SPECIAL REPORT

# The SEC Must Stop Bleeding Public Markets Dry


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## INTRODUCTION

Over the last several decades, the SEC's[2] steadily expanding exemptions from the U.S. laws governing public securities offerings have shifted capital-raising activities between two parallel markets. One is an expanding private or exempt securities market that is dark, mostly unregulated, and accessible on a limited basis. The other is a shrinking public securities market that is transparent, well-regulated, and broadly accessible.

Without meaningful corrective action by Congress and the Securities and Exchange Commission ("SEC"), the dark private markets, which escape most U.S. securities laws through a Byzantine array of exemptions and exceptions, will continue to displace the public markets. Put differently, the expanding and largely unregulated private markets threaten to bleed regulated transparent public markets dry. This is cause for concern—alarm, even—because stifling or shrinking the public capital markets threatens to harm investors, the markets as a whole, and even the economy in many ways.

The public markets confer a long list of benefits by requiring full, public disclosure of material information about a company at the offering stage and thereafter; by providing for public trading venues such as the exchanges; and by establishing strong legal obligations and remedies to protect investors, which create and increase confidence and trust in the public markets. Through these mechanisms, the public securities markets—

- equip all investors, on an equitable basis, to make informed decisions about how they want to allocate their risk capital
- protect all investors by mandating detailed disclosure of important information—both positive and negative—about an issuing company
- establish strong legal obligations backed by meaningful remedies, thus deterring fraud and abuse in the first instance and providing compensation for investors who have been damaged after the fact
- provide public trading venues that generate more reliable share pricing and company valuations for the benefit of all market participants, including those who rely on financial benchmarks
- create liquidity that makes investments more attractive and easier to enter and exit
- enable the most efficient capital formation and allocation for companies to grow and innovate
- inspire confidence in the markets that attracts investors and facilitates ever-increasing capital formation

However, if this growth in private markets at the expense of public markets continues, it will irreparably harm investors, market confidence, capital formation, and, ultimately, the economy as a whole. It will unquestionably damage the U.S. securities markets by impeding capital formation, misallocating savings, and increasing the cost of capital across the U.S. economy. This imbalance will, in turn, diminish the financing options of businesses that

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[1] We wish to thank Joe Cisewski, our former Senior Derivatives Consultant and Special Counsel for almost four years, as the author of the original draft of this report prior to his departure. However, he had no involvement in the final editing and production and, therefore, the authors listed are solely responsible for its content.

[2] Congress has of course played a central role in creating and expanding the private securities market, through, for example, its initial decision to allow for various exemptions from registration in the securities laws and its expansion of those exemptions in the JOBS Act of 2012. But the SEC is primarily responsible for the creation, design, and enlargement of the specific exemptions over the years, including most recently its 2020 rulemaking. *See* SEC Press Release, *SEC Harmonizes and Improves "Patchwork" Exempt Offering Framework* (Nov. 2, 2020). While the SEC attempted to portray those rule changes as improvements upon the "patchwork" private offering framework, the agency actually further expanded that framework by, for example, liberalizing the integration requirements where companies rely on multiple exemptions, increasing some of the capital raising limits, and allowing more "test-the-waters" contact with potential investors. It lies with the SEC to do all it can to reverse the imbalance that is the focus of this report: the dominance of the private securities market over the public market.

fuel economic growth, stifle innovation, and dampen job creation that is central to rising standards of living and American influence around the world.

To be clear, the private securities markets have a legitimate and important role in capital formation. However, they must not be permitted to supplant public markets by facilitating regulatory arbitrage and avoidance of transparency measures, investor protections, and market safeguards in contravention of the purposes of the securities markets and laws.

Private-markets exemptions must be more confined so they strike a better balance between the significant public interests achieved only through public securities markets and the advantages of small-scale, streamlined, and cost-effective private capital raising. This fact sheet previews some of the reasons why the present imbalance may be harming investors and markets.

## I. The predominant avenues for capital raising through the U.S. securities markets should require mandatory disclosures of material information and other investor protections and safeguards that are the hallmarks of public markets.

The securities markets can be conceptually separated into (1) private (dark, mostly unregulated) markets and (2) public (lit, well-regulated) markets subject to the full panoply of protections and requirements under the federal securities laws.[3] This dual market structure has been a feature of the U.S. securities laws since their inception, and it is not an unreasonable one when the balance between the private and public markets is maintained and serves the purposes of the securities markets and laws: efficient capital formation and allocation that fuels the American economy and rising living standards.

The federal securities laws were not hastily scribbled on a napkin or dreamed up as a solution to a vague policy problem. They were adopted as a practical response to a ruinous crash in the U.S. stock markets in 1929 followed by severe dislocations and failures throughout the U.S. securities markets and banking system. These events ultimately led to a Great Depression and an ensuing global economic downturn. That crisis not only had course-changing political and economic consequences but once again proved that other than war, few things destroy more wealth or cause more chaos and human tragedy than financial crises.

The silver lining was that many were forced to acknowledge the consequences of the U.S.'s reliance on privately ordered markets riddled with self-dealing and conflicts of interest, not to mention outright fraud and other illegal conduct. By opening the aperture of the policy discourse, the Great Depression instigated reforms in our securities, derivatives, and commodities markets that not only brought our economic and financial systems into better balance but propelled the U.S. into a global economic superpower. The resulting U.S. regulatory environment created market conditions that allowed our economy to flourish and permitted countless companies to rely upon liquid, transparent, and stable capital markets widely viewed as the envy of the world.

[3] For purposes of this report, the terms "private markets" and "exempt markets" generally refer to securities offerings and sales that are made in reliance upon exemptions, in whole or part, from the registration, transparency, and other requirements under the Securities Act of 1933 ("Securities Act"), including mandatory disclosure requirements that would apply to registered securities offered or issued pursuant to the Securities Act. These terms also generally refer to trading activities and companies involving or issuing unregistered securities, or companies remaining under specified shareholder-and-asset thresholds and which are therefore not subject to critical transparency and governance elements of the Securities Exchange Act of 1934 ("Exchange Act"). The term "public markets" generally refers to registered securities offerings or the companies issuing such registered securities, or exceeding specified shareholder-and-asset thresholds, and which therefore are subject to certain reporting, disclosure, and governance requirements. Because certain public companies, too, are exempted and excepted from certain requirements of the securities laws, these are not perfectly exclusive categories, but they provide useful shorthand. In this report, for simplicity's sake, we generally use the term "private" markets to denote the offerings and companies with the foregoing private or exempt attributes.

Of course, neither that historical development nor the current state of our markets was or is pre-ordained, guaranteed, or destined to be the case. The U.S. securities markets have been the envy of the world because they are, in a number of critical respects, transparent and well-regulated. That is why investors and the public historically have had confidence that our markets are relatively fair, efficient, and free of fraud. And that is why so many Americans and people from around the globe are willing to risk their hard-earned money by investing it in the U.S. capital markets.

That confidence underpins our markets; lose that, and, best case, we risk damaging capital formation and allocation and dramatically increasing the cost of capital across the U.S. economy. Worst case, we could lose the very foundations for that confidence, and our markets could take on characteristics of backwater markets around the world, which are often viewed as cesspools in which predators exploit investors and other market participants.

Unfortunately, with the steady erosion of public markets—in particular since the early 1980s—the U.S. has been heading in the wrong direction. The common-sense reforms after the Great Depression meant to transform the U.S. securities markets into a wealth creation system for the many are being deliberately unwound and steadily replaced by the wealth extraction mechanism for the few that existed before 1933. In this process, we have undermined and sabotaged the very measures that led to the preeminence of our markets in the first place, including the investor protections and transparency requirements that restored public confidence once destroyed by unregulated private markets and the catastrophic stock-market crash and Great Depression they caused.

## II. The steady expansion of private markets has come, in significant part, at the expense of the public markets.

The present imbalance between private and public markets is apparent. While the proportion shifts in any given year, the trend is unmistakable. More than two-thirds of new capital raising in the U.S. securities markets occurs in private markets that are mostly unregulated, non-transparent, and inaccessible to the public.[4] For example, the SEC estimates that "[i]n 2019, registered [public] offerings accounted for $1.2 trillion (30.8 percent) of new capital, compared to approximately $2.7 trillion (69.2 percent) . . . raised through exempt [private] offerings."[5]

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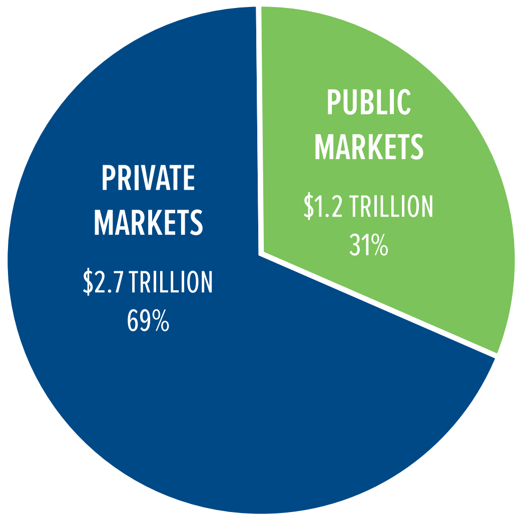
[4] SEC, *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, 86 Fed. Reg. 3496, 3553 (Jan. 14, 2021).

[5] *Id.* In this report, we rely largely on information that is current through 2019, as more recent numbers reflecting the scale of the private markets relative to the public markets are generally unavailable. Some sources indicate that 2021 saw a significant increase in IPOs. *See* Joel Rubinstein, *et al.*, *Backed by SPACs, IPOs Hit New Heights in 2021*, Harvard Law School Forum on Corporate Governance (Mar. 24, 2022); Jay R. Ritter, *Initial Public Offerings: Updated Statistics*, Warrington College of Business, University of Florida (March 11, 2022) (reporting that 311 *operating companies* went public in 2021, an increase over the 2020 level (*see* Figure 3 in text *above*)). However, these sources also make clear that this recent surge can be attributed to a number of anomalous factors, including pent-up demand for capital caused by the pandemic along with a surge in SPACs, an investment vehicle that is drawing increased scrutiny from the SEC. *See id.; see also* Echo Wang & Abhinav Ramnarayan, *Analysis: Record IPO Binge in 2021 Leaves Investors Hung Over*, Reuters (Dec. 24, 2021). In any case, none of these reports alter the basic point: The private markets have for years been outpacing the public markets as capital-raising vehicles and the trend is expected to continue and intensify—unless corrective action is taken.

