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The JOBS Act: Unintended Consequences of the “Facebook Bill”

Tyler Adam*

The Jumpstart Our Business Startups Act (“JOBS Act”), in part, amended § 12(g) of the Securities Exchange Act of 1934. Originally enacted to impose mandatory disclosure requirements on non-reporting companies with a significant volume of trading, § 12(g) became dysfunctional due to changes in the market landscape. The JOBS Act amended § 12(g), first, by raising the shareholders of record threshold, and second, by excluding from the threshold number persons who received securities pursuant to certain employee compensation plans. This note argues that the JOBS Act’s retooling of § 12(g) fails to adequately resolve fundamental problems with the rule. Specifically, the amendments will promote a dysfunctional standard for the mandatory disclosure triggering requirements, which will enable public companies to manipulate the rule. Additionally, it will reduce the number of IPOs, which is not the best policy for spurring job growth and economic growth. These unintended consequences can be avoided by changing the § 12(g) triggering requirements to a two-tiered approach that regulates the private and public spheres using different metrics. These metrics should reflect trading volumes and beneficial ownership of public and private companies, respectively.

* J.D. Candidate, 2013, University of California, Hastings College of the Law. I would like to thank Professor Abraham J.B. Cable for his insight and contributions, without which this note would not have been possible. Additionally, I am grateful to my family for their unending support.
I. INTRODUCTION

On April 5, 2012, President Barack Obama signed the Jumpstart Our Business Startups Act ("JOBS Act"). The JOBS Act is intended to stimulate job creation and economic growth by improving the ability of emerging growth companies to gain access to the public capital markets. In part, the JOBS Act amended § 12(g) of the Securities Exchange Act of 1934 ("1934 Act").

Prior to the JOBS Act, § 12(g) required any securities issuer with total assets exceeding $10 million and a class of nonexempted securities held of record by five hundred or more to file a registration statement with the Securities Exchange Commission ("SEC"). Although § 12(g) does not require companies to list shares on the public markets, once a company is required to register with the SEC, it may be induced to go public to benefit from being able to raise capital on the public markets. Therefore, the rule effectively forces companies meeting its requirement to initiate an initial public offering ("IPO").

The JOBS Act amended § 12(g), first, by raising the shareholders of record threshold from 500 to either 2,000 persons, or 500 persons who are not accredited investors (the "Threshold Provision"). Second, the Act further expanded the § 12(g) mandatory registration threshold by excluding persons who received securities pursuant to employee compensation plans in transactions exempted from the registration requirements of § 5 of the Securities Act of 1933 ("1933 Act"). The Threshold Provision of the JOBS Act has been referred to as the "Facebook Bill" because leading up to its initial registration with the

2. Id.
6. See id.
8. Id. The Threshold Provision incorporates the basic premises of two bills that were moving through the Houses, which, similarly, sought to increase the minimum record shareholder threshold requirement (S. 1824, 112 Cong. and H.R. 2167, 112th Cong.). Although H.R. 3606 is the session law at issue in this note, fundamentally, each of these bills sought to increase the registration threshold. Therefore this note cites to legislative history of each of them.
Securities and Exchange Commission ("SEC") on February 1, 2012,10 the 500-shareholder rule was cited as a reason Facebook would be forced to register with the SEC.11

Creating legislation that makes capital formation easier has been one of President Obama’s key objectives.12 Upon signing the JOBS Act, Obama articulated that the bill will make it easier for companies to go public, which is an “important step towards expanding and hiring more workers.”13 Proponents of increasing the § 12(g) mandatory registration threshold argued that it was outdated and unnecessarily impeded capital formation for startup companies.14 Their hope is that the changes to § 12(g) will alleviate challenges to capital formation and spur job growth.15

In recent years, companies have faced a difficult financing landscape. To begin, startup companies have limited financing options: they can raise capital through borrowing or equity financing.16 In the wake of the 2008 economic crisis, borrowing has become difficult because banks have tightened their lending standards.17 As a result, equity financing is increasingly essential for startups to gain capital.18 One form of equity financing is conducting an IPO. Companies typically enter the public markets in order to gain access to capital necessary to hire employees and expand business operations.19 An IPO represents a significant step in a young company’s growth cycle.20 However, the equity financing process in the public markets has become more burdensome in recent years due to increased regulations.21 As a result, the number of IPOs has decreased.22

A report published in August 2011 indicated that since 1991, the

10. Facebook, Inc., Registration Statement (Form S-1) (Feb. 1, 2012).
15. Id.
16. Id.
17. Id.
18. Id.
20. IPO TASK FORCE, supra note 19, at 9.
21. See Id. “Unfortunately, a series of rules, regulation and other compliance issues aimed at large-cap, already-public companies has increased the time and costs required for emerging companies to take [the critical first step of doing an IPO].”
22. Id. at 1.
number of emerging growth companies conducting IPOs declined dramatically relative to historic levels. From 1991 to 2002, IPOs averaged 530 per year. In contrast, there were only 38 IPOs in 2008 and 61 in 2009. Furthermore, between 1995 and 2010, the number of public companies listed on the U.S. stock exchanges fell from 8,000 to 5,000, while the number of listings on non-U.S. exchanges increased from 23,000 to 40,000. This trend has been referred to as “The Great Depression in Listings.”

Reinvigorating the IPO market is vital to rejuvenating the job market because when companies raise money in the public markets they gain the resources necessary to expand and grow their employee base. A study of 136 IPOs of venture-backed companies from 1970 to 2009 found that, on average, 92 percent of job growth occurred post-IPO. The data represents the increase in the number of employees stated in public filings at the time of IPO and in the latest year available. Given the correlation between job creation and IPOs, it follows that the recent downturn in IPOs has had a staggering impact on the U.S. job market. By one estimate, the decrease in companies entering the public markets cost America as many as 22 million jobs from 1997 through 2008.

