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Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures

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Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures

MICHAEL D. GUTTENTAG*

Provisions in the Jumpstart Our Business Startups Act of 2012 have made it much easier for firms to avoid federal periodic disclosure obligations, but these provisions were enacted based upon a virtually nonexistent legislative record and upended rules established only after careful consideration almost fifty years earlier. Determining when firms should be required to comply with federal periodic disclosure requirements is best done in the context of a broader understanding of the history and economics of periodic disclosure regulation. This Article provides such an understanding.

The history of periodic disclosure regulation in the United States is traced back to its origins in the eighteenth century, and the economic analysis of periodic disclosure regulation is updated and refined to incorporate recent findings. Building on this historical and economic understanding of periodic disclosure regulation, I identify a flaw in the underlying structure of the rules currently used to determine when firms must make periodic disclosures. To rectify this structural problem, I conclude that firms with a market capitalization of less than $35 million or fewer than one hundred beneficial shareholders should be granted an automatic exemption from periodic disclosure requirements. All other firms should be provided a choice between: (1) complying with federal periodic disclosure obligations, or (2) implementing measures that would mitigate the need for periodic disclosure regulation, such as severely restricting the tradability of the firm’s shares or committing to an acceptable alternative disclosure regime.

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This Article considers when firms in the United States should be required to comply with federal periodic disclosure requirements (FPDRs). Firms were first federally required to publicly disclose information on an ongoing basis with the passage of the Securities Exchange Act of 1934 (“Exchange Act”). As originally enacted, the Exchange Act required all firms with securities traded on a national exchange to comply with FPDRs. In 1936, the Exchange Act was amended to also require most firms to comply with FPDRs once they executed a public securities offering. In 1964, pursuant to the Securities Act Amendments of 1964 (“1964 Amendments”), the reach of mandatory compliance with FPDRs was further expanded to include firms that had neither listed their securities on a national exchange nor carried out a public offering, but that had five hundred or more shareholders of record and more than $1 million in assets.

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1. 15 U.S.C. § 78a (2006). Although not addressed in this Article, additional obligations may also be triggered when firms are required to comply with the Exchange Act periodic reporting requirements, including restrictions on the proxy voting process, trading by firm insiders, and tender offer procedures. Thomas Lee Hazen, Principles of Securities Regulation 181 (2d ed. 2006).

2. This requirement was achieved indirectly by prohibiting brokers and dealers from effecting a transaction on a national exchange involving a security that is not registered pursuant to the requirements of the Exchange Act. See 15 U.S.C. § 78a.


4. 15 U.S.C. § 78l(g)(1)(B) [hereinafter Rule 12(g)(1)]. Firms with more than $1 million in total assets and “a class of equity security (other than an exempted security) held of record by five hundred or more shareholders” in 1964 were given two years to comply with FPDRs, while firms with more than 750 shareholders of record in 1964 were given one year to comply with FPDRs. § 78l(g)(1)(A)–(B).
The threshold level of five hundred shareholders of record triggering mandatory compliance with FPDRs, established by the 1964 Amendments, remained unchanged until 2012. In 2012, the Jumpstart Our Business Startups Act (“JOBS Act”) raised the threshold shareholder level triggering mandatory compliance with FPDRs from five hundred to two thousand (so long as at least fifteen hundred of such shareholders are accredited investors). The JOBS Act also excluded from this count employees who received shares through a distribution exempt from public offering requirements. These changes will make it much easier for firms to avoid mandatory compliance with FPDRs in the future.

After almost eighty years of federal rules requiring firms of various types to comply with FPDRs and a recently enacted substantial change to these rules, how best to determine when firms should be required to comply with these FPDRs still remains largely an enigma. There are three reasons why. First, a comprehensive history detailing why the rules used to determine when firms must comply with FPDRs were initially adopted and subsequently modified does not exist. Various aspects of the relevant history appear in Joel Seligman’s survey of the history of securities regulation in the United States, but Seligman does not attempt to identify patterns in the issues determining when firms were required to comply with FPDRs over time. See Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance (1982). The history of the scope of application of FPDRs is also reviewed in the Congressional Report prepared in support of the 1964 Amendments, but this history ends prior to 1964. S. REP. NO. 379, at 6–19 (1963). Finally, a brief, but insightful, review of the relevant history appears in Donald C. Langevoort & Robert B. Thompson, “Publicness” in Contemporary Securities Regulation After the JOBS Act, GEO. L.J. (forthcoming 2012) available at http://scholarship.law.georgetown.edu/facpub/976 (manuscript at 6–10).

Second, the current scholarship on why firms should be required to make periodic disclosures is both incomplete and out of date. Third, no one has yet linked legitimate justifications for requiring firms to make periodic disclosures to specific criteria for determining which firms are required to comply with FPDRs. However, William Sjostrom, in a four-page article published in March of 2011, questioned whether the number of a firm’s shareholders should trigger required compliance with FPDRs. William K. Sjostrom, Questioning the 500 Equity Holder Trigger, 1 HARV. BUS. L. REV. ONLINE 43, 44 (2011), http://www.hblr.org/?p=1028 (arguing that the Rule 12(g)(1) criteria for when firms must comply with FPDRs should be changed to a rule based on the trading volume of the securities in question to avoid unduly burdening firms not seeking a “large infusion of equity capital and liquidity for its stock”).

Langevoort and Thompson identify several topics and findings relevant to the determination of when firms should be required to comply with FPDRs, although the primary emphasis of their article is on a proposal to separate firms required to comply with FPDRs into two categories: (1) “public” firms, which are firms with “a large public footprint,” and (2) “reporting” firms, which are smaller firms. See Langevoort & Thompson, supra note 8. Under the Langevoort and Thompson proposal, “public” firms would be required to comply with all FPDRs, while “reporting” firms would not be required to comply with those provisions of FPDRs that are related to the broader social benefits arising from
Article addresses each of these three shortcomings, and, by doing so, provides the first systematic analysis of how best to determine when firms should be required to comply with FPDRs.

The first Part of this Article revisits the history of securities regulation in the United States in order to illuminate the origins of rules used to determine when firms must comply with FPDRs. This review uncovers a previously underappreciated pattern in the political economy of the regulation of periodic disclosures. Understanding this pattern adds a new perspective to the standard narrative that periodic disclosure requirements are imposed to protect investors and reduce securities fraud. The pattern is as follows. Initially, a select group of firms voluntarily adopts a practice of committing to make periodic disclosures in order to raise low-cost funds from outside investors. Eventually, firms providing investors high-quality disclosures become concerned that these disclosures are putting them at a disadvantage, both because of the competitive information revealed by their disclosures and because their share prices are discounted when traded alongside the securities of firms providing less information to investors. To address these concerns, the firms providing high-quality disclosures and the exchanges on which the securities of these firms are traded lobby for rules to impose similar periodic disclosure obligations on otherwise comparable firms.

