its considerable discretion over whether to accelerate the effective date of a registration and thus enable sales to take place lawfully under Section 5, the SEC has the ability to demand changes and additions to the disclosure in the registration statement filed by the issuer. This can improve clarity and comparability, and probably has the effect of making management and deal participants sense that they are being watched closely, with healthy behavioral consequences. And, of course, a serious or persistent violation of either the rules or

¹⁶ A.C. Pritchard & Karen Nelson, *Carrot or Stick? The Shift from Voluntary to Mandatory Disclosure of Risk Factors*, 13 J. Empirical Legal Stud. 266 (2016).

¹⁷ See Edmund Kitch, *The Theory and Practice of Securities Disclosure*, 61 Brook. L. Rev. 763 (1995).

¹⁸ For a thorough overview, see CHARLES JOHNSON JR, JOSEPH MCLAUGHLIN & ERIC HAUETER, *CORPORATE FINANCE AND THE SECURITIES LAWS* (5th ed. 2016).

the norm of truth-telling can provoke an enforcement action. This oversight function is limited in two respects, however: SEC review is only to the disclosures, not the merits of the offering, and the SEC does not normally investigate the accuracy of what is disclosed, just inclusion and presentation.¹⁹

Second, in an effort to make disclosure effective, Section 5 of the Securities Act limits the extent to which (and if so how) offers can be made prior to the effective date, and prohibits sales until then.²⁰ The content of these “gun jumping” rules has evolved over the decades, with major liberalization in 1954 (by statute) and 2005 (by rule-making).²¹ Liberalization notwithstanding, the rules are still complicated, with potentially significant adverse consequences for slip-ups.²² For all the complications, in turn, the offering restrictions today mainly assure the availability of the preliminary prospectus at the time of any pre-effective offers so that both those soliciting and those being solicited have access to the most current version of mandated disclosures,²³ and to make other widely used written soliciting

¹⁹ The staff does review publicly available information in the media and on the internet for purposes of assessing accuracy and completeness.

²⁰ More precisely, the rules vary based on whether the solicitation efforts occur before the filing of the registration statement, during the waiting period prior to effectiveness, or in the post-effective period. Under the JOBS Act, issuers may “test the waters” prior to deciding whether to commence their IPO by reaching out to certain institutional investors.

²¹ See Donald C. Langevoort & Robert B. Thompson, *IPOs and the Slow Death of Section 5*, 102 Ky. L.J. 891 (2013-14).

²² Illegal offers under Section 5 can trigger a form of strict liability in a suit brought by a purchaser. But most enforcement of the gun-jumping rules is by the SEC staff, invoking its acceleration authority.

²³ The SEC insists that draft prospectus filed with the SEC, even though not final, be widely available during the waiting period when investors are being solicited. The free writing now permitted for such solicitations must ordinarily be linked to the preliminary prospectus then available.

materials (free writing prospectuses) available to the SEC staff at the time of their first use. There is still a “quiet period,” but not as much as there used to be.

Third, the most visible and notorious mechanism for promoting disclosure accuracy in the Securities Act is a powerful civil liability provision, Section 11, which allows any purchaser of securities issued pursuant to an effective registration statement a rescissionary measure of damages if there was any material misstatement or actionable omission in the registration statement as of the effective date, whether or not the purchaser relied on those disclosures.²⁴ Liability is strict for the issuer, while others associated with the offering bear liability unless they establish a due diligence defense.²⁵ Such damages could be catastrophic, and so the threat is assumed to induce a higher level of care in the preparation of the mandatory disclosures. A separate litigation supplement is provided by Section 12(a), which in subsection (1) creates strict rescissionary liability for illegal offers or sales and in subsection (2) creates negligence-based liability as against those who sell securities in a public offering by means of any written or oral communication (e.g., a preliminary prospectus or free writing) that contains a material misstatement or

The final prospectus and registration statement do not become available until after most or all the selling has taken place, so that the purchaser only receives notice of their availability.

²⁴ The measure of damages excludes stock price drops unrelated to the misstatements or omissions, but the burden of proof is on the defendants to prove that exclusion.

²⁵ See William Sjoström, *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 Brandeis L.J. 549 (2006). There is an enumerated list of potential defendants besides the issuer—directors of the issuer, signatories of the registration statement, underwriters and experts who attest to some portion of the registration statement. The list is exclusive, so that those not included (e.g., lawyers, notwithstanding their central role in drafting the registration statement) have no Section 11 exposure.

actionable omission. Section 12(a) thus increases the pressure on offering participants to be careful in what they say and do throughout the registration process.

Fourth and finally, the Securities Act causes, and sometimes requires, the involvement of attorneys, investment bankers, auditors and other external experts for there to be a successful IPO. These professionals have reputational incentives to avoid association with a dishonest capital-raising transaction, which itself may be a partial solution to the lemons problem.²⁶ The Act increases the incentive by making underwriters, accountants and certain other professionals liable under Section 11, subject to proof of due diligence, and potentially under Section 12(a)(2) as well.²⁷ Investment bankers are also subject to extensive regulation and disciplinary authority by the SEC and FINRA based on their broker-dealer status, creating additional responsibilities and oversight as to sales practices and the pricing and conduct of the public offering.

B. Marketplace Changes and the Opportunities for Reform

For all the many statutory and rule-based reforms and revisions to the Securities Act over the last eighty-five years, its foundation remains unchanged. That raises obvious questions about the relative balance of costs and benefits,

²⁶ On the nature and limits of gatekeeper strategies, see generally JOHN C. COFFEE, JR., *GATEKEEPERS: THE ROLE OF THE PROFESSIONS AND CORPORATE GOVERNANCE* 55-70 (2006).

²⁷ Section 12(a)(2) is limited to suits by buyers against sellers, though not necessarily with a privity requirement. A seller includes a person or firm that solicits the purchase with some pecuniary motivation for so doing.

particularly as we observe a steady drop off in the number of IPOs generally and the near-disappearance of smaller IPOs.²⁸ The four regulatory strategies described above are very costly to issuers, in terms of legal fees, accounting fees and underwriting spreads, delays and the resulting distraction and uncertainty prior to effectiveness, and (arguably) the extent of underpricing that occurs.²⁹ The latter refers to the well-studied economic phenomenon that deals are priced by underwriters below the maximum that the market would be willing to pay, so that there is a predictable near-term market price increase as soon as trading begins. Arguably, the issuer leaves money on the table. The connection between underpricing and regulation is unclear, more fully addressed in the companion economics chapter than this one. One hypothesis—highly debated and not at all resolved—is that a tacit conspiracy exists among investment bankers, lawyers and others to extract rents from the public offering process.³⁰ To the extent that the fundamentals of Securities Act regulation impede competition and innovation in the

²⁸ Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone? The Hard Life of the Small IPO*, 6 Harv. Bus. L. Rev. 83 (2016); see also Gao et al., *supra*.

²⁹ Large underwritings today are mainly “firm commitment” fixed price offerings, whereby the underwriters purchase the securities from the issuer and resell them to investors. There remain some “best efforts” underwritings wherein the underwriters do not purchase the securities for resale but rather simply assist the issuer in the sales process, compensated by commissions. The latter are for smaller, riskier public offerings.

³⁰ Some would include the issuer’s own management in the conspiracy. For legal commentary on the risk of collusion, see, e.g., Christine Hurt, *Moral Hazard and the Initial Public Offering*, 21 Cardozo L. Rev. 711 (2005); Jeremy McClane, *The Agency Costs of Teamwork*, 101 Cornell L. Rev. 1229 (2016)(collusive role of lawyers and law firms in IPOs). On the economics at work here see Xiaoding Liu & Jay Ritter, *Local Underwriter Oligopolies and IPO Underpricing*, 102 J. Fin. Econ. 579 (2011). There are many explanations for underpricing, discussed more fully in Kathleen Hanley’s companion paper. These include, but are not limited to, fear of Section 11 liability by offering participants. See Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. Rev. 17 (1993)

methods of offering securities to the public (e.g., by the de facto establishment of fixed price syndicated distributions),³¹ reassessing the Act's assumptions may be long overdue.³² Yet at the same time, there are many observers beside those with skin in the game who find considerable value in the prevailing law and surrounding investment banking practices.³³

The common practice for IPOs is book-building, whereby underwriters and issuer management spend a great deal of time and effort talking privately with large investors who might be inclined to buy, in what is a two-way conversation. The sellers reveal more about the offering than the legally-mandated documents contain (i.e., forward-looking information); in return, potential buyers reveal their assessments and willingness to buy at different price levels. The collective knowledge learned in these private contacts allows the lead underwriter to price the deal with greater confidence. In other words, a benign explanation for underpricing is that allotments at that lower-than-market price are the quid pro quo for the sharing of otherwise private information.³⁴

To the extent that this form of book-building is the norm, we might reasonably ask what useful role SEC supervision and the offering restrictions play at

³¹ See MAHONEY, *supra*, at 71-76.

³² This has led many commentators to call for a move away from firm commitment underwritings to auctions and related mechanisms better suited to a high tech investment marketplace. See Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. Ill. L. Rev. 217 (2015).

³³ See Alan D. Morrison & William Wilhelm Jr., *Opacity, Complexity and Self-Regulation in Investment Banking*, Geo. Wash. L. Rev. Arguendo, available at <http://www.gwlr.org/wp-content/uploads/2015/04/83-Geo.-Wash.-L.-Rev.-Arguendo-1.pdf> (2015).

³⁴ See Langevoort & Thompson, *IPOs*, *supra*, at 909-13 (reviewing arguments in favor of book-building)

all. Book-building resembles a private placement given the institution-only makeup of the potential buyers consulted. Even if there are others given allotments (e.g., “friends and family” arrangements), the fixed-price nature of the public offering means that the price for everyone has to be set at a level that attracts the smart money. Perhaps, then, there is an opportunity to lower the intensity and costliness of that regulation. (That opportunity is bolstered by the much richer, real-time informational environment in which all economic activity takes place in a wired society,³⁵ which clearly extends to those private companies with enough promise to qualify for a public offering.)

On a closer look, however, there are two sets of questions still to be answered. One comes from the issuer’s perspective: as noted above, can we be confident enough that the underpricing isn’t at least partially an agency cost problem? The tech boom scandals at the turn of the last century offered evidence of various anticompetitive and potentially manipulative arrangements whereby underwriters gain at the issuer’s expense. Securities Act regulation does little today to deter rent-seeking and weigh in on the side of the issuer. Maybe it should.³⁶

Much closer to the traditional concerns of securities regulation are the interests of purchasers in the aftermarket, who buy at prices higher than the official

³⁵ E.g., Joseph Grundfest, *Regulation FD in the Age of Facebook and Twitter: Should the SEC Sue Netflix?*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2209525 (Jan. 30, 2013)..