Despite the fact that IPOs are ultimately beneficial in creating job growth and maintaining robust public markets, for a company, going public is a significant undertaking. The vast majority of small closely held companies avoid going public because: (1) remaining private is cheaper; (2) private companies are easier to operate; and (3) remaining private ensures that the managers would not lose their control. First, remaining private is cheaper because private companies avoid the costs of periodically reporting to regulatory
agencies, which requires expensive legal, financial, and accounting services. Second, private companies are easier to operate because boards of directors can make business decisions without having to get approval from public shareholders. Third, when a company remains private, the board members can act without the risk of being voted out of their jobs by shareholders or losing their jobs by a hostile tender offer.

In addition to the long-term financial and corporate governance considerations described above, conducting an IPO is extremely expensive. In 2007, the estimated costs for a significant IPO were $600,000 to $800,000 in legal fees, $400,000 to $600,000 for auditor fees, $150,000 to $200,000 in printing costs, and various filing fees. Underwriter commissions take a percent of the offering amount. Furthermore, the senior officers will devote a significant amount of time to matters related to the offering instead of focusing on routine business activities.

Upon recommending increasing the § 12(g) threshold, the House Committee on Financial Services articulated that the difficulty in borrowing coupled with the regulatory roadblocks for companies trying to enter the public markets has lead to an increased use of pre-IPO equity financing. As a result, there has been an expansion in the number of shareholders of record in pre-IPO companies. Therefore, the pre-JOBS Act § 12(g) requirements inhibited companies from accomplishing their financing needs without risking being required to register with the SEC, which they may not have been strategically or financially prepared to do.

Although the Threshold Provision is well intended in its attempt to update § 12(g) to better reflect current market practices, this note argues that due to the way it is crafted, the Threshold Provision will have harmful unintended consequences. These consequences include promoting a dysfunctional standard for the mandatory disclosure triggering requirements and reducing the number of companies conducting IPOs. The later consequence will have the opposite intended effect of the JOBS Act legislation because it will hinder job creation and economic growth. Part II explores the historical purpose of § 12(g) and how it became dysfunctional. Part III discusses some of the arguments for updating § 12(g). Part IV presents some of the unintended consequences of the Threshold Provision. Finally, Part V

32. COX ET AL., supra note 31.
33. Id.
34. Id.
36. See id.
37. Id.
recommends changes to § 12(g) that would help to avoid some of the unintended pitfalls of the Threshold Provision while creating a regulatory environment that encourages entrepreneurship, enables capital formation, and fosters job creation and economic growth.

II. THE HISTORIC CONTEXT OF SECTION 12(G) AND ITS FAILURE AS AN ACCURATE SIZE TEST

A. SECTION 12(G) WAS CREATED TO REGULATE THE OVER-THE-COUNTER SECURITIES MARKETS

The securities laws were promulgated in response to the economic crisis resulting from the Great Depression. While many of the causes of the 1929 market crash were unrelated to abusive practices, evidence indicates that false and misleading information adversely affected the stock prices. Such abusive practices were in part a result of a lack of any laws requiring publicly traded firms to make public disclosures of material information, including financial reports. Additionally, investor interest had disappeared almost immediately in the wake of the stock market crash of 1929. For instance, at their high point in 1929 prior to the crash, New York Stock Exchange listed securities had a total value of $89 billion, and their value dipped to $15 billion by 1932. Therefore, because there had been market fraud preceding the Great Depression, and a significant amount of investors withdrew their capital during the Great Depression, there was a pressing need to eliminate fraud and reinvigorate investor confidence in the public markets.

In his message to Congress on March 29, 1933, recommending the federal regulation of investment securities, President Roosevelt wrote:

There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. This proposal adds to the ancient rule of caveat emptor, the

39. For example, speculative investor frenzy and significant amounts of margin trading played a substantial role in causing the crash. COX ET AL., supra note 31, at 5.
40. Id. at 6.
41. Id.
42. Id. at 5.
43. Id.
further doctrine ‘let the seller also beware.’ It puts the burden of
telling the whole truth on the seller. It should give impetus to honest
dealing in securities and thereby bring back public confidence.  

Two bodies of law were enacted to regulate the securities industry: the 1933 Act and the 1934 Act. The 1933 Act operates to protect investors in primary distributions of securities, while the 1934 Act regulates trading markets and their participants. 

Since their enactment, the cornerstone of the federal securities laws has been mandatory disclosure. The primary and longstanding mission of the SEC is to compel firms involved in the securities markets to disclose data, and thereby indirectly induce them to avoid illegal or embarrassing activities. Mandatory disclosure is generally regarded as the appropriate way to regulate corporate finance. Based on the philosophy of mandatory disclosure, the current formulation of the 1934 Act mandates continuous disclosure for three categories of companies: (1) companies that have securities listed on a national exchange; (2) companies that meet the requirements of § 12(g); and (3) companies that have an effective 1933 Act registration statement. This note addresses what the rationale is for forcing private companies to report material information to the public, and what the criteria under § 12(g) should be for doing so. To frame the discussion, it is important to understand some the benefits of mandatory disclosure as well as the context in which the SEC created § 12(g).

