THE BIRTH OF RULE 144A EQUITY OFFERINGS

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In a groundbreaking deal closed in May 2007, Oaktree Capital Management LLC, a leading private U.S. hedge fund advisory firm, sold a 15 percent equity stake in itself for $880 million. The deal is groundbreaking because it was not structured as an initial public offering (IPO), traditionally the only option for an equity offering of this size by a private company. Instead, it was structured as a private placement under Rule 144A of the Securities Act of 1933, which enables a company to market and sell securities through an underwriter to institutional investors without registering the offering with the Securities and Exchange Commission.

Oaktree's novel use of Rule 144A was driven by two factors. First, passage of the Sarbanes-Oxley Act of 2002 made it much more expensive to be a public company, thereby decreasing the attractiveness of an IPO. Second, the emergence of a centralized trading market for Rule 144A equity securities improved their liquidity, thus increasing the attractiveness of a Rule 144A equity offering. Consequently, for some firms the value of pursuing a Rule 144A equity offering exceeded the value of pursuing an IPO. The purpose of this Article is to explore this development. Specifically, this Article analyzes the legal framework of Rule 144A and details the burgeoning Rule 144A trading market. It then compares the costs and benefits of an IPO to those of a Rule 144A equity offering and theorizes about a firm's calculus for choosing one structure over the other. Finally, this Article argues that Rule 144A equity offerings are firmly grounded in public policy and thus recommends regulatory reforms to improve their viability.

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INTRODUCTION

In a groundbreaking deal closed in May 2007, Oaktree Capital Management LLC, a leading private U.S. hedge fund advisory firm, sold a 15 percent equity stake in itself for $880 million.[1] The deal is groundbreaking because it was not structured as an initial public offering (IPO), traditionally the only option for an equity offering of this size by a private company. Instead, it was structured as a private placement under Rule 144A of the Securities Act of 1933 (Securities Act).[2] The equity securities of Oaktree immediately started trading on the GS Tradable Unregistered Equity OTC Market (GSTrUE), a new market created by Goldman Sachs & Co. to facilitate trading in Rule 144A equity securities.[3]

Rule 144A enables a company to market and sell securities through an underwriter to institutional investors without registering the offering with the Securities and Exchange Commission (SEC) as is required for an IPO.[4] The SEC adopted Rule 144A in 1990 to spur further development of the

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1. *See Moving the Market: Oaktree Stock Sale Completed*, WALL ST. J., May 23, 2007, at C2.
2. 17 C.F.R. § 230.144A (2008).
3. *See* Henry Sender, *Oaktree to Try a New Twist for Share Sale; Use of Goldman Market Avoids Regulations, Doesn't Cede Control*, WALL ST. J., May 10, 2007 (describing GSTrUE). It appears that GSTrUE has since merged into NASDAQ's PORTAL system. *See infra* text accompanying notes 157–166, for a discussion of the PORTAL system.
4. *See* HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 10:17 (2006) (describing private placements under Rule 144A).

U.S. private placement market.[5] Typically, an issuer must price privately placed securities at a discount to what they would command in a public offering, since SEC rules impose a holding period and other requirements on the resale of privately placed securities.[6] The chief innovation of Rule 144A was to decrease this illiquidity discount by providing institutional investors with a regulatory avenue for the immediate resale of privately placed securities.[7]

The resulting Rule 144A private placement market started off slowly,[8] but it has since exploded. NASDAQ estimates that over $1 trillion of debt and equity capital was raised in 2006 through Rule 144A offerings, reflecting a 300 percent increase since 2002.[9] Combining debt and equity capital into one figure, however, gives the wrong impression as to the size of the equity capital component. In fact, the overwhelming majority of capital raised under Rule 144A consists of debt, because Rule 144A's "non-fungibility" condition generally prevents U.S. public companies from undertaking Rule 144A equity offerings.[10]

Foreign firms, however, have routinely relied on Rule 144A to issue equity in the U.S. Unlike a public offering, a Rule 144A offering allows a foreign firm to tap the U.S.'s deep pool of equity capital without triggering ongoing reporting obligations under the Securities Exchange Act of 1934 (Exchange Act)[11] or the corporate governance, auditing, and other requirements

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5. *See* Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6806, 53 Fed. Reg. 44,016, 44,017 (Nov. 1, 1988) [hereinafter Rule 144A 1988 Release].

6. *See infra* Part I.C, for a discussion of illiquidity discounts.

7. *See* Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6862, 55 Fed. Reg. 17,933, 17,934 (Apr. 23, 1990) [hereinafter Rule 144A Adopting Release].

8. *See* Lawrence R. Seidman, *SEC Rule 144A: The Rule Heard Round the Globe—Or the Sounds of Silence?*, 47 BUS. LAW. 333, 346 (1991) (noting the small dollar amount of Rule 144A offerings following the first eight months after its adoption).

9. Press Release, NASDAQ Stock Market, Inc., NASDAQ's Electronic Trading Platform for the 144A Private Placement Market Is Approved by the SEC; The PORTAL Market Trading System Will Begin Operating on August 15 (Aug. 1, 2007) [hereinafter PORTAL Press Release], *available at* http://www.nasdaq.com/newsroom/news/newsroomnewsStory.aspx?textpath=pr2007%5CACQPMZ200708010800PRIMZONEFULLFEED124065.htm.

10. *See* BLOOMENTHAL, *supra* note 4, § 10:14, at 654 ("For most reporting U.S. issuers, the exclusion of fungible securities limits the Rule 144A market to debt securities."). For a discussion of non-fungibility, see *infra* Part III.A.2. It should be noted that a company with publicly traded common stock could undertake a Rule 144A offering of debt or other securities that are convertible into common stock so long as at the time of issuance the securities had an effective conversion premium of 10 percent or more over the market price of the common stock. 17 C.F.R. § 230.144A(d)(3)(i) (2008).

11. 15 U.S.C. §§ 78a–78nn (2006).

of the Sarbanes-Oxley Act of 2002 (SOX).[12] Notably, in 2006 more money was raised in Rule 144A equity offerings ($162 billion) than the combined total raised that year in IPOs listed on the New York Stock Exchange (NYSE), NASDAQ Stock Market, and the American Stock Exchange (AMEX) ($154 billion).[13]

Nonetheless, up until the announcement of the Oaktree deal, a Rule 144A equity offering was unheard of as an IPO alternative for a U.S. company. The emergence of this deal structure in 2007, seventeen years after the adoption of Rule 144A, is the result of two factors. First, the passage of SOX in 2002 has made it much more expensive to be a public company, thereby decreasing the attractiveness of going public.[14] Second, the creation of a centralized trading market for Rule 144A equity securities has improved their liquidity, thus increasing the attractiveness of a Rule 144A equity offering. Hence, firms now ascribe less value to pursuing IPOs and, conversely, greater value to pursuing Rule 144A equity offerings. As a result, for some firms—presumably Oaktree is one—the value of pursuing a Rule 144A equity offering exceeds the value of pursuing an IPO.[15]

Little scholarly attention has been paid to Rule 144A equity offerings. Moreover, virtually no legal scholarship has addressed Rule 144A generally in

12. *See* PETER V. DARROW ET AL., U.S. EQUITY MARKETS FOR FOREIGN ISSUERS: PUBLIC OFFERINGS AND RULE 144A PLACEMENTS OF AMERICAN DEPOSITORY RECEIPTS 52 (2007), *available at* http://www.mayerbrown.com/saopaulo/article.asp?id=3404&nid=9860 (discussing the advantages of Rule 144A offerings for foreign companies).

13. Peter J. Wallison, *Capital Complaints*, WALL ST. J., Mar. 20, 2007, at A19. The $162 billion figure includes issuances by U.S. and foreign companies as well as issuances of debt convertible into equity. For additional data on Rule 144A offerings, see Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 345 (2008).

14. *See* William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 EMORY L.J. 141, 144–47 (2006) (describing the costs of the Sarbanes-Oxley Act of 2002 (SOX) for a public company).

15. *See* Geraldine Lambe, *Public Versus Private Equity Markets*, BANKER, Sept. 2007, at 40 (noting a Goldman Sachs statement that there are additional Rule 144A equity offerings in the pipeline). It should be noted that in August 2007, Goldman Sachs managed a $828 million Rule 144A equity offering for Apollo Global Management, LLC, a renowned U.S. private equity firm, and Apollo's securities immediately started trading on GSTrUE. *See Apollo Raises $828 Million*, WALL ST. J., Aug. 7, 2007, at C6. Unlike Oaktree, however, as part of the offering Apollo entered into a registration rights agreement with investors in the deal. The registration rights agreement obligated Apollo to file with the Securities and Exchange Commission (SEC) a shelf registration statement covering resale of its shares within 240 days. Apollo filed this registration statement on April 8, 2008. *See* Apollo Global Mgmt., LLC, Registration Statement Under the Securities Act of 1933 (Form S-1) (Apr. 8, 2008), *available at* http://www.sec.gov/Archives/edgar/data/1411494/000119312508077312/ds1.htm. Hence, Apollo's reason for pursuing a Rule 144A equity offering instead of an IPO obviously was not to avoid becoming a public company because they contractually bound themselves to do so.

more than a decade, notwithstanding the explosive growth of the Rule 144A market over the last ten years.[16] This Article fills the gap in the literature. It takes an in-depth look at Rule 144A equity offerings and, more broadly, the regulatory underpinnings of Rule 144A.

Part I discusses the historical dichotomy under federal securities laws between public and private securities offerings and delves into the regulatory framework applicable to the resale of privately placed securities. Part II analyzes the requirements of Rule 144A and explains how Rule 144A offerings blur the public/private dichotomy. It then places Rule 144A securities within the private resale regulatory framework and explores the burgeoning Rule 144A trading market. Part III underscores the legitimacy of a Rule 144A equity offering as an IPO alternative by comparing the benefits and costs of the two deal structures. It then theorizes about a firm's calculus for choosing one over the other. Part IV characterizes the birth of Rule 144A equity offerings as a market response to the increased regulation of public companies, argues that the structure is firmly grounded in public policy, and therefore recommends regulatory reforms to improve the structure's viability.

I. PUBLIC/PRIVATE OFFERING DICHOTOMY

Congress enacted the Securities Act of 1933 in the wake of the stock market crash of 1929.[17] The Act "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."[18] The core of the Securities Act is contained in Section 5, which makes it unlawful for any person to offer and sell a security unless the transaction is registered with the SEC.[19] Congress recognized, however, that it is inefficient to require the registration of securities offerings "where there is no practical need for [the Securities Act's] application or where the public benefits are too

16. Several finance-oriented articles about Rule 144A debt markets have been published during this timeframe. *See, e.g.*, George W. Fenn, *Speed of Issuance and the Adequacy of Disclosure in the 144A High-Yield Debt Market*, 56 J. FIN. ECON. 383 (2000); Miles Livingston & Lei Zhou, *The Impact of Rule 144A Debt Offerings Upon Bond Yields and Underwriter Fees*, 31 FIN. MGMT. 5 (2002); Susan Chaplinsky & Latha Ramchand, *The Impact of SEC Rule 144A on Corporate Debt Issuance by International Firms*, 77 J. BUS. 1073 (2004).

17. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77bbbb (2006)).

18. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (citing H.R. REP. NO. 73-85, at 1–5 (1933)). *See generally* LOUIS LOSS ET AL., SECURITIES REGULATION § 1-H-2 (3d ed. 1989).

19. 15 U.S.C. § 77e. *See generally* LOSS ET AL., *supra* note 18, § 2-B.

remote."[20] Thus, Section 4(2) exempts from the provisions of Section 5 "transactions by an issuer not involving any public offering."[21] This means that, as a general matter, public offerings must be registered with the SEC, and nonpublic or private offerings do not.

A. Distinguishing Between Public and Private Offerings

The Securities Act is silent on what does and does not constitute a public offering.[22] Thus, the Supreme Court's 1953 decision in *SEC v. Ralston Purina Co.*[23] represents the seminal opinion on the issue. The case involved annual offerings by Ralston Purina, a manufacturer and distributor of feed and cereal products, of its common stock to select employees.[24] In some years over 400 employees purchased stock, including many in various low-level positions.[25] At issue in the case was whether these offerings were nonpublic and therefore fell within the Section 4(2) exemption.[26] The lower court found that these offerings did fall within the exemption, reasoning that "the intra-organizational offerings of stock by [Ralston Purina], unaccompanied by any solicitation, which have resulted in a limited distribution of stock, for investment purposes, to a select group of employees considered by the management to be worthy of retention and probable future promotion" did not involve a public offering.[27]

The Supreme Court reversed.[28] It reasoned that the exemption should be interpreted in light of the statutory purpose of the Securities Act, which "is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[29] "Since exempt transactions

20. H.R. Rep. No. 73-85, at 5; *see also id.* at 7, 15–16.

21. 15 U.S.C. § 77d(2). As adopted in 1933, what is now § 4(2) of the Securities Act was the second clause of § 4(1) of the Securities Act. LOSS ET AL., *supra* note 18, § 3-C-7a n.383.