³⁶ See note 30 supra. On underwriters’ compensation as an example of rent-seeking, see William K. Sjostrom, *The Untold Story of Underwriting Compensation Regulation*, 44 U.C. Davis L. Rev. 605 (2010); on the anticompetitive effects, see Gao et al., supra. The anticompetitive potential is exacerbated by the Supreme Court’s ruling that securities regulation implicitly displaces antitrust and other lawsuits that might frustrate the SEC’s control over securities distribution practices. *Credit Suisse Securities LLC v. Billings*, 127 S.Ct. 2383 (2007).

offering price. In the face of a price “pop” after effectiveness, those allotted shares in the initial round will be tempted to flip them quickly to capture a near-guaranteed profit. Because too much short-term reselling would put downward pressure on the market price, there are various restrictions and penalties imposed.³⁷ But how strong the disincentive is, for whom, and for how long, presumably varies.

Plainly, aftermarket demand can be exuberant, some of which may be deliberately stimulated by underwriter sales practices and issuer publicity, both of which in turn are traditional regulatory worries. The retail investors who may drive some of this demand are not privy to the private book-building discussions that give institutional investors better information, insight and perspective—Reg FD (which otherwise limits the selective disclosure of material non-public information explicitly exempts such discussions from the norm, and the backwards looking disclosure may be of little help in estimating the future. The loosening of the quiet period in 2005, though conceptually sensible, invites the more aggressive use of channels for publicity that can hype the aftermarket but are difficult to police for candor, even with filing requirements in Rule 433 when free writing is used.³⁸ This is difficult terrain, because the pressures may not be entirely—or even mainly—from offering participants. The financial media and social media may generate hype well beyond what issuers or underwriters do or say. Whatever its sources, this richer

³⁷ The SEC’s Regulation M sets forth detailed anti-manipulation rules for the conduct of public offerings, which in fact allow substantial stabilization activity to occur. FINRA conduct rules and the antifraud provisions of the securities laws also address efforts by underwriters to control or influence the aftermarket price.

³⁸ See Langevoort & Thompson, *IPOs*, supra, at 911-12. There are First Amendment limits here, of course. See Susan Heyman, *The Quiet Period in a Noisy World: Rethinking Securities Regulation and Corporate Free Speech*, 74 Ohio St. L.J. 189 (2013); see also Grundfest, supra.

informational environment is neither necessarily unbiased nor one that bespeaks caution.

C. The JOBS Act “On-ramp” Reforms as a Case Study

The JOBS Act of 2012 and the FAST Act extension that followed in 2015 provide a useful case study of deregulation to stimulate economic growth and job creation. So far as registered public offerings are concerned, the main reform was an “on-ramp” for issuers that qualify as emerging growth companies, a category that covers most registrants and ceases to apply only after reaching very high levels of annual revenues (\$1 billion) or market capitalization (\$700 million).³⁹

Most reforms here are far from radical. EGCs may submit their registration statements confidentially with the SEC in order to get initial feedback on disclosure quality outside the gaze of investors and the media, though road shows with potential investors cannot start until fifteen days after the filing becomes public.⁴⁰ There is a list of “lightened” disclosure requirements, including only two (rather than three) years of audited financials, less disclosure of executive compensation, and a pass on Sarbanes-Oxley’s internal controls auditor attestation regimen. Fear that these relaxations alone allow EGCs to hide sensitive material information from investors

³⁹ See Langevoort & Thompson, *Publicness*, supra, at 371-74. There is also cut-off based on aggregate non-convertible debt offerings over a three year period ((\$1 billion). These dispensations extend to on-going disclosure requirements after the public offering, for a period of five years unless the size test is met.

⁴⁰ The JOBS Act pegged this at 21 days, which was shortened in the FAST Act.

would seem to be overblown, however. What remains subject to line-item disclosure is considerable, and the rule that there must be further disclosure of *any* fact necessary to make what is said not misleading (Rule 408) makes nondisclosure of any uncomfortable information from the issuer’s past or present legally very risky even in a shortened prospectus. Whether the on-ramp degrades the IPO informational environment—and if so why and by how much—is an open empirical question, discussed more fully in Kathleen Hanley’s paper in this volume.

Of all the legal changes in building the on-ramp, perhaps the most interesting is a relaxation on certain rules—many deriving from the sell-side analyst scandals from more than a decade ago—so as to bring “conflicted” analysts (i.e., those working for investment banks who participate in the IPO) back into the informational mix. Though by no means a complete scrapping of the idea of analyst independence, the legal reform here goes to the heart of Section 5’s sales practice restrictions: analyst research expressing any information, opinions or recommendations is explicitly excluded from the key words “offer” and “prospectus,” which means that the anti-hyping rules no longer apply, nor does the main civil liability provision to protect buyers from false hyping in sales and marketing of the offering outside the registration statement (Section 12(a)(2)).

The motivation for such a change was the fear that smaller companies simply do not get sufficient analyst coverage to sustain investor interest once the issuer goes public, and that given other prophylactic rules and economic incentives promoting

candor and objectivity, conflicted research is still better than no research.⁴¹ But the way the liberalization is drafted seems to go a step or two beyond what was necessary based on that alone, to a re-enlistment of analysts in the process of enticing investors to bid up the aftermarket price.⁴² Empirical research on this trade-off, which is only now beginning to appear, will be helpful to shed light not only on the role of sell-side analysts as such, but the bigger question of who wins and who loses in the long run in “hot” or aggressively marketed IPOs.

D. Civil Liability Reforms

If disclosure for an IPO is to be as effective as the drafters of the Securities Act hoped, it must be credible; otherwise, investors should rationally lower their bids with the risk that sound capital-raising unravels. Civil liability is the most prominent mechanism to counter this, via the two main overlapping causes of action noted earlier that are available to purchasers of the securities when there is a material misstatement or omission of some fact necessary to make statements made not misleading, Sections 11 and 12(a)(2).

⁴¹ See Benjamin J. Catalano, *The Promise of Unfavorable Research: Ramifications of Regulations Separating Research and Investment Banking for IPO Issuers and Investors*, 72 *Bus. Law.* 31 (2016-17); see also Jill Fisch, *Does Analyst Independence Sell Investors Short?*, 55 *UCLA L. Rev.* 39 (2007). In addition, letting analysts play a larger role in the offering may temper the sales enthusiasm of the underwriters.

⁴² A well-publicized FINRA enforcement proceeding in December 2014 involving analysts coveting a role in the Toys R Us IPO certainly raised doubts about the efficacy of analyst independence reforms. See LANGEVOORT, *SELLING HOPE*, *supra*, at 122. For a criticism of the enforcement action, see Catalano, *supra*.

Strict liability for issuers under Section 11 has long been controversial, even as applied to IPOs. As Merritt Fox has shown, there is a strong theoretical case for strict liability as a means to counter adverse selection.⁴³ A material misstatement or omission as of the effective date results in a distorted transfer of wealth to the issuer and its incumbent owners regardless of who knew what about the matter. Introducing a more demanding state of mind requirement (whether due diligence or intentionality) would bring about factual complications as to what could have been known and how, which takes up judicial resources and creates investor uncertainty.

How well this promise of credibility holds up in practice is open to question, of course. Section 11 cases against issuers are still challenging, even without either a state of mind or a reliance requirement. What is material, and what is a misstatement or actionable omission, are muddled mixed questions of law and fact often not easily resolved, especially against the background of a limited duty to disclose the forward-looking information that investors covet.⁴⁴ Quantifying the loss in dollar terms is not easy either, with the issuer allowed to try to separate out the recoverable loss related to the misstatement from other unrelated reasons why the stock price eventually dropped below the offering price. The result is both uncertainty and considerable litigation cost, which lessens the value of the regulatory promise. From the issuer's perspective, this introduces both risk and out-of-pocket cost, which in turn reduces

⁴³ Fox, *Public Offerings*, *supra*, at 704-07.

⁴⁴ An example here would be disclosure relating to the threat of government litigation, recently addressed in the Securities Act context—with a great deal of uncertainty as to precisely what is expected of issuers—by the Supreme Court. See Hillary A. Sale & Donald C. Langevoort, “*We Believe:*” Omnicare, *Legal Risk Disclosure and Corporate Governance*, 66 *Duke L.J.* 763 (2016).

the attractiveness of the IPO vis-à-vis other alternatives.⁴⁵ Where the right balance lies—and how much of a role these particular risks and costs play in the larger IPO context—surely invite further study.

Section 11 also employs a gatekeeper strategy, imposing on offering participants beyond the issuer's management team the same liability risk, albeit with a due diligence defense that varies depending on the role and status of the particular participant. Due diligence is two-sided: an affirmative duty to investigate, and a duty to respond reasonably to what is uncovered as the investigation unfolds. As a result, outside directors, underwriters and experts (most notably, auditors) face fearsome liability exposure. They and their insurers also offer a set of deep pockets in the event the issuer is insolvent.

Here again, the mix of costs and benefits is debatable, although there is considerable support in the legal literature for underwriter liability along these lines (and perhaps even stricter liability) given the crucial role underwriters play in the offering process.⁴⁶ To be sure, there are substitute incentives for due care and candor for offering participants, including via reputation and the policing of broker-dealer conduct by the SEC and FINRA. But there are major doubts about reputational incentives alone, or whether the resources and will are there for adequate public enforcement.

⁴⁵ See Michael Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 Va. L. Rev. 776 (1972).

⁴⁶ See COFFEE, GATEKEEPERS, *supra*, at 352-54; Fox, *Public Offerings*, *supra*, at 710-15; Frank Partnoy, *Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime*, 79 Wash. U.L.Q. 491 (2001).

E. Summary: Studying the IPO Regulatory Ecology

In many ways (putting aside the increasingly rare small or self-underwritten registered offering⁴⁷), IPOs are effectively private placements made at a fixed price to highly sophisticated institutional buyers, followed by immediate resales into a public trading market. Arguably, the first part of that process by itself—the book-building—gets too much regulatory burden, and could be left much more to private ordering. The harder question is whether the aftermarket has sufficient integrity in light of the apparent incentives to hype, which depends on a better empirical understanding of who wins, who loses, when and why. With that, it becomes possible to then look at the considerable regulatory costs associated with the public offering process and consider which contribute efficiently to investor protection and which might not.

The IPO also squarely poses the question of to what end regulation exists in the modern era of obsession with innovation, growth and job creation. The IPO is a salient “rite of passage” that has been taken by many of the world’s most successful companies, which generates the hypothesis that more IPOs would bring more growth.⁴⁸ Yet the typical IPO comes later and later in the chronology of the start-up; earlier stage financing comes via exempt offerings of various sorts, as we shall

⁴⁷ See Rose & Solomon, *supra*.