1. A Case for Mandatory Disclosure

The policy of mandatory disclosure was not originally aimed at having a significant regulatory effect on the economy. Rather, President Roosevelt approached mandatory disclosure as a mechanism for stymieing the deleterious behavior of Wall Street insiders by exposing their activities to public scrutiny. Roosevelt was influenced by, and often cited to, the regulatory philosophy articulated by Justice Brandeis that, “Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” Nonetheless, mandatory disclosure has also come to be viewed as a valuable mechanism for

45. S. REP. NO. 73-47, at 6–7 (1933).
46. COX ET AL., supra note 31, at 7.
47. Id.
49. Id. at 40. For a more complete discussion of the rationales for mandatory disclosure see EASTERBROOK & FISCHER, supra note 44, at 276–314.
50. COX ET AL., supra note 31, at 7–8.
51. SELIGMAN, supra note 38 at 39–40.
52. Id. at 41.
53. Id. at 41–42.
regulating the overall economy because it “improves the ‘allocative efficiency’ of the capital market.”

Mandatory disclosure creates economic efficiency because, in effect, society is subsidizing “search costs to secure both a greater quantity of information and a better testing of its accuracy.” As a result, society gains equal access to information, without which investors would spend time and money trying to beat the market. In the aggregate, the time investors would spend trying to search out information to beat the market would be very costly. Therefore, “investors as a group gain if firms disclose so as to minimize the opportunities for these gains and thus the incentives to search.” The time and money, which would otherwise be spent searching for information, can be spent on other endeavors.

Another important economic benefit to mandatory disclosure is that by disclosing information, firms gain more investors. They do so because, by reducing investors’ information costs, investors increase the net returns on their investments:

The net return on a security is its gross return (dividends plus any liquidating distribution) less the costs of information and transaction in holding the security. A firm can increase this net return as easily by reducing the cost of holding the stock as by increasing its business profits. Firms that promise to make disclosures for this purpose will prosper relative to others, because their investors incur relatively lower costs and can be more passive with safety.

Theoretically, this logic indicates that companies have a business incentive to voluntarily disclose, and therefore mandating disclosure is not necessary. However, in reality, there are several factors that change the equation and necessitate mandatory disclosure.

Mandatory disclosure is necessary because it has been shown that a company will only voluntarily disclose all its information if three assumptions are satisfied: (1) investors know that companies have particular information; (2) companies cannot lie; and (3) disclosure is costless. For example, if the cost of disclosure outweighs the benefit to the company, or if disclosure is not economically feasible, then the company will either choose not to disclose or to only partially disclose.

55. Coffee, supra note 54.
56. Easterbrook & Fischel, supra note 44, at 287.
57. Id. at 290.
58. Id.
the information. Alternatively, if the company has information it knows will negatively impact the stock value, but knows that the public will not find out about it, then it will not voluntarily disclose such negative information. Although a company will generally benefit from disclosure, it will only disclose enough information it can internalize a benefit from. Because, as the above examples show, there are social benefits to disclosure that companies cannot internalize, companies will not be incentivized to provide a socially optimal amount of information. Therefore, it is necessary to mandate disclosure.

In sum, the policy of mandatory disclosure has numerous social and economic benefits. These factors are important to take into account when balancing the interest of private companies in not registering with the public interest of requiring companies to register. Part II.A(2) discusses the historic context for the creation of § 12(g) and SEC’s rationale for the § 12(g) technical requirements.

2. The Origin of Section 12(g)

Section 12(g) was adopted in 1964 based primarily on a congressionally commissioned SEC study (“the Study”) concluding that securities traded on over-the-counter-markets (“OTC”), i.e., nonreporting securities exchanges, should, in a limited fashion, be brought under the purview of the SEC. The Study reviewed the efficacy of the regulatory scheme of the 1933 and 1934 Acts in order “to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection, thus preserving and enhancing the level of investor confidence.” As part of the study, the SEC surveyed every case of fraud under the 1933 and 1934 Acts, either in litigation or otherwise, that came before the SEC in a period of eighteen months beginning in January 1961. Ninety-three percent of the 107 broker dealer revocation cases reviewed involved issuers of securities that were not subject to the continuous reporting requirements of the 1934 Act. Furthermore, numerous reports indicated that companies trading OTC and not subject to the registration and reporting requirements of the 1934 Act were either

60. Zingales, supra note 59.
61. Id.
62. Id. at 19.
63. Zingales, supra note 59, at 19.
66. Id. at iv.
67. Id. at 10.
68. Id.
making no disclosures to their investors, or their disclosures were
generally inadequate to the point of being misleading.69

The Study determined that to the extent that companies have
“traded over-the-counter issues outstanding are allowed to operate in
the dark, the very conditions that encourage a resort to fraud and
manipulation are fostered”70 Therefore, the basic principles for
establishing investor protections for listed securities are equally
applicable to the OTC market.71 For the reasons discussed below, the
SEC’s solution was to require companies of a certain size to register
and report periodically with the SEC.72

Based on data gathered from 1,618 companies listed in the OTC
markets, the SEC determined what the appropriate benchmark would
be for requiring private companies to register.73 The participants
included 96 insurance companies, 358 banks, and 1,164 industrial and
other corporations.74 Of these, 1,610 provided their number of
shareholders.75 The shareholder numbers were established in terms of
record holdings, as opposed to beneficial shareholders.76 This is an
important distinction in the development of § 12(g). Record
shareholders are people or entities listed on the corporate record of
the security, whereas the beneficial owners are those who own the
shares in equity even though the legal title belongs to the record
holder. For example, the record owner may have sold divisions of
shares to numerous people who would not be listed on the corporate
record of the security.

