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How Does Relaxing the Restrictions on a Private Company's Capitalization Table Contribute to Longer Periods Companies Spend Private?

Niki Waters

I. Introduction

In the past, startup companies in the U.S. followed a predictable path: they raised angel capital, a few rounds of venture capital, and went public[1] within five years.[2] Recently there has been a trend of private[3] companies staying private for longer periods of time, without an initial public offering ("IPO") or acquisition from a public company. The results have been an increase in "mature" startups[4] and a potential decrease in IPOs.[5] Many factors have been cited as contributing to the problem, such as the rise in online brokers, decimalization, and the passage of Sarbanes-Oxley.[6] Scholars have even written about the role that the changes in technology and the changing public market dynamics have played into the decrease in IPOs.[7] However, recent regulatory changes have helped drive the trend by increasing availability of private capital to younger companies, enabling companies to avoid the risks and costs of going public.

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[1] Companies that are subject to reporting requirements are referred to as "reporting companies." If a reporting company has publicly traded stock, it is referred to as a "public company."

[2] *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 88 (2011) (statement of Barry E. Silbert, Founder and Chief Executive Officer, SecondMarket, Inc.) available at https://www.govinfo.gov/content/pkg/CHRG-112shrg74930/pdf/CHRG-112shrg74930.pdf.

[3] A non-reporting company whose stock is not publicly traded is referred to as a "private" company.

[4] IPO Task Force, Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth 6 (2011), https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf ("In addition, the companies that make it to the public markets are taking twice as long to do so: The median age of a venture-backed company at the time of its IPO has nearly doubled in recent years."); *see* Figure 3.

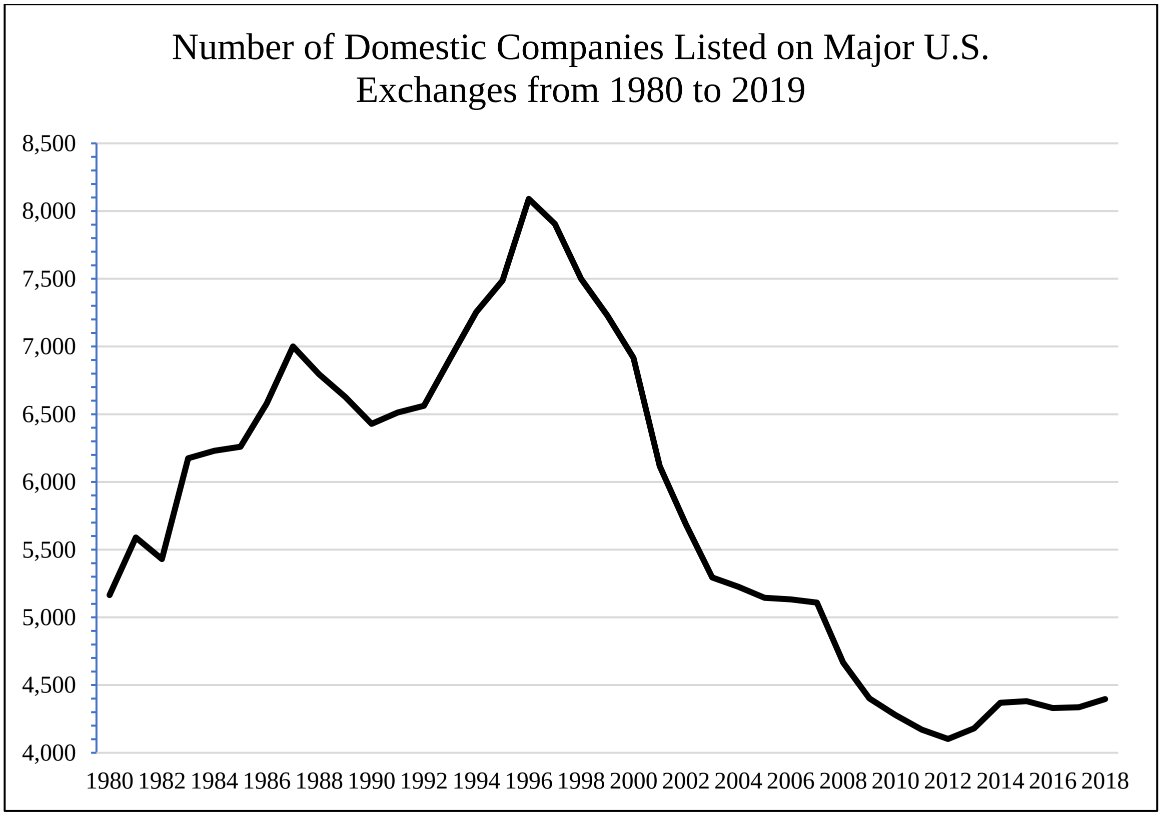
[5] Elisabeth de Fontenay, The Deregulation of Private Capital and the Decline of the Public Company, 68 HASTINGS L.J. 445 (2017) ("From 2001 through 2012, there were an average of only 99 IPOs per year, compared to 310 IPOs per year between 1980 and 2000. Given that the total number of U.S. startups grew overall during the same period, the *proportion* of U.S. firms undergoing an IPO fell even more dramatically.") (emphasis in original text); *see* Figure 2.

[6] *See Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 89-90 (2011) (statement of Barry E. Silbert, Founder and Chief Executive Officer, SecondMarket, Inc.); *see also* de Fontenay, *supra* note 5, at 449 ("information effects of our new securities-law paradigm").

[7] Elizabeth Pollman, Startup Governance, 168 U. PA. L. REV. 155, 209 (2019) ("Scholars have debated the role that regulatory costs, securities law changes, technology, and public market dynamics may have played in these developments.").