Figure 1. Private, Dark Exempt Markets vs. Public, Transparent, Well-Regulated Markets




Source: SEC

This composition marks a departure from the historical balance between public and private markets, though the minimal or non-existent federal reporting requirements for private offerings make precise measurement of this trend challenging.[6] Policymakers have observed, for example, that "[o]ver the past decade [alone], there has been a steady increase in Regulation D [private] offerings,"[7] the most relied upon exemption under the Securities Act. State regulatory authorities have sounded similar alarms, emphasizing their experience with fraud and misconduct in private markets and further noting that "[p]rivate offerings, which once comprised a small fraction of total securities issuances," have expanded dramatically in recent years.[8]

The private markets based on the SEC's expanding exemptive framework have grown, in material part, at the expense of our public markets. In the 1990s, for example, "the public markets dominated the private markets in virtually every measure," whereas "[t]oday, in many measures, the private markets outpace the public markets, including in aggregate size."[9] Moreover, the expansion of the private markets in the past three decades has coincided with an alarming drop in the number of public companies listed on the major U.S. securities exchanges. In fact, listed companies have declined almost by half since 1996,[10] although significant non-regulatory factors have also contributed to this phenomenon.

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[6] Form D was first adopted in 1982, for example, and has always been a limited filing designed to facilitate exceedingly minimal SEC monitoring and analysis of private offerings under Regulation D. It is not designed or intended to provide the SEC or the public with meaningful information on the nature, risks, or prospects of private securities offerings. *See* SEC, Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11251, 11257 (Mar. 16, 1982) (explaining that "issuers will furnish information on Form D mainly by checking appropriate boxes"); *see also, e.g.,* SEC Division of Corporation Finance, *Overview of Capital-Raising Exemption* (Mar. 29, 2021) (summarizing the most salient requirements for ten frequently used exemptions from registration).

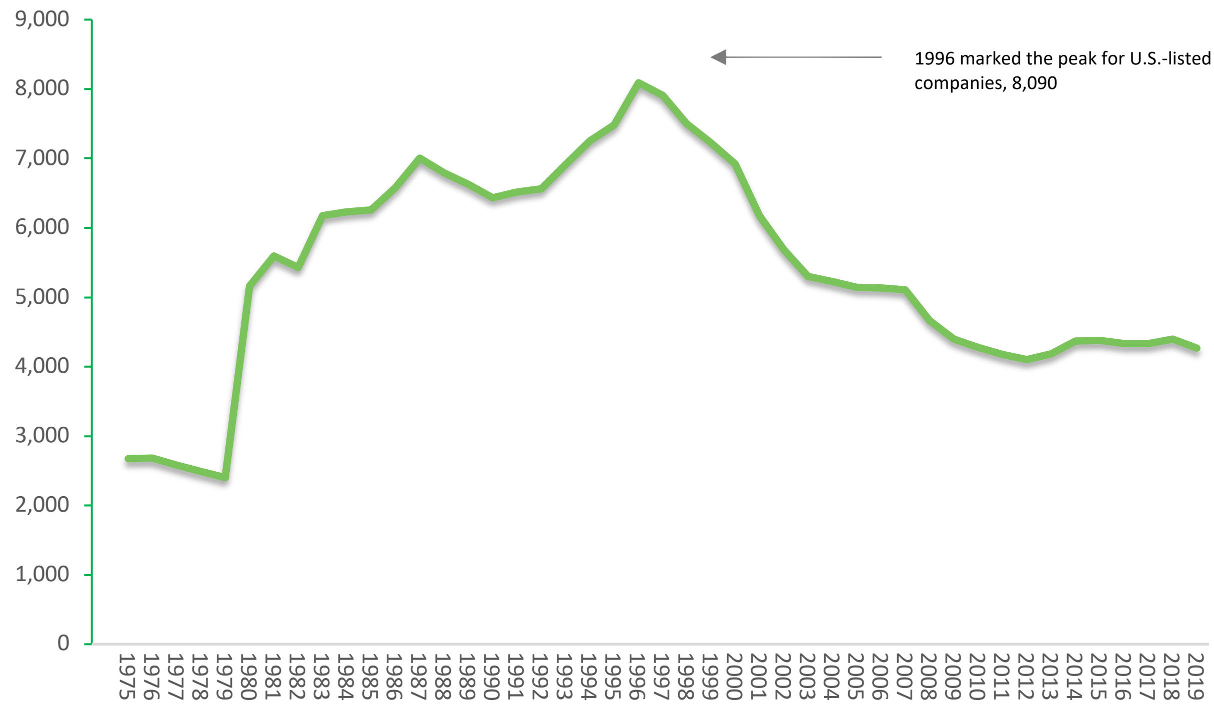
[7] SEC, Division of Economic and Risk Analysis ("DERA"), *Report to Congress on Regulation A/Regulation D Performance: As Directed by the House Committee on Appropriations in H.R. Rept. No. 116-122*, at 7 (Aug. 2020).

[8] North American Securities Administrators Association, Inc. ("NASAA"), *Letter to SEC Re: File Number S7-08-19: NASAA Comment Letter Regarding Concept Release on Harmonization of Securities Offering Exemptions* (Oct. 11, 2019).

[9] J. Clayton, SEC Chairman, *Remarks to the Economic Club of New York* (Sept. 9, 2019).

[10] C. Doidge, *et al., The U.S. Listing Gap*, J. of Fin. Econ., Vol. 123, Issue 3, 464 (2017). Even if the 1996 peak-listings figure is not the appropriate benchmark, the listings trend illustrated in Figure 2 *above* is clearly downward sloping.

Figure 2. Domestic Listed (Public) Companies, United States (1975-2019)




Source: World Bank, Data Bank: World Development Indicators

Meanwhile, some peer-group countries have experienced an increase in public listings during the same period, while others have decreased at a slower pace, giving rise to a "listings gap" that distinguishes the U.S. from much of the developed world.[11] The evidence reveals that the "U.S. now has abnormally few listed firms" relative to a number of countries at a similar level of economic development[12] and relative to the size of the U.S. economy.[13]

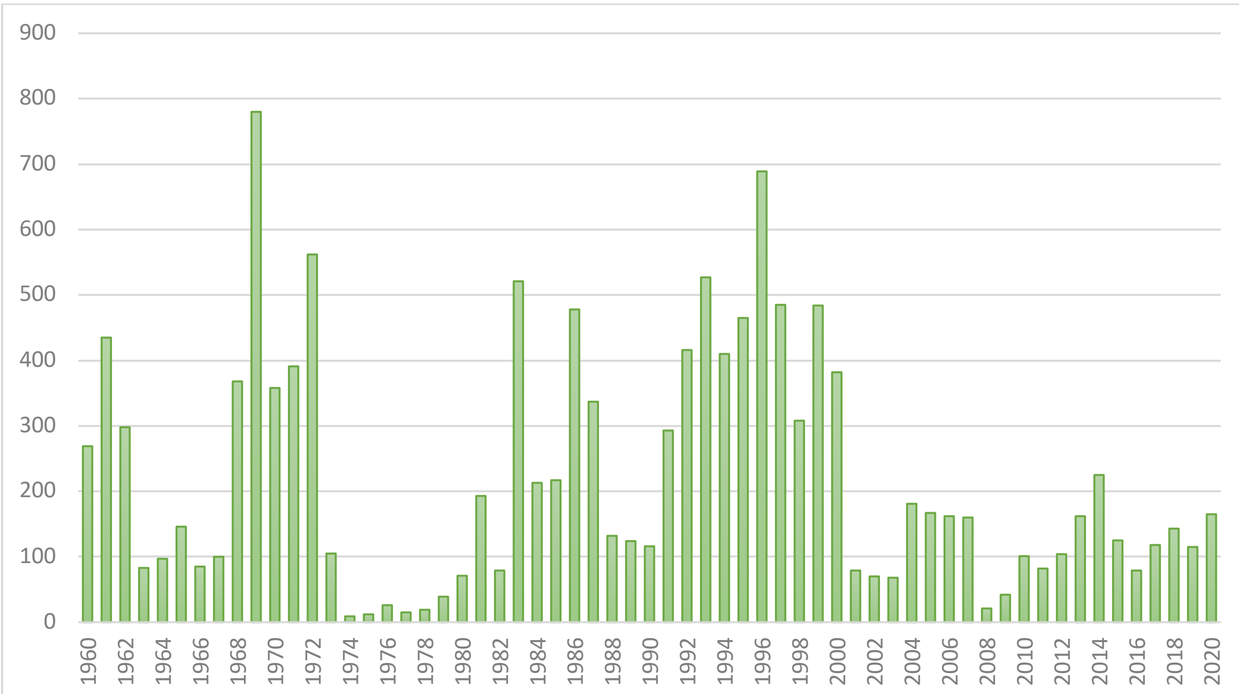
[11] R. Stulz, *Public Versus Private Equity*, The Ohio State University, NBER, Wharton Financial Institutions Center and ECGI, Finance Working Paper No. 640/2019, 4-5 (Nov. 2019).

[12] C. Doidge, *et al.*, *The U.S. Listing Gap*, J. of Fin. Econ., Vol. 123, Issue 3, at 464 (2017). De-listings have occurred at such a pace that, unfortunately, even if new listings remained in line with historical averages, the U.S. still would have a listing gap relative to the 1996 peak. Id. Interestingly, however, some global financial hubs, like London, have experienced similar declines. *See* R. Stulz, *Public Versus Private Equity*, The Ohio State University, NBER, Wharton Financial Institutions Center and ECGI, Finance Working Paper No. 640/2019, 1 (Nov. 2019) ("The U.K. reached a peak in the number of listings in 2006, but since then the number of listings has dropped by almost one third.").