⁴⁸ See Shai Bernstein, *Does Going Public Affect Innovation?*, 70 J. Fin. 1365 (2015). To be sure, there are many innovative public companies, though even these often enough out-source the work of innovation to joint venture partners and other affiliates.

see. So the IPO is commonly viewed as an exit mechanism, by which promoters and funders cash out some or all of their early-stage investments. True, the pay-off is a reward, which presumably incentivizes the risk-taking that occurs earlier in the chronology, but an unanswered question is how essential this particular kind of reward is in light of substitutes (enhanced private equity funding, trade sales) that might offer comparable incentives.⁴⁹ A useful first step in any new Special Study would be a far better mapping of the diverse welfare consequences of liberalized access to capital, whatever the stage of entrepreneurship.⁵⁰

II. SEASONED EQUITY AND OTHER PUBLIC OFFERINGS

A. Equity Offerings

The original Special Study largely assumed the need for intense regulation of the IPO, addressing it largely as part of its look at dealer-dominated over-the-counter methods of distribution. But it was fair to ask whether seasoned issuers should necessarily face the same discipline. After all, companies that have made an IPO thereby become registrants under the Securities Exchange Act, and hence subject to on-going disclosure obligations; many of them trade in relatively transparent and now largely institutional markets, the informational efficiency of which increases as

⁴⁹ On the place of the IPO as an exit mechanism in light of alternatives, see Gao et al., *supra*.

⁵⁰ It should be noted that there is no necessary connection between IPOs and net job creation; some IPOs, no doubt, involve companies that substitute technology for human labor and may “creatively” destroy higher-employing marketplace incumbents.

the impact of the selling pressure dissipates. As noted, that insight set in motion decades of effort to lessen the severity of the Securities Act strictures on companies at various levels of trading interest and market capitalization. The key initial step came with the regulatory innovations of integrated disclosure (simplified Form S-3) and shelf registration in the 1980s, the latter inviting larger issuers to have a skeletal registration statement go effective with sales occurring pursuant to later-supplied disclosure at the time of take down. Substantial enhancements to integrated disclosure and shelf registration, including creation of well-known seasoned issuer (WKSI) status, came with the 2005 offering reforms, and there was a notable extension of the availability of Form S-3 to smaller issuers a few years later.

The 1980s reforms were informational, and rested on the fairly minimalist insight that information about the issuer that was already available in a 10-K or other Exchange Act filing did not need to be repeated in the registration statement. It could be incorporated by reference, both backwards and forward.⁵¹ Motivated investors purchasing stock of large issuers could handle this easily enough, all the more so as information technology made filings so accessible; any who are motivationally impaired could free ride and probably would not be reading the documents carefully in any event. By contrast, the 2005 reforms mainly addressed sales practices. Especially for seasoned issuers, the ability to communicate with

⁵¹ Market efficiency was invoked as a justification for integrated disclosure, but need not be assumed in order to make sense of it. See Donald C. Langevoort, *Theories, Assumptions and Securities Regulation, Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851 (1992). Subsequently, there has been a substantial widening of the availability of incorporation by reference, most recently in the FAST Act for forward incorporation by smaller issuers, so that it cannot any longer be said that market efficiency is the theory behind this kind of deregulation.

investors—whether in writing or orally—was made easier by a series of new safe harbors.⁵² This lessened the chilling effect of what heretofore were serious restraints, and any conditions that remained were not hard to navigate once the dense thicket of rules was reasonably well understood. There was also a lessening of the burdens and delays of SEC review for WKSIs via automatic effectiveness for shelf registrations.

As a result of all this, we are much closer to Milton Cohen’s ideal of “company registration”—a setting in which seasoned issuers operating within the discipline of the Exchange Act could make public offerings subject to a relatively light set of restrictions on selling practices and without intensive SEC supervision.⁵³ While there no doubt could be more simplification, what remains in dispute here mainly has to do with liability risks: nothing in the 1980s era or 2005 reforms made significant changes in the Section 11 exposure faced by issuers or underwriters. If anything, Section 12(a)(2) liability was deliberately enhanced as applied to free writing and the preliminary prospectus that is widely distributed during the waiting period.⁵⁴

There are two related controversies here, one of which is whether the threat of issuer strict liability makes sense for seasoned issuers, given the many substitute

⁵² Safe harbors were created for publicity occurring sufficiently before the filing of the registration statement, factual communications and—most importantly, perhaps—free writing prospectuses both before and after effectiveness. See Steve Thel, *Free Writing*, 33 J. Corp. L. 941 (2008).

⁵³ See REPORT OF THE ADVISORY COMMITTEE ON CAPITAL FORMATION AND REGULATORY PROCESSES (1996); John C. Coffee, Jr., *Re-engineering Corporate Disclosure: The Coming Debate Over Company Registration*, 52 Wash. & Lee L. Rev. 1143 (1995).

⁵⁴ Most notably, by new Rule 159A, treating issuers as sellers even when not in privity with the purchaser in questions. Some courts have doubted the viability of this interpretive rule. For a discussion of this and other factors that may limit the effectiveness of Section 12(a)(2) litigation, see Langevoort & Thompson, *IPOs*, *supra*, at 916-18.

mechanisms that exist to promote transparency and candor. The other is whether underwriters, independent directors and experts (again, mainly the auditors) should continue to be held to the full level of due diligence expected in an IPO.⁵⁵ The 2005 reforms lessened the risk for directors and auditors via a more favorable setting of the effective date of the registration statement when they are sued under Section 11; by contrast, underwriters get the more stringent time of sale date. The impact here for both issuers and underwriters arises mainly in shelf offerings, where takedown and sales occur in an abbreviated time frame with little opportunity for “in the moment” due diligence, thereby forcing them to assume a greater liability risk.⁵⁶ The *Worldcom* case highlighted this exposure and led to multi-billion dollar settlements by the underwriters.⁵⁷

The case for a lessening of the liability risk for shelf registrations and other seasoned equity offerings largely turns on how confident one is that other accountability mechanisms in already public companies work well enough to justify such a reduction.⁵⁸ Any new Special Study agenda should include Securities Act

⁵⁵ See Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 Colum. L. Rev. 237 (2009). Jack Coffee, Larry Sonsini and Ed Greene issued a separate statement as part of the 1996 Advisory Committee Report, *supra*, raising concerns about its failure to address liability in a satisfactory fashion.

⁵⁶ This was recognized early on, with a debate quickly emerging about the efficacy of this. Compare Merritt Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 Va. L. Rev. 1005 (1984) with Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets and Shelf Registration, An Analysis of Rule 415*, 70 Va. L. Rev. 135 (1984). As a practical matter, effective due diligence in the face of a quick takedown has to be of a “continuous” sort.

⁵⁷ *In re WorldCom Inc. Sec. Litig.*, 346 F. Supp.2d 628 (S.D.N.Y. 2004).

⁵⁸ E.g., Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 Law & Contemp. Probs. 45 (2000).

liability issues as part of a broader inquiry into adequacy of regulation when the issuer is transacting in its own securities.⁵⁹ We return to the adequacy of the Exchange Act disclosure apparatus and proposals for improvement in Part V.

B. Debt and Securitization

It is probably a fair point that financial regulation as a discipline failed to address in a timely fashion the issues surrounding the dramatic leveraging of the American economy—corporate, commercial and consumer—that began in earnest in the 1980s, enabled by technological change and marketplace innovation. Major changes occurred in the debt markets, both long term and (especially) short: high-yield bonds, commercial paper, medium-term notes, repos, etc. Meanwhile, shifting economic incentives of various sorts⁶⁰ pushed companies to take advantage of this innovation and leverage all the more, taking on more risk, especially in the financial sector. A significant portion of innovation in debt financing occurred via securitization: the packaging of loans, mortgages and receivables, with sales of interests therein to a largely institutional marketplace. The route to the global financial crisis is by now an

⁵⁹ Some would suggest that issuer *repurchases* be given more regulatory attention as having comparable conflicts of interest. See Jesse Fried, *Insider Trading via the Corporation*, 164 U. Pa. L. Rev. 801 (2014).

⁶⁰ These included corporate governance pressures by institutional investors, the explosion of hostile corporate takeovers and leveraged-buyouts, and equity-based executive compensation.

oft-told and increasingly well-understood regulatory story, enabled by derivative instruments of many sorts.⁶¹

Only some of these debt and securitization transactions were registered public offerings, and so we are jumping ahead a bit here.⁶² But any new Special Study surely must pay attention to the debt markets, as individual investments and, through correlations among debt instruments throughout the real economy, systemic risk. Here, two subjects are important candidates for study. Some of the relative regulatory indifference to debt offerings was on the assumption that credit ratings were an adequate substitute for individual investor due diligence and the disclosure necessary for such diligence. The incentives to and quality of credit ratings became an issue at the turn of the last century, and became an obsession in the financial crisis and its regulatory aftermath as credit rating agencies profitably expanded the scope of the kinds of financial instruments they were willing (anxious) to rate. In turn, the Dodd-Frank Act addressed the issue through an incoherent set of reforms—mainly a mix of lessened reliance on ratings via regulatory mandate and enhanced oversight and accountability (plus recent high-dollar settlements with the major credit rating agencies). A large literature on credit rating reform in both law and economics in the last decade is largely doubtful that a stable, efficient and sustainable regulatory

⁶¹ E.g., DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS UNINTENDED CONSEQUENCES* (2011); ERIK GERDING, *LAW, BUBBLES AND FINANCIAL REGULATION* (2013); CLAIRE HILL & RICHARD PAINTER, *BETTER BANKERS, BETTER BANKS* (2015).

⁶² On the fuzzy line between securities and non-securities in the debt markets that is one part of this overlooked story, see Elizabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 *J. Corp. L.* 725 (2014).

solution has yet been found.⁶³ Arguably, for all its imperfections, the existing system of credit ratings works well enough for *common* forms of debt that there was something of an overreaction here.⁶⁴

Securitization has a similar story-line. Again, most securitization transactions were privately offered, but registered offerings—now the subject of Reg AB, upgraded as a result of Dodd-Frank—are not trivial. A number of commentators have suggested that in this context, orthodox disclosure strategies reach the end of usefulness: many financial products are “too complex to depict,” as Henry Hu writes.⁶⁵ Legal academics have urged two possible directions. On one hand, perhaps there should be mandatory simplification, with government pre-approval for complex add-ons.⁶⁶ This is surely costly, and whether a bureaucracy can do this job well under all economic (and political) conditions is disputable. An alternative, which Hu and others espouse, is greater reliance on open source access to the complex, granular mix of portfolio data and to some extent, the issuer’s code as well. This would be a massive project, albeit already begun on a much smaller scale as one

⁶³ E.g., Robert Rhee, *On Duopoly and Compensation Games in the Credit Rating Industry*, 108 Nw. U. L. Rev. (2013); Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform*, in CLAIRE HILL & BRETT MCDONNELL, EDS., RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (2012); Yair Listokin & Benjamin Taibleson, *If You Mis-rate then You Lose: Improving Credit Rating Accuracy through Incentive Compensation*, 27 Yale J. Reg. 91 (2010).