The study found a positive correlation between the number of
record shareholders and the number of transfers of record.77 That is,
companies with a larger number of record shareholders saw higher
trading volumes.78 The study ideally would have looked at trading
volumes in terms of actual trades, as opposed to transfers of record,
because significantly more transactions would have occurred without
the record actually transferring.79 However, trading volumes were
unavailable, and an attempt to obtain them was not feasible.80
Therefore, the number of record transfers was the next best indicator

70. Id. at 10.
71. Id. at 7.
72. Id. at 62.
73. Id. at 19, 36.
74. Id. at 19.
75. Id.
76. Id. at 20.
77. Id. at 20–23.
78. Id.
79. Id. at 20 n.44.
80. Id.
of market activity. Likewise, the ideal criteria for forcing a firm into the purview of the SEC would have been based on trading volumes because market activity would have been the best benchmark for determining the risk of investor fraud. However, the study notes that criteria based on market activity would not have been workable in practice, and the number of shareholders of record is “at least a rough, indirect measure of market activity.” Presumably, this is because there were no available records of trading volumes of over-the-counter issues, and it would have been extremely burdensome for the SEC to keep track of the number of record transfers taking place.

The Study found that the level of trading activity, based on record transfers became significant for companies with 300 or more shareholders. Moreover, over half of the surveyed companies had 300 or more shareholders of record. In light of the data, the study recommended extending the 1934 Act’s disclosure, proxy, and insider trading provisions to companies with 300 or more shareholders. The ultimate determination of a 500 shareholder threshold was a compromise between the SEC, who wanted the threshold to be 300 shareholders, and members of the investment banking industry who wanted the threshold set at 1,000 shareholders.

### B. THE 500 SHAREHOLDER THRESHOLD BECAME A FLAWED SIZE TEST

The 500-shareholder limit is roughly a size test. As discussed in Part II.A(2), the study determined that companies of a certain size (in terms of the number of record shareholders) traded at higher volumes in the OTC markets, and, therefore, they should be accountable to their shareholders and the public. Since its creation in 1964, the 500-shareholder metric has become dysfunctional because many

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81. H.R. Doc. No. 88-95, at 20 n.44.
82. Id. at 34.
83. Id.
84. Id.
85. H.R. Doc. No. 88-95, at 34.
86. Id. at 32. Additionally, the Study states, “it is clear also that under any definition of ‘public’ for purposes of protection of the securities laws, a company with 300 or more shareholders of record is to be deemed public.” Id. at 34.
87. Id at 62; SELIGMAN, supra note 38, at 314.
88. SELIGMAN, supra note 38, at 315.
89. DONALD C. LANGEVOORT & ROBERT B. THOMSON, “Publicness” in Contemporary Securities Regulation, GEO.L.J. (forthcoming 2012) (manuscript at 23) (on file with authors).
extraordinarily large companies (in terms of total assets) have few enough record shareholders to be able to avoid registering.\textsuperscript{91} Furthermore, many publicly traded companies have less than 500 record shareholders and less than $10 million of assets, but they have thousands of beneficial holders.\textsuperscript{92} As explained further below, these publicly traded companies can choose to delist with the SEC even though they have thousands of publicly traded shares outstanding.

When the SEC conducted the Study, they based their data on shareholders of record and not beneficial record holders.\textsuperscript{93} They noted in their report that the data presumed an understated number of beneficial record holders.\textsuperscript{94} However, this disparity has since dramatically increased because publicly traded shares are no longer recorded in the names of individual owners.\textsuperscript{95} Rather, broker-dealers “hold vast numbers of shares of vast numbers of investors under a single name.”\textsuperscript{96} This practice developed as a practical matter to cut the massive flow of paper and the costs of transferring stock that resulted from increased trading volumes.\textsuperscript{97} Because high speed trading requires that securities are easily transferrable, as a matter of practice, broker-dealers do not require the transfer of certificates every time beneficial ownership changes.\textsuperscript{98} Currently, it is “unusual for a beneficial owner to appear on the corporate books as a holder of record or hold a stock certificate.”\textsuperscript{99} For example, a company with a public float of $1 billion and 2,500 beneficial shareholders may still have fewer than 500 shareholders of record.\textsuperscript{100}

Consequently, the failure of the § 12(g) as a size test has enabled hundreds of companies to go dark. A company goes dark when it deregisters its publicly traded securities with the SEC, yet continues to trade on an OTC market.\textsuperscript{101} Companies that deregister with the SEC are

\textsuperscript{91} LANGEVOORT & THOMSON, supra note 89, at 23; JOHN C. COFFEE, JR., GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION: CAPITAL FORMATION, JOB CREATION AND CONGRESS: PRIVATE VERSUS PUBLIC MARKETS BEFORE THE SEC 13–14 (Nov. 17, 2011) [written testimony] [hereinafter Written Testimony of John C. Coffee, Jr.].


\textsuperscript{93} H.R. Doc. No. 88-95, at 20.

\textsuperscript{94} Id.

\textsuperscript{95} LANGEVOORT & THOMSON, supra note 89, at 24.

\textsuperscript{96} Id.

\textsuperscript{97} Id. at 15.

\textsuperscript{98} Id. at 15.


\textsuperscript{100} Written Testimony of John C. Coffee, Jr., supra note 91, at 14.

\textsuperscript{101} See generally Leuz et al., supra note 92 (referring to the Abstract).
described as having gone dark because, after they deregister, the
insiders of the company typically refuse to disclose any information to
public investors. Under § 12(g)(4), a company may voluntarily
terminate registration ninety days after the issuer files a certificate
with the Commission showing that the number of record shareholders
is fewer than three hundred persons. The company may also
voluntarily terminate registration if it has 500 holders of record but
less than $10 million of assets in each of the prior three years
preceding the deregistration request. Furthermore, companies with
more than 300 shareholders of record can bring the number of record
shareholders below 300 by engineering a reverse stock split or a
repurchase tender offer.