This pattern explains much of why certain firms that had neither listed their securities on a national exchange nor carried out a public offering were required to comply with FPDRs beginning in 1964. Prior to 1964, there were no provisions requiring firms with securities traded on over-the-counter markets (“OTC”) to comply with FPDRs. The absence of a requirement linking compliance with FPDRs to the trading of a firm’s securities on the OTC created an incentive for disclosure regulation. See id. at 42–43. Langevoort and Thompson also express a preference for a system triggering mandatory compliance with FPDRs based the trading volume of a firm’s securities. See id. at 26–27.

The SEC was in the process of analyzing the question of the appropriate shareholders of record threshold level triggering mandatory compliance with FPDRs when the JOBS Act was passed. Congressman Darrell Issa had sent a letter in 2011 to the SEC with several pages of questions about whether the criteria established by Section 12(g) were appropriate in light of recent developments in financial markets. Letter from Darrell Issa, Chairman, H. Comm. on Oversight and Gov’t Reform, to Mary Schapiro, Chairman, SEC (Mar. 22, 2011) at 6–10, available at http://www.knowledgemosaic.com/resourcecenter/Issa.041211.pdf. One of Issa’s questions was as follows: “Why hasn’t the SEC used its broad exemptive authority to modernize or eliminate the 499-shareholder cap?” Id. at 8. Mary Schapiro, the chairman of the SEC, in response to Issa’s letter disclosed that the SEC staff was examining the efficacy of the criteria set out in Section 12(g). Letter from Mary Schapiro, Chairman, SEC, to Darrell Issa, Chairman, H. Comm. on Oversight and Gov’t Reform (Apr. 6, 2011) at 17–22, available at http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf. Schapiro also observed in the letter that “both the question of how holders are counted and how many holders should trigger [public disclosures] need to be examined.” Id. at 18 (footnote omitted). Whether the SEC study of this issue will continue after the passage of the JOBS Act is unclear.

10. See HAZEN, supra note 1, at 13 (“[S]ecurities and the securities markets have been particularly susceptible to fraud and manipulation. The various laws that regulate securities transactions have been designed to address this susceptibility.”). See also James D. Cox & Benjamin J.C. Baucom, The Emperor Has No Clothes: Confronting the D.C. Circuit’s Usurpation of SEC Rulemaking Authority, 90 TEX. L. REV. 1811, 1818 (2012).
firms to have their shares traded on the OTC, rather than on a national exchange. By the early 1960s, the majority of equity securities trading in the United States was taking place on the OTC. Firms with securities traded on the national exchanges, and the national exchanges themselves, responded by lobbying for the imposition of FPDRs on all “public” firms, regardless of where their securities were traded. A combination of a series of scandals, the election of President John Kennedy, and a market downturn in 1962 provided the opportunity for these influential groups to ensure the passage of legislation extending the reach of FPDRs to firms with shares traded on the OTC.

However, the influence of the interest groups that had earlier successfully lobbied for expanding the reach of periodic disclosure obligations may be waning. During consideration of what was to become the JOBS Act, no interest group emerged with enough influence to force Congress to carefully consider the costs, as well as the benefits, associated with a significant reduction in the reach of federal disclosure obligations. The JOBS Act changes to the rules used to determine when firms must comply with FPDRs were enacted based upon a virtually nonexistent legislative record.

The second Part of this Article updates and refines explanations as to why firms should be required to comply with FPDRs. Understanding why a particular firm should be required to comply with FPDRs is a necessary prerequisite to the development of proposals about how best to determine when firms should be required to comply with these disclosure obligations. Unfortunately, existing scholarship on the efficacy of periodic disclosure regulation does not fully incorporate recent empirical findings about the effects of changing the criteria used to determine when firms must comply with FPDRs. Nor does the existing scholarship on the justifications for periodic disclosure regulation recognize the potential relevance to disclosure policy of research showing the multitude of ways in which agency costs can lead to the adoption of socially wasteful corporate policies in other contexts.

Updating the scholarship on why periodic disclosures should be regulated suggests three legitimate and related justifications for requiring firms to comply with FPDRs. First, requiring firms to comply with FPDRs can reduce negative spillover effects from the active trading of the securities of firms providing only limited amounts of information to investors. Second, without regulatory intervention, those who control the firm’s disclosure policy may adopt opaque

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12. See SELIGMAN, supra note 8, at 309–16. See also infra notes 80–92 and accompanying text.
14. See infra Part II.A.
disclosure policies that facilitate self-dealing in ways that are socially wasteful.  

Third, requiring firms to comply with FPDRs can provide redress from the persistent under disclosure that occurs when firms are unable to capture all of the benefits their disclosures provide to third parties, most notably to the firm’s competitors (these unrealized benefits are “positive interfirm externalities”).

The third Part of this Article builds on the historical and economic analysis of the first two Parts to generate specific conclusions about how and why to rewrite the rules used to determine when firms must comply with FPDRs. The first conclusion is that the structure of the rules currently used to determine when firms must comply with FPDRs is flawed. The problem with the current system goes beyond whether the correct metrics are used to determine when periodic disclosure obligations are triggered or whether the triggering thresholds for these metrics are set at appropriate levels. The structural problem is that the current system separates firms into only two categories: either firms receive an automatic exemption from compliance with FPDRs, or firms are required to comply with FPDRs. However, there is no good way to establish rules that efficiently separate firms into only these two categories.

A system in which firms are, instead, separated into three categories with respect to compliance with FPDRs would be much more effective. The three-category mandatory periodic disclosure regime proposed in this Article would separate firms into the following three categories: (1) firms that receive an automatic exemption from compliance with FPDRs (an existing category), (2) firms that receive a contingent exemption from compliance with FPDRs (a new category), and (3) firms that are required to comply with FPDRs (an existing category).

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15. See infra Part II.B. The term “self-dealing” is used in this Article to cover a broader range of transactions that can harm outside investors than those described as resulting from agency costs, and includes outright fraud. One source of self-dealing costs is the agency costs identified by Michael Jensen and William Meckling. Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976). Jensen and Meckling observe that a self-interested agent is likely to maximize his or her own well-being, rather than that of the principal for whom he or she is an agent. Id. at 308–09.

There are, however, other kinds of self-dealing transactions that do not fall within the traditional definition of agency costs, but that nevertheless are transactions that benefit insiders to the detriment of outside investors. For example, those who have effective control of the firm, but who are not agents of the firm, may extract value from the firm in a way that benefits themselves at the expense of other shareholders. The emphasis in scholarship in the United States tends to be on agency-based self-dealing costs, because share ownership generally is widely dispersed, whereas the emphasis in Europe tends to be on the costs of extracting private benefits of control, because share ownership is generally more concentrated. See Marco Pagano & Ailsa Röell, The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public, 113 Q. J. ECON. 187, 188 (1998).

Usage of the term “self-dealing” to describe these various types of transactions follows Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, The Law and Economics of Self-Dealing, 88 J. FIN. ECON. 430, 430–31 (2008).

16. See infra Part II.C.

17. See infra Part III.A.
Under this new three-category system for determining when firms must comply with FPDRs, some firms would continue to be granted an automatic exemption from compliance with FPDRs; however, this automatic exemption would only be granted when there are unlikely to be any significant benefits from requiring compliance with FPDRs. Firms that do not qualify for this automatic exemption from compliance with FPDRs would then have two options. First, such firms could take specified measures to minimize the social costs from persistent under disclosure, and, in return for taking these steps, avoid mandatory compliance with FPDRs. The specified ameliorative measures involve either having the firm restrict the tradability of the firm’s shares or having the firm commit to provide investors sufficient amounts of information through an acceptable alternative disclosure regime. Firms that do not qualify for an automatic exemption and that do not implement one of these ameliorative measures would be required to comply with FPDRs.