II. Public Versus Private Companies

Traditionally, going public with an IPO was seen as the best way to gain access to capital by reaching a broad range of investors for a relatively low price. However, the passage of multiple pieces of legislation made IPO expenses astronomical, and many "unicorns"[8] have demonstrated that they can raise capital without an IPO.[9] The current primary exit strategy for founders seems to be selling to a public company. There has been an overall decline in the number of publicly listed companies since its peak in 1996, as shown by Figure 1 below.[10]



[8] A unicorn company is a private company with a valuation of over $1 billion.
[9] *See* Pollman, *supra* note 7, at 210.
[10] The data is from the World Federation of Exchange Database, available at https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US ("Listed domestic companies are those which have shares listed on an exchange at the end of the year. Investment funds, unit trusts, and companies whose only business goal is to hold shares of other listed companies, such as holding companies and investment companies, regardless of their legal status, are excluded. A company with several classes of shares is counted once. Only companies admitted to listing on the exchange are included."); *see also* David Weild & Edward Kim, A Wake-Up Call for America, Capital Markets Series, Grant Thornton LLP 4 (2009) https://www.sec.gov/comments/265-26/265-26-19.pdf.

Companies need capital to invest in growth and expansion plans, to hire employees, to fund mergers and acquisitions, to finance operations, and to pay existing debt.[11] However, the underlying motivations to go public are not limited to just money. Another motivation to go public is the perceived legitimacy and prestige in being a publicly traded company. Incidentally, potential investors may feel more comfortable investing in a company if it is subject to the SEC's disclosure requirements. If successful, an IPO tends to send a signal that the company has arrived.[12] The publicity of an IPO has the potential to bring in countless new investors. Going public also brings stability to the company in the form of a reliable and liquid source of capital. IPOs also create a new form of currency—publicly traded stock—that could be used to acquire other businesses and recruit employees.[13] A company's debt-to-equity ratio usually declines after an IPO, making banks more willing to give loans.

The main factor demotivating companies from going public is, coincidentally, money. The IPO itself is expensive, but the continuous reporting requirements are subject to a high standard that makes them even more costly. Smaller companies, especially startups, are at a disadvantage in bearing these costs compared to their larger counterparts.[14] After going public, founders lose a certain amount of control since they have to answer to shareholders and independent directors on their Board. This makes the decision-making process for public companies more formal and less flexible, unlike what is notorious of startup culture. Public companies face more risk to lawsuits,

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[11] SIFMA Insights: US Equity Capital Formation Primer, *An exploration of the IPO process and listings exchanges* 5 (November 2018).
[12] Renee M. Jones, The Unicorn Governance Trap, 166 U. PA. L. REV. ONLINE 165, 170 (2017).
[13] *Id.*
[14] Caroline Rasmussen, *Where have all the public companies gone?* CNBC (Oct. 27, 2017), https://www.cnbc.com/2017/10/25/where-have-all-the-public-companies-gone.html.

public scrutiny, and takeover attempts. There has also been changes in the IPO process over the past few decades that has made it a longer and more demanding process.[15]

In the past it seemed that the benefits of going public outweighed the costs, making it a logical step in a startup's life cycle.[16] However, today's companies do not seem to be seeing the same value in going public as companies in the past, because it seems that a lot less companies are choosing IPOs than they used to. The average number of total IPOs for the years 1980 through 2000 was 310, made up by roughly equal percentages of small firms and large firms.[17] For the years 2001 through 2019, the average number of annual IPOs was 110.[18] The size of the companies making IPOs is also noteworthy, since only 28% of the IPOs were conducted by small firms, those with pre-issue annual sales of less than $50 million.[19] The data showing the trends in IPOs show that IPO trends ebb and flow, as seen in Figure 2.[20] The number of IPOs peaked in 1996, the same year the number of companies publicly listed on a U.S. exchange peaked.[21] IPOs hit an all-time low in 2008 with only 21 IPOs conducted.[22]

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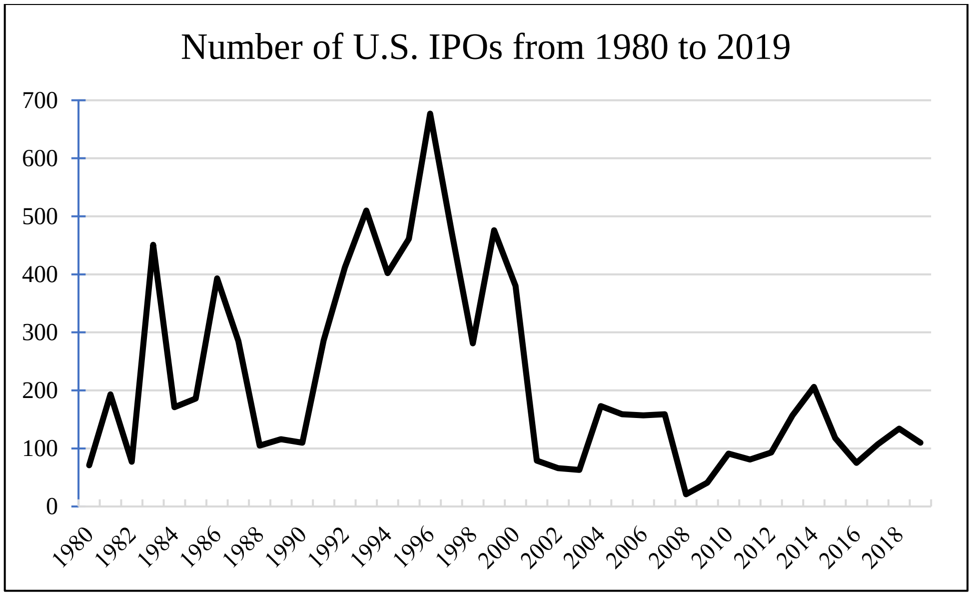
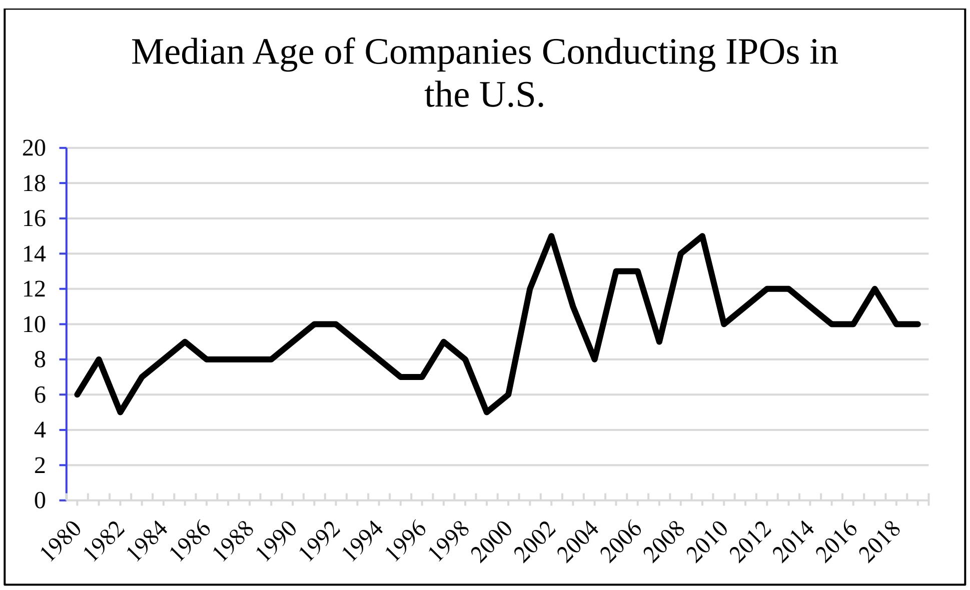
[15] Lia Der Marderosian, Wilmer Cutler Pickering Hale and Dorr LLP, 2017 IPO Report, Harvard Law School Forum on Corporate Governance (May 25, 2017) https://corpgov.law.harvard.edu/2017/05/25/2017-ipo-report/.
[16] *See* Jones, *supra* note 12, at 171.
[17] Xiaohui Gao et al., Where Have All the IPOs Gone?, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1668 (2013).
[18] *See* Jay R. Ritter, Initial Public Offerings: Updated Statistics 10 (March 18, 2020), https://site.warrington.ufl.edu/ritter/files/IPOs2019Statistics_Mar18_2020.pdf.
[19] Gao et al., *supra* note 17, at 1667.
[20] Data is from Jay R. Ritter, Initial Public Offerings: Updated Statistics 10 (March 18, 2020), https://site.warrington.ufl.edu/ritter/files/IPOs2019Statistics_Mar18_2020.pdf.
[21] *See* Figure 1.
[22] *See* Figure 2.