22. Transactions by an Issuer Deemed Not to Involve Any Public Offering, Securities Act Release No. 5487, 39 Fed. Reg. 15,261, 15,261 (Apr. 23, 1974) (noting that "the phrase 'transactions . . . not involving any public offering' is not defined in the Act"); *see also* SEC v. Ralston Purina Co., 346 U.S. 119, 122 (1953) ("The Securities Act nowhere defines the scope of § 4(1)'s private offering exemption.").

23. 346 U.S. 119 (1953).

24. The case focused on shares offered by Ralston Purina to employees who "without any solicitation by the Company or its officers or employees, inquire[d] of any of them as to how to purchase common stock of the Ralston Purina Company." *Id.* at 121.

25. *Id.* ("Among those responding to these offers were employees with the duties of artist, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill office clerk, order credit trainee, production trainee, stenographer, and veterinarian.").

26. *Id.* at 120.

27. *Id.* at 119.

28. *Id.* at 127.

29. *Id.* at 124.

are those as to which 'there is no practical need for [the bill's] application,' the applicability of § 4(1) should turn on whether the particular class of persons affected needs the protection of the [Securities] Act."[30] Hence, "a transaction 'not involving any public offering'" as used in Section 4(2) is "[a]n offering to those who are shown to be able to fend for themselves . . . ."[31] The Court went on to say that the availability of the exemption "turns on the knowledge of the offerees"[32] and that "[t]he focus of the inquiry should be on the need of the offerees for the protections afforded by registration."[33] The Court concluded that the employees to whom Ralston Purina sold its stock "were not shown to have access to the kind of information which registration would disclose," and therefore the offerings were not exempt under Section 4(2).[34]

It was, of course, left to the lower courts to flesh out how to determine which offerees can fend for themselves and/or have the requisite access to information, among other things.[35] Approaches to applying *Ralston Purina* varied. Some courts emphasized the relationship between the issuer and the purchaser,[36] some focused on the sophistication of the purchasers,[37] and some stressed the type of disclosure made to purchasers and the number of offerees.[38] One attorney categorized the resulting Section 4(2) jurisprudence as

> a kind of mishmash. The issuer is now told that all of these factors have something to do with whether he has an exemption under Section 4(2), but he is never given a hint as to the proper proportions in the brew. The saving recipe is kept secret, a moving target which he can never be sure he has hit.[39]

The uncertainty regarding the availability of Section 4(2) undoubtedly resulted in increased transaction costs for private offerings and anxiety and frustration for issuers and their securities counsel.[40]

Fortunately, the SEC has largely cleaned up the "mishmash" by adopting, revising, and reconfiguring various rules,[41] culminating with the adoption

30. *Id.* at 125.
31. *Id.*
32. *Id.* at 126.
33. *Id.* at 127.
34. *Id.*
35. *See* J. WILLIAM HICKS, 7B EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, § 11.25, at 11-43 (2d ed. 2007) (describing questions left open by *Ralston Purina*).
36. *See, e.g.*, Hill York Corp. v. Am. Int'l Franchises, Inc., 448 F.2d 680, 690 (5th Cir. 1971).
37. *See, e.g.*, United States v. Hill, [1969–1970 Transfer Binder] Fed. Sec. L. Rep. 92,461, 98,184–85 (D. Conn. Apr. 10, 1969).
38. *See, e.g.*, SEC v. Continental Tobacco Co., 463 F.2d 137, 157 (5th Cir. 1972).
39. Ray Garrett, Jr., *The Private Offering Exemption Today*, *in* FOURTH ANN. INST. ON SEC. REG. 3, 10–11 (Robert H. Mundheim et al. eds., 1973).
40. *See* 7B HICKS, *supra* note 35, § 11:3, at 11-13.

of Rule 506 of Regulation D in 1982.[42] Rule 506 serves as a "safe harbor" for Section 4(2); that is, if an offering complies with the conditions specified in Rule 506, the offering will be deemed exempt under Section 4(2).[43] To fall within the safe harbor, the offering must be limited to accredited investors and no more than thirty-five nonaccredited investors.[44] Rule 501(a) defines "accredited investor." It includes banks, insurance companies, mutual funds, and certain other specified institutional investors;[45] individuals with net worths in excess of $1,000,000, annual incomes in excess of $200,000, or joint annual incomes in excess of $300,000; and executive officers and directors of the issuer.[46] The safe harbor also requires that all nonaccredited investors in the offering have to be sophisticated, or the issuer has to reasonably believe that they are sophisticated.[47] Sophistication in this context means that the investor "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment," either in his own right or with the aid of one or more purchaser representatives.[48]

The accredited investor concept is central in cleaning up the mishmash. If an issuer excludes nonaccredited investors from its private placement, as many issuers do, it does not have to make a subjective sophistication

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41. For a description of the evolution of these rules, see William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 35–40 (2004).

42. Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251 11,258 (Mar. 8, 1982). Regulation D contains two additional exemptions (Rule 504 and Rule 505), both of which were promulgated under Section 3(b) of the Securities Act. *See id.* at 11,252. Section 3(b) empowers the SEC to adopt rules exempting offerings of certain classes of securities up to $5 million "if it finds that the enforcement of [the Securities Act] . . . is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." 15 U.S.C. § 77c(b) (2006).

43. *See* 17 C.F.R. § 230.506(a) (2008) ("Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of [Rule 506] shall be deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the [Securities] Act."). Note that compliance with Rule 506 is a nonexclusive means by which an offering falls within Section 4(2). As Preliminary Note 3 to Regulation D explains "an issuer's failure to satisfy all the terms and conditions of Rule 506 shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available." 17 C.F.R. § 735, Regulation D, Preliminary Note 3.

44. *Id.* §§ 230.501(e), .506(b)(2)(i). Technically, there could be more than thirty-five nonaccredited investors so long as the issuer reasonably believes that there are no more than thirty-five. *See id.* § 230.506(b)(2)(i).

45. *Id.* § 230.501(a)(1).

46. *See id.* § 230.501(a).

47. *Id.* § 230.506(b)(2)(ii).

48. *Id.* See *id.* § 230.501(h), for the definition of "purchaser representative."

determination that could later be disavowed by the SEC or by a court. As the SEC explained:

> [The accredited investor] approach is based on the presumption that accredited investors can fend for themselves without the protections afforded by registration and thereby satisfy the requirements of proposed Rule 506(b)(1) without a separate subjective determination by the issuer. The majority of commentators believed accredited investors as defined in proposed Rule 501(a) have the ability to fend for themselves in larger offerings contemplated under a Section 4(2) exemptive rule. The Commission agrees with these commentators . . . .[49]

As for access to information, Rule 506 requires the issuer to furnish any nonaccredited investors that purchase securities in the offering with certain specified information about the issuer and the offering within a reasonable time prior to the purchase.[50] The rule contains no specific requirement that the issuer furnish accredited investors with information, but it does essentially instruct an issuer to provide to accredited investors any information that it furnished to nonaccredited investors.[51] Further, the issuer is required to afford all investors, whether or not accredited, "the opportunity to ask questions and receive answers concerning the terms and conditions of the offering . . . ."[52]

Additionally, Rule 502 prohibits the issuer and anyone acting on its behalf from soliciting investors through "any form of general solicitation or general advertising . . . ."[53] The SEC has interpreted this prohibition to restrict investors in a company's private placement to those with whom the company or someone acting on its behalf has a preexisting, substantive relationship.[54] According to the SEC, the restriction is necessary because the SEC has "long construed general solicitation or advertising to impart a public character to an offering."[55] Consequently, "[t]he prohibition on general solicitation and advertising is what keeps the offering 'private.'"[56]

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49. Proposed Revision of Certain Exemptions From the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6339, 46 Fed. Reg. 41,791, 41,802 (Aug. 18, 1981).

50. *See* 17 C.F.R. § 230.502(b)(1).

51. Rule 502(b)(1) includes a note that provides as follows: "When an issuer provides information to investors pursuant to paragraph (b)(1), it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws." *Id.*

52. *Id.* § 230.502(b)(2)(v).

53. *Id.* § 230.502(c).

54. *See* Sjostrom, *supra* note 41, at 13–14.

55. Integration of Abandoned Offerings, Securities Act Release No. 33-7943, 66 Fed. Reg. 8887, 8889 (Mar. 7, 2001).

56. U.S. GEN. ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, COMMITTEE ON SMALL BUSINESS, U.S. SENATE, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 30 (2000), *available at* http://www.gao.gov/archive/2000/gg00190.pdf [hereinafter GAO REPORT].

B. Framework for the Resale of Privately Placed Securities

Unlike securities sold in a public offering, privately placed securities are not freely tradable, meaning they generally cannot be resold for at least six months after their issuance.[57] This results from a distinction the Securities Act draws between distributions and trading transactions.[58] A sale of securities issued in a registered offering is presumed to be a trading transaction[59] (assuming the seller is not an affiliate of the issuer[60]), while the sale of securities issued in a private placement is presumed to be a distribution.[61] As mentioned above, Section 5 prohibits the offer and sale of any security unless the transaction is registered with the SEC or is exempt from registration.[62] Consequently, every sale of securities must be registered or exempt.[63] Put differently, because of the transactional focus of Section 5, a reseller of securities must either register the resale with the SEC or structure the resale so that it qualifies for an exemption from registration. The issuer's registration or exemption only covers the original sale transaction; that is, the sale from the issuer to the reseller.

Typically, resales of securities are exempt from registration under Section 4(1) of the Securities Act.[64] Section 4(1) exempts from registration "transactions by any person other than an issuer, underwriter, or dealer."[65] However, Section 4(1) is not available for the immediate resale of restricted securities. This is because Section 2(a)(11) of the Securities Act defines the

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57. *See infra* text accompanying notes 67–68.

58. *See* 7 HICKS, *supra* note 35, § 1.3.

59. At one time, the presumption could be overcome under the so-called presumptive underwriter doctrine. Under this doctrine, the resale of securities issued in a registered offering was considered a distribution if the seller purchased ten percent or more of the securities issued in the registered offering and resold these in the public market. Rutherford B. Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*, 52 WASH. & LEE L. REV. 1333, 1347 (1995). The Commission has since abandoned the doctrine and replaced it with the rule that the resale by a nonaffiliate of the issuer of securities issued in a registered offering does not constitute a distribution so long as the seller acquired the securities "in the ordinary course of business" and the seller has "'no arrangement with [the issuer or] any person to participate in the distribution of such securities.'" *Id.* at 1349 (alteration in original) (quoting Exxon Capital Holdings Corp., SEC No-Action Letter, 1988 WL 234336, at *1 (Apr. 13, 1988)).

60. Under SEC rules, a person is considered an affiliate of an issuer if the person "directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1) (2008).

61. *See* 7 HICKS, *supra* note 35, § 1:3.

62. *See* 15 U.S.C. § 77e (2006).

63. *See* 17 C.F.R. § 230.144, Preliminary Note 1 ("If any person sells a non-exempt security to any other person, the sale must be registered unless an exemption can be found for the transaction.").

64. *See* 15 U.S.C. § 77d(1).

65. *Id.*

term "underwriter", among other things, as "any person who has purchased from an issuer with a view to . . . the distribution of any security."[66] Under SEC interpretations, anyone who sells restricted securities is presumed to be an underwriter unless the sale is made in compliance with Securities Act Rule 144.

Rule 144 sets forth conditions under which a person who sells unregistered privately placed securities "shall be deemed not to be an underwriter of those securities within the meaning of section 2(a)(11) of the [Securities] Act."[67] The rule essentially requires investors to hold restricted stock at a minimum for six months or one year before reselling, depending on whether the issuer is a reporting or nonreporting company under the Exchange Act.[68]

Once the applicable holding period has run, restricted securities are still not freely tradable to the same extent as securities issued in a registered offering. This is because an issuer of privately placed securities is required to take reasonable steps to prevent resales in violation of Section 5 of the Securities Act.[69] Therefore, an issuer typically implements various safeguards when issuing securities in a private placement, such as (1) placing a restrictive legend on the certificates representing the securities that specifies that they may not be sold unless the transaction is registered or the seller furnishes the issuer an opinion of counsel that the proposed sale is exempt from registration, and (2) instructing the issuer's transfer agent not to process any transfer of the securities unless the transfer is cleared by company counsel.[70] These types of safeguards force investors to contend with a number of formalities to

66. 15 U.S.C. § 77b(a)(11).