⁶⁴ In his commentary, Bill Williams rightly noted that given the many debt financing alternatives issuers have (see also De Fontenay, *supra*), overregulation of publicly offered debt has the potential to distort these choices in inefficient ways.

⁶⁵ Henry T.C. Hu, *Too Complex to Depict? Innovation, “Pure Information,” and the SEC Disclosure Paradigm*, 90 Tex. L. Rev. 1601 (2012); Henry T.C. Hu, *Disclosure, Universes and Modes of Information: Banks, Innovation and Divergent Regulatory Quests*, 31 Yale J. Reg. 565 (2014).

⁶⁶ E.g., Eric A. Posner & E. Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets*, 107 Nw. U. L. Rev. 1307 (2015).

rulemaking reform within Dodd-Frank.⁶⁷ Proponents claim that this open access approach might be useful beyond securitization, extending to any issuer whose balance sheet (and off-balance sheet) assets and liabilities is largely a bundle of hard-to-value financial instruments, e.g., banking institutions. Here, of course, we are edging out of the domain of private corporate finance toward the very different safety-stability norms of prudential regulation.⁶⁸

III. EXEMPT CAPITAL RAISING

We started with registered public offerings because that is how the Securities Act is structured: offerings of securities using the facilities of interstate commerce must be registered unless an exemption is available. But that is backwards from a functional perspective: nearly all issuers who engage in real economic activity raise their initial rounds of capital in the private marketplace and only later (if ever) grow to the stage where an IPO is feasible.⁶⁹ This statutory presumption is probably unfortunate, though historically understandable given capital-raising practices in the 1930s. Today, private financing dominates the IPO for smaller and start-up issuers,⁷⁰ such that the IPO is a graduation exercise for those who wish to go public and a

⁶⁷ Sec. Act Rel. 9638, Sept. 4, 2014.

⁶⁸ See Hu, *Disclosure Universes*, *supra*.

⁶⁹ On the many legal preconditions to successful entrepreneurship, see D. Gordon Smith & Darian Ibrahim, *Law and Entrepreneurial Opportunities*, 98 *Cornell L. Rev.* 1533 (2013).

⁷⁰ See SCOTT BAUGUESS ET AL., *CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS 2009-2014* (2015), available at <https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf>.

reward for successful product or service innovation, not the antecedent. The JOBS Act (and subsequent, continuing reform efforts) recognizes the importance of this private space. Although the on-ramp for emerging growth company IPOs is important, the political headline was a series of liberalizations for exempt financing.⁷¹

In this, we confront what is probably the most conceptually interesting subject in securities law, crucial to any new Special Study: is it possible—indeed desirable—that a large segment of economically important firms in the American economy stay private, perhaps indefinitely, yet with easy access to large amounts of capital? If so, what would the consequences be for investors, the public markets, and society generally? And what ring fence, precisely, can or should separate the private from the public?

A. Conventional Start-Up Financing

The earliest stages of entrepreneurial capital-raising tend to be informal—friends, family and the promoters’ own credit cards—and poorly situated within the framework of the Securities Act because of the statutory fixation on the public offering. The statutory exemptions address such early stage financing indirectly.

⁷¹ For a balanced assessment, see James D. Cox, *Who Can’t Raise Capital?: The Scylla and Charybdis of Capital Formation*, 102 Ky. L.J. 1 (2013-14). Though outside the scope of this high level overview, certain other hybrid transactions—e.g., confidentially marketed public offerings, PIPE offerings, reverse mergers—straddle the public-private boundary and add to its blurry character. See Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 Cornell L. Rev. 1573, 1588-1604 (2013).

There is an exemption for truly intrastate offerings (and an exclusion from Section 5's registration requirement for those not using the facilities of interstate commerce), which may offer cover to these first steps. There is also an exemption for non-public offerings, which early stage offerings may (or may not) turn out to be, for reasons we are about to see. And ever since the late 1930s there have been rule-based exemptions, never very generous at least until very recently.

The intrastate offering exemption (Section 3(a)(11) and Rules 147 and 147A) has never been central from a policy-standpoint, though it received a boost recently from the SEC.⁷² While it has constitutional origins from a time of doubt about Congress' Commerce Clause power, this exemption only makes conceptual sense today as a delegation to state securities administrators to handle transactions wholly or mainly within their jurisdiction. There is a larger issue worthy of study about how much value state blue sky laws add via registration of securities (as opposed to empowering local law enforcers), especially because many carry the legacy of the "merit regulation" that federal securities law disavowed in 1933.⁷³ That lively debate carries over to a number of other exemptions, and has the attention of the SEC and Congress.

More central to the regulatory story is Section 4(a)(2), for non-public offerings. Congress' failure to define non-public was a striking omission, leaving to the SEC and the courts to work out the borderline between private and public

⁷² *Exemptions to Facilitate Intrastate and Regional Securities Offerings*, Sec. Act Rel. 10238, Oct. 26, 2016.

⁷³ See Rutheford B. Campbell, Jr., *The Role of Blue Sky Laws after NSMIA and the JOBS Act*, 66 Duke L.J. 605 (2016); Cox, *Scylla*, supra.

offerings. Famously, useful guidance was long in coming, undermined by the Supreme Court’s question-begging suggestion that an offering is private only when the offerees do not need the disclosure and other protections of a registered offering, i.e., can “fend for themselves.”⁷⁴ Beyond the classic private placement involving a sophisticated financial institution, or offerings to senior company insiders, navigating this territory was risky for any start-up or small business.

After fits and starts, greater clarity was eventually achieved in the early 1980s, with the SEC’s adoption of Regulation D. It offered three safe harbors for making a federally unregistered offering (the middle one of which was recently repealed). One, Rule 504, was for small offerings of no more than what is now \$5 million (\$1 million for most of its duration), with only minimal additional conditions so long as the offering is registered in at least one state. As with the intrastate exemption, with which it has long been closely coordinated, this is more a form of regulatory delegation to state blue sky regulation than an expression of substantive policy of how very small offerings should be handled.

Most important—then and now—was the Rule 506 safe harbor,⁷⁵ which has no cap on how much can be raised. Rule 506 was designed around the relatively

⁷⁴ SEC v. Ralston Purina Co., 346 U.S. 119 (1953). On the subsequent uncertainties, see JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 254-64 (8th ed. 2016). The SEC rulemaking arguably calls for a new understanding of 4(a)(2) in light of the more modern principles expressed therein. See ABA Committee on the Federal Regulation of Securities, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report*, 66 Bus. Law. 85 (2010). *Ralston Purina* involved sales of securities to employees of the issuer, which later emerged as a distinct topic of interest. For non-public companies issuing stock and options for compensatory purposes as opposed to capital-raising, there is now an explicit exemption in Rule 701, with numerous conditions.

⁷⁵ On the relative use of Rule 506 vis-à-vis other exemptions, see BAUGUËSS ET AL., *supra*.

new construct of the “accredited investor,” defined to include a variety of institutional investors plus natural persons (and members of their household) earning more than \$200,000 a year (\$300,000 with spouse) or having net assets in excess of \$1 million—figures that have not changed in the thirty-five years since adoption.⁷⁶ Rule 506 imposes a disclosure requirement if—but only if—there are non-accredited purchasers; it also requires that there be no more than thirty-five non-accredited investors and that these purchasers be “sophisticated” or represented by someone who is. Because of the added burdens of including non-accredited investors, common practice became to make offerings to accredited investors only. The main limitation with respect to Rule 506 was a prohibition on general solicitations that effectively forbade widespread marketing or advertising in search of investors, instead demanding some form of pre-existing relationship that made the use of broker-dealers as placement agents a de facto requirement for any significant outreach. While Reg D was a sea-change in the private offering process, small business and start-up advocates were frustrated by many of the lingering conditions for the exemption, particularly the general solicitation ban.⁷⁷

The JOBS Act put all of this in play. Within the Reg D framework, the most notable statutory change was the repeal of the ban on general solicitation for offerings sold only to accredited investors, subject to an arguably heightened

⁷⁶ There was a change as a result of the Dodd-Frank Act to exclude the value of the investor’s principal residence from the calculation of net worth.

⁷⁷ See Stuart Cohn & George Yadley, *Capital Offense: The SEC’s Continuing Failure to Address Small Business Financing Concerns*, 4 NYU J. L. & Bus. 1 (2007). The SEC did occasionally make issuer-friendly reforms, including the introduction of a “substantial compliance” defense for inadvertent violations in 1989.

obligation to reasonably verify purchaser status (new Rule 506(c)). Issuers remain free to use the older form of the exemption if they wish (now Rule 506(b)),⁷⁸ and early data indicated an inclination to stick to those more familiar practices.⁷⁹

To most legal commentators, the ban on general solicitation never made all that much sense in the first place assuming the ability of accredited investors to fend for themselves, such that its repeal seemed logical, if not welcomed.⁸⁰ To be sure, there was substantial debate about whether that assumption is correct in the first place, and whether the now long-unchanged metric for accredited investor status was still sound.⁸¹ More aggressive marketing under Rule 506(c) would certainly test those questions.

The issues here are worthy of close study.⁸² Disclosure in a private offering made solely to accredited investors is a matter of private bargaining, leading to two

⁷⁸ Rule 506(b) insists on the issuer's reasonable belief as to accredited investor status.

⁷⁹ Verification in 506(c) offerings is controversial because many potential investors may not be comfortable providing the information (tax returns, bank account statements, etc.) necessary to make such a determination to issuers and their marketing agents. The SEC offered guidance on how verification can occur within the framework of the rule, including a non-exclusive safe harbor for certain practices.

⁸⁰ The ban appeared to many to be rent seeking by placement agents and other brokers, imposing extra costs on issuers. See William Sjostrom, *Direct Private Placements*, 102 Ky. L.J. 1 (2013-14).

⁸¹ See Jennifer Johnson, *Fleeing Grandma: A Regulatory Ponzi Scheme*, 16 Lewis & Clark L. Rev. 993 (2012).

⁸² Private equity investments are indirectly available to lower-income public investors via any number of publicly offered or traded intermediaries that, in turn, manage investments or themselves make private investments in portfolio companies. See Steven Davidoff Solomon, *Black Market Capital*, 2008 Colum. Bus. L. Rev. 172. For a useful survey, see Sun Eun (Summer) Kim, *Typology of Public-Private Equity*, Fla. St. L. Rev. (forthcoming, 2017). This complication is an important part of the public-private topology, but does not directly affect the question of the public versus private status of the portfolio company.

concerns. One, of course, is whether accredited offerees are likely to bargain well.⁸³ The other is that even if savvy bargaining occurs at the time of sale it may not produce a socially optimal level of publicly available information to support an efficient allocation of start-up capital.