Another noteworthy trend is the increased median age of companies conducting IPOs, as evidenced by Figure 3 below.[23] Enabling private companies to stay private longer is undoubtedly one of the reasons for this.



[23] *See* Figure 3. Data is from Jay R. Ritter, Initial Public Offerings: Updated Statistics 10 (March 18, 2020), https://site.warrington.ufl.edu/ritter/files/IPOs2019Statistics_Mar18_2020.pdf.

A major concern about the decline in IPOs is that the United States is missing out on millions of jobs that would have been created by IPOs. Additionally, a lack of disclosure leaves investors vulnerable, especially if not accredited investors. This decline may be stifling innovation by disincentivizing entrepreneurs from pursuing a startup. Companies used to grow up in the public market,[24] but today's companies are earning most of their value pre-IPO.

III. Securities Regulation Background

The two main federal securities laws, the Securities Act of 1933 and the Securities Exchange Act of 1934, were passed in the midst of the Great Depression. In 1929, the stock market crashed and public confidence in the securities markets plummeted. In the following years, investors and banks lost huge sums of money. The consensus was that, for the economy to recover, the public had to have faith in the markets again. And to restore faith meant providing transparency in the markets by requiring disclosure. In 1923, only 25% of the firms with securities listed on the New York Stock Exchange ("NYSE") provided investors with quarterly and annual financial statements.[25] There were multiple federal bills proposed to regulate securities by requiring public firms to make periodic disclosures, but they were not successful.

A. The Securities Act of 1933

The Securities Act of 1933 ("Securities Act" or "1933 Act") was adopted "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."[26] It requires firms making public

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[24] Timothy B. Lee, *The IPO is dying. Marc Andreessen explains why*, VOX (June 26, 2014), https://www.vox.com/2014/6/26/5837638/the-ipo-is-dying-marc-andreessen-explains-why.

[25] Michael D. Guttentag, Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures, 88 IND. L.J. 151, 162 (2013).

[26] Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77 (1933)).

offerings of securities to follow a certain procedure, including disclosing material information about the firm and the securities.[27] It has two basic objectives: "[t]o require that investors receive financial and other significant information concerning securities being offered for public sale; and [t]o prohibit deceit, misrepresentations, and other fraud in the sale of securities."[28]

In other words, it regulates the offer and sale of securities by requiring that every offer and sale of securities be registered with the SEC or qualify for an exemption. The SEC seeks to foster capital formation through its exemptions of many small offerings by lowering the cost of offering securities to the public. Section 5 requires that an issuer register any offer or sale of its securities unless an exemption applies.[29] Sections 3[30] and 4[31] generally exempt certain types of securities and transactions in securities, respectively, from the registration requirements of Section 5. Additionally, Section 28 gives the SEC authority to exempt others if it is in the public interest and consistent with protection of investors.[32] One major limitation of the Securities Act was that it did not require continual disclosure once the public offering was complete.[33]

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[27] Guttentag, *supra* note 25, at 163.

[28] SEC Website, Fast Answers, Registration Under the Securities Act of 1933, https://www.sec.gov/fast-answers/answersregis33htm.html.

[29] 15 U.S.C. § 77e.

[30] 15 U.S.C. § 77c(a) ("Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities: (2) Any security issued or guaranteed by the United States…(3) Any note, draft, bill of exchange, or banker's acceptance with arises out of a current transaction or the proceeds of which have been or are to be used for current transactions…(4) Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit…").

[31] 15 U.S.C. § 77d(a) ("The provisions of section 77e of this title shall not apply to—(1) transactions by any person other than an issuer, underwriter, or dealer; (2) transactions by an issuer not involving any public offering; (3) transactions by a dealer…; (4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders; (5) transactions involving offers or sales by an issuer solely to one or more accredited investors…").

[32] 15 U.S.C. § 77z-3 ("The Commission, 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 this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.").

[33] Guttentag, *supra* note 25, at 163.

B. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934, also known as "the Exchange Act," was enacted "[t]o provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets."[34] One of the main goals of the Act was to require certain firms to make periodic disclosures, rather than the one-time disclosure required by the Securities Act.[35] Compared to the Securities Act, which regulates the process of "becoming" public, the Exchange Act regulates the status of "being" public.[36] Section 4(a)[37] of the Exchange Act established the Security Exchange Commission, whose goals are to enforce securities laws, to promote stability in the markets, and to protect investors.[38]

A company becomes subject to the continuous reporting requirements of the Exchange Act in one of three ways, but at the time of its enactment, the only trigger was trading on a national exchange, such as NYSE or Nasdaq. The Exchange Act targeted companies with securities traded on a national exchange since "over 80% of the dollar value of trading in equity securities occurred on a national exchange."[39] Section 12 sets out the registration requirements for securities, prohibiting "any transaction in any security…on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of

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[34] Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified at 15 U.S.C. §78a *et seq*.).
[35] Guttentag, *supra* note 25, at 163.
[36] Onnig H. Dombalagian, Principles for Publicness, 67 FLA. L. REV. 649, 652 (2015); *see also* Exchange Act Registration: Overview, Practical Law Practice Note Overview 7-506-3135 ("An Exchange Act registration is a single registration of an entire class of securities (debt or equity). This is different from a Securities Act regulation, in which a company registers a certain number of a class of securities (debt or equity) for a particular public distribution.").
[37] 15 U.S.C. § 78d(a) ("There is hereby established a Securities and Exchange Commission (hereinafter referred to as the "Commission") to be composed of five commissioners to be appointed by the President by and with the advice and consent of the Senate…").
[38] U.S. Securities and Exchange Commission, About the SEC, What We Do https://www.sec.gov/Article/whatwedo.html.
[39] *See* S. Rep. No. 379, at 14 (1963).

this title and the rules and regulations thereunder."[40] Registration requires companies to file quarterly reports, annual reports, and periodic updates when certain material events occur. Since the Exchange Act's passage, the *content* of federal periodic disclosure requirements has evolved, but the *criteria* used to decide which firms were required to disclose has rarely been changed.[41]

C. The 1936 Amendments to the Exchange Act

After the passage of the Exchange Act, legislators were concerned that firms without securities traded on a national exchange remained unregulated. The 1936 Amendments added a second trigger to complying with the periodic public reporting requirements of the Exchange Act: publicly offering securities in compliance with the Securities Act. It added Section 15(d)[42] to the Exchange Act, which required compliance with the continuous reporting requirements of the Exchange Act "when the aggregate offering price of the securities being registered [pursuant to Section 5 of the Securities Act], plus the value of the securities of the same class outstanding, amounts to $2 million or more."[43]

D. The 1964 Amendments to the Securities Act

The 1964 amendments to the Securities Act expanded mandatory compliance with disclosure requirements to firms that had neither offered securities publicly pursuant to the Securities Act nor listed their securities on a national exchange.[44] The Exchange Act, as originally enacted, did not require companies in the over-the-counter (OTC) markets to register. Prior to the amendment's passage, there was a push from national exchanges to force certain companies in

[40] 15 U.S.C. § 78l(a).
[41] Guttentag, *supra* note 25, at 164.
[42] 15 U.S.C. § 78o(d).
[43] Guttentag, *supra* note 25, at 165 (citing S. Rep. No. 379, at 15 (1963)).
[44] Guttentag, *supra* note 25, at 166.

OTC markets to comply with the same mandatory disclosure requirements that their publicly listed companies had to comply with.[45]

Former Chairman of the SEC, William Cary, received funds from Congress to conduct research on how to improve securities regulation, which culminated with the "Report of Special Study of Securities Markets of the Securities and Exchange Commission" ("Special Study"). The Special Study concluded that there were companies who had neither offered securities publicly nor listed securities on a national exchange that should nevertheless be subject to disclosure requirements.[46] At the time of the study, 61% of the dollar volume of equity securities trading in the U.S. was taking place in over-the-counter markets.[47] The study noted that providing protections for investors in the OTC market would encourage a more healthy development of that market and eliminate the unfairness of the double standard of regulation.[48] The reasons that led Congress to establish the disclosure, proxy, and insider-trading protections for investors in publicly listed securities applied equally to the OTC market.[49] The Special Study pointed out that the "keystone of the entire structure of Federal securities legislation is disclosure,"[50] and emphasized the correlation between fraud and lack of disclosure.[51] Afterall, issues that are "[r]elatively unknown, insubstantial, and unseasoned" should be subjected to *more* disclosure than their public counterparts.[52]

[45] *See* Usha R. Rodrigues, The Once and Future Irrelevancy of Section 12(G), U. ILL. L. REV. 1529, 1532 (2015).
[46] Report of Special Study of Securities Markets of the Securities and Exchange Commission, H. Doc. 95 (1963) [hereinafter "Special Study"], http://www.sechistorical.org/museum/papers/1960/page-2.php.
[47] Special Study, Chapter VII at 547.
[48] Special Study, Chapter IX at 16.
[49] Special Study, Chapter IX at 7.
[50] Special Study, Chapter IX at 1.
[51] Special Study, Chapter IX at 10.
[52] Special Study, Chapter IX at 9.

In determining the criteria of coverage, the Special Study recognized that it needed a standard that was both reasonably reliable and easily enforceable.[53] It wanted to "bring within the statutory controls those issuers that are sufficiently significant from the point of view of the public interest to warrant the regulatory burden to be assumed by the Government and the compliance burden to be imposed on the issuers involved."[54] It surmised that the number of shareholders was the most direct and simple measure of public-investor interest.[55] Although the study found no relationship between the amount of total assets and the interest in investor protection, it ultimately had relevance "in defining a limit where burdens may be disproportionate to needs."[56] It recognized that the amount of assets would be, at best, a secondary criterion.[57]

The 1964 amendment added Section 12(g)(1), which created a shareholder threshold triggering disclosure requirements (known as the "12(g) threshold"):[58]

> (1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall: (A) within one hundred and twenty days after the last day of its first fiscal year ended after the effective date of this subsection on which the issuer has *total assets* exceeding $1,000,000 and a *class* of equity security (other than an exempted security) *held of record* by seven hundred and fifty or more persons; and (B) within one hundred and twenty days after the last day of its first fiscal year ended after two years from the effective date of this subsection on which the issuer has *total assets*[59] exceeding $1,000,000 and a class of equity security (other than an exempted security) *held of record*[60] by five hundred or more but less than seven hundred and fifty persons, register such security by filing with the Commission a registration statement.[61]