Christian Leuz, Alexander Triantis, and Tracy Wang conducted a
study ("Leuz Study") analyzing a sample of approximately 480 firms
that went dark between 1998 and 2004. The Leuz Study revealed
interesting insight about the going dark phenomena. The Leuz Study
companies had an average of $90.96 million in assets, with a median of
$3.36 million, and an average of $25.19 million in market value, with a
median of 3.96 million. The study does not report the number of
beneficial record holders for each company. However, to put it in
perspective, many of the companies that have gone dark had
significant assets and more than 300 beneficial shareholders. For
example, when United Road Services went dark in 2003, it had
approximately over 6,000 beneficial shareholders and $97,767,000 in
total assets. Once deregistered, fewer than 10 percent of the Leuz
Study companies disclosed financial statements and even fewer were
audited. The main motivation for companies to go dark was the high
cost of reporting. By in large, the Leuz study found that "smaller
firms with relatively poor performance and low growth, for which
reporting costs are particularly burdensome, are more likely to go
dark, as are firms in the period following the passage of [the Sarbanes-
Oxley Act of 2002]."

On average there was a negative stock price reaction of -10

104. Kanagawa Holdings LLC, supra note 99.
105. Fried, supra note 102, at 141.
107. Id. at 51–52.
108. Fried, supra note 102, at 145.
110. Leuz et al, supra note 92, at 33.
111. Id. at 2.
112. Id.
percent to firms’ decision to go dark.\textsuperscript{113} The negative reaction may be explained in two ways. First, the market’s strong negative reaction may be attributed to shareholders inferring that the company’s future growth prospects have diminished, even though the decision to go dark may help the company trim administrative costs and thus maximize value.\textsuperscript{114} Second, the negative reaction could be explained by agency costs, because the negative market reaction reflects an anticipated increase in private control benefits.\textsuperscript{115} These private control benefits may include the managers’ ability to hide poor performances that would otherwise lead to their dismissal, or protection against legal liability.\textsuperscript{116}

Not only do companies that go dark experience a negative market reaction, but going dark also increases the likelihood that investor fraud and other manipulative behavior may take place. The SEC warns that stocks traded “in the OTC market are generally among the most risky and most susceptible to manipulation.”\textsuperscript{117} When investors are deprived of periodic reporting under the 1934 Act, the stocks trade on “rumor, innuendo and uncertainty.”\textsuperscript{118} The informational asymmetry and increased volatility leaves investors susceptible to the unscrupulous behavior of insiders who are well positioned to deprive investors of the remaining value of their investments.\textsuperscript{119}

The Threshold Provision did not change the requirements that allow most firms to deregister;\textsuperscript{120} Nonetheless, the problem of companies going dark demonstrates the serious inadequacy of using the number of record holders as a benchmark for a company’s size. The Threshold Provision will only promulgate this flawed standard. Additionally, the issue of companies going dark reflects the perils of discretionary reporting because it demonstrates that when the costs of reporting outweigh the benefits, companies will not report. Moreover, reporting is needed to protect investors against fraud precisely in the situations where it is not desirable for a company to report. Therefore, a different standard is necessary for determining when registration should be mandated.

\begin{footnotes}
\item 113. Leuz et al., \textit{ supra } note 92, at 2.
\item 114. \textit{Id.}
\item 115. \textit{Id.} at 3.
\item 116. \textit{Id.}
\item 118. Kanagawa Holdings LLC, \textit{ supra } note 99, at 6.
\item 119. \textit{Id.}
\end{footnotes}
III. ARGUMENTS FOR UPDATING SECTION 12(G)

In early December, a group of thirty-eight executives and investors, including Twitter CEO Dick Costolo and Gilt CEO Kevin Ryan wrote a letter to Congress in support of the JOBS Act, stating that “’[t]he 500 shareholder rule is outdated, overly restrictive, and limits U.S. job creation and American global competitiveness.’” Proponents of the Act proffered two changes to the startup landscape that support overhauling § 12(g). First, unlike the companies of 1964, the pay structures in current startups generally involve giving employees stock options. However, to stay within the 500 record holder threshold, companies are faced with the choice of limiting the number of employees they hire, the number of new investors they take on, or their ability to acquire other businesses for stock. Second, the emergence of secondary markets, such as Sharespost and SecondMarket, has created an alternative liquidity opportunity for investors and employees. Arguably, these secondary markets encourage more private investment in startups because they provide confidence for early stage investors that they will have multiple exit options.

A. EMPLOYEE EQUITY COMPENSATION

Upon introducing the Act, Representative David Schweikert explained, “’[i]f a company is really growing, it could start to hit its 500-shareholder limit just from its employee base.’” Notably, the 500-shareholder threshold contributed to the IPO’s of Microsoft, Google, and Facebook. Although the use of equity compensation has

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123. See Written Testimony of Eric Koester, supra note 124, at 7; see Written Testimony of Barry Silbert, supra note 122, at 7.


126. Peter Lattman, Share Rules Could Prompt an Offering by Facebook, N.Y. TIMES (Dec. 28,
been problematic for some companies, the argument that a company’s employee base is a major threat to a company’s record shareholder count is a bit misleading for two reasons. First, it is not commonplace for companies to be forced to go public due to § 12(g). Second, not all employee equity holders are counted towards the § 12(g) threshold.