67. 17 C.F.R. § 230.144(b).

68. *See id.* § 230.144(b)(1)(i), (d)(1)(i)–(ii). In some situations, Rule 144 allows an investor to include the holding period of previous investors in determining when her holding period ends. *See id.* § 230.144(d). Rule 144 imposes additional conditions for the resale of restricted stock by an affiliate of an issuer. *See, e.g.*, § 230.144(c), (e), (h).

69. *See* 7A HICKS, *supra* note 35, § 10:12, at 10-24. Regulation D states that "[t]he issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(a)(11) of the [Securities] Act." 17 C.F.R. § 230.502(d) (2008). The reasonable steps requirement stems from the SEC's view that a resale in violation of Section 5 jeopardizes the exempt status of an issuer's private placement because the reseller may be viewed as a conduit for a wider distribution of the issuer's offering. *See* Commission's Statement Setting Forth Its Policy on Use of Legends and Stop-Transfer Instructions as Evidence of Nonpublic Offering, Securities Act Release No. 5121, 1970 SEC LEXIS 1463, *1–2 (Dec. 30, 1970). In such an event, the resale will be considered part of the original offering by the issuer. This, in turn, could destroy the issuer's Section 4(2)/Rule 506 exemption, if, for example, resales were made to nonaccredited investors without providing any information about the issuer or through general solicitation. *See* JAMES D. COX ET AL., SECURITIES REGULATION CASES AND MATERIALS 400 (3d ed. 2001) (noting that issuers are "vitally concerned with the effect of resales, for a determination that supposed investors were actually acting as conduits in a public offering will retroactively negate the validity of the original transaction as a private placement").

70. *See* LOSS ET AL., *supra* note 18, § 3-D-1.

sell the private placement securities, including filling out various forms and obtaining a legal opinion that the resale can be made without registration.[71]

Restricted securities can also be resold outside of Rule 144 under the so-called Section 4(1-1/2) exemption—an exemption that does not actually appear in the Securities Act but has long been recognized by the SEC.[72] The exemption permits the resale of restricted securities "so long as some of the established criteria for sales under both Section 4(1) and Section 4(2) of the [Securities] Act are satisfied."[73] Specifically, when selling restricted securities under Section 4(1-1/2), a reseller claims he is not an underwriter because the resale does not involve a distribution, and therefore the resale transaction is exempt under Section 4(1).[74] Courts and the SEC have equated the term "distribution" with public offering.[75] Therefore, the analysis of whether a resale involves a distribution is based on Section 4(2) as interpreted by *Ralston Purina* and its progeny. This approach is conceptually sound but can be difficult to apply in practice because of the Section 4(2) jurisprudence mishmash. Hence, to avoid the mishmash, the standard advice is instead to sell in compliance with Rule 144.

C. Resulting Illiquidity Discount

The net effect of restricted stock resale regulation is that the restricted stock is less liquid or more costly to resell than freely tradable stock.[76] As a result, the issuer has to discount the price at which it offers restricted shares in order to attract investors.[77] A number of empirical studies have researched public firms that issued restricted stock of the same class as their

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71. *See generally* ARNOLD S. JACOBS, 8B OPINION LETTERS IN SECURITIES MATTERS § 58:2 (2007) (describing the formalities associated with selling restricted stock); *see also* 17 C.F.R. § 230.502(d) (listing measures the issuer can take to ensure investors are not underwriters).

72. *See* Employee Benefit Plans, Securities Act Release No. 6188, 19 SEC Docket 465, 496 n.178 (Feb. 1, 1980) (acknowledging the existence of the Section 4(1-1/2) exemption).

73. *Id.*

74. *See* 7A HICKS, *supra* note 35, § 9:109.

75. *See id.* § 9:110.

76. *See* Aswath Damodaran, Marketability and Value: Measuring the Illiquidity Discount 3 (July 30, 2005) (unpublished manuscript), http://pages.stern.nyu.edu/~adamodar/pdfiles/papers/liquidity.pdf (noting that "[y]ou can sell any asset, no matter how illiquid it is perceived to be, if you are willing to accept a lower price for it").

77. Rule 144A 1988 Release, *supra* note 5, at 44,020 n.44 ("Restricted securities typically sell at a discount to securities that are freely tradeable in the public market."); *see also* Investment Company Act Release No. 5847, 35 Fed. Reg. 19,989, 19,990 (Oct. 21, 1969) ("Restricted securities are often purchased at a discount, frequently substantial, from the market price of outstanding unrestricted securities of the same class. This reflects the fact that securities which cannot be readily sold in the public market place are less valuable than securities which can be sold . . . .").

publicly traded stock (for example, common stock).[78] These studies calculated the difference between the issuance price of the restricted stock and the market price of the publicly traded stock on the date of issuance of the restricted stock,[79] a difference largely comprised of an illiquidity discount.[80] The aggregation of eleven of these studies appearing in a recent paper by William P. Dukes indicates that public firms have issued restricted stock at an average discount ranging from 25.8 percent to 45 percent of the prevailing market price.[81]

The existence and magnitude of the illiquidity discount priced into a restricted stock issuance can be conceptualized in terms of transaction costs.[82] Specifically, restricted stock gives rise to compliance and trade delay costs. Compliance costs are those incurred by an investor in order to conform with securities regulations and market requirements when selling restricted stock: principally, the time and expense of navigating the restricted stock sale process described above.[83] Trade delay costs include costs incurred as a consequence of waiting for the Rule 144 holding period to run before trading.[84] The waiting can result in lost profits from a drop in stock price between when the investor would have liked to sell and when she was able to sell.[85]

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78. *See* William P. Dukes, *Business Valuation Basics for Attorneys*, J. BUS. VALUATION & ECON. LOSS ANALYSIS, Jan. 2006, at 16 tbl.1, *available at* http://www.bepress.com/cgi/viewcontent.cgi?article=1008&context=jbvela (providing a summary table of eleven restricted stock studies).

79. *Id.* at 7.

80. *See* Damodaran, *supra* note 76, at 28 (noting that "the difference can be viewed as a discount for illiquidity").

81. Dukes, *supra* note 78, at 16 tbl.1. See Damodaran, *supra* note 76, at 28–29, for a discussion of additional studies. Damodaran notes several limitations to "two of the earliest and most quoted studies" (Maher and Silber, both of which are included in Dukes's aggregation), including small sample sizes, long time periods, selection bias skewing, and factors other than illiquidity reflected in the discount. *Id.* at 28.

82. *See* Damodaran, *supra* note 76, at 3 (noting that "[o]ne way of capturing the cost of illiquidity is through transaction costs").

83. *See supra* text accompanying notes 69–71. It should be noted that the cost, time for completing, and number of steps will vary depending on whether the investor is selling in compliance with Rule 144. If, for example, the investor is selling outside of the Rule in reliance on the 4(1-1/2) exemption, the legal opinion of seller's counsel referenced above will undoubtedly be more complicated and time consuming for counsel to prepare, more risky to provide, and therefore more expensive for the investor.

84. *See* Damodaran, *supra* note 76, at 4 (describing the opportunity cost resulting from waiting to trade). Of course, instead of waiting, an investor could attempt to sell under the 4(1-1/2) exemption, but as discussed above, doing so is viewed as imprudent.

85. *Id.* An issuer can diminish the segment of discount resulting from expected trade delay costs by granting investors registration rights. *See* Livingston & Zhou, *supra* note 16, at 22 (finding that the yield premium for high-yield Rule 144A debt offerings is greater than that of offerings with registration rights). See generally ROBERT J. HAFT, 2 VENTURE CAPITAL AND SMALL BUSINESS FINANCING § 1:22 (2007), for a description of registration rights. The extent the grant of registration rights will decrease the discount depends on issuer characteristics. For example, it is much quicker

In addition to compliance and trade delay costs, investors in restricted stock of a private company will also face search and bargaining costs. Because there generally is no established market for the stock of a private company, a reseller will have to expend nontrivial resources to locate a willing buyer. This is not the case for restricted stock of a public company because it may be sold into the market once the Rule 144 holding period has run. Furthermore, a reseller of private company restricted stock will incur nontrivial bargaining costs because, given the lack of a market, it will have to negotiate and document the terms of the sale after finding a buyer.

The bottom line is that an issuer will have to discount the price at which it offers restricted stock to reflect the above noted transaction costs that investors will incur. In fact, an issuer may very well have to discount the offering price to reflect not only the initial investors' expected transaction costs but the present value of expected transaction costs of all future holders of the shares.[86]

II. RULE 144A

Rule 144A was adopted in 1990 to facilitate "a more liquid and efficient institutional resale market for unregistered securities."[87] The Rule provides a nonexclusive safe harbor from the registration requirements of the Securities Act for resales of "non-fungible" restricted securities to "qualified institutional buyers" (QIBs).[88] Unlike Rule 144, however, Rule 144A imposes no holding period, and therefore allows for the immediate resale of restricted securities with fewer formalities than Rule 144. Thus, Rule 144A increases the liquidity of restricted securities eligible for resale under the Rule by lowering trade delay and compliance costs. The SEC elaborated on these points in its initial Rule 144A proposing release:

> Proposed Rule 144A could have a significant impact on both the primary and secondary domestic markets for unregistered securities of reporting as well as non-reporting issuers. Removing uncertainties as to the legitimacy of resales to institutional buyers by providing a safe harbor from registration could permit some transactions to take place

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and cheaper for an issuer to register a resale of restricted stock if the issuer is already public and is eligible to register the transaction on Form S-3. Conversely, registration rights are of little value in reducing trade delay costs if they are granted by a private company that is years away from an IPO.

86. *See* Damodaran, *supra* note 76, at 18.

87. Rule 144A Adopting Release, *supra* note 7, at 17,934; *see also id.* at 17,943 ("It appears . . . that Rule 144A will provide various benefits, including increased liquidity of restricted securities and greater certainty as to the registration requirements of the Securities Act.").

88. *Id.* at 17,935–36.

> that otherwise might not occur. Such transactions might include resales by persons that purchased securities privately with a view to their immediate resale to a number of institutions. Providing a framework in which institutional resales could be made freely may increase the efficiency of the private placement market. . . . The potential increase in efficiency and liquidity could significantly lower the discount commonly associated with private placements, which in turn may attract an increasing number of issuers to the private placement market.[89]

Rule 144A is similar in operation to Rule 144 in that it specifies conditions under which a reseller of restricted securities will be deemed not to be engaged in a distribution and, therefore, not an underwriter for purposes of Section 4(1).[90] The Rule is in essence a Section 4(1-1/2) safe harbor for QIBs. It is based on the premise "that certain institutions can fend for themselves and that offers and sales to such institutions do not involve a public offering."[91] As mentioned above, courts and the SEC equate the term public offering with the term distribution.[92] Consequently, resales limited to eligible institutions do not involve distributions.[93] As the SEC put it, "[t]he Rule, in effect, defines a class of transactions as outside the term 'distribution.'"[94]

A. Conditions

A reseller of restricted securities must comply with the following three conditions in order to avail itself of Rule 144A.

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89. Rule 144A 1988 Release, *supra* note 5, at 44,022. Increased liquidity also potentially opens up the market for investments by regulated institutions such as banks that can only invest in marketable securities. *See* Jeanne M. Campanelli & Peter Castellon, *The Mechanics of Rule 144A/Regulation S Underwritings*, *in* SECURITIES OFFERINGS 2006: OPERATING UNDER THE NEW RULES 387, 426 (2006). In a similar vein, the SEC has taken the position that the Investment Company Act of 1940 "prudent[ly] limits" open-end investment companies from investing more than 10 percent of their portfolios in restricted securities or other assets lacking readily available market quotations. *See* Investment Company Act Release No. 5847, *supra* note 77, at 19,991. However, in the Rule 144A adopting release, the SEC modified its position with respect to Rule 144A securities essentially allowing an investment company's board to determine whether the security is liquid enough not to count against the 10 percent limitation. Rule 144A Adopting Release, *supra* note 7, at 17,940.