[13] On a gross domestic product-adjusted basis, the problem may be markedly worse than suggested by the absolute numbers alone. *See* D. Weild & E. Kim, *Capital Markets Series: A Wake-Up Call for America*, at 4 (Nov. 2009) (noting that the listing gap "understates the problem . . . because the economy has grown significantly since the [1990s]. A larger economy logically should support more, not fewer, public companies. Adjusting for real GDP growth, the true decline in the number of listed companies on U.S. stock markets is [not 22.2% but] 52.8% since 1991.").

This has been driven, in part, by accelerating de-listings,[14] delayed transitions to public status,[15] and the related glut of capital to fund acquisitions as part of exit and privatization strategies.[16]

Figure 3. U.S. Initial Public Offerings (1960–2020)




Source: IPO Data Published by J. Ritter, University of Florida

A confluence of complex factors undoubtedly contributed to these facts, but it is likely that the expansion of private markets, both in "number and scope . . . over several decades"[17] has shifted capital formation away from transparent and well-regulated public securities markets to less transparent and largely unregulated markets. The series of deregulatory actions taken during the very time period that public listings precipitously fell, at a minimum, exacerbated the trend. In this report, we outline decades of such actions by Congress and the SEC.

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[14] There are multiple reasons that companies delist, but delistings appear to have been driven, in material part, by acquisitions in recent years. *See* R. Stulz, *Public Versus Private Equity*, The Ohio State University, NBER, Wharton Financial Institutions Center and ECGI, Finance Working Paper No 640/2019, at 4 (Nov. 2019); *see also* X. Gao et al., *Where Have All the IPOs Gone?*, 48 J. of Fin. & Quant. Anal. 1663, 1665 (Dec. 2013

[15] *See* IPO Task Force, *Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth*, Presented to the U.S. Department of the Treasury, at 6 (Oct. 20, 2011); *see also* D. Weild & E. Kim, *Capital Markets Series: A Wake-Up Call for America*, at 2 (Nov. 2009) ("Within the venture capital universe, the average time from first venture investment to IPO has more than doubled.

[16] V. Winship, *Private Company Fraud*, 54 U.C. Davis L. Rev. 663, 673 (2020) ("Between 1997 and 2017, the number of IPOs declined and the number of acquisitions and leveraged buyouts (a mode of "going private") increased."); see also, e.g., X. Gao et al., *Where Have All the IPOs Gone?*, 48 J. of Fin. & Quant. Anal. 1663 (Dec. 2013).

[17] E. de Fontenay, *et al.*, *Comment Letter to the SEC Re: Concept Release on Harmonization of Offering Exemptions, File No. S7-08-19* (Sept. 24, 2019).

None of this is to overlook a number of unhelpful practices in the public markets. While the present overreliance on private securities markets must be brought back into balance, no one should idealize the present state of the public markets.[18] Indeed, as Congress and the SEC seek to strike a better balance between private and public markets by circumscribing exemptions, they must also ensure that the public markets operate as public markets should—in a fully transparent, orderly, and fair manner.

The flaws of the private markets, however, especially with respect to exempt offerings with large numbers of diffuse shareholders and large investment amounts, are dramatically more concerning than the flaws in the public markets. After all, the public markets provide transparency and other investor protections, not to mention market integrity benefits and regulatory oversight, almost completely (or completely, depending on the exemption) absent in private markets.

## III. The overreliance on the SEC's exemptive framework is apparent and diminishes the public markets and their critical capital formation and allocation purposes.

In judging the appropriate scope of private and public securities markets, policymakers must address, as an initial matter, whether private ordering[19] of securities offerings to the extent contemplated by the array of statutory and regulatory exemptions does or can best serve the fundamental purposes of the securities markets.[20] We conclude that it does not and cannot and that the present imbalance between private and public markets has been influenced by the substance and breadth of securities-offering exemptions.

For present purposes, we will simply state that by permitting companies in the private, dark markets to raise essentially unlimited amounts of capital[21] and to increasingly take on a character of "publicness"[22]—while avoiding even the most basic and critical transparency and governance requirements applicable to public companies—Congress and the SEC have created a harmful imbalance in the U.S. securities markets. This threatens to critically

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[18] We have explained at length elsewhere that the secondary securities markets, while "public," are anti-competitive in significant respects and seemingly structured to maximize created complexity and entrench dark markets to the detriment of public, transparent exchanges and investors. *See* Better Markets, *White Paper: Select Issues Raised by the Speculative Frenzy in GameStop and Other Stocks*, Better Markets (Mar. 26, 2021). However, the public markets themselves have been essentially forced to modify order routing and execution practices in problematic ways to attract trading interest.

[19] There is a considerable literature on "private ordering" mechanisms, and it often focuses on non-state mechanisms for creating and enforcing various forms of "law." Here, we refer to private ordering in the narrow sense of relying on rule and enforcement mechanisms mostly outside of the federal securities laws to govern the issuance of securities but where governmental mechanisms (*e.g.,* state corporate and common law and the judicial system) may be available in these private markets. We use the term "mostly" because Congress, the SEC, and the courts have designed an exemptive framework that conditions reliance on factors and criteria that, in a very limited sense, provide regulation by exemption.

[20] In this brief preview, we obviously cannot explore—much less do justice to—all of the arguments and counterarguments throughout the theoretical and empirical legal and economic literature. The debate is particularly substantial, technical, and voluminous in the substantive area of mandatory disclosure. The literature challenging the value of mandatory disclosure as contemplated by the securities laws and arguing for private ordering in one form or another erupted in 1964 and has been raging for almost 60 years, with seemingly endless nuances to the competing contentions.

[21] For example, SEC Rule 506(b) under Regulation D permits issuers can file a skeletal Form D and raise an (1) unlimited amount of capital (2) with no mandatory disclosures (3) to unlimited "accredited investors" and as many as 35 additional non-accredited investors within specified time limits. *See* 17 C.F.R. § 230.506(b). We discuss concerns with respect to Form D's informational deficiencies *below*.

[22] *See, e.g.,* D. Langevoort and R.Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 Geo. L.J. 337 (2013).

erode public markets, impede capital formation, and create market conditions that misallocate the savings of working families and increase the cost of capital for business across the U.S. economy.

## A. The Securities Law Framework

As discussed above, the federal securities laws were designed to transform the dark, predator-infested private U.S. securities markets that existed in the pre-1933 era. Numerous provisions provided new safeguards and realigned incentives in the new public markets relative to those in the private markets. However, the key new regulatory requirement under the Securities Act was the replacement of (1) the minimal, inadequate, and often inaccurate voluntary disclosures extracted from issuers based solely on the unequal bargaining power and informational advantages of certain investors with (2) mandatory disclosure of all material information affecting public securities offerings to all investors.

In his March 1934 defense of the Securities Act, the future SEC chairman and U.S. Supreme Court Justice William O. Douglas explained that the then-new securities laws "presuppose that the glaring light of publicity will give the investors needed protection" and emphasized that the laws would prevent and deter fraud, provide investors remedies that were practically difficult to obtain under the common law, and ensure that market prices reflect truthful information about securities.[23] Much has been written about the purposes and effects of the Securities Act, but this nearly contemporaneous summary is as useful as any.

Under the federal securities laws, a transaction involving an offer[24] or sale of securities[25] is registered, exempt, or unlawful.[26] As an outcome of congressional investigations exposing shameless, widespread, and fraudulent practices throughout the securities industry in the lead-up to the Great Depression,[27] Securities Act section 5

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[23] W. Douglas, *Protecting the Investor*, 23 Yale L. Rev. 522, 524 (Mar. 1934) (emphasizing, for example, that "the requirement that the truth about securities be told will in and of itself prevent some fraudulent transactions which cannot stand the scrutiny of publicity;" and that "[t]he judgment of . . . experts will be reflected in the market price" of registered securities, even when investors are unaware of it).

[24] Securities Act section 2(a)(3) defines the term "offer" broadly to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." *See* 15 U.S.C. § 77b(a)(3). In light of the sweeping scope of the statutory term "offer," the SEC has explained that the term "offer" encompasses "the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities." SEC, *Securities Offering Reform*, 70 Fed. Reg. 44722, 44731, n. 88 (Aug. 3, 2005); *see also* SEC, *Publication of Information Prior to or After the Effective Date of a Registration Statement*, 22 Fed. Reg. 8359 Release No. 33-3844 (Oct. 8, 1957).

[25] Securities Act section 2(a)(1) defines the term "securities" broadly as well and captures almost endless permutations of enumerated financial instruments, like equities (or stocks representing ownership interests in a company) and bonds (or debt instruments representing creditor interests), and "investment contracts." *See* 15 U.S.C. § 77b(a)(1); *see also* *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99, 66 S. Ct. 1100, 1102-03 (1946) (interpreting the term "investment contract" for purposes of the Securities Act to include any contract, transaction, or scheme whereby a person (1) invests money, (2) in a common enterprise, (3) in expectation of profits, (4) solely from the efforts of the promoter or a third party"). The *Howey* test has confirmed its continued relevance more than 70 years later, as numerous promoters of cryptocurrencies have sought to escape the application of the securities laws to the issuance and trading of digital tokens that, in the overwhelming majority of cases, likely constitute "securities" under that broad test.

[26] This report does not purport to provide a comprehensive discussion of the Securities Act, Exchange Act, or regulations promulgated thereunder. For a more comprehensive review of the scope of securities registration and exemptive provisions and requirements, *see, e.g.,* T.L. Hazen, *The Law of Securities Regulation*, Eighth Edition, LEG, Inc. d/b/a West Academic (2021).