This proposed three-category system for determining which firms must comply with FPDRs would offer firms a degree of issuer choice about whether to be subject to FPDRs missing from the current system, while still insuring that evidence-based concerns about persistent market failures in securities markets related to periodic disclosure practices are not ignored.18

There is sufficient information available to offer preliminary guidance about how the three-category system for determining when firms must comply with FPDRs proposed in this Article should be implemented. First, in terms of when an automatic exemption from mandatory compliance with FPDRs should be granted, I present evidence that firms with less than $35 million in market capitalization or fewer than one hundred beneficial owners should be granted an automatic exemption from mandatory compliance with FPDRs.19

Preliminary guidance can also be provided as to what a firm should be required to do in order to qualify for the new contingent exemption from a requirement to comply with FPDRs. One pathway for firms to receive this new contingent exemption would be for the firm to place significant restrictions on the tradability of the firm’s shares, such as only allowing shareholders to transfer their securities to family members, affiliates, or back to the firm. An alternative pathway for firms to receive this new contingent exemption would be for the firm to participate in a disclosure regime other than the one established pursuant to FPDRs, of which there are several possible candidates. Determining more precise specifications for each of these ameliorative pathways will be challenging, because the deleterious effects from a single firm underdisclosing information to investors are difficult to measure. However, with the system for granting an exemption from mandatory compliance

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18. There already is some element of issuer choice provided by the rules triggering mandatory compliance with FPDRs, because firms can take steps to avoid crossing the thresholds that trigger periodic disclosure obligations, an observation nicely elucidated in John C. Coates IV, Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis, 41 Va. J. Int’l L. 531 (2001). But the steps firms currently can take to avoid crossing the thresholds that trigger periodic disclosure obligations have little direct relationship to the types of measures that can minimize the deleterious effects of market failures related to the periodic disclosure of information by the firm. Id.

19. See infra Part III.B.
with FPDRs properly structured, the correct research questions can be asked, answered, and used to better inform policy.

The passage of the JOBS Act has made it much easier for firms to avoid being required to comply with FPDRs. This change represents the first time since the Exchange Act was enacted in 1934 that the reach of the federal periodic disclosure regime has been rolled back to any significant degree. The analysis here shows that the JOBS Act changes, although dramatic, actually failed to address the more fundamental structural problem with the system of rules used to determine when firms must comply with FPDRs. This Article explains how and why to correct the problems that remain with the rules requiring compliance with FPDRs.

I. A BRIEF HISTORY OF PERIODIC FINANCIAL DISCLOSURE REQUIREMENTS IN THE UNITED STATES

Mandated periodic disclosure is now a central feature of federal securities regulation in the United States. This aspect of securities regulation represents the culmination of hundreds of years of interrelated developments in securities markets and securities market regulation. The first objective of this Article is to ascertain why periodic disclosure requirements have selectively been imposed on different groups of firms over time.

This review of the history of the application of periodic disclosure requirements in the United States separates the discussion into four historical epochs: (1) developments related to periodic disclosure practices prior to 1900, (2) the emergence of privately enforced mandatory periodic disclosure requirements between 1900 and 1934, (3) the federalization of mandatory periodic disclosure requirements in 1934, and (4) major developments in the determination of which firms are required to comply with FPDRs since 1934.

This historical review reveals that much of the impetus for imposing periodic disclosure requirements on particular types of firms comes from those already committed or required to make high-quality disclosures working to ensure that otherwise comparable firms make similar high-quality disclosures.

A. Minimal Periodic Firm Disclosures Prior to 1900

The public trading of securities began in the United States toward the end of the eighteenth century. Various forms of state and federal debt were the primary securities traded at the time. The most active trading market for these securities was in New York City, and by 1791 there were public auctions of various government securities held in New York City twice each day.20

In 1792, there was a crash in what would now be called the public debt market.21 In response to the 1792 crash, several states started to regulate these new trading markets, marking the first time trading securities was regulated in the United States.


21. See Banner, supra note 20, at 144–45; see also Werner & Smith, supra note 20, at 18.
In New York, legislation was enacted that banned the public auctioning of securities and that prohibited the sale of an interest in a security which was not owned by the seller at the time of the transaction. None of the securities regulation measures implemented in response to the 1792 crash contained provisions related to the disclosure of information.

The first half of the nineteenth century saw a transition in securities markets in the United States away from the almost exclusive trading of public debt securities to markets in which the securities of private enterprises were also traded. Securities regulation during this period was almost exclusively self-imposed. For example, some firms chose to put restrictions on the trading of the firm’s securities in the firm’s charter. A few firms did begin making disclosures about the firm’s financial condition or about transactions between the firm and its agents, but there was not a common law affirmative duty or other obligation to make such disclosures. Investors primarily relied on the reputation of those sponsoring a firm or the firm’s ability to pay dividends to gauge the value of a firm’s securities.

Commentators writing during this period noted the potential benefits that might be provided if firms periodically disclosed financial information. A circular drafted by a shareholder in the Hope Insurance Company in the 1820s observed that, in the absence of disclosure, a firm’s directors could use access to proprietary firm information to profit at the expense of outside investors. Daniel Raymond, a political economist, similarly noted that firm directors “endeavor to keep the stockholders and the public in the dark respecting the condition of the corporation, while they are themselves in the light . . . . They make no exhibit to the stockholders about the actual condition of the company.”

In England, a commission headed by William Gladstone suggested that “[p]eriodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern; and by means of improved remedies, parties to mismanagement may be made more amenable for acts of fraud and illegality.”

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23. Id. at 173–74; Werner & Smith, supra note 20, at 18. One irony of the New York legislation is that it fostered the growth of securities trading in New York by encouraging the formation of private securities exchanges, including the progenitor of the NYSE, where systems could be put in place to enforce contracts by private ordering.
24. Banner, supra note 20, at 193.
25. Id. at 180 (“Governments often delegated to the enterprises themselves the power further to regulate transactions in their own stock.”). The charter provisions of many firms at the time “specified how stock was . . . to be subsequently transferred to others.” Id. at 179.
However, the systems necessary to support the widespread adoption of periodic disclosure practices and periodic disclosure regulation did not yet exist.