90. 17 C.F.R. § 230.144A(b) (2008).

91. Rule 144A 1988 Release, *supra* note 5, at 44,026.

92. *See supra* text accompanying note 75.

93. *See* Rule 144A 1988 Release, *supra* note 5, at 44,026; *see also* Rule 144A Adopting Release, *supra* note 7, at 17,934.

94. Rule 144A 1988 Release, *supra* note 5, at 44,026.

1. Qualified Institutional Buyers

First, the securities must be offered and sold only to QIBs, or to persons the seller or someone acting on the seller's behalf reasonably believes to be QIBs.[95] Subject to the exceptions discussed below, a QIB is an institutional investor (for example, an employee benefit plan, hedge fund, insurance company, mutual fund, or pension fund)[96] that "acting for its own account or the accounts of other qualified institutional buyers . . . in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity"[97] (hereinafter, the $100 million test), or any entity whose equity interests are owned entirely by QIBs.[98] An individual, regardless of the size of her investment portfolio, cannot qualify as a QIB.

The SEC explained the policy underlying the QIB concept and, in particular, the $100 million test, as an attempt "to establish a level at which [the SEC] can be confident that participating investors have extensive experience in the private resale market for restricted securities."[99] The SEC further explained that the QIB definition "identif[ies] a class of investors that can be conclusively assumed to be sophisticated and in little need of the protection afforded by the Securities Act's registration provisions."[100] Clearly, this sentence is meant to position Rule 144A as consistent with the

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95. 17 C.F.R. § 230.144A(d)(1).

96. The list of entities that qualify as qualified institutional buyers (QIBs), provided they meet the $100 million test, is comprised of business development companies, business trusts, corporations (other than banks or savings and loans associations), ERISA employee benefit plans, insurance companies, licensed small business investment companies, organizations described in Section 501(c)(3) of the Internal Revenue Code, partnerships, public employee benefit plans, registered investment advisers, registered investment companies, and trust funds whose trustees are banks or trust companies and whose participants include only public ERISA employee benefit plans (other than individual retirement accounts or H.R. 10 plans). *Id.* § 230.144A(a)(1)(i). It should be noted that a registered investment company also qualifies as a QIB if "acting for its own account or for the accounts of other qualified institutional buyers . . . [it] is part of a family of investment companies which own in the aggregate at least $100 million in securities of issuers, other than issuers that are affiliated with the investment company or are part of such family of investment companies." *Id.* § 230.144A(a)(1)(iv). Additionally, limited liability companies as well as U.S. states and their incorporated political subdivisions are viewed as qualifying as "corporations" for purposes of the QIB definition. *See* CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS § 7.08{A}, at 7-40 n. 79.

97. 17 C.F.R. § 230.144A(a)(1)(i).

98. *Id.* § 230.144A(a)(1)(v).

99. Rule 144A 1988 Release, *supra* note 5, at 44,028.

100. *Id.*

edicts of *SEC v. Ralston Purina Co.*,[101] which, as discussed above, are used to dictate when transactions do not constitute public offerings/distributions.[102]

A bank or savings and loan association qualifies as a QIB if it meets the $100 million test and has "an audited net worth of at least $25 million."[103] This additional requirement reflects the SEC's concern that these institutions purchase securities with federally insured customer funds, and thus do not put themselves at risk to the same degree as other institutions.[104] This means that the amount of securities owned by these institutions may not be adequate as a proxy for sophistication.[105]

A registered broker-dealer qualifies as a QIB if it owns and invests on a discretionary basis an aggregate of at least $10 million of securities of nonaffiliated companies, excluding securities that are part of an unsold public offering allotment.[106] A registered broker-dealer "acting in a riskless principal transaction"[107] for a QIB also qualifies as a QIB even if it does not meet the foregoing $10 million test.[108] A less stringent test was adopted for broker-dealers out of concern that the $100 million test would exclude "significant segments of the registered broker-dealer community, whose participation was important to the efficient functioning of the market . . . from participation in the market as principals."[109] It should be noted that regardless of whether a broker-dealer qualifies as a QIB, it may act as an agent in a transaction with a QIB.[110]

The Rule provides four nonexclusive methods a seller or person acting on its behalf can employ to determine whether a prospective purchaser owns and manages the requisite amount of securities to qualify as a QIB: (1) the purchaser's most recent publicly available financial statements;[111] (2) information contained in the purchaser's most recent SEC or other regulatory filings;[112] (3) "the most

101. 346 U.S. 119 (1953).
102. *See supra* text accompanying notes 24–33.
103. 17 C.F.R. § 230.144A(a)(1)(vi).
104. Rule 144A Adopting Release, *supra* note 7, at 17,936.
105. *Id.*
106. 17 C.F.R. § 230.144A(a)(1)(ii).
107. *Id.* § 230.144A(a)(1)(iii). Rule 144A defines a "riskless principal transaction" as "a transaction in which a dealer buys a security from any person and makes a simultaneous offsetting sale of such security to a qualified institutional buyer, including another dealer acting as riskless principal for a qualified institutional buyer." *Id.* § 230.144A(a)(5).
108. *Id.* § 230.144A(a)(1)(iii).
109. Rule 144A Adopting Release, *supra* note 7, at 17,936.
110. *Id.*
111. 17 C.F.R. § 230.144A(d)(1)(i).
112. *Id.* § 230.144A(d)(1)(ii). The adopting release notes that "[t]he seller and any person acting on its behalf would be able to rely on the foregoing information notwithstanding the existence of other, more current, information that may show a lower amount of securities owned by the prospective purchaser." Rule 144A Adopting Release, *supra* note 7, at 17,938.

recent publicly available information appearing in a recognized securities manual";[113] and (4) the certification of an executive officer of the purchaser as to the amount of securities owned and managed by the purchaser.[114] However, the information described in the first three methods must be less than 16 months old or 18 months old for a foreign purchaser.[115]

In determining whether a prospective purchaser qualifies as a QIB, a seller may rely on the "QIB List" maintained by Dealogic (the successor to CommScan LLC)[116] or Communicator Inc.[117] These companies arrange for institutions to fill out QIB certifications, a form indicating that the institution falls under the definition of QIB because it is one of the specified entities and owns and manages the requisite amount of securities.[118] Upon completion of the certification, the institution is added to the QIB List.[119] Therefore, a seller merely needs to verify a prospective purchaser is on the QIB List (many broker-dealers pay one of these companies for access) to establish a reasonable belief that the prospective purchaser is a QIB.[120]

2. Non-Fungibility

A second condition of Rule 144A is that the securities to be sold cannot have been, when originally issued, of the same class as securities listed on a national exchange (for example, the New York Stock Exchange or NASDAQ

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113. 17 C.F.R. § 230.144A(d)(1)(iii).
114. *Id.* § 230.144A(d)(1)(iv).
115. *Id.* § 230.144A(d)(1)(i), (ii), (iii).
116. CommScan LLC, SEC No-Action Letter, 1999 WL 46707 (Feb. 3, 1999) [hereinafter CommScan Letter].
117. Communicator Inc., SEC No-Action Letter, 2002 WL 31626913 (Sept. 20, 2002).
118. For a certification form used by Communicator Inc., see Certificate of Rule 144A Qualified Institutional Buyer and Section 3(c)(7) Qualified Purchaser (2004), https://www.compliancehub.com/html/Form_QIB-QP_Certification.pdf. *See also* CommScan Letter, *supra* note 116, at *2.
119. *See* CommScan Letter, *supra* note 116, at *2. Commscan noted in its letter that it would delete companies from the list as follows:

> Institutions will be deleted from the QIB List if their most recent questionnaire becomes stale or if it is learned that such institution is no longer a qualified institutional buyer. CommScan will automatically delete an institution from the list if the most recent questionnaire provided by such institution is more than 16 months old in the case of a domestic institution or 18 months old in the case of a foreign institution. CommScan will also delete institutions from the list promptly upon the employees of CommScan responsible for the QIB List learning that such institution is no longer a qualified institutional buyer.

Id. at *2–3.
120. *Id.* at *1 ("[I]t is the position of the [Commission] that a seller and any person acting on its behalf may rely on the QIB List as a method for establishing a reasonable belief that a prospective purchaser is a qualified institutional buyer.").

Stock Market) or quoted on a U.S. automated inter-dealer quotation system.[121] They can, however, have been of the same class as securities quoted on the OTC Bulletin Board or the Pink Sheets, as neither of these markets is a national exchange or inter-dealer quotation system.[122]

"[I]n the interest of certainty," non-fungibility is determined as of the securities' original issuance date and not their subsequent resale date.[123] Thus, securities issued in a private placement by a private issuer still meet the non-fungibility condition even if the issuer has since gone public and listed the same class of securities on an exchange.[124] The condition reflects commentator concerns that Rule 144A could otherwise "result in the development of side-by-side public and private markets for the same class of securities."[125] Side-by-side markets are viewed as problematic because they "might have the effect of diverting some securities away from the public market to the private market . . . and investors in those markets might be disadvantaged by resulting reduced liquidity, differential pricing, and volatility."[126] The SEC, however, was not overly concerned with this issue. Its initial Rule 144A proposal did not include a non-fungibility condition because the SEC viewed it unlikely that a significant side-by-side market would develop.[127]

3. Buyer Notification

Third, the Rule requires a reseller or anyone acting on its behalf to take reasonable steps to make the purchaser aware that the reseller is relying on the Rule for an exemption from the registration requirements of the Securities Act.[128] This requirement is sometimes fulfilled by including language to that effect in a sale confirmation.[129] The SEC chose not to impose a requirement,

121. 17 C.F.R. § 230.144A(d)(3)(i) (2008).
122. BLOOMENTHAL, *supra* note 4, § 10:14.
123. *See* Resale of Restricted Securities International Series—104; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release No. 6839, 54 Fed. Reg. 30,076, 30,081 (July 18, 1989).
124. *Id.*
125. *Id.*
126. *Id.* at 30,077.
127. This view was based on "information currently available to the Commission [which] suggests that it would not be financially advantageous for companies generally to sell securities in a market that was limited in its depth and liquidity compared to an existing public market for the same securities." *Id.* at 30,078.
128. 17 C.F.R. § 230.144A(d)(2) (2008).
129. DARROW ET. AL., *supra* note 12, at 48 ("The way in which Rule 144A placements are conducted, from an issuer's standpoint, is very similar to traditional underwritten public offerings.").

like the one contained in Regulation D,[130] that the seller take steps to guard against a subsequent sale by its buyer in violation of Section 5.[131] The SEC reasoned that QIBs "are sufficiently aware of the resale limitations on restricted securities and their potential liabilities under Section 5 for improper disposition of such securities."[132] Therefore, there is no need for any policing by the seller.[133]

4. Information Requirement

The Rule also contains an information requirement. However, its application is essentially limited to domestic private companies. Specifically, neither the issuer nor a reseller is required by Rule 144A to provide a prospective purchaser with any information about the issuer and securities to be sold if the issuer is a public company, that is, a company required to file Exchange Act reports with the SEC or a foreign company exempt from the reporting requirements of the Exchange Act pursuant to Rule 12g3-2(b).[134] Conversely, an issuer that does not fall under one of these categories is required to furnish the following upon request by a holder or prospective purchaser of Rule 144A securities: a "very brief" description of the issuer's business, products and services; its most recent balance sheet and profit and loss and retained earnings statements; and similar financial statements for the issuer's two preceding fiscal years.[135] The financial statements do not have to be audited, but the required information must be reasonably current.[136] If the information is requested by the prospective purchaser, the Rule requires that it be furnished at or prior to the time of resale.[137]

The SEC added the information requirement in response to commenter concern about the lack of publicly available information about private companies.[138]

130. *See* 17 C.F.R. § 230.502(d).
131. *See* Rule 144A 1988 Release, *supra* note 5, at 44,028.
132. *Id.*
133. *Id.* at 44,029.
134. 17 C.F.R. § 230.144A(d)(4)(i). Rule 12g3-2(b) under the Exchange Act, 17 C.F.R. § 240.12g3-2(b), provides an exemption from the reporting requirements of the Exchange Act for a foreign private issuer provided it files with the SEC information required by its home-country regulator or exchange and meets certain other conditions. See BLOOMENTHAL, *supra* note 4, § 22:11, for a discussion of these conditions.
135. 17 C.F.R. § 230.144A(d)(4)(i).
136. *Id.* Section (d)(4)(ii) provides various parameters for how old the information can be and still be deemed reasonably current.
137. *Id.* § 230.144A(d)(4)(i).
138. Rule 144A Adopting Release, *supra* note 7, at 17,939.