The dominance of Rule 506 offerings in the private investment space means that the primary offering space remains quite opaque.⁸⁴ Although Form D allows for the collection of certain basic information about exempt offerings by private issuers, it does not provide—nor are there reliable alternative sources for—data that allows us to assess confidently how much risk and return there is for investors.⁸⁵ Perhaps, as some suggest, private investments are a source of value in an appropriately diversified portfolio, such that greater access to this marketplace is warranted.⁸⁶ Or perhaps it truly is dangerous. We simply don't know enough. Glimpses of the market for alternative-style investments (including some common ones sold via face-to-face marketing) indicate substantial segmentation among investor-types, which is what may also be happening in Rule 506 offerings. Plenty of savvy investors,

⁸³ There is a large body of research today—in the laboratory and in the field—demonstrating flaws and biases in investor decision-making, including among the well-to-do. See LANGEVOORT, *SELLING HOPE*, supra, at 15-17, 114-35. It is possible, of course, that wealth-based tests are not predictions that such people will bargain well, but a normative assessment that they should be expected to, and presumably can bear the risk of not doing so.

⁸⁴ See Jennifer Johnson, *Private Placements: A Regulatory Black Hole*, 35 Del. J. Corp. L. 151 (2010).

⁸⁵ There is sufficient transparency of the over-the-counter secondary trading markets for small issuers to draw an inference that the risk to investors is considerable with respect to thinly-traded stocks. See Joshua White, *Outcomes of Investing in OTC Stocks*, Dec. 16, 2016, available at <https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf>.

⁸⁶ See Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 Ford. L. Rev. 3389 (2013)(advocating greater, if indirect, retail investor participation in private offerings); on indirect participation, see note 82 supra.

institutional and individual, do fend for themselves and demand credibility. They seek out reputable brokers and placement agents, who cater to that high-end niche, and get high-quality disclosure from those better issuers anxious to distinguish themselves from the lemons. As such, their returns are appropriate on a risk-adjusted basis. But because investors vary in their savvy and endowments, the market segments in such a way that, further toward the bottom, salesmanship dominates and returns are poorer.⁸⁷ Again, we lack the information to test this thoroughly or estimate the extent of segmentation and the degree of risk in the lower reaches.

The regulatory eclipse here is not total, of course—there is some policing by the SEC, FINRA and/or the states, especially when brokers and investment advisers are involved.⁸⁸ But without more transparency, we can't assess the adequacy of that presence, and few think it anywhere near enough. An effort by FINRA (which requires the filing of sales and marketing materials) to create more accountability and shed more light on broker sales practices in private offerings was scaled back under political pressure, but did increase oversight to an extent.⁸⁹ Nor should we dwell entirely on the investor risk side of the argument. Start-up financing is crucial to innovation, and it is not unreasonable to trade off some investor protection at the

⁸⁷ Matthew Cain et al., *Intermediation in Private Equity: The Role of Placement Agents*, working paper, Sept. 2016, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2586273. Similar segmentation (and rewards to sales pressure) has been observed with respect to PIPE offerings, reverse mergers and broker-sold mutual funds.

⁸⁸ Rule 506 offerings (and Reg A offerings, discussed *infra*) are not available to those “statutorily disqualified” by some bad act or status. On the issues raised by statutory disqualifications and their frequent waiver by the SEC, see Urska Velikonja, *Waiving Disqualification: When Do Securities Violators Receive a Reprieve?*, 103 Cal. L. Rev. 1081 (2015).

⁸⁹ See Jennifer Johnson, *Private Placements: Will FINRA Sink the Sea Change?*, 82 U. Cinn. L. Rev. 465 (2013).

margins for ease of capital formation for small businesses that simply cannot afford heavy costs. But at present, this is policy-making largely in the dark.

These issues are compelling enough, but their significance is compounded going forward. Once again, keep in mind that Rule 506(c) invites a substantial step-up in the tactics that sellers can use to go bottom fishing among the well-off, including older investors.⁹⁰ If the test for accredited investor remains static, gradually the substantial majority of active investors will be accredited. Combine that with the never-ceasing institutionalization of the markets and the potential for private offerings to become an acceptable source of equity and debt capital for issuers of all sizes and stages of growth. Because this issue requires assumptions about resales and liquidity—the subjects of the next two sections—we will defer further discussion of what Merritt Fox terms the “brave experiment”⁹¹ of the new Rule 506 environment to then. But for now, we can say at the very least that a far better mapping of the private offering terrain is a pressing task for a new Special Study.

B. Crowdfunding

In the mainstream media, the headline of the JOBS Act was crowdfunding, a new exemption—which went into effect in mid-2016—to make certain smaller

⁹⁰ See Johnson, *Fleecing*, *supra* (examining a multi-billion dollar MedCap fraud aimed heavily at accredited but vulnerable investors).

⁹¹ Fox, *Public Offerings*, *supra*, at 721.

capital raising transactions (capped at \$1 million) widely available to investors of all levels of wealth and sophistication on web portals, via an exemption from both federal and state registration requirements. The theory was that mandatory disclosure could be sacrificed to the “wisdom of crowds” to choose early-stage investment projects to fund, with limits on what portion of their wealth or income a given investor could bet on such ventures.⁹² In a political compromise, however, the JOBS Act in the end contained additional layers of regulation, including issuer and portal disclosure requirements, marketing restrictions and civil liability. A common assessment is that the compromise made crowdfunding unattractive,⁹³ regardless of SEC considerable efforts to build a robust regime within those limits. It is too early to tell, although a survey of the earliest crowdfunding offerings shows a fairly sophisticated willingness by portal sponsors to offer templates and other off-the-rack options to make this particular fundraising tool more attractive to issuers and investors.⁹⁴ And it may well be that Congress revisits the regulation in the name of easing burdens; some states have already offered more generous state level crowdfunding plans that take advantage of Securities Act exemptions noted earlier.⁹⁵

⁹² For those with annual income or net worth less than \$100,000, the aggregate amount sold to the purchaser in a twelve month period cannot exceed the greater of \$2000 or 5% of annual income or net worth. With the removal of the ban on general solicitations under Rule 506(c), it is possible to use crowdfunding techniques directed entirely at accredited investors.

⁹³ Joan Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions and Inexpert Judgment that Begs for a Happy Ending*, 102 Ky. L.J. 865 (2013-14).

⁹⁴ Exempt or not from the securities laws, crowdfunding also poses challenging corporate law questions, involving voting rights (if any), the ability to sue for breach of fiduciary duty, etc. On solutions proposed by portal sponsors, see Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 Va. L. & Bus. Rev. (forthcoming, 2017).

⁹⁵ See Matthew Pei, *Intrastate Crowdfunding*, 2014 Colum. Bus. L. Rev. 854.

There is a considerable legal literature on crowdfunding, starkly split between pro and con.⁹⁶ Non-investment crowdsourcing has a mixed record, with some evidence that crowds can be relatively good at funding taste-oriented projects like music and food ventures.⁹⁷ How well this is likely to extend to sophisticated technology ventures is less clear, since a promoter cannot afford to reveal much about the project to attract funding because of the risk that the best ideas will be snatched away. However, one positive feature of crowdfunding vis-à-vis private offerings is the level of transparency: projects are publicly visible from inception to after the funding rounds, generating information and accountability that may mitigate some of the risk and educate potential investors tempted to join in the buzz. Regulators can watch. Beyond that, however, the adverse selection problem looms large, and crowdfunding comes to look much like gambling.⁹⁸

C. Regulation A

The SEC has long had authority to deregulate smaller offerings even if they were public offerings, and by the time of the first Special Study, it had developed a

⁹⁶ E.g., Darian Ibrham, *Equity Crowdfunding: A Market for Lemons?*, 100 Minn. L. Rev. 561 (2015); Jason Parsont, *Crowdfunding: The Real and Illusory Exemption*, 4 Harv. Bus. L. Rev. 281 (2014); Andrew Schwartz, *Crowdfunding Securities*, 88 Notre Dame L. Rev. 1457 (2013); Heminway, *supra*; Thompson & Langevoort, *supra*, at 1604-08. On the ideological discord, see LANGEVOORT, *SELLING HOPE*, *supra*, at 127-31.

⁹⁷ It also has an appealing inclusiveness to it, as to geography, gender and racial diversity and other opportunities heretofore blocked to certain entrepreneurs. See Andrew Schwartz, *Inclusive Crowdfunding*, 2016 Utah L. Rev. 661, 671-74.

⁹⁸ See Fox, *Public Offerings*, *supra*, at 726 (noting the similarities and suggesting that the experience of crowdfunding may be enough reward to overcome low expected returns).

stepped-down system for very small offerings. Under Regulation A, a small offering by a non-public issuer would be exempt so long as it followed rules much like—but simpler—than those found in registered ones. That is, there would be less intense SEC review, selling restrictions and liability risk. Most notably, there was no issuer strict liability, as there is in Section 11.⁹⁹ Once Reg D was available, especially, Reg A was little-used. The SEC gave it a boost in 1992 by allowing “test-the-waters” solicitations of the sort that were barred in IPOs and most of Reg D, thereby letting issuers get early feedback on whether the offering was feasible. But the cap (\$5 million) still made the exemption a doubtful trade-off given all the other regulatory conditions and concurrent state blue sky registration with which to contend.

The JOBS Act makes a considerable change by raising the cap for Reg A offerings to \$50 million. The SEC implementing rules went into effect in 2015, creating two alternative offering tiers. Tier 1 offerings are capped at \$20 million, and can be made to an unlimited number of investors without any accreditation requirements. State blue sky registration remains. Tier 2 offerings can go to the full \$50 million, with blue sky registration preempted. The price of graduation to Tier 2 is that unaccredited investors can purchase the securities only up to certain portion of their wealth or income,¹⁰⁰ somewhat like the crowdfunding rules. Congress also added an explicit civil liability provision, drawn from Section 12(a)(2)’s negligence-based cause of action.

⁹⁹ Section 11 only creates a right of action with respect to false registrations statements that have become effective. Reg A is an exemption from registration, and the relevant filing is an offering statement.

¹⁰⁰ No more than 10% of the greater of annual income or net worth over a twelve-month period.