The elements necessary for firms to provide credible periodic disclosures started to emerge in the second half of the nineteenth century. One important development during this period was work by the New York Stock Exchange (NYSE or “Exchange”) to increase the amount of information disclosed by firms with securities listed on the Exchange. In 1869, a NYSE committee called for “disclosures of financial condition” by firms with securities listed on the Exchange.31 From 1870 through the 1890s, this committee required listing firms to provide a “statement of condition and a list of officers.”32

The extent to which firms complied with the evolving NYSE disclosure requirements during this period was limited. Part of the reason for the limited implementation of these Exchange disclosure requirements was that relationships between the NYSE and firms with shares listed on the Exchange were governed by individual contracts, and these individual contracts generally did not require disclosures by the listed firm.33 Thus, the NYSE “was unable to enforce its authority upon recalcitrant listed companies.”34 In fact, many “large and long established firms” continued to resist complying with the NYSE periodic financial reporting requirements through the 1920s.35

These NYSE listing requirements provide a first illustration in the United States of how a system of periodic disclosure requirements might be imposed on certain firms. The NYSE disclosure initiative was likely the result of pressure from firms already providing high-quality disclosures. A related example of efforts to create a trading venue where firms were of similar quality were efforts to exclude noncompliant firms from trading on the NYSE. Prior to 1910, securities could be traded on the NYSE, whether or not the issuer complied with the Exchange’s listing requirements. In 1910, the NYSE disallowed trading on the Exchange floor of unlisted securities.36 Starting in 1910, firms were forced to choose between complying with the NYSE’s increasingly stringent disclosure requirements and other listing requirements, or losing access to the NYSE trading market.37

B. The Growing Practice of Periodic Firm Disclosures Between 1900 and 1934

Between 1900 and 1934, imposing periodic disclosure requirements on firms began to emerge as an increasingly viable tool for securities regulation in the

32. Id.
33. S. REP. NO. 73-792, at 5 (1934).
34. Hawkins, supra note 26, at 193.
35. See Hilke, supra note 31, at 231.
36. Id. at 230; Paul G. Mahoney, The Exchange as Regulator, 83 VA. L. REV. 1453, 1469 (1997).
37. See Mahoney, supra note 36, at 1469. The choice to leave the NYSE had only limited adverse consequences for a firm at the time. The trading of the securities of firms that were not listed on the NYSE continued just outside of the doors of the NYSE on what became the American Stock Exchange. See SELIGMAN, supra note 8, at 47.
United States. Among the developments supporting the growing viability of periodic disclosure requirements as a regulatory tool during this period were: (1) the maturation of a disclosure-based model for securities offerings in Britain, (2) a growing appetite for inexpensive external financing, (3) the emergence of accounting as an independent profession, and (4) the increasing efforts of legitimate issuers to differentiate their securities from securities issued primarily for fraudulent purposes. Each of these developments is discussed briefly below.

Developments in securities regulation in Britain in the late 1800s and early 1900s provided a model for disclosure-based securities regulation in the United States.38 Securities trading had begun in Britain well before the emergence of similar markets in the United States. As early as 1720, “the [securities] market and its participants were established London institutions.”39 By the middle of the nineteenth century in Britain, public periodic disclosure of shareholder names and addresses was an established feature of English company law.40 In 1867, the British Parliament enacted the Companies Act of 1867, which increased the amount of disclosure required of companies selling securities to the public. In particular, Section 38 of this Act required that firms disclose all significant contracts between the firm and its principals prior to a public offering.41

However, significant loopholes remained in the Companies Act of 1867 that were not addressed until the adoption of the Companies Act of 1900. Paul Mahoney, a legal historian, concludes the Companies Act of 1900 “was the first statute in Anglo-American law to impose comprehensive disclosure requirements on companies selling securities to the public.”42 This British legislation would provide a crucial model for future American securities regulation.43

Around the start of the twentieth century, the growing recognition that firms could lower the cost of financing their operations by credibly committing to make periodic disclosures also supported the adoption of periodic disclosure practices. A lower cost of capital would, in turn, provide a crucial competitive advantage during this period of intense industry consolidation. In a review of developments among industrial firms from 1887 through 1902, Thomas Navin and Marian Sears note that “[b]y the turn of the century the transition was well under way from closely held, ‘inside’ ownership of American business to semipublic, ‘outside’ hands.”44 As

39. BANNER, supra note 20, at 14; see also WERNER & SMITH, supra note 20, at 11.
41. Id. at 1063.
42. Id.
43. See Landis, supra note 38, at 34. While British practices may have provided a helpful precedent for the implementation in the United States of a system of periodic disclosure requirements, the Companies Act of 1900 only addressed the disclosure duties associated with public offerings, not ongoing disclosure obligations, and thus provides a more direct precedent for the Securities Act. See also Mahoney, supra note 40, at 1073 (explaining that the Companies Act of 1929 had only “minor changes” from the 1900 Act).
44. Thomas R. Navin & Marian V. Sears, The Rise of a Market for Industrial Securities,
firms committed to disclose more information, a symbiotic relationship began to emerge between increased disclosure, lower costs of capital, and more robust securities markets.

A third development supporting the adoption of a securities regulation system based on periodic disclosures was the emergence of reliable accounting standards, and the related development of accounting as an accredited profession. In 1900, the first university accounting department was established at New York University, and, in 1905, competing national accounting organizations were united to form what was to become the American Institute of Accountants.

The adoption of accounting standards in the United States during this period was further advanced by the imposition of a federal income tax in 1913. The first standards for auditing practices in the United States were published in 1917. David Hawkins, an economic historian, observes that by 1926 the auditing of prominent industrial companies was “almost universal.” These developments increased the ubiquity and reliability of ongoing information about the firm that could potentially be made available to investors on a periodic basis.

A fourth significant antecedent to a securities regulation system in the United States was the effort of established players in securities markets to distinguish their legitimate capital-raising efforts from fraudulent securities offerings. Throughout the 1920s, the Investment Bankers Association of America (IBAA) sought to have firms offering securities present information about their operations in a standardized manner. The IBAA “also suggested, in the case of holding companies, that there should be readily available through annual reports” information about the firm’s capitalization and balance sheet.

The trend toward an increased amount of periodic disclosure was evident in the behavior of firms with securities traded on the NYSE. In 1923, only 25% of the firms with securities listed on the NYSE provided investors both quarterly and annual financial statements. By 1933, all of the 1157 NYSE firms provided investors annual financial reports, and the majority also provided investors quarterly financial reports.

Exploratory efforts to enact legislation that would make periodic disclosures mandatory in the United States began at the start of the twentieth century. In 1900, a committee of investors sent a report to Congress suggesting that legislation be enacted which would require certain firms “to publish annually a properly audited

46. Id. at 185 (originally the organization was the American Association of Public Accountants).
47. Id. at 184 (“complete and accurate accounting records became necessary for income tax purposes”) (footnote omitted). See also U.S. CONST. amend. XVI.
49. Id. at 187–88 (citing George O. May, Corporate Publicity and the Auditor, 42 J. ACCT. 321, 322–23 (1926)).
50. See id. at 182.
51. Id. at 183.
52. SELIGMAN, supra note 8, at 48 (explaining “only 242 of the 957 listed firms provided both annual and quarterly financial reports”).
53. Id.
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report, showing in reasonable detail their assets and liabilities, with profit or loss; such report and audit under oath to be subject to Government inspection. 54 In 1918, 1919, and 1921, federal bills were proposed to regulate securities markets by requiring firms with publicly traded securities to make periodic disclosure, but they were not enacted. 55

By the early 1930s periodic disclosures had become an established method in the United States with which to inform investors about the firm’s performance, and firms already making high-quality disclosures were beginning to press for measures to make such disclosures mandatory.