B. Blurring the Dichotomy

The net effect of Rule 144A is that it blurs the dichotomy between public and private offerings because it allows private placements to be marketed and sold in the same manner in which public offerings are marketed and sold.[139] Specifically, in a Rule 144A offering the company sells securities to a syndicate of underwriters that immediately resells them to investors, just like in a firm commitment public offering. The syndicate markets the deal to QIBs in the same way that it markets a public offering to institutional investors—through sales force calls, investor meetings, and road show presentations.[140] As with a public offering, the syndicate gathers indications of interest from investors, prices the offering accordingly, and unloads the shares to investors.

Rule 144A enables private placements to be structured like public offerings because it allows for the immediate resale of restricted securities. Technically, the sale from the company to the underwriters is made in reliance on Section 4(2) and Rule 506 rather than Rule 144A,[141] since Rule 144A is a safe harbor for the exemptions provided by Sections 4(1), which is unavailable to an issuer.[142] Even though the securities are restricted and the underwriters clearly purchase them from the company with a view to resale, the company's Section 4(2)/Rule 506 exemption is not destroyed. This point is made clear in the Rule 144A adopting release[143] and reflected in Preliminary Note 7 and section (e) of the Rule.[144] In fact, enabling financial intermediaries to serve as underwriters for Rule 144A offerings is viewed as a key feature of the Rule.[145]

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139. *See* JOHNSON & MCLAUGHLIN, *supra* note 96, § 7.09[A][1], at 7-48.7; *see also* Campanelli & Castellon, *supra* note 89, at 391; DARROW ET. AL., *supra* note 12, at 46; BLOOMENTHAL, *supra* note 4, § 10:17.

140. *See* Campanelli & Castellon, *supra* note 89, at 448.

141. *See id.*; *see also* BLOOMENTHAL, *supra* note 4, § 10:17.

142. *See supra* note 65.

143. The release provides:

> In the case of securities originally offered and sold under Regulation D of the Securities Act, a person that purchases securities from an issuer and immediately offers and sells such securities in accordance with the Rule is not an "underwriter" within the meaning of Rule 502(d) of Regulation D. Issuers making a Regulation D offering, who generally must exercise reasonable care to assure that purchasers are not underwriters, therefore would not be required to preclude resales under Rule 144A. Similarly, the fact that purchasers of securities from the issuer may purchase such securities with a view to reselling such securities pursuant to the Rule will not affect the availability to such issuer of an exemption under Section 4(2) of the Securities Act from the registration requirements of the Securities Act.

Rule 144A Adopting Release, *supra* note 7, at 19,735.

144. *See* 17 C.F.R. § 230.144A, Preliminary Note 7., (e) (2008).

145. *See* JOHNSON & MCLAUGHLIN, *supra* note 96, § 7.08, at 7-39.

C. Resale of Rule 144A Securities

Since Rule 144A imposes no holding period on investors, Rule 144A securities can be immediately resold to QIBs. Although Rule 144 deems Rule 144A securities to be "restricted,"[146] an issuer is not required to place the full panoply of transfer restrictions seen in a Rule 506 offering.[147] While issuers typically restrict transfers to QIBs unless the transfer can be made in accordance with Rule 144, issuers do not require resellers to furnish legal opinions.[148] Hence the securities can be resold to QIBs without going through the cumbersome process for transferring restricted securities described above.[149] Consequently, QIBs can freely trade Rule 144A-eligible securities among themselves.[150] Additionally, QIBs are free to sell Rule 144A securities to anyone once the applicable Rule 144 holding period (six months or one year) has run.[151]

Goldman Sachs recently launched the GS Tradable Unregistered Equity OTC Market (GSTrUE) to facilitate trading of Rule 144A equity securities.[152] Goldman Sachs limits access to GSTrUE to QIBs so that there is no need for sellers utilizing it to expend any resources determining whether their trading counterparties are QIBs,[153] because GSTrUE is a closed, nonpublic market. A number of investment banking firms have launched competing markets. For example, JPMorgan Chase & Co. unveiled 144A PLUS in July 2007;[154] Citigroup Inc., Lehman Brothers Holdings Inc., Merrill Lynch & Co., and Morgan Stanley introduced Opus-5 in July 2007;[155] and Bear Stearns & Co. Inc. started Best Markets in August 2007.[156]

Although the current status of these markets is unclear following the extensive consolidation of the financial services industry triggered by the credit

146. 17 C.F.R. § 230.144(a)(3)(iii).
147. *See* Campanelli & Castellon, *supra* note 89, at 428.
148. *See, e.g.*, Catlin Insurance Company LTD., Offering Memorandum 119–20 (Jan. 11, 2007) (describing transfer restrictions applicable to shares issued in Catlin's January 2007 Rule 144A offering of preferred stock).
149. *See, e.g.*, *supra* text accompanying note 71 (describing the process for transferring restricted securities).
150. *See* Campanelli & Castellon, *supra* note 89, at 391.
151. BLOOMENTHAL, *supra* note 4, § 10:16. Note that Rule 144(d)(1) allows an owner of restricted securities to add to its holding period the holding periods of prior owners unaffiliated with the issuer. *See* 17 C.F.R. § 230.144(d)(1).
152. *See* Sender, *supra* note 3.
153. *See id.*
154. Lynn Cowan, *Rival Bankers Teaming Up in Private Securities Sales*, WALL. ST. J., Oct. 29, 2007, at A14.
155. *See Wall Street Firms to Launch Electronic-Trading Platform*, WALL ST. J., Jul. 24, 2007, at C6.
156. Cowan, *supra* note 154.

crisis of 2008, it appears that many of them have been consolidated into a single trading system operated by NASDAQ called the PORTAL Alliance.[157] PORTAL was started by NASDAQ in 1990, in connection with the SEC's adoption of Rule 144A, in an effort to facilitate secondary trading among QIBs in Rule 144A-eligible securities.[158] However, secondary trading failed to develop as anticipated,[159] and NASDAQ discontinued PORTAL's trading capabilities in 2001.[160] Presumably in response to the market opportunity first exploited by Goldman and underscored by other firms following suit, NASDAQ reestablished PORTAL's trading capabilities and relaunched the system in August 2007.[161] This new and improved PORTAL is a Web-based

157. *See* Press Release, NASDAQ Stock Market, Inc., The PORTAL Alliance to Create Industry-Standard Facility for 144A Equity Securities (Nov. 12, 2007), http://ir.nasdaq.com/releasedetail.cfm?ReleaseID=275224. Firms involved at the time included Bank of America, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan, Lehman Brothers, Merrill Lynch, Morgan Stanley, UBS, and Wachovia. *Id.*

158. *See* Self Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendments to Proposed Rule Change of the National Association of Securities Dealers, Inc., Relating to the Operation of the PORTAL Market, Exchange Act Release No. 34-27956, 1990 SEC LEXIS 815 (Apr. 27, 1990) [hereinafter PORTAL Adopting Release]. Specifically, PORTAL was designed as a computer and communications system to be used to disseminate quotes and transaction information concerning Rule 144A-eligible securities as well as clear and settle trades. *Id.* at *1. Note that initially PORTAL was an acronym for "Private Offering, Resale and Trading through Automated Linkages." Seidman, *supra* note 8, at 344 n.97. The National Association of Securities Dealers, however, dropped the title but kept "PORTAL" as the nonacronym name for the platform. *Id.*

159. Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Approving Proposed Rule Change as Modified by Amendments No. 1, 3, and 4 Thereto to Reestablish a Quotation and Trading System, The PORTAL(R) Market, for Securities That Are Designated by Nasdaq as PORTAL Securities, Exchange Act Release No. 56172, 2007 SEC LEXIS 1714, at *4 (Jul. 31, 2007) [hereinafter PORTAL Reestablishment Release]. NASDAQ believes the failure "is, in part, because PORTAL securities could only be traded in the PORTAL Market and the original PORTAL rules imposed trade reporting for all transactions in PORTAL securities at a time when there were no trade reporting requirements for privately-placed securities. In addition, NASDAQ believes PORTAL did not develop because it required use of cumbersome technology for access to the PORTAL Market computer system for reporting purposes, which was a stand-alone computer system." *Id.*

160. *Id.* at *5. It should be noted that issuers do nonetheless typically register Rule 144A-eligible securities as PORTAL securities. This is because, with exception of investment grade rated debt securities, PORTAL designation is required for a security to be assigned a CUSIP identification number and eligible for book-entry delivery services of The Depository Trust Company (DTC), both of which are critical for attracting investors and facilitating trading in the securities. NASDAQ Stock Market LLC, SEC No-Action Letter, 2007 SEC No-Act. LEXIS 553, at *11 (July 31, 2007) [hereinafter NASDAQ No-Action Letter]. In fact, up until its relaunch, PORTAL has served as little more than a gatekeeper for CUSIP and DTC eligibility for Rule 144A securities. *See* PORTAL Reestablishment Release, *supra* note 159, at *5.

161. *See* Press Release, NASDAQ Stock Market, Inc., NASDAQ's Electronic Trading Platform for the 144A Private Placement Market Is Approved by the SEC (Aug. 1, 2007), http://www.nasdaq.com/newsroom/news/newsroomnewsStory.aspx?textpath=pr2007%5CACQPMZ200708010800PRIMZONEFULLFEED124065.htm (noting that the new and improved PORTAL system would go live on August 15, 2007).

"centralized trading and negotiation system for 144A securities. . . . intended to improve the efficiency and transparency of the private placement market."[162]

Like GSTrUE, PORTAL is a closed, nonpublic market.[163] Access to PORTAL is limited to dealers, brokers, and QIBs that meet PORTAL's qualification requirements.[164] To qualify for PORTAL, a QIB has to execute a subscriber agreement and agree to comply with PORTAL's rules.[165] Among these rules is a prohibition against disclosing PORTAL market information (such as price quotes and transactions) except to other PORTAL participants.[166] Consequently, PORTAL market information is not publicly available.

III. IPO VERSUS RULE 144A EQUITY OFFERING

With the passage of SOX and the unveiling of GSTrUE and relaunch of PORTAL, a Rule 144A equity offering is now a bona fide alternative to an IPO for a domestic private company. This becomes apparent when the principal benefits and costs to an issuer of an IPO are compared to those of a Rule 144A equity offering. Below is a comparison followed by an analysis of what may ultimately drive a firm's decision between the two deal types.

A. Benefits of Going Public

1. Capital Infusion

The most obvious benefit of an IPO is that it provides the issuer with a large infusion of equity capital. The size of the infusion ranges from several to hundreds of millions of dollars in cash, depending on the size of the offering. In comparison, as the Oaktree deal demonstrates, large sums of equity capital can also be raised through 144A deals.[167]

2. Increased Liquidity

Perhaps more important than a capital infusion, an IPO leads to the development of a trading market for the company's shares, typically through a

162. *Id.*
163. PORTAL Reestablishment Release, *supra* note 159, at *1.
164. *See id.* at *6–10.
165. *Id.* at *6.
166. *Id.* at *6–7.
167. The Oaktree deal raised $880 million. *See supra* note 1.

New York Stock Exchange or NASDAQ Stock Market listing.[168] An active trading market greatly enhances liquidity by minimizing search, bargaining, and other transaction costs associated with selling shares. Once a trading market is established, pre-IPO investors and insiders can easily cash out some or all of their holdings by selling their shares into the market.[169] With the exception of large block sales, a trading market eliminates the need to search for a willing buyer and to then negotiate the transaction.

Liquidity is particularly important to venture capital investors because it allows them to recycle their capital into other ventures.[170] Likewise, it is important to a company founder because his ownership stake likely represents a large percentage of his net worth. Selling a portion of his holdings allows him to have a more diversified portfolio.[171] Similarly, liquid stock makes equity compensation more attractive to employees by letting them know both the value of their holdings and that those holdings can be readily converted into cash. This, in turn, aids employee recruitment and retention.[172] Furthermore, fluctuations in the market price of a company's stock aids management by providing feedback on the market consensus on the company's strategy and performance.[173] Finally, liquid stock can serve as currency for future acquisitions.[174] Target companies are frequently willing to be acquired in exchange for stock provided there is an active market for the stock.[175]

The extent to which a liquid market will develop for Rule 144A shares remains to be seen. As mentioned above, Goldman Sachs launched GSTrUE in

168. For a description of the New York Stock Exchange's (NYSE) and NASDAQ's listing requirements, see BLOOMENTHAL, *supra* note 4, ch.11.