[53] Special Study, Chapter IX at 17.
[54] Special Study, Chapter IX at 17.
[55] Special Study, Chapter IX at 18.
[56] Special Study, Chapter IX at 18.
[57] Special Study, Chapter IX at 18.
[58] Securities Act Amendments of 1964, Pub. L. No. 88-467, § 2, 78 Stat. 565, 567 (1964) (amended 2012).
[59] 17 C.F.R. § 240.12g5-2 (defining total assets as "the total assets as shown on the issuer's balance sheet or the balance sheet of the issuer and its subsidiaries consolidated, whichever is larger").
[60] 17 C.F.R. § 240.12g5-1 (determining that "securities shall be deemed to be 'held of record' by each person who is identified as the owner of such securities on records of security holders maintained by or on behalf of the issuer," subject to certain exemptions).
[61] 15 U.S.C. § 78l(g) (emphasis added).

This became the third trigger for mandatory compliance with the periodic disclosures required by the Exchange Act. The original 12(g) threshold capped total assets at $1 million, but it was increased to $3 million in 1982,[62] and increased again in 1986 to $5 million.[63]

Although it was not designed to force private companies to go public sooner than they otherwise would, it had that effect on several companies, such as Google, Facebook, and Apple.[64] The 12(g) registration requirement was "aimed at issuers that had sufficiently active trading markets and public interest and consequently were in need of mandatory disclosure to ensure the protection of investors."[65] In other words, the purpose was "to impose disclosure on firms that were already trading over the counter—and thus where, as a practical matter, a public market already existed."[66]

Since the 1964 amendment, a company becomes subject to the continuous reporting requirements of the Exchange Act in one of three ways: 1) by trading securities on a national securities exchange;[67] 2) by issuing equity or debt securities to the public in a registered offering under the Securities Act;[68] or 3) by triggering certain numeric thresholds.[69] The first two ways, listing on a national exchange or conducting a public offering, are quite different than the third way. Listing on a national exchange or holding a public offering are conscious choices and,

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[62] *System of Classification for Purposes of Exempting Smaller Issuers from Certain Reporting and Other Requirements*, Release No. 34-18647 (April 21, 1982) [47 FR 17046].
[63] *Reporting by Small Issuers,* Release No. 34-23406 (July 14, 1986) [51 FR 25360].
[64] William K. Sjostrom, Questioning the 500 Equity Holders Trigger, 1 HARV. BUS. L. REV. ONLINE 43, 44 (2011).
[65] *Id*. at 45; Rodrigues, *supra* note 45, at 1530.
[66] Rodrigues, *supra* note 45, at 1532.
[67] 15 U.S.C. § 78l(a) ("It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this title and the rules and regulations thereunder.").
[68] 15 U.S.C. § 78o-6.
[69] 15 U.S.C. § 78l(g).

therefore, increasingly easy to avoid. Triggering the 12(g) threshold is not something a private company would elect to do; it can happen inadvertently.

E. The Jumpstart Our Business Startups Act

The notorious decline in IPOs[70] became so concerning that Congress sought to pass legislation that would encourage companies to go public and reverse the downward trend.[71] The Jumpstart Our Business Startups Act, also called the JOBS Act, was enacted on April 5, 2012.[72] It was the consolidation of six earlier bills.[73] Its stated purpose was "[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."

The JOBS Act relaxes statutory restrictions on launching IPOs via Title I (Reopening American Capital Markets to Emerging Growth Companies), which created a new category of companies—emerging growth companies—who would be subject to looser public disclosure requirements over the first five years of its publicly listed status. The Act amends parts of the Securities Act and the Exchange Act to allow exemptions from "certain mandatory public company requirements for this new category of corporate issuers."[74] Title II of the JOBS Act (Access to Capital for Job Creators) relaxed prior limitations on general solicitation. Title III established the crowdfunding exemptions. Title IV (Small Company Capital Formation) expanded the Regulation A exemption. Title V (Private Company Flexibility and Growth) amended the Section 12(g) threshold trigger and the definition of "held of record." Title VI (Capital Expansion) also raised the 12(g) threshold trigger specifically for banks and bank holding companies.

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[70] *See* Figure 2.
[71] De Fontenay, *supra* note 5, at 456.
[72] P.L. 112-106.
[73] H.R. 2930, H.R. 2940, H.R. 1070, H.R. 2167, H.R. 3606, and H.R. 4088.
[74] Rena S. Miller & Gary Shorter, U.S. Initial Public Stock Offerings and the JOBS Act, Congressional Research Service 7 (Sept. 27, 2012), https://fas.org/sgp/crs/misc/R42427.pdf.

IV. Regulatory Changes Enabling Private Companies to Stay Private

In the past decade, there have been numerous regulatory changes aimed at creating jobs, encouraging IPOs, and helping startups earn capital. The 2012 JOBS Act increased the 12(g) threshold and amended the definition of "held of record" to exclude employees who are granted stock options pursuant to employee compensation plans. The JOBS Act also amended Rule 506 of Regulation D to allow for general solicitation, which was previously prohibited. Rule 701(e) was also amended, changing the trigger for requiring additional disclosures to employee-investors from $5 million to $10 million.

A. The JOBS Act Increases the Shareholder Threshold and Excludes Employee Compensation Shares from "Held of Record"

While the JOBS Act was aimed at encouraging U.S. companies to go public to increase jobs, the Act created new exemptions from securities registration, making it easier to remain private. Prior to the JOBS Act, a private company with more than $10 million in total assets and a class of equity security held by 500 or more record holders on the last day of its fiscal year was required by Section 12(g) of the Exchange Act to register within 120 days. Section 501 of the JOBS Act[75] amended the 12(g) threshold at which a company is required to register under the Exchange Act, increasing the holders of record threshold to either (1) 2,000 or more persons or (2) 500 or more persons who are *not* accredited investors.[76]

Additionally, Section 502 of the JOBS Act amended the definition of "held of record" by excluding "securities held by persons who received the securities pursuant to an employee

[75] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).
[76] JOBS Act § 501(A) ("[W]ithin 120 days after the last day of its first fiscal year ended on which the issuer has total assets exceeding $10,000,000 and a class of equity security (other than an exempted security) held of record by either— (i) 2,000 persons, or (ii) 500 persons who are not accredited investors (as such term is defined by the Commission).").

compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act of 1933."[77] Increasing the holders of record threshold from 500 to 2,000 was a big deal on its own, but excluding employees from that count was a major contributor to companies staying private longer.