C. The Federalization of Periodic Firm Disclosure Requirements in 1934

The federalization of securities regulation in the United States began with the passage of the Securities Act of 1933 (“Securities Act”). 56 The Securities Act required firms making public offerings of securities to follow a statutorily defined procedure, which included the disclosure of all material information about the firm and the securities being offered for sale. 57 Even at the time of its passage, there were, however, obvious limitations to the Securities Act. 58 One shortcoming of the Securities Act was that firms had no obligation to continue to disclose information once the public offering was complete. 59 Even opponents of the Securities Act expected that any subsequent legislation would include a requirement “for periodic corporate reporting.” 60

When President Franklin Delano Roosevelt decided to introduce additional federal securities regulation legislation in 1934, a central feature of the legislation was a requirement that certain firms be required to make periodic disclosures, rather than just the one-time disclosures required under the Securities Act. Roosevelt’s decision to introduce a periodic disclosure requirement raised the issue of how to determine which firms would be required to comply with these new FPDRs. The Exchange Act was targeted at improving the transparency and reducing conflicts of interest at the national securities exchanges. At the time, over 80% of the dollar value of trading in equity securities occurred on a national exchange. 61 Therefore, it was not surprising when the enacted legislation simply imposed periodic disclosure requirements on all firms with securities traded on a national exchange. 62

54. U.S. INDUS. COMM’N, PRELIMINARY REPORT ON TRUSTS AND INDUSTRIAL COMBINATIONS 6 (1900), cited in Hawkins, supra note 26, at 177.
55. Hawkins, supra note 26, at 182; SELIGMAN, supra note 8, at 49–50.
57. SELIGMAN, supra note 8, at 70.
58. Id. at 71 (observing, for example, “No one better understood the modest nature of the statute than Felix Frankfurter.”).
59. Id. at 71 (“There is no machinery provided for obtaining subsequent reliable information either in the form of annual reports or otherwise . . . .” (citing William O. Douglas, Protecting the Investor, 23 YALE L. REV. 522, 528–30 (1934))).
60. SELIGMAN, supra note 8, at 84–85.
61. See id. at 73; see also S. REP. NO. 379, at 14 (1963) (citation omitted).
62. See supra note 2.
The members of the NYSE applauded the idea of imposing periodic disclosure requirements on all firms with securities traded on a national exchange. As noted above, the NYSE had been trying with mixed success, since 1869, to impose upon all of its members a requirement that periodic disclosures be provided to investors. With the passage of the Exchange Act, the federal government imposed periodic disclosure requirements not only on all NYSE-listed firms, but also on the larger group of firms with securities listed on any of the national exchanges.

The enactment of the Exchange Act also provided an opportunity to address the fact that, under the Securities Act, firms making public offerings had no ongoing disclosure obligations. The initial drafts of the Exchange Act required firms that registered securities pursuant to the Securities Act to continue to make periodic disclosures after their public offering was complete. However, political challenges to the passage of the Exchange Act required compromise. In the final Exchange Act legislation, only firms with securities traded on a national exchange were required to comply with the new periodic disclosure requirements.

The authors of the Exchange Act realized that this compromise left the disclosure practices of firms without securities traded on a national exchange unregulated, and instructed the newly formed Securities Exchange Commission (SEC) to investigate how best to address the topic of the regulation of periodic disclosures by firms whose securities were not traded on a national exchange, but went no further. A decision on how to put in place a comprehensive plan to address the difficult issue of specifying which firms should be required to comply with the newly-created FPDRs was deferred.

D. Changes Concerning Which Firms Must Make Periodic Disclosures Since 1934

Since the passage of the Exchange Act, the content of FPDRs has steadily evolved, but the criteria used to determine which firms should be required to comply with FPDRs have been changed only on rare occasion.

Four of the major changes since 1934 in the criteria used to determine which firms are required to comply with FPDRs are reviewed below. These changes are (1) the inclusion in 1936 of a requirement to comply with FPDRs for firms that execute a public offering of securities, (2) the inclusion in 1964 of a trigger requiring compliance with FPDRs based on a combination of firm size and the number of a firm’s shareholders of record, (3) the adoption in 1999 by the SEC of

63. See supra notes 32 and 36 and accompanying text.
64. See SELIGMAN, supra note 8, at 83; see also supra notes 60–61 and accompanying text.
65. SELIGMAN, supra note 8, at 99.
66. Id.
67. Section 15 of the Exchange Act as originally enacted granted the SEC the right to regulate the OTC markets as “appropriate to insure to investors protection comparable to that which is accorded in the case of registered exchanges under the [Exchange Act].” S. REP. NO. 73-792, at 20 (1934). See also SELIGMAN, supra note 8, at 99–100; COMM’N ON INTERSTATE & FOREIGN COMMERCE, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. 95, Pt. 3, at 1 (1963) [hereinafter SPECIAL STUDY].
rules requiring compliance with FPDRs by firms with shares traded on the Over-the-Counter Bulletin Board (OTCBB), and (4) the passage of the JOBS Act in 2012, which increased the shareholders of record threshold triggering mandatory compliance with FPDRs from 500 to 2000 in many circumstances and excluded some firm employee shareholders from this count.

The first three of these changes expanded the reach of the criteria triggering required compliance with FPDRs, and in each case at least part of the impetus for the expansion came from firms which were already required to comply with FPDRs. The passage of the provisions of the JOBS Act, which reduced the reach of mandatory compliance with FPDRs, suggests the power and influence of interest groups that had in the past endorsed expanding the reach of mandatory compliance with periodic disclosure regulations is declining.

1. The Exchange Act Amendments of 1936

The first change to the criteria used to determine which firms must comply with FPDRs was enacted in 1936 (the “1936 Amendments”). The 1936 Amendments extended reporting requirements to most firms that publicly offered securities in compliance with the Securities Act. This change was accomplished by adding Section 15(d) to the Exchange Act, which requires compliance with the periodic 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.”68

The 1936 Amendments completed what was generally recognized to be some of the unfinished business left over after the passage of the Exchange Act.69 The report prepared in conjunction with the 1936 Amendments noted one goal of the amendments was “an endeavor to create a fair field of competition among exchanges and between exchanges as a group and the over-the-counter markets . . . .”70 Another justification offered for such a change was that most of the benefits from requiring disclosure by firms at the time of offering their securities publicly would continue once the securities of the firm were publicly traded.

The drafters of the 1936 Amendments recognized that firms that had neither completed a securities offering pursuant to the Securities Act nor listed their securities on a national exchange could still avoid a requirement to comply with FPDRs.71 The primary motivation for the decision in 1936 not to impose any disclosure requirements on such firms was political. The SEC chairman at the time, James Landis, was concerned about the possibility of a Supreme Court challenge to the 1936 Amendment.72 Landis worried that a disclosure requirement applied to

68. S. REP. NO. 379, at 15 (1963). The duration of this periodic reporting requirement was, however, limited to a period of one year following the offering, if the firm had less than three hundred shareholders of record. Id. See also 15 U.S.C. § 78o(d) (2006).
69. See SELIGMAN, supra note 8, at 142–43.
71. See id. at 4.
72. SELIGMAN, supra note 8, at 142.
securities which were neither traded on a national exchange nor sold pursuant to federal securities law might not withstand Supreme Court scrutiny.73

Once again, a decision about how to systematically and consistently determine which firms should be required to comply with FPDRs was deferred.