169. Insider sales are subject to any applicable lock-up agreement and various securities regulations. *See* JOHNSON & MCLAUGHLIN, *supra* note 96, at 2–34 (discussing lock-up agreements); BLOOMENTHAL, *supra* note 4, ch.14 (discussing reporting and short-swing profit liability under Section 16 of the Securities Exchange Act of 1934).

170. *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 256 (1998).

171. *See* NASDAQ, GOING PUBLIC: A GUIDE FOR NORTH AMERICAN COMPANIES TO LISTING ON THE U.S. SECURITIES MARKETS 15–16 (Nicole Lew ed., 2005) [hereinafter GOING PUBLIC GUIDE].

172. *See id.* at 15.

173. *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 256 (2008) ("[T]he informational efficiency of public company share prices provides an important management tool—a company receives virtually instant feedback through prices and periodic feedback through analyst reports, concerning its strategy and performance and that of its competitors . . . ."); *see also* Vojislav Maksimovic & Pegaret Pichler, *Technological Innovation and Initial Public Offerings*, 14 REV. FIN. STUD. 459, 461 (2001).

174. *See* James C. Brau et. al., *The Choice of IPO Versus Takeover: Empirical Evidence*, 76 J. BUS. 583, 590 (2003).

175. *See* 11 SIMON M. LORNE, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 3:4 (2008).

connection with the Oaktree deal in an effort to enhance liquidity. However, initial reports indicate that trading on GSTrUE has not been particularly active, with shares "sometimes not trading for days at a time."[176] NASDAQ's consolidation of the competing Rule 144A markets in PORTAL will likely help liquidity. As a result, a Rule 144A equity offering should afford an issuer some level of liquidity for its shares, although not to the same degree as an NYSE or NASDAQ stock listing, since buyers are limited to QIBs. Nevertheless, liquidity may be sufficient to allow early investors, founders, employees, and others to cash out.

Regardless of the extent of liquidity, PORTAL trading does establish a market price that a company could use as part of a phantom stock or other market-priced-based incentive compensation plan,[177] and it would provide management with some degree of price feedback. Curiously, however, current PORTAL rules appear to detract from the value and usefulness of a market determined price because, as mentioned above, the rules prohibit dissemination of price data to non-PORTAL participants, and participation is limited to brokers, dealers, and QIBs.[178] Thus, for example, it may not be possible for an employee contemplating selling shares to get a price quote because it is not possible for him to be a PORTAL participant. He would be able to sell his shares through a PORTAL-qualified broker, but apparently he would have to do so blindly.

3. Increased Visibility and Reputation

A third benefit of going public is that it will likely increase a firm's visibility and reputation.[179] Increased visibility results from a broadened shareholder base and increased attention from financial analysts and the business press.[180] More people now own the stock and have an incentive to

176. Andrew Ross Sorkin & Michael J. de la Merced, *Buyout Firms Said to Seek a Private Market Offering*, N.Y. TIMES, July 18, 2007, at C3.

177. I mention a phantom stock plan because the 500 record holder trigger for Exchange Act reporting, discussed *infra* text accompanying note 203, essentially limits the number of employees to whom a company can issue stock or stock options.

178. *See supra* note 166 and accompanying text.

179. *See* GOING PUBLIC GUIDE, *supra* note 171, at 15; James C. Brau & Stanley E. Fawcett, *Evidence on What CFOs Think About the IPO Process: Practice, Theory, and Managerial Implications*, J. APPLIED CORP. FIN., Summer 2006, at 107, 108; Richard A. Mann et al., *Starting From Scratch: A Lawyers Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 840–41 (2004).

180. *See* Stacy J. Kanter, *Deciding Whether to Go Public: Certain Basic Considerations*, *in* HOW TO PREPARE AN INITIAL PUBLIC OFFERING 9, 24–25 (2002); William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 575 (2001); sources cited *supra* note 179.

follow the firm. This, in turn, motivates financial analysts to provide coverage of the firm and the business press to write stories about the firm.[181]

Going public may also increase a firm's reputation among customers, lenders, and vendors. They may be more willing to do business with a public firm because its financial and other data are now publicly available and have been scrutinized by analysts, investors, and regulators.[182] Few of these benefits will be realized by a company opting for a Rule 144A equity offering (hereinafter, a Rule 144A company) given that the deals are marketed only to QIBs and neither the firm's disclosure documents nor trading market data are publicly available.

B. Costs of Going Public

1. IPO Costs

Completing an IPO is expensive and involves both direct and indirect costs.[183] The largest direct cost is underwriting expenses.[184] Underwriters charge a commission of four to ten percent of gross offering proceeds for their services.[185] Additionally, an issuer typically covers the managing underwriter's legal, due diligence, and marketing expenses related to the IPO.[186] Other direct costs include legal, accounting, filing, listing, printing, and registrar fees.[187] These fees generally range from $300,000 to $500,000 in total, depending on the size and complexity of the deal and the issuer.[188] Indirect costs include the opportunity cost of management time and effort devoted to the IPO process (for example, drafting sessions and road shows) and underpricing.[189] Underpricing refers to the fact that the IPO "price to public" is routinely set at an amount considerably below the price at which the IPO

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181. *See* GOING PUBLIC GUIDE, *supra* note 171, at 15.
182. *See* Gilson & Whitehead, *supra* note 173, at 257; Sjostrom, *supra* note 180, at 575.
183. *See* GOING PUBLIC GUIDE, *supra* note 171, at 16.
184. GAO REPORT, *supra* note 56, at 23.
185. *See id.* at 23–24. The rate is "generally lower for large issues than for small issues because large issues involve less risk and work per dollar of offering." *Id.* at 24.
186. *See id.* at 24.
187. *See id.*
188. *See* Sjostrom, *supra* note 180, at 575–76; *see also* John F. Olson & Daniel W. Nelson, *What Makes a Company a Good Candidate for Going Public? Criteria, Advantages and Disadvantages Related to Going Public*, *in* POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW 240 (2001).
189. *See* TIM JENKINSON & ALEXANDER LJUNGQVIST, GOING PUBLIC 24 (2d ed. 2001); Jay R. Ritter, *Investment Banking and Securities Issuance*, *in* 1A HANDBOOK OF THE ECONOMICS OF FINANCE 255, 281 (2003).

shares change hands in the secondary market on the first day of trading.[190] Hence, the issuer is "leaving money on the table" because it could have sold the shares at a higher price.[191]

As described above, a Rule 144A equity offering is marketed and sold much the same as an IPO. Therefore, a Rule 144A issuer will incur many of the same offering costs.[192] However, because a Rule 144A offering does not involve SEC review, the timeframe is shorter than an IPO (on average, ten weeks[193] versus fifteen to twenty weeks[194]) and therefore an issuer may see modest savings in the opportunity cost of management time and effort. As for underpricing, the Oaktree deal offers a single data point. Its units traded up from $44 to $50 in the first day of trading, a 12 percent increase.[195]

2. Exchange Act Compliance Costs

Once a company completes an IPO it becomes subject to the reporting requirements of the Exchange Act.[196] As a result, it has to prepare and file with the SEC annual, quarterly, and current reports.[197] The company will incur legal and accounting fees and management opportunity costs year after year when complying with these requirements; fees and costs that have increased significantly following the passage of the Sarbanes-Oxley Act of 2002 (SOX).[198] The company also likely becomes subject to SEC proxy regulations, meaning it will have to prepare, file with the SEC, and distribute to shareholders a detailed proxy statement and other documents every time it solicits proxies.[199] "Often, compliance with disclosure requirements necessitates

190. *See* JENKINSON & LJUNGQVIST, *supra* note 189, at 4. For a discussion of various theories of the new issues underpricing phenomenon, see Ritter, *supra* note 189, at 286–91.

191. *See* JENKINSON & LJUNGQVIST, *supra* note 189, at 5.

192. For example, a study comparing gross underwriter spreads between Rule 144A and public debt offerings found that these costs were not statistically different. Livingston & Zhou, *supra* note 16, at 24.

193. *See* DARROW ET. AL., *supra* note 12, at II-1 to -3 (setting forth an illustrative time schedule for a Rule 144A placement).

194. GOING PUBLIC GUIDE, *supra* note 171, at 18.

195. Lambe, *supra* note 15, at 40–41.

196. 15 U.S.C. §§ 78a–78nn (2006).

197. See generally BLOOMENTHAL, *supra* note 4, §§ 12:26, 12:31, 12:33, 12:52, for a description of annual, quarterly, and current reports.

198. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) (SOX). *See generally* HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT 37–42 (2006) (describing the direct compliance costs of SOX). One estimate puts the cost of complying with SOX at $4.36 million per company. *See id.* at 40.

199. A company typically has to register securities pursuant to Section 12 of the Exchange Act concurrently with its IPO. Section 12 registration triggers proxy regulation compliance. In narrow

a comprehensive and costly expansion—or outright replacement—of existing corporate information systems."[200]

Conversely, completion of a Rule 144A equity offering generally does not subject a company to the reporting requirements of the Exchange Act. These requirements are triggered by registering an offering under the Securities Act[201] and/or by registering under the Exchange Act. A company is not required to register under the Exchange Act unless it has listed its securities on a national securities exchange (for example, NYSE or NASDAQ),[202] or has more than $10 million in total assets and a class of equity securities held of record by 500 or more holders.[203] As discussed above, a Rule 144A equity deal is not registered under the Securities Act nor are the offered securities listed on a national securities exchange. Hence, as long as the deal is not sold to so many investors that the issuer ends up with 500 or more record holders, the issuer will not be required to register under the Exchange Act and therefore will not be subject to the Act's reporting and proxy solicitation requirements. As a result, its SEC compliance costs will be substantially lower than those of an IPO company.

However, a Rule 144A company will need to monitor closely the number of shareholders it has in order to avoid inadvertently exceeding 499 holders and thereby necessitating Exchange Act registration. To that end, NASDAQ plans to incorporate shareholder tracking into PORTAL.[204]

3. Increased Liability Exposure

Going public exposes a company and its officers and directors to potential civil and criminal liability under various federal securities laws and regulations. Among other things, these parties could be held liable for: (1) misstatements of material fact in, or misleading omissions of material fact from, the IPO registration statement,[205] Exchange Act reports,[206] or proxy statements;[207] (2) deficiencies in the company's internal controls;[208] (3) disseminating false

circumstances, it is possible to go public and not be required to register under Section 12. *See* THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION § 9.2[1] (5th ed. 2005).

200. *See* GOING PUBLIC GUIDE, *supra* note 171, at 16.

201. *See* 15 U.S.C. § 78o(d) (2006).

202. *See Id.* § 78*l*(a).

203. *See Id.* § 78*l*(g)(1); 17 C.F.R. § 240.12g-1 (2008).

204. *See* PORTAL Press Release, *supra* note 9.

205. *See* HAZEN, *supra* note 199, § 7.3.

206. *See id.* § 12.4.

207. *See id.* § 10.3.

208. *See* BUTLER & RIBSTEIN, *supra* note 198, at 75–76 (describing liability threats resulting from the SOX requirement that officers certify as to various aspects of a company's internal controls).

or misleading information or failing to timely disclose material information;[209] and (4) trading in the company's stock on the basis of material, nonpublic information[210] or within six months of a previous trade.[211]

Costs of this increased liability risk include director and officer liability insurance premiums, and, of course, legal fees and diversion of management time if a suit is threatened or filed, regardless of merit. They also may include reduced risk-taking by management to minimize the chances of suit, and increased director and officer compensation as recompense for bearing this increased risk.[212]

Conversely, completing a Rule 144A equity deal does not dramatically change liability exposure for a private company or its officers and directors. Because the offering is private (that is, not registered with the SEC), Sections 11[213] and 12(a)(2)[214] of the Securities Act, which impose liability for errors or omissions in a registration statement or prospectus, simply do not apply. Because the company remains private (that is, it does not register under the Exchange Act), it is not subject to Exchange Act requirements to prepare and file annual, quarterly, and current reports or proxy statements. As a result, there are no such reports for a plaintiff to claim deficient in order to file a lawsuit. Similarly, company officers are not required to certify the sufficiency of internal controls, and the short-swing profit rules of the Exchange Act do not apply.