Although the 500 shareholder rule worked well when it was first enacted in 1964, it eventually began to directly impact a company's financial decisions. With only 500 total possible shareholders—including founders, employees, and investors—private companies were fearful of reaching that threshold. It made companies hesitant to hire new employees and discouraged them from providing equity-based compensation to employees.[78] Equity-based compensation was what attracted the brightest potential employees to the company, and incentivized employees to make sure the startup was successful.

By increasing the number of shareholders a private company is allowed to have before being required to register under the Exchange Act, private companies are less likely to register and, consequently, go public. Private companies are now able to have many more shareholders, thus it is unlikely that many, if any, companies will be forced to go public by passing the threshold. Private companies can give equity-based compensation to more employees without worrying about triggering 12(g).

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[77] JOBS Act § 502.

[78] *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 92 (2011) (statement of Barry E. Silbert, Founder and Chief Executive Officer, SecondMarket, Inc.).

B. Rule 506(c) Lifts the Prohibition on General Solicitation

Regulation D was created in 1982 to "provide a unified scheme for exempting certain capital offerings from registration requirements."[79] Its purpose was to facilitate capital formation, especially for small businesses. Rule 506 was amended pursuant to Section 201(a)(1) of the JOBS Act, which directed the SEC to remove the prohibition on general solicitation or general advertising for securities offerings relying on Rule 506.[80] To implement Section 201(a), paragraph (c) was added to Rule 506 and the prior Rule 506[81] safe harbor was retained at paragraph (b). Now, Regulation D is comprised of four rules: Rule 504,[82] Rule 505,[83] Rule 506(b), and Rule 506(c). Most Regulation D offerings are issued under Rule 506.[84]

The amended Rule 506(c) permits issuers to use general solicitation[85] and general advertising to offer their securities, provided that the following conditions are met:

- Rule 501[86] (definitions for the terms used in Regulation D)

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[79] Scott Bauguess, Rachita Gullapalli, and Vladimir Ivanov, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014, at 8 (2015).
[80] JOBS Act § 201(a)(1) ("Not later than 90 days after the date of the enactment of this Act, the Securities and Exchange Commission shall revise its rules issued in section 230.506 of title 17, Code of Federal Regulations, to provide that the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors. Such rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission. Section 230.506 of title 17, Code of Federal Regulations, as revised pursuant to this section, shall continue to be treated as a regulation issued under section 4(2) of the Securities Act of 1933 (15 U.S.C. 77d(2)).").
[81] 17 C.F.R. § 230.506 (allowing a private offering under the Section 4(2) registration exemption of the Securities Act if certain criteria are met).
[82] 17 C.F.R. § 230.504 (allowing an exemption from registration for some companies when they offer and sell up to $1 million of their securities within a 12-month period).
[83] 17 C.F.R. § 230.505 (saying a company can offer and sell only up to $5 million of its securities in a 12-month period, to an unlimited number of accredited investors and up to 35 other investors who do not satisfy the accredited investor standard).
[84] Bauguess et al., *supra* note 79, at 12.
[85] The term is not defined in Regulation D, but 17 C.F.R. §230.502(c) provides examples of general solicitation including advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars where attendees have been invited by general solicitation or general advertising.
[86] 17 C.F.R. § 230.501 (including complying with the 501(a) definition of accredited investor, the 501(c) definition of aggregate offering price, how to calculate the number of purchasers in 501(c), etc.).

- Rule 502(a)[87] regarding integration[88]
- Rule 502(d)[89] specifying limitations on resale
- Rule 506(d)'s[90] bad actor disqualification
- All purchasers in the offering are accredited investors,[91] and
- The issuer takes reasonable steps to verify purchaser's accredited investor status.

Rule 506(c) offerings do not have a limit on the number of accredited investors that can invest or on the amount of money that can be raised from each investor or in total.[92]

The issuer has taken reasonable steps if it uses either the principles-based method of verification[93] or one of the four non-exclusive methods of verifying that a natural person who purchases securities in such offering is an accredited investor; provided, however, that the issuer does not have knowledge that such a person is not an accredited investor. The principles-based method of verification is an objective determination by the issuer considering the particular facts

[87] 17 C.F.R. § 230.502(a) ("All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in rule 405 under the Act.").
[88] The integration doctrine concerns whether multiple securities transactions should be considered part of the same offering to determine whether an exemption is available for the entire offering. The SEC has identified five factors to consider when analyzing the facts and circumstances of the offerings: (1) whether the different offerings are part of a single plan of financing, (2) whether the offerings involve issuance of the same class of security, (3) whether the offerings are made at or about the same time, (4) whether the same type of consideration is to be received, and (5) whether the offerings are made for the same general purpose.
[89] 17 C.F.R. § 230.502(d) ("Except as provided in §230.504(b)(1), securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under section 4(a)(2) of the Act and cannot be resold without registration under the Act or an exemption therefrom. The 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 Act…").
[90] 17 C.F.R. § 230.506(d) (disqualifying an offering if the issuer or any other person covered by 506(d) has a relevant criminal conviction, regulatory or court order or other disqualifying event that occurred since the rule became effective).
[91] 17 C.F.R. § 230.506(c)(2)(i).
[92] *Concept Release on Harmonization of Securities Offering Exemptions*, Release No. 33-10649 at 71 (June 18, 2019) [84 Fed. Reg. 30460], https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf.
[93] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, 78 Fed. Reg. 44771, 44778 (July 24, 2013).

and circumstances of each purchaser and transaction. Factors that should be considered are: (1) the nature of the purchaser and the type of accredited investor that the purchaser claims to be; (2) the amount and type of information that the issuer has about the purchaser; and (3) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as minimum investor amount.[94]