[27] *See, e.g.,* U.S. Committee on Banking and Currency, *Report on Stock Exchange Practices Pursuant to S. Res. 84 (A Resolution to Investigate Practices of Stock Exchanges With Respect to the Buying and Selling and the Borrowing and Lending of Listed Securities)*, 73rd Cong., 2d Session, Report No. 1455 (June 6, 1934). This report was ultimately published subsequent to the early New Deal legislation governing securities markets, but the "Pecora Commission's" preliminary conclusions from a series of high-profile hearings informed much of the public pressure and congressional willingness to enact securities markets reforms. Recent activities in the U.S. securities markets, like frenzied trading in GameStop and other meme stocks or "stonks," provide congressional

requires a transaction involving an initial distribution of securities to the general public—for example through an IPO—to be conducted in conjunction with an effective registration statement filed with the SEC. The Securities Act imposes certain prohibitions and restrictions on offers and sales subsequent to the effective date of a registration statement as well.

The registration process for new issuances is the key transparency measure in the Securities Act because it requires the filing of a "prospectus"—a public disclosure document—with specified information concerning the ownership structure, financial condition, management, risks, and business prospects and plans of a company prior to any offers to sell its securities.[28]

Despite these core elements of the Securities Act and the widespread abuses that necessitated its transparency and other reforms in the first place, today, most transactions involving the issuance of securities are not registered. The overwhelming majority of securities offerings today are conducted in reliance upon exemptions in sections 3 and 4 of the Securities Act[29] and related SEC regulations setting forth related exemptions and/or safe harbors (which, in essence, are regulatory conditions that if met, keep securities transactions within parameters that the SEC would view as consistent with a statutory exemption).

Securities Act section 3 sets forth self-executing exemptions generally based on the characteristics of the securities being issued, though it also contains transaction-based exemptions. For example, Securities Act section 3(b)(1) applies to certain securities offerings of a "limited character" or having a "small amount involved."[30] Securities Act section 4 likewise identifies transactions exempted from registration requirements,[31] although its reach is practically set forth in SEC regulations.

The most important of these statutory exemptions for our present purposes is Securities Act section 4(a)(2), which provides that section 5's registration requirements do not apply to "transactions by an issuer not involving any public offering."[32] Under this provision, the SEC instituted the Regulation D exemptive framework in 1982 that now governs the vast majority of private securities offerings.[33]

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leaders a unique opportunity to similarly investigate conflicts of interest and harmful practices that have crept back into markets, or never left.

[28] 15 U.S.C. § 77e(b). In practice, the information provided in connection with unregistered offerings through private placement memoranda can be similar in certain respects, but it is usually far more limited and dependent on the nature of the issuers and the types of securities being offered, as well as the scope of the offering and its investor base. *See also* SEC Form S-1.

[29] *See* 15 U.S.C. § 77c; 15 U.S.C. § 77d. These exemptions, or enabling authority for these exemptions, were embedded in the Securities Act at inception and therefore arise from provisions that date as far back as the 1930s. The Securities Act also authorized the SEC to adopt discretionary exemptions, provided any such exemptive action(s) would be determined "necessary or appropriate in the public interest and consistent with the protection of investors." *See* 15 U.S.C. 77z-3. The SEC adopted its first iteration of Regulation A in 1936, for example, as an exemption for small issuers under section 3(b) of the Securities Act. *See* SEC Staff, *Report to the Commission: Regulation A Lookback Study and Offering Limit Review Analysis*, at 3 (Mar. 4, 2020).

[30] *See* 15 U.S.C. § 77c.

[31] *See* 15 U.S.C. § 77d.

[32] 15 U.S.C. § 77d(a)(2).

[33] *See* SEC, *Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales*, 47 Fed. Reg. 11251, 11257 (Mar. 16, 1982). SEC Rule 506 contains the most relied upon safe harbor from the broader statutory exemption under section 4(a)(2) of the Securities Act. Offers and sales of securities by an issuer that satisfy the conditions in paragraphs (b) and (c) of SEC Rule 506 are deemed, in essence, to be transactions not involving any "public offering" within the meaning of Section 4(a)(2) of the Securities Act. See 17 C.F.R. § 230.506(a). Regulation D is codified in 17 C.F.R. §§ 230.501-270.508 (2010). Like most other aspects of the SEC's exemptive framework, Rule 506 has been substantially expanded to include general advertising and general solicitation for certain subparts, which is a considerable departure from the SEC's reasoning in adopting Rule 506. Today, private

## B. The Long-Abandoned Presumption of "Publicness" (If It Ever Existed)

Most companies in the 1930s and 1940s determined to limit their potential liabilities—including the risk of rescission of the offering—by complying with the registration framework of the Securities Act. There is little reliable information on the extent of private securities offerings after the Great Depression and enactment of the securities laws, but many companies appear to have been advised for at least the first 20 years of the securities laws' existence to conduct issuances in accordance with the public offering provisions of the Securities Act.

The U.S. Supreme Court acknowledged by the early 1950s that questions on the scope of exemptions from the Securities Act had "arisen many times since the [Securities] Act was passed" and had made "apparent" the "need to define the scope of the private offering exemption."[34] Long before that opinion, commenters writing in close proximity to the passage of the Securities Act—including an SEC General Counsel in the 1930s—recognized the challenge of "ascertain[ing] the precise limits of the exemption afforded to non-public offerings," given "the border region of considerable extent where the prudent issuer will register until such time as judicial decision has furnished a rosetta stone of interpretation of the public-offering concept."[35]

That risk aversion of the "prudent issuer" and the presumption of an offering's "publicness," if it existed in the early years following passage of the Securities Act, is long gone. Today, the overwhelming majority of securities offerings—even those offered to a substantial number of eligible people with no relationship to the issuer and in substantial amounts—are conducted in reliance upon so-called "safe harbors" designed to provide regulatory certainty and avenues for avoiding the transparency and other investor protections of the Securities Act. Although the SEC has established numerous exemptions, Regulation D remains, by far, the most significant exemptive framework, comprised of three regulatory exemptions under SEC Rule 504, SEC Rule 506(b), and SEC Rule 506(c).[36]

In fact, the SEC estimates that almost half of all private offerings ($1.492 trillion) in 2019 (in terms of total amount raised) were conducted in reliance upon the SEC Rule 506(b) safe harbor alone, which itself exceeds the capital raised through all public markets.[37] That is consistent with the overall trend with respect to the number of private offerings during the last decade:

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offerings conducted pursuant to SEC Rule 506 can raise unlimited funds from an unlimited number of accredited investors. In addition, under SEC Rule 506(c), companies can engage in general solicitation of investors, including through websites, provided they reasonably ensure that purchasers of such privately offered securities are accredited. 17 C.F.R. § 230.506(c) (2017).

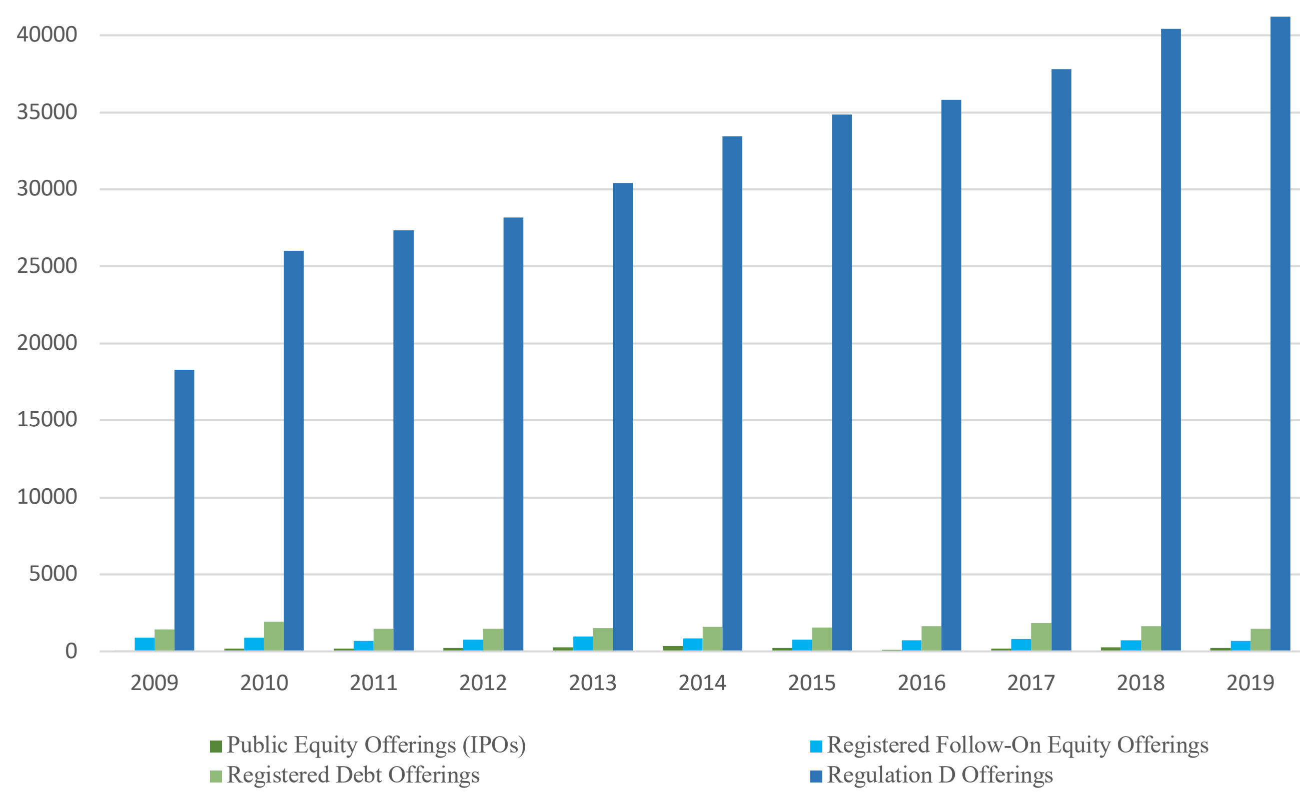
[34] *SEC v. Ralston Purina Co.*, 346 U.S. 119, at 120 (1953). Some academic literature indicates that private offerings in reliance on section 4(a)(2) were not infrequent but also that judicial explication of section 4(a)(2) left issuers with considerable risks in conducting securities offerings outside of the section 5 registration framework. *See* R. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 Bus. Law. 919, 923, n. 22 (2011).