2. The Securities Acts Amendments of 1964

The next significant change in the criteria used to determine which firms must comply with FPDRs was enacted in 1964. The 1964 Amendments expanded mandatory compliance with FPDRs to firms that had neither offered securities publicly pursuant to the Securities Act nor listed their securities on a national exchange.

The enactment of the 1964 Amendments was a slow-in-coming measure to close a loophole in the application of FPDRs that was evident even when the Exchange Act was originally enacted.74 After the passage of the 1936 Amendments, there were still many otherwise comparable firms that would or would not be required to comply with FPDRs depending on where their securities were traded. By 1938, government officials began to propose methods to address this disparate application of FPDRs. Then SEC Chairman William O. Douglas recommended to President Roosevelt that all firms “with $1 million or more in assets be subject to the periodic disclosure provisions of the 1934 act,” and a 1938 NYSE report proposed making such an amendment to the Exchange Act.75 In 1941, the NYSE and the American Stock Exchanges proposed that mandatory compliance with FPDRs be required of all firms that had at least $3 million in book value and at least 300 shareholders of record, but no legislation was proposed.76

A 1955 Senate report, which considered the issue of whether firms with securities traded on the OTC should be required to comply with FPDRs, cited several witnesses who:

[Q]uestioned the “double standard” that exists in the regulation of securities on the exchanges and over the counter. An issuer of securities registered on a national securities exchange is subject to one set of regulations, whereas another issuer in the same industry, of the same size, with the same number of securityholders . . . is subject to entirely different regulations.77

Those who ran the national exchanges were clearly dissatisfied with the disparate regulatory treatment that depended solely upon where a firm’s securities were traded. The 1955 Senate report concluded that “companies whose stocks are traded over the counter be required to comply with the same statutory provisions

73. See id. at 143–44.
74. See supra note 68 and accompanying text.
75. SELIGMAN, supra note 8, at 312.
and the same rules and regulations as companies whose stocks are listed on national securities exchanges.”

However, no legislation followed the 1955 Senate report. President Kennedy’s appointment of William Cary as chairman of the SEC, a series of scandals on the American Stock Exchange, and a substantial downturn in the stock market in June of 1962 gave new impetus to efforts to require at least some firms with securities traded on the OTC to comply with FPDRs. Cary made completing “unfinished projects first attempted during the New Deal” his goal for the SEC during his tenure. He requested and received $750,000 (over $5 million in 2011 dollars) from Congress to fund research by a group of academics and practitioners on how to improve securities regulation in the United States. The result was the Report of Special Study of Securities Markets of the Securities and Exchange Commission (“Special Study”) delivered to Congress in the spring of 1963.

Determining which firms with securities traded on the OTC should be required to comply with FPDRs was one of the chief areas of research for the Special Study. By the time the Special Study commenced, the majority of equity securities trading was occurring on the OTC, rather than on the national exchanges. In 1961, 61% of the dollar volume of equity securities trading in the United States was taking place on the OTC, as compared to only 16% in 1929. The Special Study group also found that the vast majority (93%) of reported securities fraud cases involved firms that were not required to comply with FPDRs.

The Special Study concluded that there were at least some firms which had neither offered securities publicly nor listed securities on a national exchange but which should, nevertheless, be required to comply with FPDRs. The Special Study specifically recommended that all firms with at least 300 shareholders of record be required to comply with FPDRs, regardless of firm size. The Special Study

78. Id. (emphasis removed).
80. SELIGMAN, supra note 8, at 293.
82. See SPECIAL STUDY, supra note 67.
83. See SPECIAL STUDY, supra note 67, at xv. Of particular relevance to the establishment of specific thresholds triggering mandatory compliance with FPDRs was Part 3, Chapter IX—Obligations of Issuers of Publicly Held Securities. See id. at 1–64.
85. SPECIAL STUDY, supra note 67, at 10.
86. The legislative report concluded that the “selection of a standard of coverage, necessarily a matter of judgment, is based on several factors.” S. REP. NO. 88-379, at 19. Among the factors considered was the small number of purchasers necessary to characterize certain offerings as public offering under the Securities Act, and the fact that the Investment Company Act at the time used “100 shareholders as the standard for measuring the public
concluded that the number of a firm’s shareholders of record provided, at the time, the most reliable proxy for the costs and benefits of periodic disclosure regulation and considered, but rejected, alternative measures, such as firm size or the volume of trading in a firm’s shares.\textsuperscript{87} The Special Study estimated that the 300 shareholders of record threshold level would require an additional 5500 firms to comply with FPDRs.\textsuperscript{88}

The logic driving the Special Study conclusion that certain OTC firms should be required to comply with FPDRs was that a level regulatory playing field should be provided for similar firms, regardless of where their securities were traded. The Senate Report accompanying the 1964 Amendments observed that “[t]here is no convincing reason why the comprehensive scheme of disclosure that affords effective protection to investors in the exchange markets should not also apply in the over-the-counter market.”\textsuperscript{89}

In the legislation, as finally enacted, the number of shareholders of record triggering periodic disclosure requirements was increased to 500, reflecting a compromise based on a level proposed by Senator Fulbright in 1955. Also, a minimum firm size, measured in terms of balance sheet total assets, was added to the criteria below which a firm could receive an automatic exemption from compliance with FPDRs.\textsuperscript{90} As enacted, it was estimated the 1964 Amendments would require an additional 3900 firms in the United States to comply with FPDRs.\textsuperscript{91}

With the passage of the 1964 Amendments, the reach of FPDRs was substantially expanded to “level the playing field” between the OTC and the national exchanges. But again, this time despite access to substantial resources, no analytically rigorous answers, beyond the notion of equal treatment for otherwise similar firms, were provided to the underlying question of why certain firms and not others should be required to comply with FPDRs.

\begin{itemize}
\item Interest.” \textit{Id.} The report also noted a study of the impact of moving up to a threshold of 1000 shareholders of record would “exclude from coverage about 1,400 companies [with securities] . . . . held by approximately 1 million investors.” \textit{Id.} at 20.
\item \textsuperscript{87} See \textit{SPECIAL STUDY, supra} note 67, at 17–35. The rationale offered by the Special Study for rejecting a measure based on a firm’s size was that the “amount of assets would seem to be no more than a secondary criterion at best, since for many reasons there is an absence of clear or necessary relationship between total assets and the equity interest of investors to be protected; yet it may ultimately have relevance in defining a limit where burdens may be disproportionate to needs.” \textit{Id.} at 18.
\item The rationale offered by the Special Study for rejecting a measure based on trading volume appears to have been motivated by concerns about the practical challenges to implementing such a rule. The Special Study authors concluded: “In theory, a criterion expressed in terms of market activity might be appealing, but it is difficult to conceive of any direct test that could ever be meaningful and workable in practice and it has been seen that the shareholder criterion itself is at least a rough, indirect measure of activity.” \textit{Id.} at 34.
\item \textsuperscript{88} \textit{Id.} at 31.
\item \textsuperscript{89} \textit{S. REP. NO.} 88–379, at 9.
\item \textsuperscript{90} \textit{Id.} at 16–18.
\item \textsuperscript{91} \textit{SELMAN, supra} note 8, at 315–16.
\end{itemize}
3. The Eligibility Rule for OTCBB Stocks Adopted in 1999

More than thirty years passed after the enactment of the 1964 Amendments before another large group of firms was required to comply with FPDRs. In 1999, all firms whose shares were traded on the OTCBB were required by SEC rule making to comply with FPDRs or exit the OTCBB ("1999 OTCBB Rule"). This rule was applied regardless of firm size or number of shareholders.