First, it is uncommon for companies to be forced to go public due to reaching the § 12(g) threshold,128 Given that thousands of publicly traded companies have fewer than 300 record holders, or 500 record holders and less than $10 million in assets at the end of their three most recent fiscal years,129 it is likely that many companies have less than 500 shareholders of record at the time they enter the public markets. For example, at the time of its IPO, Amazon.com, Inc. reported having seventy-six record holders of its common stock.130

Second, the SEC has already carved out exceptions to § 12(g) for certain employee benefits plans, including stock options. In 1965, the SEC adopted Exchange Act Rule 12h-1(a), which exempts employee stock from the provisions of § 12(g).131 Then, in 1988, the SEC adopted Rule 701,132 which provides an issuer exemption to the 1934 Act registration requirements for securities offerings in compensatory benefits plans.133 In the 1980’s private non-reporting companies began compensating employees with stock options to attract and motivate employees.134 As the practice grew from 1990 until 2006, a number of companies exceeded the § 12(g) 500 shareholder threshold due to issuing stock options.135 In

128. LANGEVOORT & THOMSON, supra note 89, at 42.
129. See Leuz et al., supra note 92, at 14–15.
130. Amazon.com, Inc., Amendment No. 5 to Form S-1 Registration Statement Under The Securities Act of 1933 (Form S-1/A) 59 (May 14, 1997). Note, Amazon.com, Inc. did not report the number of record holders of its preferred stock.
131. 17 C.F.R. § 240.12h-1(a) (West 2012) (“[a]ny interest or participation in an employee stock bonus, stock purchase, profit sharing, pension, retirement, incentive, thrift, savings or similar plan which is not transferable by the holder except in the event of death or mental incompetency, or any security issued solely to fund such plans.”).
133. Id. § 230.701(c) (West 2012) (exempting registration requirements for securities offerings in compensatory benefits plans to “employees, directors, general partners, trustees (where the issuer is a business trust), officers, or consultants and advisors, and their family members who acquire such securities from such persons through gifts or domestic relations orders”).
response to a series of no-action letters exempting these companies from the § 12(g) requirements, on December 10, 2007, the SEC amended the §12h-1 to exempt stock options for issuers not subject to the Exchange Act’s reporting requirements.\footnote{U.S. SEC, Release No. 34-56887, supra note 134, at 4–5.}

Despite the SEC’s carve outs for employee equity compensation, a company’s employee base can still contribute to the § 12(g) threshold because the SEC’s exemption of stock options from § 12(g) does not apply to securities issued upon the exercise of a stock option.\footnote{Written Testimony of Barry Silbert, supra note 122, at 12.} The standard vesting time period used by startup companies for founders and non-founders employee stock options is four years.\footnote{Doug Collom, Vesting of Founders’ Stock: Beyond the Basics, The Entrepreneur’s Report: Private Company Financing Trends (Wilson Sonsini Goodrich & Rosati, Palo Alto, CA.), Spring 2008, at 9, available at http://www.wsgr.com/PDFsearch/vftrends0608.pdf.} Because, in the new IPO market, companies may take nearly a decade to go public, option holders are often fully vested and may exercise their options before the IPO event.\footnote{Written Testimony of Barry Silbert, supra note 122, at 12.} If the employees exercise their options, they are counted as shareholders of record for purpose of § 12(g).\footnote{Id.} As a result, § 12(g) discourages companies fearful of reaching the 500 shareholder threshold from hiring more employees and providing equity-based compensation.\footnote{Written Testimony of Barry Silbert, supra note 122, at 12.}

B. Secondary Markets

Changing the § 12(g) threshold had considerable support from proponents of secondary market exchanges.\footnote{See id.} Trading on the private markets has increased dramatically in recent years.\footnote{Steven Russolillo, Public Problem: Private Markets Grapple With Tech IPOs, WALL ST. J., Oct. 31, 2011, http://online.wsj.com/article/SB10001424052970203687504576655311056016704.html.} In 2010, the
value of all private share transactions was $4.6 billion, an increase from the $2.4 billion in 2009. These numbers were estimated to keep increasing. Eric Koester, former securities lawyer and current chief operating officer of startup company Zaarly, explained that from entrepreneurs’ perspective, the private markets are beneficial because they offer an alternative option for providing liquidity to employees and investors in late stage businesses that are not ready to sell their companies or enter the public markets.

At a time when companies are taking longer to IPO due to increasing costs of public company compliance and offerings, the secondary markets provide confidence for early stage investors that they will be able to exit. They also provide greater visibility and market pricing into the valuation of the business. In this sense, they create an onramp for the ultimate goal of going public. Companies benefit from this new onramp because they can have a longer period to mature before going public, and insiders and investors seeking short term liquidity can access it on the secondary markets. The 500 record shareholder threshold hinders this process because it forces companies out into the public markets when they would otherwise benefit from a longer incubation period.

However, there is skepticism about the public benefit of these secondary markets and increasing the § 12(g) to enable them. For example, Professor John Coffee argues that increasing the § 12(g) threshold primarily serves the interests of the private equity brokers without creating new jobs. Professor Coffee explains that increasing the § 12(g) threshold allows private equity brokers “to service not just small companies as they grow, but much larger companies that are discouraging their shareholders from holding record ownership.” Therefore, raising the § 12(g) threshold exclusively benefits those seeking to avoid the § 12(g) requirements.