Of course, a Rule 144A company continues to face potential liability under Exchange Act Rule 10b-5,[215] as it applies to all companies, whether public or private.[216] Rule 10b-5 imposes liability for misstatements of material fact or misleading omissions of material fact in connection with the purchase or sale of a security.[217] Hence, a Rule 144A company faces potential Rule 10b-5 liability for errors or omissions in the offering memorandum or other documents distributed to investors. Rule 10b-5, however, does not cast the same specter of liability as, for example, Section 11 under the Securities Act, because to prevail in a Rule 10b-5 cause of action, a plaintiff must prove,

209. *See* BLOOMENTHAL, *supra* note 4, § 27:27.
210. *See* HAZEN, *supra* note 199, § 12.17.
211. *See id.* § 13.2.
212. *See* BUTLER & RIBSTEIN, *supra* note 198, at 45.
213. 15 U.S.C. § 77k (2006).
214. *Id.* § 77*l*(a)(2). At one time, many commentators and courts believed that Section 12(a)(2) applied to private offerings. However, in a 1992 decision, the Supreme Court limited application of Section 12(a)(2) to public offerings by an issuer or controlling person. *See* Gustafson v. Alloyd Co., 513 U.S. 561, 569 (1995).
215. 17 C.F.R. § 240.10b-5 (2007).
216. COX ET AL., *supra* note 69, at 629–30.
217. *See* 17 C.F.R. § 240.10b-5(b) (2007).

among other things, scienter, reliance, and causation,[218] none of which are elements of a Section 11 claim.[219] And again, a Rule 144A company will not be distributing the quarterly, annual, and current reports that often serve as the basis for Rule 10b-5 lawsuits against public companies.

4. Decreased Flexibility

A company gives up a great deal of flexibility by going public. Exchange listing rules have extensive corporate governance requirements that, among other things, dictate the composition of a company's board of directors, the types and composition of board committees, and even the frequency of executive sessions.[220] For example, NYSE listing rules require a listed company to have a majority of independent directors and a nominating/corporate governance committee, a compensation committee, and an audit committee composed entirely of independent directors.[221] Further, the audit committee must have a minimum of three members who "must be financially literate . . . or must become financially literate within a reasonable period of time after his or her appointment to the audit committee."[222] Additionally, NYSE listing rules require a listed company's nonmanagement directors to hold regular executive sessions without management present.[223] NASDAQ listing rules contain similar requirements.[224]

A public company also becomes subject to various inflexible rules imposed by SOX. For example, SOX requires a company's audit committee to hire and oversee the company's outside auditor.[225] SOX also generally prohibits a public company's auditor from providing nonaudit services "contemporaneously with the audit."[226] Additionally, SOX requires that audit firms rotate the lead audit partner of public company clients at least

218. *See* HAZEN, *supra* note 199, § 12.4.

219. *See id.* § 7.3[4], [7], [8].

220. It should be noted, however, that a "controlled company," that is, a company of which a majority of voting power is held by an individual, company, or group, is exempt from the requirement to have a majority of independent directors, a nominating/corporate governance committee, and a compensation committee. *See* NYSE, Inc., Listed Company Manual § 303A (2008) [hereinafter NYSE Manual]; NASDAQ Stock Market Rules § 4350(c)(5) (2008), *available at* http://www.nasdaqtrader.com/trader.aspx?id=rules [hereinafter NASDAQ Rules]. Hence, a company can preserve some flexibility in this regard by selling only a minority of voting power in its IPO.

221. *See* NYSE Manual, *supra* note 220, §§ 303A.01, .04–.06.

222. *See id.* § 303A.07(a).

223. *See id.* § 303A.03.

224. *See* NASDAQ Rules, *supra* note 220, § 4350(c)–(e).

225. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 202, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

226. *See id.* § 201.

every five years.[227] Further, SOX prohibits a public company from making personal loans to its directors or executive officers.[228]

Conversely, a Rule 144A company does not list its shares on an exchange, so it is not subject to exchange listing rules. Additionally, the only provisions of SOX that apply to a private company are the whistleblower protections and prohibitions on altering or falsifying records. Consequently, a Rule 144A company is free to have a board comprised of all insiders, to use its audit firm for nonaudit services, and to lend money to its executives, among other things.

Finally, a public company is less flexible simply because it has public shareholders. This means it must consider expected stock market reaction as part of the decisionmaking process.[229] Having to factor in market reaction may make it difficult for a company to pursue a strategy that will hurt its market price in the short-term but that is expected payoff in the long-term.[230] In fact, labor-market reputational concerns of managers may cause them to focus on short-term stock performance to the detriment of long-run shareholder value.[231]

A Rule 144A company, on the other hand, must answer to a new set of institutional shareholders. Some of these investors might have a short-term focus, but the lack of public filings and other disclosure obligations (and therefore reduced public scrutiny as well as limited dissemination of market data) could reduce pressure on management to focus on the short-term. As a result, management of a Rule 144A company might be afforded more flexibility than management of a public company.

5. Loss of Confidentiality

Another cost of going public is loss of confidentiality.[232] A company is required to disclose in its IPO registration statement information such as executive compensation, financial results, its principal shareholders and their holdings, and transactions with management.[233] Thereafter, the company is required to update periodically this information in various SEC filings, all of

227. *See id.* § 203.
228. *See id.* § 402.
229. *See* GOING PUBLIC GUIDE, *supra* note 171, at 16 ("As a matter of practical necessity, the management of a public company must consider the likely impact of business decisions on the price of the company's shares.").
230. *See id.*
231. *See* Jeremy C. Stein, *Agency, Information and Corporate Investment*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 111, 131 (2003). Basically, management with aspirations to climb the corporate ladder in the short-term have an incentive to focus on the short-term.
232. *See* GOING PUBLIC GUIDE, *supra* note 171, at 16.
233. *See* 17 C.F.R. §§ 229.402–.404, .506 (2007).

which are easily accessible to the public at www.sec.gov. Further, a public company is generally obligated to disclose material events to the marketplace as they occur.[234]

More significantly, the loss of confidentiality as a result of mandatory disclosure requirements can result in lost competitive advantage. A company's competitors will now know much more about the company's business plans, product development, and perceived risks, than they ever did before. Additionally, the very fact that a company has completed a successful IPO could encourage new firms to enter the industry, thus increasing the number of competitors.[235]

Rule 144A companies are required to furnish information to potential investors upon request (pursuant to Rule 144A(d)(4), discussed above) regardless of how few shareholders they have.[236] However, the required disclosure is much less extensive than that required of public companies under the Exchange Act and is not filed with the SEC and therefore not publicly available. Further, Rule 144A companies can require recipients of the information to agree contractually to keep the information confidential. Additionally, as a result of a successful request by NASDAQ, Rule 144A broker-dealers are exempted from the application of Rule 15c2-11, and need not maintain in their files certain information about the issuer of the quoted securities.[237]

C. Rule 144A Equity Offering Calculus

Fundamentally, a Rule 144A equity offering will result in reduced costs and reduced benefits as compared to an IPO. Cost savings are largely attributable to the fact that a Rule 144A company remains private. On the benefit side, as Oaktree has demonstrated, a company can raise hundreds of millions of dollars in equity financing through a Rule 144A offering, but a Rule 144A offering cannot match the post-deal share liquidity resulting from an IPO. As a result, a company needs to weigh the net benefit of each structure in choosing between the two.

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234. *See* BLOOMENTHAL, *supra* note 4, § 27:27.

235. *See* Maksimovic & Pichler, *supra* note 173, at 460.

236. *See supra* Part II.A.4, for a description of Rule 144A's information requirements.

237. NASDAQ No-Action Letter, *supra* note 160, at *5–6; *see also* 17 C.F.R. § 240.15c2-11 (2007). Required information includes the nature of the issuers business, products or services offered, and facilities; the name of the issuer's chief executive officer and members of its board of directors; and the issuer's most recent balance sheet and profit and loss and retained earnings statement. *See id.* § 240.15c2-11(a)(5).

Ultimately, however, the calculus will be largely driven by considerations from the investors', and not the issuer's, perspective. Specifically, the most important input in determining the size of the net benefit of a Rule 144A equity offering will likely be the magnitude of the valuation discount required by investors. As discussed above, restricted shares (including those sold under Rule 144A) must be priced at a discount to what they would command in an IPO in order to attract investors. Certainly, a significant portion of this discount reflects the reduced liquidity associated with Rule 144A securities, PORTAL notwithstanding. Additionally, presumably investors will also require a discount in light of the fact that exchange listing standards and most of the provisions of the Exchange Act and SOX do not apply to a Rule 144A company. Broadly speaking, these provisions were put in place to protect investors.[238] As a result, investors will need to be compensated for forgoing them. The size of such a discount, however, is open to debate, as disagreement continues to rage on the efficacy (especially from a cost-benefit perspective) of many of these provisions.[239]

Obviously, a firm's decision to choose a Rule 144A offering instead of an IPO is complicated and multifaceted. In the end, the decision may turn on firm-specific characteristics such as the premium a firm ascribes to maintaining confidentiality or to minimizing securities litigation exposure. The higher such a premium, the larger the net benefit of a Rule 144A offering. While the exact calculus performed by Oaktree is unknown, according to one source, "[t]he founders of Oaktree stated . . . that they were happy to sacrifice a little public market liquidity, and even take a slightly lower valuation, in return for a less onerous regulatory environment and the benefits of remaining private."[240]

IV. REGULATORY REFORM

The birth of Rule 144A equity offerings by domestic private companies can be viewed as the market's response to increasing regulation. As the Interim Report of the Committee on Capital Markets and Regulation noted in November 2006, few would disagree "that the level of regulatory intensity, in the form of new laws such as SOX, outcomes of shareholder and government litigation, and the behavior of securities regulators, has increased markedly in

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238. *See* Edmund W. Kitch, *Regulation of the Securities Markets*, *in* 3 ENCYCLOPEDIA OF LAW AND ECONOMICS 813, 822 (2000) ("The most commonly asserted objective of securities regulation is the protection of investors.").

239. *See generally, e.g.*, Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703 (2007) (describing and challenging criticisms of SOX § 404).

240. Lambe, *supra* note 15, at 40.

recent years."[241] In fact, many have argued that regulation has gone too far and should be rolled back.[242] Our dynamic and ever-evolving capital markets, however, do not sit idly by, waiting for governmental action; instead they give birth to new deal structures in an effort to decrease the costs of regulation.

Of course, this raises the issue of whether regulations should be revised to reach these market innovations. When it comes to Rule 144A offerings, they should not. The reason is simple: At least since 1953, when the Supreme Court issued its opinion in *SEC v. Ralston Purina Co.*,[243] it has been firmly established that sophisticated investors do not need the same protections as the unsophisticated. In the words of the Supreme Court, the sophisticated can "fend for themselves."[244] Rule 144A offerings, by definition, are marketed and sold only to sophisticated investors; that is, QIBs, since, as the SEC stated in its Rule 144A proposing release, QIBs "are fully able to fend for themselves."[245] More broadly, as Dean Robert Clark wrote: "Institutional investors are usually sophisticated and powerful enough to demand and get the information they need before committing their money. The legal system does not have to protect them with a superimposed mandatory disclosure system."[246] In this light, there simply is no need to expand regulation of Rule 144A deals.

Conversely, in order to improve the viability of Rule 144A equity deals by domestic private companies and thereby facilitate the continued development of more complete U.S. capital markets, the SEC should consider some deregulatory measures. First, as other commentators have suggested, the definition of QIB should be expanded to include accredited investors.[247] As mentioned above, the SEC has long presumed "that accredited investors can fend for themselves."[248] Therefore, adding accredited investors to the QIB definition would be fully consistent with the premise of Rule 144A, that QIBs can fend for themselves. In fact, it is possible (and perhaps better) simply to replace the concept of QIB in

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241. COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION, at xi (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

242. *See* BUTLER & RIBSTEIN, *supra* note 198, at 86–93; *see also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1544–94 (2005).

243. 346 U.S. 119 (1953).

244. *Id.* at 125.

245. Rule 144A 1988 Release, *supra* note 5, at 44,027.

246. ROBERT CLARK, CORPORATE LAW 730 (1986).

247. *See, e.g.*, Luis F. Moreno Treviño, *Access to U.S. Capital Markets for Foreign Issuers: Rule 144A Private Placements*, 16 HOUS. J. INT'L L. 159, 206 (1993); Kellye Y. Testy, Note, *The Capital Markets in Transition: A Response to New SEC Rule 144A*, 66 IND. L.J. 233, 260 (1990).