A fair characterization of the new Reg A regime is “public offering lite” rather than the pass from registration of the sort we see in Rule 506 or even crowdfunding.¹⁰¹ From a regulatory perspective, presumably, it is now the regulatory route of choice for smaller public offerings. The package of information is smaller, to be sure, but not skeletal, again keeping in mind the obligation of the issuer to volunteer additional material information necessary to make statements made not misleading. From the investor’s perspective, the question is whether the combination of diminished information and the loss of issuer strict liability leaves too much to chance. From the issuer’s perspective, the question is whether the significant regulatory costs associated with mini-registration makes this a desirable alternative to a less transparent private offering.

IV. REALES UNDER THE SECURITIES ACT

The drafters of the Securities Act understood that public offerings were commonly conducted by having the issuer sell the securities to underwriters, who in turn sell (at a markup) to the allotted investors, with resales into the aftermarket. Because of the sensitive conduit role they play, underwriters are heavily regulated and face potentially painful liability under Section 11 absent a sufficient showing of

¹⁰¹ See Thompson & Langevoort, *supra*, at 1608. Not all are impressed, with many arguing that the SEC did not do enough liberalization. See Rutheford B. Campbell, Jr., *The SEC’s Regulation A+: Small Business Goes under the Bus Again*, 102 Ky. L.J. 325 (2013-14). On the other hand, two states sued the SEC for overreaching, especially in granting the blue sky preemption in Tier 2. See *Lindeen v. SEC*, 825 F.3d 646 (D.C. Cir. 2016)(rejecting claim).

due diligence. For registered public offerings, the resale problem is assumed away: the strictures of the Securities Act end, essentially, when the sales pressure of the offering has dissipated.¹⁰² By that time, public company obligations under the Exchange Act have already taken hold, so that the transition is simply from one disclosure-based regime to another.

The definition of underwriter that the drafters created in Section 2(a)(11), however, was put to more use than this, generating some of the most vexing conceptual problems in all Securities Act jurisprudence.¹⁰³ With respect to exempt offerings, what if a fully qualified “fend for yourself” purchaser quickly turns around—perhaps by design—and aggressively resells to others who do need protection? It was soon understood that securities issued in private offerings should “come to rest” in the hands of qualified purchasers, with some combination of investment intent and holding period determining if, how and when resales could occur freely. That mandatory lock-up diminished liquidity, creating a costly downside to raising capital via a private offering. In the early 1970s, the SEC adopted Rule 144 to specify the necessary holding period and methods of resale; in subsequent years these holding periods were repeatedly shortened so that today, for private issuers, the lock-up is a simple one year term, with free resales thereafter.¹⁰⁴

There is no guarantee that Exchange Act registration kicks in at that point or ever—

¹⁰² Issuer and underwriter manipulation concerns during the offering period are addressed comprehensively in Regulation M. See note 37 *supra*.

¹⁰³ See COX ET AL., *supra*, chap. 6.

¹⁰⁴ Rule 144 also addresses resales by “control persons” (affiliates) of the issuer, which may pose issues comparable to the issuer’s own public offering. There are additional “dribble out” requirements here, beyond any holding period arising from a private offering.

that is a matter of the trading venue for the resales and the Section 12(g) metrics for public company status by virtue of size, to which we turn shortly.¹⁰⁵

So far as the Securities Act is concerned, an important question is whether any restriction is necessary if the resale is to those deemed able to fend for themselves. Practitioners and regulators came to an understanding—without explicit textual support in the statute—that such resales could occur (the so-called 4(1½)) exemption, but left the outer limits of that de facto exemption fuzzy. One obvious question was whether any accredited investor should be deemed so qualified. In Rule 144A, the SEC implicitly said no. That safe harbor was designated as a free resale space for large institutional investors (QIBs) only. Why? The reasons were a mix of legal, political and pragmatic.¹⁰⁶ The legal conundrum was that “fending for oneself” was thought to be about both investment sophistication *and* access to information. A second-level purchaser, much less one further down the line, would not necessarily have the ability to extract from the issuer the desired level of current information. That would have to come via either regulation (as, minimally, in 144A) or private contractual covenant, which raises its own set of monitoring and enforcement problems once investor capital is paid-in. If the socially optimal quantity and quality of issuer disclosure are higher than what parties would bargain for privately, the contractual solution is incomplete anyway.

¹⁰⁵ To address this, Rule 15c2-11 requires brokers providing liquidity in the over-the-counter market to have a certain quantity of information in their possession. Brokers also have a self-regulatory obligation to “know your security” before making any recommendation.

¹⁰⁶ See Donald C. Langevoort, *The SEC, Retail Investors and the Institutionalization of the Securities Markets*, 95 Va. L. Rev. 1025 (2009); Langevoort & Thompson, *supra*, at 362-65.

But the question is tantalizing, because to those troubled by the potential for regulatory overreach, the image of large-scale private financing with a high level of resale liquidity but none of the burdens of regulatory “publicness” is something of a nirvana.¹⁰⁷ Getting to that nirvana—or avoiding that terrifying void, depending on one’s perspective—is as much a matter of Exchange Act law as Securities Act law, but both pieces are crucial. Thus the importance of the 2015 statutory reform found in the FAST Act, which creates a new Securities Act exemption (4(a)(7)) for resales to accredited investors, so long as there are no special selling efforts that would constitute a general solicitation. This invites the building of accredited-only resale markets that could very easily produce a great deal of liquidity and make private financing of the sort suggested earlier a viable permanent solution for issuers averse to heavy regulation. That is the brave experiment to which Merritt Fox was referring.¹⁰⁸

¹⁰⁷ Adam Pritchard has advocated abolition of the IPO in favor of requiring emerging issuers to be “seasoned” in the private marketplace before graduating to the public. See A.C. Pritchard, *Revisiting “Truth in Securities Revisited:” Abolishing IPOs and Harnessing Private Markets for Public Good*, 36 Seattle L. Rev. 999 (2013). This is somewhat akin to the current policy to reverse mergers, which had been a vibrant backdoor method for issuers (domestic and foreign) to access the public marketplace, particularly Nasdaq. See Thompson & Langevoort, *supra*, at 1596-98.

¹⁰⁸ Various aspects of this subject have garnered a great deal of attention from legal academics in the last few years, with attention to the law, economics and politics. In addition to articles cited earlier, see Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 Cardozo L. Rev. 531 (2012); Darian Ibrahim, *The New Exit in Venture Capital*, 65 Vand. L. Rev. 1 (2012); Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. Pa. L. Rev. 179 (2012); Zachary Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. Rev. 745 (2013); Michael Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 Ind. L.J. 151 (2013); Usha Rodrigues, *The Once and Future Irrelevancy of Section 12(g)*, 2015 U. Ill. L. Rev. 1529 (2015); Elizabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 Hastings L.J. 101 (2017).

V. SECONDARY TRADING AND THE SECURITIES EXCHANGE ACT

As noted at the outset, a legal survey focused on primary capital-raising might be expected to stop at the outer limits of the Securities Act. But it cannot, either conceptually or legally. Conceptually, liquidity affects the cost of capital, and liquidity depends on forward-looking confidence in the integrity of both corporate governance and the secondary trading marketplace. Legally, as we have seen, the Exchange Act plays an important role within the registered public offering, via integration and incorporation by reference in seasoned offerings and the seamless handoff from one statute to the other that usually occurs after a few weeks of post-effective constraints, even in an IPO.

But Exchange Act regulation of public companies is by itself a massive subject that could take us far afield in search of topics for a new Special Study, so that we will have to be even more selective in our attention here. Among other things, this encompasses the content of periodic and continuous reporting via 10-Ks, 10-Qs and 8-Ks, including the optimal frequency of required disclosure, the uneasy line between forward and backward-looking information, scaled-back mandates for smaller issuers and the emergence of social and sustainability-oriented disclosure.¹⁰⁹ It also includes the structural mechanisms and abundance of assigned tasks that have been imposed to generate higher quality disclosure, many of which are products of

¹⁰⁹ All this is currently under review. See note 15 *supra*; Roberta Karmel, *Disclosure Reform—The SEC Is Riding Off in Two Directions at Once*, 71 *Bus. Law.* 781 (2016).

the Sarbanes-Oxley Act, such as stepped-up auditor and audit committee regulation, internal controls, executive certifications, whistleblowing and the like.¹¹⁰

The threshold legal standard for public company status under the Exchange Act is in three parts.¹¹¹ A company that makes a registered public offering under the Securities Act becomes one for that reason alone, guaranteeing the handoff described above.¹¹² So does a company that is listed on a national securities exchange, whether or not associated with a public offering. By contrast, however, there are many trading venues that are not designated as national securities exchanges. That leaves the third pathway found in Section 12(g), based on issuer size. After the JOBS Act, there is now an awkward standard by which the issuer must register if it has sufficient assets (\$10 million) and shareholders of record (2000, no more than 500 of which can be non-accredited investors). As many have stressed, shareholder of record is archaic and dysfunctional as a test, presumably left in place as a political

¹¹⁰ See John Coates IV & Suri Srinivasan, *SOX after Ten Years: A Multidisciplinary Analysis*, 28 *Acct'g Horizons* 627 (2014). There is much more to that portion of Exchange Act regulation assigned to the Division of Corporation Finance that we are not touching on here, including proxy regulation, large shareholder reporting, tender offers, and statutory insider trading regulation.

¹¹¹ The Exchange Act actually uses multiple trigger points for various sorts of regulation. Public company status pursuant to Sections 12(b) and 12(g) predominates, but some regulation depends on listed-company status (directly or through listing standards affected by regulatory mandate). The antifraud provisions apply to all companies, public and private—indeed to all persons. There is also “voluntary filer” status, with a variety of regulatory effects. See Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-Private Decisions*, 76 *U. Chi. L. Rev.* 7 (2009)(observing incidence of contractual commitments made by private companies to make SEC disclosures).

¹¹² There are mechanisms for exit from public company status (“going dark”) but not necessarily easy to achieve. See Edward Rock, *Securities Regulation as a Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 *Cardozo L. Rev.* 675 (2002).

matter precisely because of its plasticity. Currently, 12(g) is not a particularly stable expression of any coherent policy.¹¹³

Of all the many questions that could usefully be covered in a new Special Study, four seem especially important:

A. Public v. Private

The express lane toward large-scale privatization of corporate finance would be paved by the combination of (1) a continued flourishing and robust primary capital marketplace under Section 4(a)(2) and other exemptions (particularly Rule 506) and (2) a liquid secondary trading market for qualified investors largely free of regulatory burdens on issuers as a result of either the Securities Act or the Exchange Act.¹¹⁴ Of course, nothing makes this combination inevitable, or even likely. Elsewhere I have written about the political economy of this move and the reticence of the SEC to anything that could threaten the public capital marketplace, the protection of which is the Commission's core mission.¹¹⁵ But as the JOBS and

¹¹³ See Rodrigues, *supra*; Langevoort & Thompson, *Publicness*, *supra*, at 355-61. An SEC staff report offered very little determinate guidance as to when 12(g) applies or not to corporations with more than the requisite number of beneficial owners with shareholder-like stakes. See *Report on Authority to Enforce Exchange Act Rule 12g5-1 and Subsection (b)(3)*, Oct. 15, 2012.