[35] *See, e.g.,* A. Throop & C. Lane, *Some Problems of Exemption under the Securities Act of 1933*, J. of L. & Contemp. Prob., at 114 (1937) (emphasis added).

[36] *See* n. 31 *above*.

[37] SEC, Division of Economic and Risk Analysis, *Report to Congress on Regulation A/Regulation D Performance: As Directed by the House Committee on Appropriations in H.R. Rept. No. 116-122*, at 16 (Aug. 2020).

Figure 4. Number of Unregistered Regulation D Offerings and Registered Offerings (2009-2019)




Source: SEC DERA[38]

Although we would expect a large number of private offerings even in a regulatory framework that creates a better balance between lit and dark markets, the actual numbers are striking, in part because of their magnitude and in part because of the trend.  In terms of securities offering activities, as well as capital raising amounts, the private markets now simply dwarf the public markets (see also Figure 1).

As Figure 5 on the following page indicates, the issuer reliance on Regulation D is highly concentrated in SEC Rule 506(b) offerings, which we suspect is, in large part, because the provision preempts state laws (which some exemptions under the SEC's framework do, while others do not).

[38] *Id.* at 41-42.

Figure 5. Offerings by Exemptions Available under Regulation D 2019

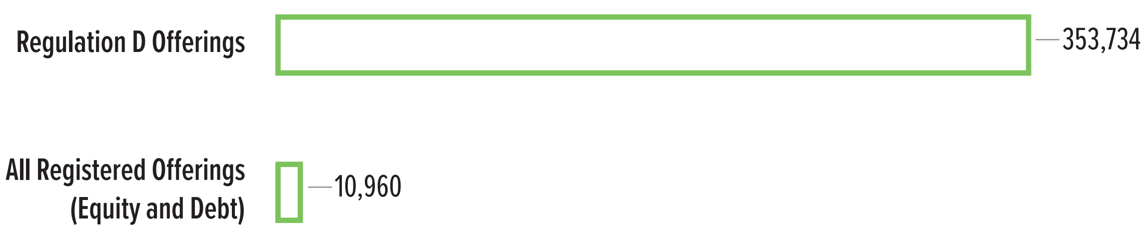
| | Rule 504 | Rule 506(b) | Rule 506(c) | Regulation D (Total) |
|---|---|---|---|---|
| Number of New Offerings | 476 | 24,636 | 2,269 | 27,381 |
| Amount Reported Raised | $2 billion | $1,491.9 Billion | $66.3 Billion | $1,558.4 Billion |

Source: SEC DERA[39]

The cumulative total over this period is equally striking. Graphically, one can see beyond any reasonable doubt that the private markets (through Regulation D, specifically) have become the norm. It's a classic case of the exemption swallowing the rule. The public markets have become the decided exception.

In our view, this shift from public to private markets evades the core purposes of the regulatory framework envisioned by the Securities Act, including most importantly investor protection, although the impact on public markets and capital formation cannot be overlooked.

Figure 6. Total Number of Regulation D Offerings and Registered Offerings (2009–2019)




Source: SEC DERA[40]

Over roughly the last decade (at least from 2009 through 2019), an astonishing $13.6 trillion was raised through Regulation D offerings alone.[41] Beginning in 2017, "the amounts raised in the Regulation D market have surpassed aggregate amounts raised through registered [public] offerings of debt and equity"[42] in each year.

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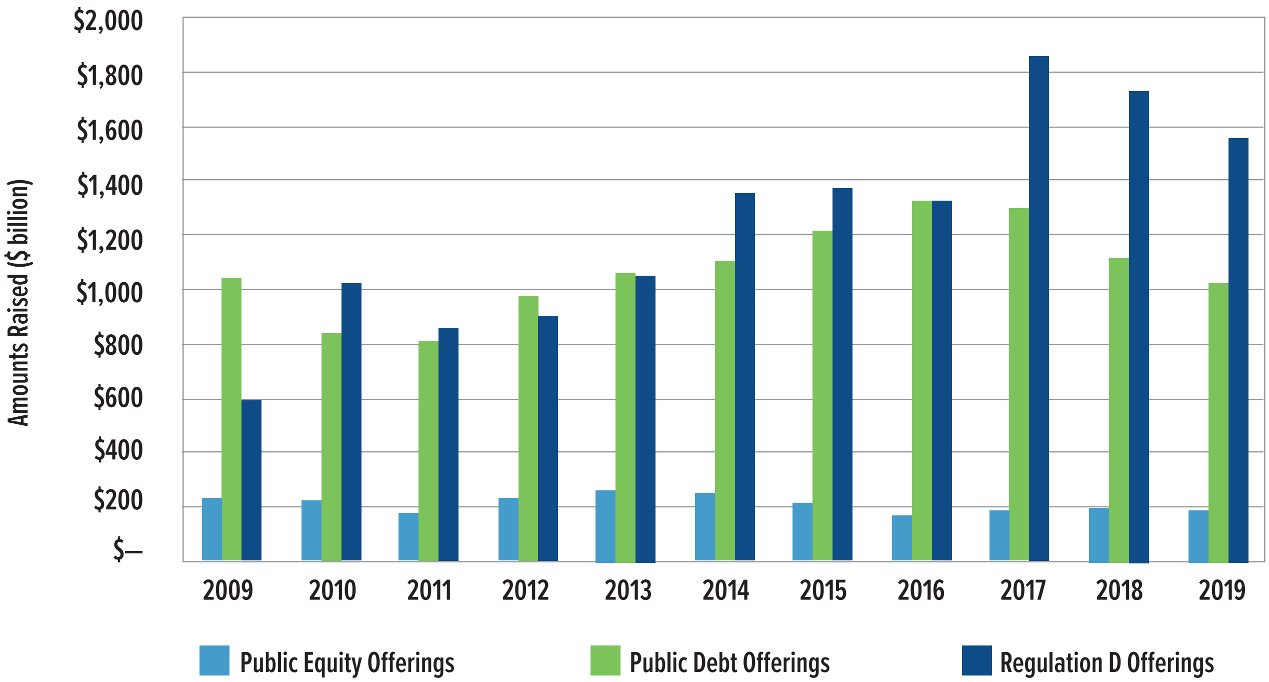
[39] SEC, Division of Economic and Risk Analysis, *Report to Congress on Regulation A/Regulation D Performance: As Directed by the House Committee on Appropriations in H.R. Rept. No. 116-122*, at 18 (Aug. 2020).

[40] *Id.*

[41] *Id* at 40. The total amount of registered offerings across debt and equities was slightly higher than the private offerings during this 10-year period—$14.1 trillion. However, as noted in text, Regulation D offerings have surpassed the aggregate amounts raised through public offerings every year since 2017, confirming the trend toward private versus public access to capital. Moreover, these data predate the SEC's most recent rules that further liberalized certain aspects of the SEC's private offering framework. See SEC Press Release, *SEC Harmonizes and Improves "Patchwork" Exempt Offering Framework* (Nov. 2, 2020). As observed *above*, at n. 1, while the SEC attempted to portray those rule changes as improvements upon the "patchwork" private offering framework, the agency actually further expanded that framework substantially.

[42] *Id.*

Figure 7. Aggregate Capital Reported Raised in 2009–2019 through Regulation D Offerings and Registered Offerings (in Billions)




Source: SEC DERA[43]

Remarkably, Regulation D is only one element of a much broader (and still expanding) exemptive framework. Congress and the SEC have created and expanded a number of other exemptions, to the point that the SEC now has an entire page on its website dedicated to summarizing the multiplicity of current exemptions.[44] These other exemptions include Regulation A, Regulation Crowdfunding, Regulation S, Securities Act section 4(a)(2), and SEC Rule 144A (technically applicable only to resale transactions but often used to facilitate a two-step offering by issuing securities in a private offering to a small number of financial institution(s) under other exemptions and then reselling securities in reliance upon the rule).

In the absence of a single offering under any of these alternative exemptions, however, the Regulation D numbers for the decade preceding 2019, by themselves, raise serious concerns about the adverse consequences that may be associated with a market structure increasingly reliant on caveat emptor ("let the buyer beware" or, better said, "investors, you're on your own!"). President Roosevelt once stated that the Securities Act was intended to "add to the ancient rule of caveat emptor, the further doctrine 'let the seller beware.'"[45] But issuers do not appear to be wary, and why should they be? The imbalance in the private and public markets suggests that with minimal effort, they can readily avoid the Securities Act and the vast majority of hard-fought reforms to the securities markets.

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[43] *Id.* at 27 (Aug. 2020).

[44] *See* SEC Division of Corporation Finance, Overview of Capital-Raising Exemptions (Mar. 29, 2021) (summarizing the most salient requirements for ten frequently used exemptions from registration).

[45] E. Keller, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, Ohio State L. J. 49, at 339 (1988).

## IV. The SEC has inexplicably tied its own hands despite broad authority to require filings that at least would facilitate monitoring of private markets and enforcement of the law.

With the growth of private markets, it is not just investors that live with a dearth of material information.[46] The SEC is in the dark as well—which is especially puzzling because the agency has chosen to deny itself the information it needs to monitor private offerings. This approach is doubly harmful, as it undermines the SEC's enforcement program and also leaves investors, once again, to fend for themselves.

In the absence of mandatory public information, there is undoubtedly a "loss of the information needed to detect and punish fraud."[47] With the exception of Form D, which provides almost no meaningful information and is not a condition of reliance on Regulation D,[48] private companies issuing exempt securities need say little more than necessary to raise capital. When there is serious competition for investment opportunities—as today—the ability of even very large and reputable providers of capital (the buy side) to get sufficient and sufficiently dependable information may be limited. Moreover, even when bargaining leverage is sufficient to extract disclosures from private companies, the disclosures are a function of contract, meaning the extracting parties (the sell side) need not, and almost certainly would not, share them with other investors, much less the markets as a whole.