248. Proposed Revision of Certain Exemptions From the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Release No. 33-6339, 46 Fed. Reg. 41,791, 41,801 (Aug. 18, 1981).

Rule 144A with that of accredited investor. As a general matter, QIBs "would undoubtedly fall within the definition of accredited investor."[249]

Presumably, the SEC drafted the concept of QIB more narrowly than that of accredited investor because it does not view all accredited investors equally. Specifically, for individuals, the definition of accredited investor uses net worth and income as proxies for sophistication/fending ability.[250] As a result, the definition is both under- and over-inclusive.[251] For example, a finance professor with a net worth under $1 million and yearly income under $200,000 would not qualify as an accredited investor but a $10 million lottery winner would, regardless of age, education, or experience. Conversely, the fact that an institution is in the business of investing and has been able to accumulate at least $100 million in assets makes it much less likely that it lacks sufficient sophistication/fending ability. The SEC indicated as much in its Rule 144A proposing release when it noted that the QIB definition "identif[ies] a class of investors that can be *conclusively assumed* to be sophisticated and in little need of the protection afforded by the Securities Act's registration provisions."[252] In contrast, the SEC has characterized accredited investor status as creating a presumption (as opposed to a conclusive assumption) of sophistication/fending ability.[253]

Somewhat ironically, under current rules, a person who qualifies as an accredited investor but not as a QIB could purchase the very same securities sold by an underwriter in a Rule 144A deal to QIBs so long as the purchase was made directly from the issuer and not from the underwriter. This result occurs because the issuer can rely on a Regulation D exemption for the sale to the non-QIB.[254] Further, it is not uncommon for a Rule 144A deal to include a "side-by-side" offering through an underwriter to accredited investors in reliance on the section 4(1-1/2) exemption.[255]

Replacing the concept of QIB with accredited investor would increase the pool of potential investors in Rule 144A offerings, which in turn could

249. *See* Defining the Term "Qualified Purchaser" Under the Securities Act of 1933, Exchange Act Release No. 33-8041, 76 SEC Docket 1035 (Dec. 19, 2001).
250. See *supra* text accompanying note 46, for these proxies.
251. *See* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 305 (2000).
252. Rule 144A 1988 Release, *supra* note 5, at 44,028 (emphasis added).
253. *See supra* text accompanying note 50.
254. See *supra* text accompanying notes 42–47, for an overview of Regulation D. Note that the underwriter could not rely on Regulation D for a sale to a non-QIB because the Regulation D exemptions are only available to issuers of the securities. *See* 17 C.F.R. § 230.501, Regulation D, Preliminary Note 4 ("These rules are available only to the issuer of the securities and not to any affiliate of that issuer or to any other person for resales of the issuer's securities.").
255. *See* John C. Cocchiarella et. al., *Private Placements, Resales and Rule 144A and Regulation S Offerings*, *in* SECURITIES OFFERINGS 2007: OPERATING UNDER THE NEW RULES 181, 237 (2007).

increase the liquidity of the Rule 144A equity market. As discussed above, the level of liquidity existing in the market impacts the extent of the valuation discount for a Rule 144A deal. The greater the liquidity, the smaller the liquidity discount and therefore the greater the viability of a Rule 144A equity deal for a particular firm. It would also make the market accessible to more investors, an important consideration if the deal structure gains in popularity. The ire expressed by many investors concerning a proposed SEC rule that would generally require an investor to own at least $2.5 million in investments in order to invest in a hedge fund (that is, a rule that would increase the number of investors shut out of hedge funds) underscores this consideration.[256]

Additionally, the SEC should revise Rule 144A to explicitly allow underwriters to engage in general solicitation and advertising in marketing Rule 144A deals. As discussed above, neither an issuer nor anyone acting on its behalf can engage in general solicitation or advertising in connection with a Rule 506 offering.[257] While Rule 144A does not expressly prohibit general solicitation, practitioners have long held the view that it is nonetheless disallowed under the rule,[258] a view stemming in part from informal comments by an SEC staff member to that effect,[259] and in part from the fact that Rule 144A is essentially a section 4(1-1/2) safe harbor for QIBs, and general solicitation and advertising are not allowed in an offering made in reliance on Section 4(2).[260]

The SEC could now recast Rule 144A under Section 28 of the Securities Act. Section 28 was added to the Securities Act in 1996 and provides the SEC with broad authority to exempt persons, securities, or transactions from any provision of, or rule under, the Securities Act.[261] Thus, if Rule 144A was

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256. *See Many Investors Fume Over Hedge-Fund Rule*, N.Y. TIMES, Feb. 12, 2007, http://dealbook.blogs.nytimes.com/2007/02/12/many-investors-fume-over-hedge-fund-rule (describing various comments filed with the SEC that are critical of the proposal). The proposed rules include amendments to Regulation D that change the definition of accredited investor to be applied to a natural person with respect to an investment in a "private investment vehicle" (for example, a hedge fund). Under the proposal, for a natural person hedge fund investor to be considered accredited (what the release refers to as an "accredited natural person"), he or she would need to meet the existing definition of accredited investor under Rule 501(a)(5) or (6) (that is, a net worth of at least $1,000,000, annual income of at least $200,000, or joint annual income of at least $300,000) and own at least $2.5 million in investments. *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 33-8766, 72 Fed. Reg. 400, 405–408 (Jan. 27, 2007).

257. *See supra* text accompanying notes 53–56.

258. *See* 7A HICKS, *supra* note 35, § 10A:46, at 10A-61.

259. *See id.*

260. *See id.* § 10A:46, at 10A-62.

261. Section 28 provides:

> The [SEC], by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under

based on Section 28 instead of Sections 4(1) and 4(2), it could explicitly allow general solicitation and advertising because doing so is permissible under Section 28. In fact, the SEC recently took such an approach when it proposed adding a new exemption under Regulation D that allows a limited form of general solicitation.[262]

Allowing general solicitation and advertising in Rule 144A deals should allow underwriters to more effectively market these deals. This will likely increase investor participation, which would lead to increased marketplace liquidity and, therefore, increased viability of the deal structure. Increased viability will allow the new deal structure to evolve and will result in more complete capital markets.

Some regulatory tweaking may be necessary in the future depending on the amount of leakage of Rule 144A equity securities from PORTAL or other similar markets. Specifically, investors are free to sell Rule 144A securities to anyone regardless of QIB status once the Rule 144 holding period has run, which, for nonaffiliates of a private issuer, is one year.[263] Hence, it is foreseeable that Rule 144A equity securities could end up being quoted on the Pink Sheets, a publicly accessible, web-based electronic quotation services for over-the-counter stocks.[264] Generally, all that is required for securities to be quoted on the Pink Sheets is for a registered broker-dealer to file a form along with minimal information about the issuer,[265] information that likely could be gleaned from the information a Rule 144A company is required to provide when requested.[266] More importantly, Pink Sheet companies do not have to register under the Exchange Act and therefore can remain private.[267]

In such an event, Rule 144A equity securities would be available for purchase and sale by the general public, including those who cannot "fend for themselves."[268] The company would, however, remain private and thus would continue to be outside of mandatory disclosure rules and most of SOX. Of course, the company must be mindful of the 500 shareholder-of-record rule.

> this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

15 U.S.C. § 77z-3 (2006).

262. *See* Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116, 45,117 (Aug. 3, 2007) (proposing Rule 507 under the general exemptive authority provided by Section 28 of the Securities Act).

263. *See* 17 C.F.R. § 230.144(b)(1)(i).

264. For a brief description of the Pink Sheets, see Sjostrom, *supra* note 180, at 568.

265. *See id.*; *see also* Michael K. Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers With Quoted Securities*, 39 IND. L. REV. 309, 331 (2006).

266. *See supra* Part III.A.

267. *See* Molitor, *supra* note 265, at 311.

268. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

Presumably, that rule represents a determination by Congress (at least in 1964, when Section 12(g) of the Exchange Act was passed) that once a company has 500 shareholders, it can be assumed that the societal benefits of subjecting a company to the full panoply of federal securities laws outweigh the costs.[269] Thus, if retail investors start buying Rule 144A equity securities on the Pink Sheets, this tipping point may very well be reached, triggering a company's obligation to register under the Exchange Act and thus the full panoply of federal securities regulations.

The rub, however, is that the five hundred number is based on record as opposed to beneficial owners of equity securities. Because most publicly traded shares are held in "street name,"[270] the number of record owners reflected on a company's share register is likely significantly less than the number of actual or beneficial owners of the company's shares. Thus, a company could easily have thousands of beneficial owners but fewer than five hundred record holders and therefore not be required to register under the Exchange Act. Therefore, if Rule 144A equity offerings take off and there is a lot of leakage to the Pink Sheets or similar markets, it may be time to revisit the 500-record-holder trigger.

Deregulation (or at least regulatory restraint) is also arguably warranted by the potential for Rule 144A companies to shed light on the long-standing debate concerning the necessity of mandatory disclosure rules for public companies. Critics of mandatory disclosure argue that capital markets provide a strong incentive for firms to disclose voluntarily the information that investors demand,[271] and thus mandatory disclosure (at least in its current form) is unwarranted.[272] Proponents counter that because of market imperfections a voluntary disclosure system will result in inadequate disclosure.[273]

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269. In recommending the scope of Section 12(g)(1) to Congress, the SEC recognized that the recordholder cutoff had to be set at a level that was "manageable from the regulatory standpoint and not disproportionately burdensome on issuers in relation to the national public interest to be served." SEC. & EXCH. COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, pt. 3, at 17 (1963).

270. "Street name" means that the shares are held of record in the name of a depository company used by the brokerage house and not the name of the beneficial owner.

271. *See* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 421–22 (2003) ("Critics of mandatory disclosure argue that a company will voluntarily disclose information that investors demand in order to reduce its cost of capital and avoid any discount that the market might apply to the company's stock price if investors think that they have too little information to evaluate the company and its securities properly or, worse yet, if investors think that the company is hiding something.").

272. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 714–15 (1984).

273. *See* Paredes, *supra* note 271, at 421 ("Supporters of mandatory disclosure counter that because information has public good aspects, voluntary disclosure will result in too little disclosure."). The details of this debate have been discussed at length elsewhere and are beyond the scope of this Article. See, for example, *id.* at 485 n.11, for cites to some of the leading works in the area.

Nonetheless, as discussed above, Rule 144A companies have quasi-publicly traded stock yet are exempt from the mandatory disclosure rules. As a result, assuming a critical mass of companies, studying their disclosure practices could provide additional empirical data to inform the debate.

Similarly, the cost effectiveness of SOX has been intensely debated since the outset of its passage.[274] As discussed above, unlike public companies, Rule 144A companies are exempt from almost all provisions of SOX. Hence, comparing market price and other data of Rule 144A companies with those of comparable public companies could shed further light on the market's take on SOX's cost effectiveness.

The debates surrounding the necessity of mandatory disclosure and the cost effectiveness of SOX are not just academic: They are critical to designing a socially optimal securities regulation regime. Consequently, the potential that further development of the Rule 144A equity market could provide new insights into these debates is further support for a deregulatory stance.

CONCLUSION

A private company Rule 144A equity offering blurs the dichotomy between a public offering and a private offering. It is marketed and sold through an underwriter much the same as an IPO, yet the company remains private. In some respects, a Rule 144A equity offering imparts the best of both worlds: It results in a large infusion of equity capital and a trading market for the company's equity securities, without increasing liability exposure or sacrificing confidentiality and flexibility. Hence, a Rule 144A equity offering is now a bona fide alternative to an IPO.

The birth of this structure reflects the market's response to the increased regulation of public companies. While the structure does blur a long established line, it is firmly rooted in the principle of federal securities laws that sophisticated investors can fend for themselves. The birth of this structure also represents an advance towards more complete U.S. capital markets. Consequently, this Article has proposed regulatory reforms to improve the viability of Rule 144A equity offerings. In any case, the structure's

274. *See, e.g.*, BUTLER & RIBSTEIN, *supra* note 198, at 3 ("Both logic and evidence make it clear that SOX was a costly mistake."); Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1908 (2007) (challenging the characterization of SOX as "quack corporate governance" and arguing in favor of some of its provisions); Romano, *supra* note 242, at 1602 (arguing that substantive corporate governance provisions of SOX "were seriously misconceived, because they are not likely to improve audit quality or otherwise enhance firm performance and thereby benefit investors as Congress intended").

development should be followed with interest as it may reinvigorate the attractiveness of raising equity capital in the U.S. and the debate of the efficacy of mandatory disclosure and SOX.