Additionally, a rule that generates more trading in the secondary markets could increase the likelihood of fraud and reduce investor confidence in the public markets. The emergence of the private equity trading platforms has been described as creating a “situation not unlike the pre-1964 period in which there are companies with widely-traded secondary shares which are outside of the periodic disclosure

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144. Russolillo, supra note 143.
145. Id.
146. Written Testimony of Eric Koester, supra note 124, at 7.
147. Id.
149. Written Testimony of John C. Coffee, Jr., supra note 91, at 14.
150. Id.
151. Id.
requirements of the 1934 Act." 152 Granted, private trading on the secondary markets is different than the OTC markets of the pre-1964 period because trading occurs between investors who are deemed accredited under the securities laws. 153 Nevertheless, there are doubts about whether accredited investors are effective at fending for themselves. 154 If it is true that accredited investors are ineffective at fending for themselves, then increasing liquidity in the public markets may only exacerbate the problem because it will allow them more opportunities to trade. As a result, the Act would defeat the original purpose of § 12(g), which was to require companies of a certain size and with substantial trading volumes to be “public” for purposes of protection of the securities laws.” 155

IV. POTENTIAL UNINTENDED CONSEQUENCES OF THE ACT

Despite proponents of the Threshold Provision arguing that the § 12(g) 500 shareholder threshold impedes capital formation, 156 the Threshold Provision will have unintended consequences, including decreasing the number of companies going public. 157 The decrease will inhibit capital formation and job growth because a majority of job growth occurs after a company goes public whereby it experiences a large influx of capital that it can use to expand business and hire more employees. 158 Having a lower threshold for mandatory disclosure forces more companies into the public markets, which helps to maintain robust public markets.

When the markets are robust, “efficient pricing and funding of entrepreneurial activity” occurs. 159 For example, companies that have a price set on the open market attract more investors, while those that are not on the open markets are traded at a discount of 30 percent or more. 160 When a company is able to raise capital more efficiently, job growth occurs more rapidly. 161 And, the efficient allocation of

152. LANGEVOORT & THOMSON, supra note 89, at 17.
154. LANGEVOORT & THOMSON, supra note 89, at 32.
155. H.R. Doc. No. 88-95, at 34.
157. Deborah Gage, supra note 126.
158. IPO TASK FORCE, supra note 26, at 3.
159. Written Testimony of Edward Knight, supra note 26, at 3.
160. Id.
161. Id.
resources creates a more productive economy.\textsuperscript{162} In that regard, legislation should encourage companies to go public to allow the market to allocate capital to the best performing companies so they can create long lasting economic growth.

Mandatory disclosure may also be in the best interest of companies for capital formation because firms that choose to go public benefit from lower capital costs. When a company discloses information to investors, it will prosper relative to others because investors incur lower costs for searching out information on which to base their investments.\textsuperscript{163} However, as discussed in Part II, companies generally are not incentivized to disclose information because they do not internalize all of the social benefits derived from it.\textsuperscript{164} As such, firms generally will provide less information than it is socially optimal. Therefore, without mandatory disclosure, companies will under produce information. Nonetheless, if the purpose of the Act is to reinvigorate the economy and enable job growth, a law that creates strong incentives for companies to stay private will not accomplish that goal. Congress should work to make the public markets more attractive for startups as opposed to creating a superficial fix that allows startups to avoid the public markets.

Policies that strengthen the public markets also benefit the public at large by enabling democratic ownership and the rewards that come with it.\textsuperscript{165} When IPOs are delayed, the numbers of pre-IPO financing rounds increase, and by the time that the public gets access to shares, there is less upside.\textsuperscript{166} The IPO market is already seeing this trend. For example, for companies such as Microsoft (IPO in 1986), Cisco (IPO in 1990), and Amazon (IPO in 1997), public investors participated in 99 percent of the terminal value of the company.\textsuperscript{167} However, in more recent technology IPOs, private investors accrued most of the terminal value. For example, Google’s pre-IPO value was $40 billion and Facebook’s was $70 billion.\textsuperscript{168}

In part, tech companies are staying private longer because they are able to raise huge financing rounds in what have been referred to as “the public financing of twelve years ago.”\textsuperscript{169} If companies are able

\textsuperscript{162}. Written Testimony of Edward Knight, supra note 26, at 3.
\textsuperscript{163}. EASTERBROOK & FISCHEL, supra note 44, at 290.
\textsuperscript{164}. Id. at 287; Zingales, supra note 59, at 19.
\textsuperscript{165}. Written Testimony of Edward Knight, supra note 26, at 3.
\textsuperscript{168}. Quigley, supra note 167.
\textsuperscript{169}. Schonfeld, supra note 166.
to easily raise pre-IPO capital and have liquidity in the secondary markets, they may be incentivized to stay private longer. As a result, public investor confidence may diminish, and divestment of the public markets may occur. Additionally, more companies may seek to list their stocks on foreign exchanges.\textsuperscript{170} Divestment resulting from lack of investor confidence is an issue that the enactment of § 12(g) sought to tackle in the first place.\textsuperscript{171} Therefore, creating legislation that increases the likelihood of public divestment runs contrary to public policy.

In sum, although increasing the § 12(g) mandatory registration threshold has some benefits, that are drawbacks. The downsides include increasing the time companies remain private and reducing the number of companies that conduct IPOs. Part V recommends changes to § 12(g) that would help reconcile the needs of private companies with the policy objectives of mandatory disclosure.

\section*{V. PROPOSED SOLUTIONS}

In light of failure of § 12 (g) as an accurate size test and the changes to the market landscape since § 12 (g) was originally enacted, a new regulatory approach should be adopted. As discussed in Part II, significantly raising the shareholder of record threshold promotes an inaccurate size test that allows companies to have large numbers of beneficial shareholders without being subject to the reporting requirements of the 1934 Act.\textsuperscript{172} However, when adopted, the SEC did not contemplate that that the 500-shareholder threshold would force private companies with illiquid stock to go public. The SEC simply sought to reign in OTC trading.\textsuperscript{173} Nevertheless, the rise of the secondary markets has lead to a situation that is similar to the pre-1964 period when shares of nonreporting companies were widely traded.\textsuperscript{174} Therefore, the § 12(g) mandatory disclosure rules should be modified in order to balance the burdens on private companies—which should not have to make a decision between hiring more employees or going public—with the public interest benefits of