¹¹⁴ Trading venues like Second Market and SharesPost emerged to facilitate qualified resales of larger non-public companies like Facebook. E.g., Pollman, *supra*. In contrast, OTC Markets Group operates a variety of trading venues encompassing some 10,000 securities (OTCQX, OTCQB and Pink) for resales of the securities of smaller private and public issuers, with varying disclosure obligations. On investor risk in the OTC markets, see note 85 *supra*.

¹¹⁵ See Langevoort, *Retail Investors*, *supra*, at 1065-70; for doubts that this is so, see Gubler, *supra*.

FAST Acts show, the matter is not entirely within its administrative discretion.¹¹⁶ Even without regulatory reform, there are signs of growing privatization under the status quo, as sequential private equity arrangements sustain successful start-ups for longer and longer. And there are powerful normative arguments that private equity is the preferable source of capital for “new economy” firms that need the privacy and governance flexibility to be nimble and more consistently innovative.¹¹⁷

On the other hand, issuers might hesitate to reject public company status even if the private capital markets offer a sufficiently deep, liquid and deregulated alternative. Perhaps valuable status or branding effects follow from public trading.¹¹⁸ If public markets continue to become frothy in cycles, there will always be a temptation to exploit noise trader exuberance by going public at an opportune time. We need not predict the future, however, but simply conclude there that this is an immensely promising and important subject for further study along with the better mapping of the private finance terrain suggested earlier. Enough has occurred in this direction to offer data points and invite digging into what has already happened more deeply. Three topics seem particularly crucial.

One is the efficacy of private ordering, which many scholars have advocated as a superior alternative to bureaucratically-imposed disclosure and governance

¹¹⁶ Pending legislation in Congress embraces this reform goal.

¹¹⁷ See Zimmerman, *supra*. This is a theme in the “eclipse of the public corporation” genre stimulated many years ago by Peter Drucker and Michael Jensen. See Roger L. Martin, *The Public Corporation is Finally in Eclipse*, Harv. Bus. Rev., April 2014.

¹¹⁸ See Victor Fleischer, *Brand New Deal: The Branding Effects of Corporate Deal Structures*, 104 Mich. L. Rev. 1581 (2006). Public trading might also be important in using issuer stock as an acquisition currency or for large scale compensation grants.

mandates. How well do private capital markets meet informational needs so as to overcome adverse selection when there is a minimalist regulatory infrastructure and only fraud-based liability for enforcement?¹¹⁹ If we gain confidence that there are satisfactory answers, prices in the private secondary markets might be reliable enough to sustain liquidity.¹²⁰

Conversely, even if the level of disclosure is privately negotiated is there a gap here between what is disclosed and socially optimal disclosure? Many have noted that disclosure benefits a wide variety of economic actors—for example, disclosure about information inside Company X can make both product and capital markets more efficient via the spillover effects on the other companies (private and public) in those same markets. Do mandatory disclosure line-items efficiently address any such gaps? It may be, for example, that robust public disclosures by other firms in a relevant market are essential to the valuation of private equity, such that without a critical mass of public information both public and private markets might devolve.¹²¹

This issue of public versus private also helps frame the increasingly heated debate over how tightly coupled SEC disclosure should be to notions of financial

¹¹⁹ See Fox, *Public Offerings*, *supra*. On how institutional investors bargain for credible disclosure, see Howell E. Jackson & Eric Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe, Part II*, 3 Va. L. & Bus. Rev. 207 (2008).

¹²⁰ For efficient private markets, there must be substantial depth of order flow, and opportunities for short-selling that keep a lid on upward demand pressures. Given the presence of substantial “noise trading” in public markets, the efficiency comparison between public and private is not obvious. As noted earlier, Adam Pritchard has called for greater reliance on accredited-investor only markets as a seasoning mechanism prior to public marketplace trading, thereby effectively abolishing IPOs.

¹²¹ See de Fontenay, *Private Capital*, *supra*.

materiality, and how much socially-optimal disclosure can veer away from the tasks of investor protection and capital formation.¹²² Currently, there are some disclosure items designed (mainly by Congress) to have primarily non-investment consequences, but legitimate ones nonetheless.¹²³ Of course, there is significant risk that these can be mainly expressive or symbolic, yet very costly. Others, like environmental matters, can readily be material but determining what should be disclosed inevitably invites into the process those whose main ends are social, not just (or for the most part) financial. The work of organizations such as the Sustainability Accounting Standards Board in connecting orthodox materiality to social and sustainability issues is entirely legitimate as an economic matter, notwithstanding the risk of normative bias. There is no clean conceptual separation, and simply declaring that the SEC must be limited to a core mission of investor protection and capital formation is probably futile as a matter of both statutory and administrative law the way the securities statutes are currently written.¹²⁴

So, any new Special Study should consider the costs and benefits of private versus public markets broadly from a social welfare perspective. (This inquiry would presumably include consideration of facilitating new hybrid or quasi-public

¹²² See, e.g., Karmel, *supra*. Particularly controversial examples include conflict mineral disclosure and political spending.

¹²³ A recent study, for example, shows that increased mine safety disclosure for coal and other affected companies reduced accidents. See Hans Christensen et al., *The Real Effects of Mandated Information on Social Responsibility in Financial Reports: Evidence from Mine Safety Records*, Jan. 2017, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2680296.

¹²⁴ See Yoon Ho (Alex) Lee, *Beyond Agency Core Mission*, 68 Admin. L. Rev. 551 (2016). On legislative text and history, see also Cynthia Williams, *The Securities and Exchange Commission and Social Responsibility*, 112 Harv. L. Rev. 1197 (1999).

markets for emerging or smaller issuers, with limited retail access or other structural protections.¹²⁵) Perhaps the outcome would lead to a more sensitive “tiering” of disclosure and governance responsibilities, with the most intensity for those firms with the biggest footprints on the financial markets and society generally.¹²⁶ To be sure, the idea of a heavily deregulated regulatory regime for all companies that elect to go dark in the new world of private capital is ideologically and normatively seductive. Others consider “publicness” a strong social value.¹²⁷ A new Special Study could usefully weigh in on this debate empirically and analytically, rather than in pursuit of some pre-determined resolution.

B. Contemporary Corporate Disclosure

A lengthy to-do list could be compiled to better understand the contemporary corporate disclosure environment. There is a strong and plausible impression that many disclosure requirements are outmoded, overly complicated or inefficient, the subject of the SEC’s statutorily-mandated Disclosure Effectiveness project.¹²⁸ (The same could be said for task overload: too many disclosure and governance-related assignments to directors, auditors and management in the aftermath of Sarbanes-

¹²⁵ There is long-standing interest in replicating specialized markets for emerging issuers along the lines of London’s Alternative Investment Market (AIM) or Brazil’s Novo Mercado.

¹²⁶ See Langevoort & Thompson, *Publicness*, supra, at 379-83; Oonig Dombalagian, *Principles for Publicness*, 67 Fla. L. Rev. 649 (2015); Jeff Schwartz, *The Law and Economics of Scaled Equity Market Regulation*, 39 J. Corp. L. 347 (2014).

¹²⁷ See note 9 supra.

¹²⁸ See note 15 supra.

Oxley and Dodd-Frank.) At the same time, new candidates for mandatory disclosure pop up continuously, especially in those related to innovation, sustainability and social responsibility, as just noted. The extraordinary institutionalization of large segments of the financial markets presumably justifies some adjustment to all this in both content and style. Unfortunately, we lack an agreed-upon methodology for confidently assessing the costs and benefits of both disclosure and accountability tools across all markets, whether in terms of investor protection, capital formation or total social welfare. Absent the ability to engage in rigorous regulatory experimentalism, both benefits and costs are too diffuse and dynamic to capture confidently,¹²⁹ which quickly shifts the argument to politics and ideology. In practice, there is considerable stubbornness to the precautionary principle¹³⁰ and the status quo in the face of all this uncertainty, costly as that may be.

Technological innovation relating to disclosure has both promise and peril. On one hand, technology counters concern about information overload, especially as artificial intelligence and algorithmic trading programs extend beyond anticipating order flow to react almost instantly to corporate news released by formal EDGAR filings or even social media.¹³¹ (XBRL and open source initiatives could enable this all the more.) All this enhances very short-term informational efficiency. Less well

¹²⁹ E.g., Jeffrey Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. Leg. Stud. S351 (2014); John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 114 Yale L.J. (2015).

¹³⁰ The precautionary principle is a thumb on the scale in favor of caution in the face of uncertainty. For a criticism, see Troy Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory, Style and Mission*, 2006 U. Ill. L. Rev. 975.

¹³¹ See Erik Gerding, *Disclosure 2.0: Can Technology Solve Overload, Complexity and Other Information Failures?*, 90 Tulane L. Rev. 1143 (2016).

understood are the incentive effects on longer-term efficiency—the returns to serious fundamental analysis—as well as the reality and perception of public access to the markets.¹³² Maybe the latter is a romantic (or political) illusion in any event, but clearly ties into the future of public markets. As New York’s highly-publicized enforcement initiatives show in making fair access to information a building block for “Insider Trading 2.0,” there is not yet any coherent assessment of how best to respond to the connections among public access, investment technology and corporate disclosure.¹³³ This is another place where a new Special Study could help, bridging concerns about corporate finance with market structure issues.

The mechanisms of market efficiency have changed over time, with an increasing recognition that information search is costly and will occur only to the extent that reasonable returns can be expected.¹³⁴ Hence, pricing imperfections are persistent, especially with respect to innovative financial products and kinds of information that evolve constantly. Here again, the question of expected returns to fundamental research becomes all the more important and contestable.¹³⁵ The role of the sell-side analyst has changed, with the diminishing returns to public advice-

¹³² See M. Todd Henderson & Kevin Haeberle, *Information Dissemination Law: The Regulation of How Market Moving Information is Revealed*, 101 Cornell L. Rev. 1373 (2016); Yesha Yadav, *How Algorithmic Trading Undermines Efficiency in Capital Markets*, 68 Vand. L. Rev. 1607 (2015).

¹³³ See Chris Brummer, *Disruptive Technology and Securities Regulation*, 81 Ford. L. Rev. 977 (2015); LANGEVOORT, *SELLING HOPE*, supra, at 82-84.

¹³⁴ Market efficiency has served as justification for deregulation over much of the last decades, perhaps excessively given the persistence of information and transaction costs as markets evolve. See Ronald Gilson & Reinier Kraakman, *Market Efficiency after the Financial Crisis: It’s Still a Matter of Information Costs*, 100 Va. L. Rev. 313 (2013); Robert P. Bartlett III, *Inefficiencies in the Information Thicket: A Case Study of Derivatives Disclosure during the Financial Crisis*, 36 J. Corp. L. 1 (2010).