The Rule also provides a non-exclusive list of four methods that would satisfy the verification requirements.[95] First, a purchaser can be an accredited investor based on income if the purchaser has an individual income in excess of $200,000 in each of the two most recent years, or joint income with a spouse in excess of $300,000.[96] The issuer must review any IRS form that reports the purchaser's income for the two most recent years *and* obtain a written representation from the purchaser that he or she has a reasonable expectation of reaching aforementioned income level during the current year.[97]

Second, a purchaser can qualify as an accredited investor based on net worth if the person's individual net worth, or joint net worth with a spouse, exceeds $1,000,000.[98] The issuer must review documentation dated within the prior three months with respect to assets[99] and liabilities,[100] *and* obtain a written representation from the purchaser that all liabilities necessary to make a

[94] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, *supra* note 93, at 44778.
[95] 17 C.F.R. § 230.506(c)(2)(ii).
[96] 17 C.F.R. § 230.501(a)(6).
[97] 17 C.F.R. § 230.506(c)(2)(ii)(A).
[98] 17 C.F.R. § 230.501(a)(5).
[99] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, *supra* note 93, at 44781 ("For assets: Bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and appraisal reports issued by independent third parties are deemed to be satisfactory.").
[100] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, *supra* note 93, at 44781 ("[F]or liabilities: A consumer report (also known as a credit report) from at least one of the nationwide consumer reporting agencies is required.").

determination of net worth have been disclosed.[101] The net worth standard generally excludes the person's primary residence from the calculation.

Third, an issuer can satisfy the verification requirement by "obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor."[102] Fourth, the issuer is deemed to have satisfied the verification requirement with respect to a "person who invested in an issuer's Rule 506(b) offering as an accredited investor…and remains an investor of the issuer…by obtaining certification by such person at the time of sale that he or she qualifies as an accredited investor."[103]

The purpose of permitting general solicitation was "to boost capital formation through increased accessibility of certain issuers to accredited investors."[104] Between September 23, 2013 and December 31, 2014, a total of almost $32.5 billion was raised using the new 506(c) offerings.[105] Issuances using the new Rule 506(c) exemption accounted for only 2.1% of the capital raised pursuant to Rule 506.[106] However, Rule 506(c) is used more often than Rules 504 and 505, even among offering sizes that are eligible for Rules 504 and 505.[107]

Regulation D, and especially Rule 506(c) capital markets, are active avenues for small business capital formation, as intended by the legislature.[108] Generally, issuers of Regulation D

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[101] 17 C.F.R. § 230.506(c)(2)(ii)(B).
[102] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, *supra* note 93, at 44781.
[103] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, *supra* note 93, at 44781.
[104] Bauguess et al., *supra* note 79, at 13.
[105] Bauguess et al., *supra* note 79, at 12.
[106] Bauguess et al., *supra* note 79, at 13.
[107] Bauguess et al., *supra* note 79, at 15.
[108] Bauguess et al., *supra* note 79, at 29.

offerings are small companies. A large majority of 506(c) issuers were either startup firms or small, early-stage firms with less than $1 million in revenue.[109] Issuers of Regulation D offerings also tend to be young companies. 74% of Rule 506(c) issuers initiated their offering within two years of incorporation.[110]

The prohibition against general solicitation was problematic. It required "that issuers and intermediaries have a pre-existing relationship with the accredited investor in order to make offerings available."[111] One of the reasons for the ban on general solicitation was to help prevent fraud "by making it more difficult for fraudsters to find potential victims or unscrupulous issuers to condition the market."[112] However, it unnecessarily limited the pool of potential investors, inhibiting the company's ability to raise capital.[113] Allowing general solicitation means companies can reach more investors with less effort; and with more investors, companies can raise more capital without going public.

C. Rule 701(e) Threshold Triggering Additional Disclosures Increased

Rule 701 is an exemption from section 5 of the Securities Act. Rule 701 was adopted by the SEC in 1988 to allow non-reporting companies to sell securities to their employees without the

[109] Bauguess et al., *supra* note 79, at 29.
[110] Bauguess et al., *supra* note 79, at 30.
[111] *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 92-93 (2011) (statement of Barry E. Silbert, Founder and Chief Executive Officer, SecondMarket, Inc.).
[112] *Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation: Hearing Before the H. Subcomm. On Gov't Sponsored Enterprises of the H. Comm. on Fin. Servs*., 112th Cong. 11 (statement of Meredith B. Cross, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission), available at https://financialservices.house.gov/uploadedfiles/112-63.pdf.
[113] *See Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the Comm. on Banking, Housing, and Urban Affairs*, 112th Cong. 93 (2011) (statement of Barry E. Silbert, Founder and Chief Executive Officer, SecondMarket, Inc.) ("Frankly, if only accredited investors are eligible to purchase unregistered securities, shouldn't we strive to maximize the pool of accredited investors that have access to the offering? It should not matter that non-accredited individuals know that unregistered securities are available for sale. No one prohibits car manufacturers from advertising, even though children under the legal driving age are viewing the advertisements, and pharmaceutical companies are free to advertise to people who do not have (and are not eligible for) prescription medication.").

need to register the offer and sale of such securities under Section 5 of the Securities Act.[114] Only issuers not subject to the reporting requirements of Section 13[115] or 15(d)[116] of the Exchange Act are eligible to use Rule 701.[117] The SEC thought it would be too much of a burden to require non-reporting companies to incur the expenses and disclosure obligations of public companies when their sales of securities were to employees.[118] The exemption is not available when the true purpose of the transaction is to raise capital.[119]

Rule 701 exempts "offers and sales of securities…under a written compensatory benefit plan…established by the issuer…for the participation of their employees, directors, general partners…"[120] When enacted, Rule 701 had a $5 million aggregate offering price ceiling which was removed in 1999.[121] Currently, the amount of securities sold in reliance of Rule 701 during any consecutive 12-month period cannot exceed the greatest of the following:

- $1,000,000;
- 15% of the issuer's total assets; or
- 15% of the outstanding securities of that class.[122]

After removing the $5 million ceiling in its 1999 amendment, the SEC was concerned that this could result in some large securities offerings without any investor (here, employee) protections.[123] Therefore, it decided to implement disclosure requirements if the sale of securities