Thus, although investor tips, media coverage, whistleblowers, and other sources can lead to SEC investigations of companies in both private and public markets, this is much more likely in the public markets where there is mandatory disclosure of all material information, including information regarding the company's management, internal transactions, and financial statements.

SEC Commissioners Lee and Crenshaw had this to say about the SEC's oversight of dark private markets created by the agency's exemptive framework:

> [T]here is a great deal we [the SEC] simply do not know about how the private market functions. We don't know how many investors participate in these offerings. We can't distinguish individual investors who participate in such offerings from institutions. We don't know how much they invest or how they fare. We can't say with confidence how many private offerings even take place. We don't know how many investors will be . . . eligible for private offerings . . . Thus we are operating under significant data constraints—largely of our own making.[49]

In essence, the SEC has taken a series of actions to expand the private markets with limited or no reliable information with which to reasonably judge the implications, much less advisability, of its actions.

This lack of data is associated not only with primary issuances but also with the absence of ongoing reporting obligations. Private companies readily avoid most of the ongoing requirements of the securities laws, unless they

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[46] Marvin R. Mohney, *Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933*, 24 Wm. & Mary L. Rev. 121, 132 (1982) ("Thus, the new regulation increases the opportunity for issuers to make securities offerings with less burdensome disclosure requirements."); see also SEC Chair Mary Jo White, *Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative* (Mar. 31, 2016) (expressing concern about inaccuracies in disclosures provided in private offerings).

[47] V. Winship, *Private Company Fraud*, 54 U.C. Davis L. Rev. 663, 669 (2020) (discussing numerous examples of fraud that the SEC uncovered primarily because of filed offering documentation).

[48] A. Herron Lee & C. Crenshaw, SEC Commissioners, *Joint Statement on the Failure to Modernize the Accredited Investor Definition* (Aug. 26, 2020).

[49] *Id.*

exceed shareholder-of-record and asset thresholds that, in yet another area, Congress has seen fit to relax in the interest of exempting more companies from the Exchange Act's reporting requirements.[50]

The SEC's willful blindness here is inexcusable, in part because it can improve its insight into the private markets with minimal effort, while still serving its mandates, including the duty to facilitate capital formation. For example, the Form D filing could easily be revised to provide more timely and useful information about private offerings.

As a clear demonstration of the inadequacy of the current version of this form and the limited value of the information it provides, consider the example of Theranos, the now legendary collapsed firm that is alleged to have engaged in numerous fraudulent practices:[51]

> The Form D that Theranos filed in July 2010 . . . [was] a six-page document [that] indicates that Theranos was incorporated in Delaware "Over Five Years Ago" and had once been called "RealTime Cures, Inc." It includes the address, corporate role and identity of Elizabeth Holmes and other directors, and identifies Theranos as a company within the biotechnology industry. In response to a section on "Issuer Size" that referred to revenue range, the company checked the box labelled "Decline to Disclose." Other than that, information in the Form D is limited to the claimed exemption from a public offering, types of securities, and offering or sale amounts ($100 million).[52]

The founder and CEO of Theranos, Elizabeth Holmes, was convicted on fraud charges early this year and is scheduled to be sentenced in September.[53]

The SEC simply must strike a better balance between private and public markets, at a minimum reducing if not eliminating the deficiencies in Form D. Unfortunately, it has only done the opposite, tying its own hands despite broad authority (and, we would argue, a duty) to require information that would enable it to more effectively monitor the private markets and enforce the few laws that continue to apply to them.

## V. Most of these exempted securities offerings are not moored to their claimed statutory and judicial origins.

In 1953, the U.S. Supreme Court's decision in SEC v. Ralston Purina Co. perhaps inadvertently set us in motion towards the current state of the markets.[54] That case provides insight into the origins of the flawed legal

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[50] Until recently, the Exchange Act imposed reporting requirements on issuers that (1) had registered securities, (2) had a class of securities listed on a national exchange, or (3) had a class of equities held by at least 500 shareholders of record and assets of $10 million. In the JOBS Act, the last test was expanded four-fold to apply only to issuers with classes of equity, in essence, involving at least 2,000 shareholders of record and at least $10 million of assets. *See, e.g.,* D. Langevoort and R. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 Geo. L.J. 337, 344-346 (2013). Because of this consequential revision, many significant private companies are less likely to become public companies and equally importantly, they now have less pressure and incentive to design compliance and controls frameworks over financial reporting and other matters in preparation for becoming public. In the previous era with more confined private markets, "[r]apidly growing companies would hire executives with experience working at publicly traded firms, recruit outside directors with strong reputations, and take steps to clean up conflicts of interest or other unorthodox transactions." R. Jones, *Written Testimony of Renee M. Jones*, Before the House Financial Services Committee Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, at 2 (Sept. 11, 2019).

[51] *See, e.g.,* S. Randazzo, *The Theranos Trial: Elizabeth Holmes, the Charges and What Else to Know*, Wall St. J. (Aug. 17, 2021); *see also* John Carreyrou, Bad Blood: Secrets and Lies in a Silicon Valley Startup (Knopf Pub. Grp. 2018).

[52] V. Winship, *Private Company Fraud*, 54 U.C. Davis L. Rev. 663, 708 (2020).

[53] Erin Griffith, *Elizabeth Holmes is set to be sentenced on Sept. 26,* N.Y. Times (Jan. 12, 2022).

[54] 346 U.S. 119, 125, 73 (1953).

foundations of the SEC's Regulation D framework, including the distortion of the Ralston Court's reasoning through the "accredited investor" standard.

## A. The Changing Notion of "Public"

The reasonable basis of the Ralston decision and its puzzling extension reveal the unsound basis for the most relied upon exemptions from the Securities Act. The Ralston Court considered whether the SEC properly enjoined Ralston Purina from offering unregistered shares of company stock to certain of its "key employees." In essence, the Court held that Ralston could not rely upon the statutory exemption for "transactions by an issuer not involving any public offering" because the meaning of the term "public offering" within the exemption included an offering solely to the company's key employees.

This holding is somewhat ironic because the Ralston case—though rightly confining the most significant exemption from the Securities Act—ultimately would provide the basis for expanding the reach of the section 4(a)(2) exemption to significant swaths of the public. The Ralston Court undoubtedly would be surprised to learn that, today, private markets eclipse the public markets by every measure and that its reasoning served as the foundation for the SEC's expansive exemptive framework giving rise to that fact.

The SEC nevertheless has taken the view that securities primarily offered and sold to certain relatively high-income or high net-worth categories of the general public, namely "accredited investors," fall within the contours of the Securities Act section 4(a)(2) exemption for "transactions by an issuer not involving any public offering."[55] As a consequence, the vast majority of securities are now sold through unregistered offerings (see Figure 6 above), avoiding the transparency and other investor protections of the Securities Act.

The ostensible basis for the SEC's re-writing of Securities Act section 4(a)(2) exemption is the Ralston case. However, the SEC's actions actually defy the language and logic of the Ralston decision.

For example, in considering the context of the Securities Act and its exemptions, the Court emphasized that "statutory antecedents of federal securities legislation . . . have made one thing clear—to be public an offer need not be open to the whole world."[56] In this regard, it approvingly cited the following passage from a U.S. court of appeals, which is worth revisiting in its entirety:

> In its broadest meaning the term "public" distinguishes the populace at large from groups of individual members of the public segregated because of some common interest or characteristic.
>
> Yet such a distinction is inadequate for practical purposes; manifestly, an offering of securities to all red-headed men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone & Telegraph Company, is no less "public," in every realistic sense of the word, than an unrestricted offering to the world at large.

[55] The accredited investor concept, discussed further in text, figures prominently in the private market framework, as it denotes those investors deemed eligible to participate in a number of the exempted offerings. It covers certain types of institutions as well as individuals, but for present purposes, the core definitional element is an individual investor with gross income exceeding $200,000 for the two most recent years; a net worth exceeding $1 million; or professional knowledge, experience, or certification such as a securities license. *See* 17 C.F.R. § 230.501.

[56] *Id.* at 123 (emphasis added).

> Such an offering, though not open to everyone who may choose to apply, is none the less "public" in character, for the means used to select the particular individuals to whom the offering is to be made bear no sensible relation to the purposes for which the selection is made . . . .[57]

In other words, the Court rejected the claim that the term "public" could be evaded simply by identifying an eligible subset of the population at large. Conversely, to be "public," a securities offering need not include everyone or even a large number of people.

The Court's mistake was in discussing hypothetical exemptions that were not central to the holding. In determining not to "superimpos[e] a quantity limit on private offerings," the Court instead focused on the "knowledge of offerees" and "the need of the offerees for the protections afforded by registration."[58] This was meant to contrast employees from senior-level insiders, like the company's executives, on the basis that the former did not "have access to the kind of information which registration would disclose."[59] Under that logic, accredited investors should be viewed more like the Ralston employees than the company's executives, and an offering of unregistered stock solely to accredited investors therefore should be viewed in the same light as an offering of unregistered stock to employees—as a public offering subject to the Securities Act.

Much has been forgotten, lost in translation, or buried (perhaps intentionally) in the 70 years since the Ralston case, and few issuers and fewer securities lawyers have incentives to faithfully read it and apply it. The result is that the notion of excluding investors that can ostensibly "fend for themselves" from the protections of the Securities Act has become an entrenched rationale for the SEC's nearly continuous expansion of exemptions, allowing the majority of companies to avoid transparency, accountability, and oversight.

Yet, the Ralston Court's reasoning leaves little doubt that the Court at one time would have rejected the claim that (1) general solicitation of investors (2) leading to hundreds of millions of dollars or more in securities sales, and (3) ultimately involving hundreds of "accredited investors" or more, (4) all without required disclosures (beyond what little there is in Form D), as permitted by some exemptions, could constitute activities that are solely private in nature for purposes of Securities Act section 4(a)(2). However, even if the SEC wanted to reverse course and take action to bring its exemptive framework closer to the one envisioned by the Ralston decision and the securities laws, it could not do so now because Congress has since codified, with bipartisan support, new exemptive provisions clearly at odds with them.