Prior to the rule change, approximately 3600 firms had securities traded on the OTCBB without complying with FPDRs. These firms represented almost half of the firms with shares traded on the OTCBB at the time. More than three-quarters of the firms that were not complying with FPDRs prior to the 1999 OTCBB Rule elected to exit the OTCBB market rather than begin complying with FPDRs.

The primary impetus for requiring all firms with securities traded on the OTCBB to comply with FPDRs came, once again, from other market participants. The National Association of Securities Dealers (NASD), which runs the NASDAQ exchange, had become concerned that investors were under the false impression that securities traded on the OTCBB were similar to and were making disclosures comparable to those provided by firms with securities traded on NASDAQ. Neither an analysis of the costs and benefits of imposing FPDRs on a particular group of firms nor an analysis of the underlying economic justifications for expanding the reach of FPDRs was provided.

4. The JOBS Act of 2012

The JOBS Act changed the threshold level of shareholders of record triggering mandatory compliance with FPDRs in five ways. First, under the JOBS Act, shares held by employees who receive their stock pursuant to an employee compensation plan exempt from Securities Act public registration requirements will not be included in the count of shareholders of record used to determine if the number of a firm’s shareholders of record exceeds the threshold level triggering compliance.

92. The OTCBB was established by the Financial Industry Regulatory Authority ("FINRA") in 1990 on a pilot basis as part of market structure reforms to provide transparency in the OTC equities market in response to the Penny Stock Reform Act of 1990. In 1997 the OTCBB was given permanent status. FINRA, Overview and History of the OTCBB, OTC BULL. BOARD (2007) http://www.otcbb.com/aboutOTCBB/overview.stm.
95. Id. at 242.
96. Id. at 235.
97. Id. at 239.
98. The JOBS Act also raised the threshold asset level triggering mandatory compliance with FPDRs from $1 million to $10 million. However, this change was not significant. The 1964 Amendments had granted the SEC the right to change threshold levels, and the SEC has used that power several times to raise the asset threshold from its initial level of $1 million to the current level of $10 million. See 15 U.S.C. § 78l(g)(1) (2006); Exchange Act Rule, 17 C.F.R. § 240.12(g) (2011).
mandatory compliance with FPDRs.\textsuperscript{99} Second, the threshold level below which firms would not be required to comply with FPDRs is increased to 2000 shareholders of record.\textsuperscript{100} Third, and as a caveat to the increase in the threshold level to 2000 shareholders of record, firms with more than 499 shareholders of record who are not accredited investors will lose their automatic exemption from mandatory compliance with FPDRs.\textsuperscript{101} Fourth, an exclusion from the count of shareholders of record is provided for investors who become shareholders through a crowd-funding offering.\textsuperscript{102} The details of this exemption are left to the SEC to determine by rule.\textsuperscript{103} Fifth, banks and bank holding companies receive special treatment with respect to the shareholders of record threshold level triggering mandatory compliance with FPDRs under the JOBS Act. The limit of 499 non-accredited shareholders of record does not apply to banks or bank holding companies.\textsuperscript{104} Also, a change was made for banks and bank holding companies with respect to the rules regulating exit from the mandatory disclosure regime. Specifically, the shareholders of record level below which a firm can exit the mandatory periodic disclosure regime was raised from 300 shareholders of record to 1200 such shareholders for banks and bank holding companies.\textsuperscript{105}

The immediate impact of provisions in the JOBS Act which change the shareholders of record thresholds triggering mandatory compliance with FPDRs is

\textsuperscript{99} See JOBS Act, Pub. L. No. 112-106, § 502, 126 Stat. 306, 326 (2012). In order to receive this exemption, the employee-owned shares must be issued in compliance with Securities Act Rule 701, which requires that the shares be issued pursuant to an approved compensation plan, and, if the value of the securities issued exceeds $5 million over a given period of time, the firm must also provide the persons receiving the shares information about the firm identical to that required when a firm carries out an offering pursuant to Regulation A of the Securities Act. See 17 C.F.R. § 230.701 (2011). Regulation A requires firms to provide the information set out on Form 1-A, available at http://www.sec.gov/about/forms/form1-a.pdf. There is also an obligation under Regulation A to disclose “any other material information necessary to make the required statements, in light of the circumstances under which they are made, not misleading.” 17 C.F.R. § 230.252(a) (2011). See also, Joan Heminway, Special Forum: JOBS Act - Teaching Exemptions, Ralston Purina, Google, and Section 12(g), THE CONGLOMERATE (Apr. 24, 2012), http://www.theconglomerate.org/2012/04/special-forum-jobs-act-the-on-ramp-to-publicness-under-section-12g.html.

\textsuperscript{100} See JOBS Act § 501.

\textsuperscript{101} See id. This change means that for the first time firms will need to determine whether their shareholders of record are accredited investors. Importing the accredited investor concept into this context may prove problematic. It is unclear, for example, why firms would not have an ongoing, and potentially quite burdensome, obligation to determine whether or not shareholders of record remain accredited over time. Another issue is that one shareholder of record may represent the holdings of several beneficial owners. Presumably, all such beneficial owners would have to be shown to be accredited for the shareholder of record to qualify as an accredited investor. See also Robert B. Thompson, The JOBS Act: Raising the Threshold for 34 Act Obligations, THE CONGLOMERATE (Apr. 24, 2012), http://www.theconglomerate.org/2012/04/the-jobs-act-raising-the-threshold-for-34-act-obligations.html.

\textsuperscript{102} JOBS Act § 303.

\textsuperscript{103} Id.

\textsuperscript{104} JOBS Act § 601(a).

\textsuperscript{105} Id.
likely to be minimal. It is improbable that there are many firms that will elect to
remain private thanks to the timely passage of the JOBS Act but that were about to
be required to comply with FPDRs as a result of the old threshold levels. Rather,
firms have been cognizant of and strategizing about the threshold levels established
pursuant to section 12(g)(1) of the Exchange Act for some time.106 Firms that had
already decided to take steps to avoid mandatory compliance with FPDRs will
simply have the cost of such efforts reduced as a result of the JOBS Act changes.