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[114] *Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33-7645 (Feb. 25, 1999) [64 FR 11095 (Mar. 8, 1999)].
[115] 15 U.S.C. § 78m.
[116] 15 U.S.C. § 78o(d).
[117] 17 C.F.R. § 230.701(b)(1).
[118] *Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33-7645 (Feb. 25, 1999) [64 FR 11095 (Mar. 8, 1999)].
[119] 17 C.F.R. § 230.701, Preliminary Note 5.
[120] 17 C.F.R. § 230.701(c).
[121] *Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33-7645 (Feb. 25, 1999) [64 FR 11095 (Mar. 8, 1999)].
[122] 17 C.F.R. § 230.701(d)(2).
[123] *Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33-7645 (Feb. 25, 1999) [64 FR 11095 (Mar. 8, 1999)].

during a 12-month period exceeded $5 million. The SEC believed that offerings below $5 million were not particularly susceptible to abuse. However, if the offerings exceed $5 million, the company must provide the investors with specific disclosures. An amendment, effective July 23, 2018, increased the threshold at which the issuer must make additional disclosures to investors under Rule 701(e) from $5 million to $10 million.[124] The amendment was mandated by Section 507 of the Economic Growth, Regulatory Relief, and Consumer Protection Act.[125] Section 507 was aimed at addressing two major concerns with the existing 701(e) threshold for requiring additional disclosure.[126] The first concern was that the additional disclosure was a financial encumbrance for companies to compensate employees with the company's stock.[127] The second concern was that disclosure puts non-reporting companies at risk of disclosing confidential financial information.[128]

Today, Rule 701(e) requires the issuer to deliver to investors the following disclosures, if the aggregate sales price or amount of securities sold during the 12-month period exceeds $10 million:

- If subject to the Employee Retirement Income Security Act (ERISA) of 1974, a copy of the summary plan description required by ERISA;[129] if not subject to ERISA, a summary of the material terms of the plan;[130]
- Information about the risks associated with investment in the securities sold pursuant to the compensatory benefit plan or compensation contract;[131] and

[124] *Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33-10520 (July 23, 2018).
[125] Pub. L. 115-174, 132 Stat. 1296 (2018).
[126] *Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33-10520, at 5 (July 23, 2018).
[127] *Id.*
[128] *Id.*
[129] 17 C.F.R. § 230.701(e)(1).
[130] 17 C.F.R. § 230.701(e)(2).
[131] 17 C.F.R. § 230.701(e)(3).

- Financial statements required to be furnished by Part F/S of Form 1-A (Regulation A Offering Statement) under Regulation A (§§230-251 through 230.263). The financial statements required by this section must be as of a date no more than 180 days before the sale of securities in reliance on this exemption.[132]

The disclosures above are minimal because the nature of the transaction is for the purpose of compensating the employee-investor, not raising capital.[133] Additionally, when investors are employees, they undoubtedly have some knowledge about the business and require less disclosure than a typical investor would require.[134]

Increasing the threshold amount of sales of securities pursuant to compensatory benefit plans at which Rule 701(e) requires the issuer to provide additional disclosures to investors has helped private companies remain private. The financial disclosures required by Rule 701(e) could be costly and discourage companies, especially startups, from offering and issuing equity-based compensation. Small startups are unlikely to meet the $10 million threshold, but unicorns might. However, the issuers that are large enough to go over the $10 million threshold will be able to provide the required disclosure at an insignificant cost.

Equity-based compensation is an important part of startup culture. It allows the company to conserve its limited cash by issuing stock options in lieu of a competitive salary. It also incentivizes employees to work harder to increase the company's worth and, therefore, the value of their own stock. Stock options help companies retain employees because most employees probably would not want to forfeit their unvested stock by quitting. The ability to reward and retain employees with a company's securities will give startups one less reason to fail.

[132] 17 C.F.R. § 230.701(e)(4).
[133] *Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements*, Release No. 33-7645 (Feb. 25, 1999) [64 FR 11095 (Mar. 8, 1999)].
[134] *Id.*

V. Conclusion

The above regulatory changes (increasing the 12(g) threshold, excluding employees from the "held of record" definition, allowing general solicitation in Rule 506(c) offerings, and increasing the thresholding of Rule 701(e) triggering disclosure requirements) have undoubtedly made it easier for private companies to stay private. They have more room to grow without having to turn away shareholders in anticipation of passing the 12(g) threshold and being "forced" to go public. They can freely offer employees stock options because they are excluded from the "held of record" definition. General solicitation allows companies to reach a larger pool of potential investors with less effort. They do not have to provide employee-investors with any additional disclosures unless they sell/offer over $10 million worth of equity options in a 12-month period. But the question remains, is this a good thing?

To the private companies, these regulatory changes allowing them to remain private are most likely a good thing. They do not have to expend funds to conduct an IPO or to comply with the periodic reporting requirements. Companies have greater flexibility in timing their IPOs (if at all) and can wait until they have name recognition, a demand for their shares, financial stability, and when the market would be most receptive. The founders remain in control of the company, unless they allow another company to acquire theirs.

The foundation of Federal securities laws is disclosure, and without it, people who do invest in private companies may be taking on more risk for multiple reasons. First, with no IPO in sight, management may feel less obligated to conduct business in an honest and fair way, with less accountability. Second, many of the investors are employees who ideally have knowledge about the company but may not be as sophisticated as the average accredited investor. Third, the only way for these investors to liquidate their shares is to trade them on secondary markets.

In terms of the general public, we may be missing out on millions of jobs that would have otherwise been created after companies conducted IPOs. There has been a huge decline in the number of publicly listed companies, and these regulatory changes may very well be a contributing factor. There may be less investment opportunities for non-accredited investors, making it more challenging to diversify portfolios. A lack of regulation and disclosure of private companies tends to only benefit the private companies.

The above regulatory changes are by no means the only factor contributing to companies spending longer periods private. It's easier to raise venture capital than it used to be, the regulatory burdens going public entails are higher than in the past, and going public is a risk that a lot of companies don't want to take. The result of an underperforming IPO would negatively influence stock price, employee morale, the ability to attract new customers, and the ability to raise capital. It also may be due to a new generation of entrepreneurs who have different priorities. Consequently, it may just be one more thing our millennial generation is ruining.