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\item \textsuperscript{170} See \textit{Written Testimony of Edward S. Knight, supra note 26}, at 3.
\item \textsuperscript{171} H.R. Doc. No. 88-95, at iv.
\item \textsuperscript{172} See \textit{JOHN C. COFFEE, JR. & ADOLF A. BERLE, SPURRING JOB GROWTH THROUGH CAPITAL FORMATION WHILE PROTECTING INVESTORS: HEARING BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS 12–13 (Dec. 1, 2011) (written testimony), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=a96c1b c1-b06 4-b01-a8ad-11e86438c7e5}. The current framework enables companies to go dark even though they have over 500 beneficial shareholders. \textit{See discussion supra Part II.B.}
\item \textsuperscript{173} H.R. Doc. No. 88-95, at 10.
\item \textsuperscript{174} \textit{LANGEVOORT & THOMSON, supra note 89}, at 17.
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mandatory disclosure. To that end, in order to fit with the original purpose of §12(g), Congress should change the § 12(g) size standard to better reflect trading volume and beneficial ownership.

Several alternatives to using the number of record shareholders as a threshold have been suggested. These include, counting the number of beneficial shareholders, or moving to a public float or market capitalization approach. Either one of these would improve upon the current approach. However, because the shareholders of private and public companies are inherently different, as are the markets in which they trade, meaningful regulation of the two can be accomplished by creating a size test that reflects trading volume using distinct criteria for the private and public spheres.

A. BENEFICIAL SHAREHOLDERS, PUBLIC FLOAT, OR MARKET CAP APPROACHES

Either a standard based on beneficial shareholders, public float, or market capitalization would be an improvement to § 12 (g) mandatory disclosure benchmark. However, these approaches are not ideal. First, by looking at the number of beneficial shareholders as a benchmark for size, Congress could increase the pre-IPO shareholder threshold that triggers mandatory disclosure and alleviate the Facebook problem. Simultaneously, basing the rule on beneficial ownership would prevent public companies with large numbers of beneficial shareholders from going dark. However, while the technology is likely available to track beneficial ownership in the public markets, it may be difficult to do so in the private setting because private companies are less regulated, and companies may have difficulty tracking indirect holdings by way of institutional investors. Therefore, in the private setting, record ownership is a more practical approach because companies can more easily maintain records of who has title to the securities.

Second, under a public float or market capitalization test, the SEC would look to the value of the shares outstanding by nonaffiliates of the company. In effect, this would correlate more appropriately with notions of creating an efficient market. Additionally, it would limit large companies from being able to go dark. However, market capitalization could not be used as a threshold for private companies

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175. Changing the size test is not an innovative concept. It has been recommended numerous times. See, e.g., Written Testimony of John C. Coffee, Jr., supra note 91, at 14; Langevoort & Thompson, supra note 89, at 41; Kanagawa Holdings LLC, supra note 99.

176. Kanagawa Holdings LLC, supra note 99; Written Testimony of John C. Coffee, Jr., supra note 91, at 14; Langevoort & Thompson, supra note 89, at 41.

177. Langevoort & Thompson, supra note 89, at 41.

178. Id.


180. Id.
because, without a competitive marketplace, it would be difficult to accurately calculate the value of outstanding securities.

B. A TWO-TIERED APPROACH

Given that the private markets and public markets are inherently different, they should be regulated in different ways. Therefore, a two-tiered approach could be used that measures the size of private companies and public companies based on different criteria. When companies are private, the mandatory registration threshold could be defined by both the number of record shareholders and trading volume.

For the private sphere, the 500 record shareholder limit could be increased to allow businesses to make hiring and acquisition decisions without worrying about triggering the registration requirement. In order to protect investors, the record shareholder increase could be offset by restricting the volume of private trading. Just as the SEC’s 1964 Study based its size test on the correlation between the number of shareholders and companies’ trading volumes,\footnote{H.R. Doc. No. 88-95, at 34.} § 12(g) could be changed to reflect the volume of stocks trading on the secondary markets. For example, privately traded companies could trade until a certain volume limit, at which point they could be required to go public. This would enable a larger incubation period while minimizing the risk of fraud. Once in the public sphere, Congress could determine whether a company can delist by setting a size limit based on beneficial ownership, public float, or market capitalization.\footnote{See Langevoort & Thompson, supra note 89, at 41. For companies that have gone public, a size limit based on either beneficial, public float, or market capitalization would suffice. For the purpose of my argument, conceptually, what is important is that the standards are different for private companies and public companies.} This would help avoid the issue of large companies with a significant number of beneficial shareholders going dark.\footnote{At the time of the Study, using criteria based on market activity would not have been workable in practice. H.R. Doc. No. 88-95, at 34. However, with modern technology criteria based on market activity seems practical. With hi-tech trading platforms such as SecondMarket, it should not be overly burdensome to calculate the trading volumes of particular companies in the private market. See Claims Trading Monthly: February 2012, Second Mkt., https://www.secondmarket.com/discover/reports/february-2012-claims-traded-monthly2 [last visited Aug. 28, 2012] (indicating that SecondMarket can track the number of trades, as well as other comprehensive data taking place on its platform).}
VI. CONCLUSION

As it stood before the adoption of the Threshold Provision, § 12(g) was out of step with the realities of the modern securities industry. There was certainly a need to reform § 12(g). However, due to the way the Threshold Provision is drafted, it fails to adequately resolve fundamental problems with § 12(g). As a result, the Threshold Provision will promote a dysfunctional standard for the mandatory disclosure triggering requirements, and it will reduce the number of companies that conduct IPOs. These unintended consequences can be avoided by changing the § 12(g) criteria to reflect trading volumes and beneficial ownership in the private and public spheres.