### B. A Few More Thoughts on Accredited Investors

Whatever the Ralston Court's view would have been, it must be acknowledged at least that accredited investors achieve such status on the basis of wealth—and comparatively little of it, at that. Such a wealth test forms a remarkably imperfect proxy for the ability an investor to "fend for himself or herself." Furthermore, like the employees in Ralston—whom the Court found were involved in a public offering—accredited investors have no special claim to the timely and accurate information about a company that registration would reveal, and there is no reason to believe that they generally have specialized expertise (or time) to make sense of such information.

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[57] *Id.* at 123-124 (emphasis added).

[58] *Id.* at 126-127.

[59] *Id.* at 127.

Moreover, the accredited investor standard is seriously outdated, eroded by almost four decades of inflation and increasing economic activities, incomes, and wealth.

According to recent data, it is likely that several hundred thousand individual investors participate in private market offerings. For example, SEC researchers estimate that "[a]pproximately 398,000 investors participated in Regulation D offerings during 2017."[60] That may be more than twice the total number of eligible accredited investors when Regulation D was implemented:

> As originally adopted in 1982, an accredited investor included one with a net worth of $1 million and included one with an annual income of $200,000. Those thresholds for accredited investor status essentially remained unchanged for nearly thirty years. During that time, of course, inflation's impact and other economic forces significantly increased the number of persons that met one of those standards. What may be the most vivid way to see the expansionary impact of holding the accredited investor criteria constant is to consider data from the Internal Revenue Service regarding high income tax returns. Those data show that in 1982, 169,367 returns with adjusted gross income of $200,000 or more were filed, which amounted to 0.178 percent of all returns. In 2007, the number of returns with adjusted gross income of $200,000 or more had grown to 4,535,632, or 3.172 percent of all returns. [61]

Remarkably, the number of accredited investors eligible to participate in the private markets today has increased 550% since 1983 and continues to rise.[62]

## VI. The public markets, unlike the private markets, mandate the disclosure of material information, which provides significant benefits to issuers, investors, and markets.

The U.S. regulatory framework for securities is not paternalistic; the SEC does not step into investors' shoes, recommend securities, or pass judgment on the supposed value or prospects of investment opportunities. Instead, the registration, disclosure, and reporting processes for securities arising under this regulatory framework are designed to ensure that investors channeling their savings to companies through the securities markets receive full and fair disclosure of material information about a particular security before arriving at their own judgments.

The eminently reasonable idea—accepted by all but the most radical policymakers—is that investors can make rational, informed investment and governance decisions if, but only if, they receive adequate accurate information concerning the risks, prospects, and realities of a company's financial and business condition (which is referred to under the securities laws as "all information that would be material to a reasonable investor").[63]

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[60] S. Bauguess *et al.,* SEC Division of Economic and Risk Analysis, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017*, at 2 (Aug. 2018).

[61] R. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 Bus. Law. 919, 936 (2011).

[62] A. Herron Lee & C. Crenshaw, SEC Commissioners, *Joint Statement on the Failure to Modernize the Accredited Investor Definition* (Aug. 26, 2020).

[63] *See, e.g.,* P. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. of Chic. Law Rev. 1047, 1076 n. 122 (1995) (quoting the "Message from the President" on the "Regulation of Securities Issues," in which President Roosevelt explained 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," but rejecting the accuracy-enhancement explanation for the Securities Act and contending that mitigation of self-dealing and similar agency costs served as the primary objective).

## A. The Benefits of Mandatory Disclosure Over Private Ordering

The federal registration and mandatory disclosure framework has numerous beneficial effects on the U.S. securities markets, issuers, and investors. Many of the benefits described below have nuances and complexities that we cannot adequately address in this report, but this list provides and overview of the benefits of the public markets relative to the private markets. Overarching all of these benefits is the core role that public markets play by facilitating capital formation, economic growth, and wealth accumulation across the broadest spectrum of public investors.

- Increases Investor Confidence: Mandatory disclosures of material information—provided under penalty of law and with a potential for rescission or other civil and criminal liabilities—ensures that investors have information necessary to judge the prospects of each issuer's business model and value. That, in itself, is a worthy and sufficient investor protection and regulatory objective. However, it has the added benefit of increasing investor confidence in the markets and contributing to fair and efficient capital formation and allocation through various mechanisms, and these benefits accrue even to issuances with mandatory disclosures that some individual investors may never read.

- Provides More Equal Access to Material Information: Because all material information must be disclosed timely and publicly, the securities laws also ensure that all investors have equal access to material information with respect to public securities. In contrast, the private markets have the effect of segmenting capital markets and creating privileged information and rights solely based on the leverage and bargaining power (and perhaps expertise) of potential investors. For this reason, public markets limit information asymmetry between investors; and between issuers and investors.

- Reduces Fraud: Mandatory disclosures also diminish and expose fraud and provide unique remedies for those harmed by misrepresentations or omissions. In private markets, "fraud can be easier to effect and much harder to detect."[64] There are no required disclosures at all under some exemptions and few limits on the tactics used in solicitation. The limited regulatory oversight of the private markets creates an environment that is almost ideal for illegitimate offerings and almost irresistible to persons seeking to exploit uninformed investors, which is why the experiences of state securities regulators consistently confirm that the private markets are rife with fraud.[65] In addition, the common law remedies for fraud and the antifraud provisions of the federal securities laws provide an insufficient deterrent to fraud and other forms of misconduct involving unregistered securities. Even when promoters in private markets are discovered and punished, investors' money is often long gone and unrecoverable.

- Increases Material Information: Mandatory disclosure brings more light to markets than would be the case in privately ordered markets. This is because the conflicts of interest, interfirm competitive costs,[66] and other costs and incentives relating to information production—both from the perspective of an issuer and

[64] L. Aguilar, Commissioner of the SEC, *Increasing the Vulnerability of Investors* (Aug. 29, 2012) ("History shows that, when stock promoters are allowed to advertise and solicit the public without any sort of registration or qualification whatsoever, it opens the door to fraudsters and scam artists of every description.").

[65] *See, e.g.,* North American Securities Administrators Association (NASAA), *NASAA 2020 Enforcement Report, Based on 2019 Data* (2020).

[66] Interfirm competitive costs refer to the use of disclosed information by those economically competing with the issuer or having other conflicts of interest with the issuer. In short, "[i]nterfirm costs arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors, major suppliers and major customers." M. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 Virg. L. Rev. 1335 (Oct. 1999) (at 8 in linked).

its executives and third-parties—would not account for the costs and benefits of disclosure to the broader markets and investors. These externalities extend well beyond the issuers themselves and for this reason, critical issuer information is often prevented from being publicized in markets with private ordering.[67]

- Enhances the Efficiency of Markets and the Accuracy of Securities Prices: It is vital to consider not only the level of inadequate disclosure but what is inadequately disclosed; and whether what little is disclosed is accurate. In this regard, public markets also make securities prices more reflective of material information and therefore more likely to be reflective of fundamental value. This, in turn, affects the allocation and cost of capital across the U.S. economy. Private markets, in contrast, may not incorporate all material information and do not have a readily ascertainable public price to anchor company valuations, which are therefore often, if not always, subjectively determined by conflicted parties.

- Contributes Useful Public Pricing Information: Public markets also contribute to public pricing, which in turn serves a variety of critical purposes. Securities indexes, like the Dow Jones Industrial Average, are used to gauge economic activities and market sentiments, to serve as a benchmark for assessing investment performance for funds and other financial instruments, and to price numerous types of securities and derivatives products that have price levels derived from secondary market information created and published in public markets. Many investors and retirement plans have employee savings tied to these indexes through a combination of index mutual funds, exchange-traded funds ("ETFs"), and derivatives (some of which are held by ETFs), which either hold or reference public securities.[68] In short, public prices and indexes are critically important public goods with important values that cannot exist in private markets and may be harmed when the balance of private and public markets is not maintained.

- Provides Baseline Information for Corporate Decisionmaking: Performance, financing, and other metrics are often tied to public information as well. For example, "managers making long-term decisions—such as whether to invest in human capital, equipment and research—rely substantially on metrics that are themselves dependent on today's public market-generated pricing information," including "[Earnings Before Interest, Taxes, Depreciation, and Amortization] multiples and cost of capital estimates" essential to corporate decision-making.[69]

- Improves Issuer Accountability and Reduces Agency Costs: Public markets also substantially reign in agency costs. In many cases, small businesses begin with little more than an idea and very few, if any, outside investors or shareholders. The actions of executives of such a closely held company affect the success of the enterprise but do not have implications for the financial interests of third parties. In contrast, when companies receive capital from outside investors or shareholders, there is an inherent conflict of interest that arises from the separation of the management and ownership of the business.

[67] *Id.* at 7 in linked. In economics-speak, it is likely that "over the whole range of levels at which an issuer could disclose, the social marginal cost of an issuer's disclosure is below the private marginal cost to its managers, and the social marginal benefit of its disclosure is above the private marginal benefit to these individuals." *Id.; see also* J. Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717, 725-733 (1984).

[68] *See, e.g.,* M. Mauboussin & D. Callahan, *Public to Private Equity in the United States: A Long-Term Look*, Morgan Stanley Investment Management, at 5 (Aug. 4, 2020). In fact, "since 2008 [alone], investors have directed $2.0 trillion into index mutual funds and ETFs." *Id.*

[69] J. Clayton, SEC Chairman, *Remarks to the Economic Club of New York* (Sept. 9, 2019).

## B. A Case in Point: WeWork and the Planned IPO That Exposed Key Information

The interests of insiders, like corporate executives, and outsiders, namely shareholders (owners), may collide in various forms, including on account of lavish "executive perquisites, excessive compensation, transfer pricing, appropriation of corporate opportunities, self-serving financial transactions such as directed equity issuance or personal loans to insiders, and outright theft of corporate assets."[70] Some agency costs are more benign and psychological. Corporate executives, "like anyone, can be expected to value . . . respect, power, affection, a sense of rectitude, and job security,"[71] and this can adversely affect their decision-making. Still broader conceptions can include retention of incompetent management, inadequate managerial effort, or excessive risk-taking or overinvestment to meet performance or growth objectives.