¹³⁵ As is the presence of index investing, purchasing and selling in massive quantities without any analysis at all.

giving and persistent conflicts of interest as other ways are sought to make this activity profitable (another issue connected to debates about insider trading enforcement). Conflicts of interest are problematic well beyond the IPO setting noted earlier, to disputes about insider trading, fair disclosure, broker-dealer recommendations, robo-advisers and many other lively controversies. The information environment for smaller public issuers with little or no analyst coverage (and the means for improving it, as with the recent tick-size experiment) is still only dimly understood.

In the face of all these developments, the old problems of corporate disclosure remain. The right approach to forward-looking disclosure—analyzed by the SEC in multiple reports starting not long after the first Special Study—remains indeterminate,¹³⁶ as so many public and private lawsuits still struggle with questions about whether, how and when issuers must reveal developments running the gamut from preliminary government investigations to outright disasters. So, too, with timeliness: what are the virtues and harms associated with leaving most disclosure to quarterly reporting, rather than continuous market alerts? Conversely, what are the adverse effects of immediate disclosures, or of being so insistent on its public release (the costs and benefits of Reg FD¹³⁷)?

There are also interesting questions about the real economic effects of mandatory disclosure, beyond informing investors and markets. Notoriously,

¹³⁶ See note 17 *supra*.

¹³⁷ See Jill Fisch, *Regulation FD: An Alternative Approach to Addressing Information Asymmetry*, in STEPHEN BAINBRIDGE, ED., RESEARCH HANDBOOK ON INSIDER TRADING 112 (2013).

managers indicate that they will choose different (presumably inferior) projects as to long-term value depending on the accounting and reporting effects—so-called real earnings management.¹³⁸ Corporate risk-taking is seemingly affected, too,¹³⁹ along with many other behaviors put in the glare of public scrutiny via government-chosen metrics. Some of this is presumably good, but not necessarily—hence, the many connections between securities regulation and worries about “short-termism.”¹⁴⁰

C. Company Registration Revisited

Whether or not this last cluster of questions is answerable, it seems irresistible for any new Special Study to revisit one of the key issues posed by the first Special Study: how well can the Securities Act and the Exchange Act be knitted together to permit seamless company registration, so that capital-raising transactions by seasoned issuers can take place with the least amount of additional regulatory burden? This was Milton Cohen’s campaign, fully vetted in the mid-1990s by an SEC Advisory Committee, with many intermediate steps in between.¹⁴¹ The 2005 rule-based offering reforms moved in this direction mainly via shelf registration enhancement, especially for WKSIs, but arguably still short of total integration.

¹³⁸ See John Graham et al., *The Economic Implications of Financial Reporting*, 40 J. Acct’g & Econ. 3 (2005).

¹³⁹ See Kate Litvak, *Defensive Management: Does the Sarbanes-Oxley Act Discourage Corporate Risk-taking?*, 2014 U. Ill. L. Rev. 1663.

¹⁴⁰ See Mark Roe, *Corporate Short-termism in the Boardroom and the Courtroom*, 68 Bus. Law. 977 (2013); LANGEVOORT, *SELLING HOPE*, supra, at 105-08.

¹⁴¹ See note 53 supra.

The open question is whether there is enough distance between the current system and true integration to make the effort worthwhile, and if so what further steps might be taken. (We might discover the opposite, of course—that reform has gone too far, for some or all levels of issuers.) We covered some possibilities in Part II, particularly ones relating to the impact of Section 11 of the Securities Act on shelf registration and seasoned offerings—clearly the biggest speed bump on the road as currently paved. Alternatively or in addition to the changes discussed earlier, there could be tweaks on the Exchange Act side beyond the layering of additional tasks. The ill-fated Federal Securities Code drafted under the auspices of the American Law Institute in the 1970s (sheperded by Cohen and Professor Louis Loss) proposed a privately-enforced due diligence liability standard for annual reports, designed to make a careful look into the company’s condition and results a yearly exercise. This is costly, however, and depending on periodicity, may miss opportunistically-timed offerings. But proposals like these illustrate the kinds of interventions that might be seriously considered depending on what a closer study of the efficacy of the existing Exchange Act and integrated disclosure system reveals.¹⁴²

D. Enforcement Intensity

¹⁴² For other proposals, see Fox, *Civil Liability*, supra (proposing expert external certification requirement for annual reports, with a “measured” due diligence based liability for the certifier); James D. Cox, *The Fundamentals of an Electronic-based Federal Securities Act*, 75 Wash. U.L.Q. 857 (1997); Cox, *Public Offerings*, supra, at 19-20 (proposals for “redistributing” due diligence obligations for seasoned issuers).

The emphasis on civil liability in discussions of disclosure quality under both the Securities Act and the Exchange Act makes clear that such quality is not simply a function of well-articulated disclosure rules but of enforcement intensity, both public and private. Whether the considerable resources devoted to enforcement are well-spent is another source of controversy in need of illumination.¹⁴³ We are far from sure how much fraud and financial misreporting by seasoned issuers there is in our financial markets. One often-cited (but unpublished) study estimates roughly that as many as 14.5% of public companies are misleading the market at any given time.¹⁴⁴ If that is anywhere near accurate, there are hard questions about why and what to do about it.

On the public enforcement side, how the SEC enforcement staff picks cases to pursue is opaque.¹⁴⁵ Settlement policy and practices relating to sanction size, enterprise versus individual liability, and whether to impose collateral consequences or insist on admissions of liability, are too. The appropriate degree of criminalization of securities law enforcement is contestable, especially on the highly-contested subject of insider trading. All of these relate to the much bigger question

¹⁴³ See John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229 (2007); Howell Jackson & Mark Roe, *Public and Private Enforcement of Securities Laws: Resource Based Evidence*, 93 J. Fin. Econ. 207 (2009); LANGEVOORT, *SELLING HOPE*, supra, at 42-48.

¹⁴⁴ Alexander Dyck et al., *How Pervasive is Corporate Fraud?*, February 2013, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222608.

¹⁴⁵ See Urska Velikonja, *Reporting Agency Performance: Behind the SEC's Enforcement Statistics*, 101 Cornell L. Rev. 901 (2016).

of whether the SEC has the resources and incentives to do its enforcement job well, or whether instead it is impoverished either deliberately or through neglect.¹⁴⁶

As to corporate disclosure, much of the policing is via private class actions under Rule 10b-5.¹⁴⁷ That rule requires plaintiffs to plead and prove both scienter and reliance, thus making Exchange Act civil liability very different from the more potent private remedies found in the Securities Act. This puts a heavier burden of proof on investors, complicates trials and settlement negotiations, and incentivizes ignorance by those whose knowledge would be attributed to the firm. Yet there is immense controversy on whether the litigation threat is nonetheless excessive because of settlement pressures that reward the bringing of claims that would not succeed if tried. As a compensatory matter, moreover, corporate defendants pay judgments and settlements, thus reaching into some shareholders' pockets (or insurance) to shift money to the pockets of others. Whether this "circularity" makes sense—indeed, what its impact on investors even is over time—has been the subject of considerable academic debate, without resolution.¹⁴⁸ Separately, there is a question of how much deterrence these lawsuits provide if, once again, the alleged

¹⁴⁶ Though beyond the scope of this Chapter, this touches on the long-standing debate about SEC self-funding.

¹⁴⁷ E.g., Joseph A. Grundfest, *Damages and Reliance Under Section 10(b) of the Exchange Act*, 67 *Bus. Law.* 307 (2014); James D. Cox & Randall Thomas, *Mapping the American Shareholder Litigation Experience; A Survey of Empirical Studies of the U.S. Securities Laws*, 6 *Eur. Co. & Fin. L. Rev.* 164 (2009); Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers do not Trade?*, 2009 *Wisconsin Law Review* 299.

¹⁴⁸ See, e.g., William Bratton & Michael Wachter, *The Political Economy of Fraud on the Market*, 160 *U. Pa. L. Rev.* 69 (2011); James Spindler, *We Have a Consensus on Fraud on the Market – And It's Wrong*, *Harv. Bus. L. Rev.* (forthcoming, 2017). More generally, see JOHN C. COFFEE, JR., *ENTREPRENEURIAL LITIGATION: ITS RISE, FALL, AND FUTURE* (2015).

wrongdoers personally may not suffer the full burden (if any) of their wrongdoing, or if they fail to fully appreciate the legal risks they take.¹⁴⁹

VI. CONCLUSION

My assignment here was to describe in broad strokes the legal framework for primary and secondary marketplace regulation and identify the knowledge gaps that frustrate rigorous policy-making. Kathleen Hanley's companion paper assesses what research in financial economics tells us already and how we might devise an empirical research agenda—a new Special Study—to move both the state of knowledge and policy-making forward, and push back against pure ideology and rent-seeking.

I have suggested quite a few such knowledge gaps as to both the Securities Act and the Exchange Act that make it difficult to decide whether prevailing law is excessive, insufficient or (implausibly) perfectly right, or precisely how to make it better. One could easily add more. From the regulatory perspective, my priorities would be:

- (1) As thorough as possible a mapping of the nature, risks, and rewards to investors and entrepreneurs of the largely unregulated (10b-5 only) private offering marketplace, comparing and contrasting what is observed in terms of

¹⁴⁹ LANGEVOORT, *SELLING HOPE*, *supra*, at 35-45 (discussing cognitive and cultural biases that distort risk perception). These questions are relevant to public enforcement as well.

behavior and outcomes where sophisticated institutions are the buyers as opposed to retail investors;

(2) A rigorous assessment of trends affecting the long-term balance between private and public markets as sources of corporate financing and liquidity, and the consequences of a strong turn toward the private markets;

(3) An accounting of who wins and who loses in the IPO marketplace, and whether the current system of Securities Act registration addresses the right stress points, including potentially distortive or anticompetitive securities industry practices;

(4) A comparable accounting of the risks to investors in shelf and other seasoned equity offerings, with a view to moving further toward (or away from) more complete company registration, especially as to liability issues;

(5) An examination of the efficacy of periodic and real-time disclosure (e.g., Reg FD and other “prompt” disclosure obligations) in a technology-driven, information rich environment; and

(6) An assessment of enforcement mechanisms and policies under the Exchange Act, both private civil liability and public enforcement actions, and how well they serve goals of compensation and deterrence and reduce the negative consequences of adverse selection.

This is an ambitious agenda, to be sure, and what is on it is politically combustible. But in framing a fruitful Special Study for the 21st century, these truly are things we need to know much better than we currently do, wherever that leads.