The mandatory disclosures implemented by the Securities Act reduce the effects of these agency costs by (1) limiting the opportunities for agency costs to arise, (2) increasing the public, media, and shareholder scrutiny of transactions driven by conflicts of interest and other issues, and (3) subjecting executives to legitimate policing of their fiduciary duties.

The disciplining effect of mandatory disclosure is evidenced by transactions uncovered in the 2019 lead-up to the We Company (parent of WeWork) IPO. WeWork was a unicorn private company that had raised billions of dollars in private financings over its ten-year history.[72] However, as it prepared for its IPO in 2019, it was required to accurately and completely disclose all material information in the registration documents it was required to file with the SEC. The IPO was expected to be oversubscribed based on the pre-IPO hype generated largely by the company's unverified statements and claims. However, the company's disclosures in the required IPO filings revealed a different story, which enabled potential investors, the media, and others to ask informed questions about the representations made about the company's business, revenues, and prospects.

For example, the "publicly available S-1 registration statement contained [classic self-dealing] red flags such as the founder's (attempted) sale of the "we" trademark back to the company for almost six million dollars,"[73] which was presumably far more expensive than such a trademark would have been in an arm's length transaction. The public and investor scrutiny facilitated by the planned IPO ultimately unearthed a variety of concerning transactions and practices that raised significant doubts about the claims made, not to mention valuations provided, by investors in the private markets. The result is well known: WeWork imploded; the CEO was ousted; there was a major retrenchment and restructuring of the company; and the IPO was withdrawn (although resurrected in 2021, ironically through a SPAC merger involving minimal disclosure[74]).

This highlights the general rule that mandatory disclosures dramatically improve if not enable direct shareholder monitoring. That includes, for example, performance indicators for executives, providing shareholders with an informed basis on which to decide whether management warrants shareholder support or opposition. Similarly, such information may inform shareholder views on particular matters presented for a vote of the company's

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[70] S. Djankov *et al.*, *The law and economics of self-dealing*, 88 J. of Fin. Econ. 430 and 463 (2008) ("Perhaps the most basic conclusion from the data is that laissez-faire—the strategy of no public involvement at all—does not lead to more developed financial markets . . . First, our results suggest that effective regulation of large self-dealing transactions combines full public disclosure of such transactions (including potential conflicts) with the requirement of approval by disinterested shareholders . . . Second, the evidence suggests that ongoing disclosure of self-dealing transactions, combined with a relative ease of litigation by aggrieved shareholders, also benefits stock market development.").

[71] M. Fox, *Required Disclosure and Corporate Governance*, 62 J. of L. & Contemp. Probs. 113, 124 (Summer 1999).

[72] *See, e.g.,* Matthew Johnson, *WeWork's SPAC Merger: What You Need to Know*, Investopedia (Oct. 21, 2021).

[73] V. Winship, *Private Company Fraud*, 54 U.C. Davis L. Rev. 663, 702 (2020).

[74] *See, e.g.,* Better Markets, *Fact Sheet: Cutting Through the Hype on SPACs* (Nov. 18, 2021).

investors. Executives are less likely to act inconsistently with the shareholders' interests if the shareholders are more likely to know about such deviations.

In this regard, mandatory disclosures also correct for shareholder collective action problems. In private markets, the more diffuse the shareholder base, the less each shareholder may be able or willing to do to extract adverse information from issuers or their executives. This is because each shareholder may be unwilling to expend necessary funds to ensure appropriate monitoring of its own investments in the absence of coordinated action by similarly situated shareholders. Such collective action problems prevent effective organization and protection of shareholder interests. Because there is no mandatory ongoing reporting, once shareholders are invested in a private security, the executives always have means of controlling the flow of information that is uniquely in their possession regarding the businesses they control and that often is uniquely in the knowledge of a handful of corporate executives with incentives to manage perceptions about their performance.

## VII. The risks inherent in private markets are many and beyond the risk tolerance of the vast majority of investors.

The Securities Act exemptions include a spectrum of restrictions and requirements dependent on the specific facts and circumstances of the securities issuance and the nature of the financial instrument, issuer, and investor base. Although it has a number of harmful consequences for investors and markets, the exemptive framework at least does not contemplate an all-or-none exemption from securities registration. Yet, setting aside the conditions that must be met for the exemption itself, private securities are ultimately issued based on private ordering, with minimal or no mandatory transparency, yet with substantial risks that we suspect would fall beyond the risk tolerance of the vast majority of investors.

Consider a comparison of the attributes of the two markets:

Issuers in public markets that have readily saleable securities must disclose, under the Securities Act, financial and other information under penalty of law (diminishing the potential for deception and misinformation),[75] and disclosed information is first examined by a host of gatekeepers and financial intermediaries with reputational, legal, and regulatory risks relating to the issuance (further minimizing the potential for fraud).

In addition, the companies (issuers) have initial and ongoing Exchange Act reporting, governance, and other requirements that increase the informational value of trading in their securities. That trading often occurs on transparent, well-regulated exchanges that vet listed companies and apply rules governing orderly trading. Those public markets generate reasonably reliable public prices. In addition, they attract institutional participants, like market-makers, that facilitate trading and thereby encourage efficient allocation of capital to useful purposes. Investors in public markets also have additional avenues for legal recourse based on required disclosures.

In private markets, securities are frequently subject to lock-up periods that prevent trading, which presents liquidity risks to investors who cannot extract their initial investment from the company for a specific period of time (usually at least 12 months). The legal lock-in period in some types of private securities offerings is supplemented by the commercial lock-in arrangements established by the issuer, which are often used "to attract investors,

[75] Disclosure has been shown to increase liquidity and reduce the cost of capital even when it voluntarily exceeds the information required to be disclosed by law. *See also* K. Balakrishnan, *et al.*, *Shaping Liquidity: On the Causal Effects of Voluntary Disclosure*, J. of Finance (Nov. 2, 2011) ("[W]e show that voluntary disclosure has a large and beneficial effect on liquidity and that this effect is plausibly causal. This result provides a justification to firms for voluntarily disclosing more information than is mandated by law and regulations . . .").

managers, and employees by assuring them that no investor can withdraw her capital on demand and threaten the firm's stability."[76]

The explicit lock-in period in private markets may be less problematic than the implicit lock-in arising from the lack of a secondary market for privately issues securities. Even if the investor can seek liquidity from a market beyond the issuer itself (which may not be the case), the costs of transacting in that market are almost certain to be substantial for all but the most prominent of private companies. Furthermore, the value of private securities on the secondary markets is often dubious or non-existent due to the limited transparency, price information, market participation, and media and other attention on the issuers. In addition, few if any of the institutional elements supporting the generally robust liquidity in the public markets—such as market-makers, publicity, analyst coverage, and listing standards—exist in the private markets. For the bulk of private companies, none of these elements are present.

## CONCLUSION

The SEC has all but abandoned its mandate to curb and rationalize the ever-expanding exemptions from the registration and transparency framework envisioned by the Securities Act. The SEC has taken the almost shocking view—at least in recent years—that any exemption from the securities laws is not serving its purpose unless it is used to a significant degree. For example, in effecting its expansions to the exemptive framework, it has quite explicitly noted that its amended and new regulations "facilitate the use of the exemptive framework, particularly by smaller issuers."[77] And the SEC has not been subtle in implying through successive releases that the minimal uptake of certain exemptions warrants further deregulation as necessary to pull capital raising into the private framework, which, of course, means away from the public markets.

It should be self-evident that reliance on an exemptive provision, or lack thereof, says almost nothing about whether the exemption has an appropriate reach, much less whether it is consistent with the SEC's mandates. This approach emphasizes quantity over quality in precisely the wrong way. The analysis instead should account for the full scope of the detrimental impacts on public markets, investors, and issuers that would be associated with any further migration of securities activities into dark, private, mostly unregulated markets where investors have few if any protections. Stated differently, new and expanded exemptions that facilitate regulatory arbitrage are almost certain to increase reliance on exemptive provisions, but that actually runs counter to the SEC's guiding objectives, which are supposed to be protecting investors and supporting the productive formation and allocation of capital.

In addition to driving out the undisclosed conflicts of interest and widespread fraud that proliferated in the markets before the Crash of 1929, the U.S. securities law framework governing public issuance of securities is the essential means for ensuring that securities markets serve their fundamental economic purposes. Public markets, with disclosure, transparency, and investor protections, are not what some shortsighted critics mischaracterize as hurdles to capital formation. Indeed, in the absence of the U.S. securities law framework, non-transparent, unregulated securities offerings would be relatively costly and difficult to analyze and price, carry fewer deterrents to fraud and misconduct, and over time, undermine the public confidence necessary to attract and maintain investor participation in the U.S. securities markets. This would constrain capital formation critical to U.S. job creation and economic growth, raise the cost of capital for businesses, limit the value and reliability of information derived from secondary trading, and ultimately, distort capital allocation and increase costs across the U.S. economy.

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[76] D. Ibrahim, *The New Exit in Venture Capital,* 65 Vand. L. Rev. 1, 6 (Jan. 2012).

[77] SEC, *Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, 86 Fed. Reg. 3496, 3497 (Jan. 14, 2021).

The U.S. public capital markets are the deepest, broadest, and most reliable in the world because of the many features and protections they provide, as discussed above. The results are investor confidence and trust. That is the foundation of successful capital markets and why the U.S. markets are the envy of the world. Make no mistake about it: expanding dark, unregulated private markets at the expense of public markets threatens the integrity and vitality of our capital markets and ultimately the financial lifeblood of our economy.

Better Markets will continue to engage with the SEC's new leadership to halt any further expansion of the private markets to the detriment of our public markets and assist the agency in any way it can to strike a better balance between the markets.

Better Banks | Better Businesses
Better Jobs | Better Economic Growth
Better Lives | Better Communities

**Better Markets** is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

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