If the JOBS Act had implemented a major change in the rules that determine
when firms can exit from the mandatory disclosure regime, such a change would
likely have had a more immediate impact. Some already-public firms might have
chosen to take advantage of lowered barriers to exit, but the JOBS Act made no
overall changes to the rules governing when firms may exit from the mandatory
periodic disclosure regime. For example, the text of the JOBS Act suggests that the
exclusion of certain employee shareholders from the count of shareholders of
record used to determine whether compliance with FPDRs will become mandatory
does not apply in the context of determining whether the number of a firm’s
shareholders of record has fallen below the level under which firms are permitted to
exit from the mandatory disclosure regime.107

The longer-term impact of the JOBS Act on the extent to which firms comply
with FPDRs is, however, likely to be quite significant. The 500 shareholders of
record threshold had increasingly become the binding constraint, which forced
firms that otherwise could avoid mandatory compliance with FPDRs to comply
with these requirements. Several well-known firms, including Facebook, Google,
and Microsoft, had all chosen to go public, at least in part, because they could not
easily avoid crossing the 500 shareholders of record threshold that would trigger
mandatory compliance with FPDRs.108

106. See, e.g., Steven M. Davidoff, Facebook May be Forced to Go Public Amid Market
Gloom, N.Y. TIMES, Nov. 30, 2011, at B5 (“LinkedIn, for example, worked with SharesPost,
the private trading market, to ensure that before its offering, its shares were bought on the
exchange only by existing investors. Zynga has taken even a stronger stance, refusing to
register share trades in some instances.”).

107. JOBS Act § 502, refers specifically to Rule 12(g)(1) when describing the
circumstances under which certain employee shareholders are to be excluded from the count
of shareholders of record, whereas the provisions regarding the threshold levels used to
determine when a firm can exit from the periodic disclosure regime are set out in 15 U.S.C.
§§ 78l(g)(1), 78l(g)(4), 78o(d).

108. With respect to Facebook’s decision to go public, the Wall Street Journal identified
the requirements triggering mandatory compliance with FPDRs as the primary motivation of
Mark Zuckerberg, the Chief Executive Officer of Facebook, in filing for an initial public
offering (IPO) of Facebook:

Mr. Zuckerberg’s thinking began changing when Facebook realized in 2010
that it would have more than 500 shareholders by the end of 2011, which would
trigger a regulatory requirement that the company start publicly reporting
financials. Mr. Zuckerberg decided it made more sense for Facebook to go
public and reap some financial benefit from an IPO.

Shayndi Raice, Facebook Sets Historic IPO—Potential $10 Billion Deal Would Dwarf
Google’s decision to go public, see Victor Fleischer, Brand New Deal: The Branding Effect
One of the reasons for the growing importance of the 500 shareholders of record threshold is that the other criteria potentially triggering a firm’s obligation to comply with FPDRs, namely listing the firm’s securities on a national exchange or carrying out a public offering, are increasingly easy to evade. Alternative venues on which equity securities can be bought and sold, such as SecondMarket or SharesPost, have grown rapidly.109 These alternative venues provide a firm’s shareholders some of the benefits of an active trading market for the firm’s securities without requiring that the firm’s securities be listed on a national exchange. With respect to the ease of avoiding a public offering, opportunities for firms to offer securities privately have increased steadily in the United States over the past thirty years.110 Firms can now relatively easily raise billions of dollars in capital without registering a public offering.111

Information gathered in the Special Study of securities markets published in 1963 provides one data point suggesting the potential magnitude of the long-term impact of the JOBS Act changes in the number of shareholders of record threshold levels triggering mandatory compliance with FPDRs.112 The Special Study researchers collected information about the number of shareholders of record from

of Corporate Deal Structures, 104 M ICH. L. REV. 1581, 1592 (2006) (explaining that Google’s decision to go public was motivated by the need to comply with Rule 12(g)(1)). With respect to Microsoft’s decision to go public, see Bro Uttal, Inside the Deal that Made Bill Gates $350,000,000, FORTUNE, July 21, 1986, at 23, 24 (“By 1987, Microsoft estimated, over 500 people would own shares, enough to force the company to register with the SEC.”).


111. The facility with which funds can be raised privately is likely to be increased further as a result of the relaxation of restrictions on public solicitation in the context of a private offering in the JOBS Act. JOBS Act § 201; see also Andrew Ross Sorkin, Goldman Limits Facebook Offering to Foreign Clients, N.Y. TIMES DEALBOOK (Jan. 17, 2011, 8:55 PM), http://dealbook.nytimes.com/2011/01/17/goldman-limits-facebook-investment-to-foreign-clients/ (describing a private equity offering to foreign investors by Facebook).

112. For a discussion of the Special Study see supra notes 80–90 and accompanying text.
many of the firms with securities traded on the OTC that were not complying with FPDRs. Specifically, information on the number of shareholders of record was collected from 1610 such firms. Of these firms, 31% (507) had between 500 and 2000 shareholders of record, while only 16% (264) had more than 2000 shareholders of record. This Special Study finding suggests that if the threshold level triggering mandatory compliance with FPDRs had been raised from 500 to 2000, such a change would have reduced the number of firms required to comply with FPDRs by approximately two-thirds as a result of the 1964 Amendments. There are, however, several reasons why the Special Study findings in this regard provide only suggestive evidence as to how firms might be affected by the JOBS Act changes.

The motivation for including in the JOBS Act such significant changes in the criteria used to determine which firms are required to comply with FPDRs is unclear. Overall, the JOBS Act had bipartisan support and was easily and quickly passed by Congress. The general rationale offered for the passage of the JOBS Act was that the new law would make it easier for firms to go public in the United States. However, the specific provisions of the JOBS Act under consideration

113. SPECIAL STUDY, supra note 67, at 19–20.
114. Id. at 20 (using provided data to determine percentages).
115. There is also evidence supporting the continued relevance of the Special Study finding that two-thirds of the firms required to comply with FPDRs as result of the 1964 Amendments would not have had to comply if the threshold had been increased to 2000 shareholders of record. In an editorial by John Coates and Robert Pozen challenging the advisability of enacting the JOBS Act, Coates and Pozen observe: “More than two-thirds of all public companies would be exempt under the bill’s new criterion [regarding when compliance with FPDRs is mandatory].” John Coates & Robert Pozen, Editorial, A Regulatory Bill That Cuts Investor Protections, WASH. POST, Mar. 16, 2012, at A13.
116. The group of firms studied in the early 1960s and those affected by the JOBS Act are distinguishable by many changes in investing and management practices over the past fifty years. First, the number of a firm’s shareholders of record is both an imprecise measure of beneficial ownership and a measure the characteristics of which have changed substantially in the past fifty years. Another confounding factor is that the Special Study data did not exclude employee shareholders from the count of shareholders of record, many of whom would be excluded in a count made pursuant to the JOBS Act as a result of the exclusion for certain employee shares. See supra note 101 and accompanying text. But the significance of not excluding employees in the early 1960s may be minimal, since employee ownership may have been less common in that earlier era. A further complicating factor is that firms can take steps to maintain their shareholders of record count below a given level, which was not considered in drawing inferences from the Special Study findings.
118. On signing the JOBS Act into law President Obama stated: “For business owners who want to take their companies to the next level, this bill will make it easier for you to go public. And that’s a big deal because going public is a major step towards expanding and hiring more workers.” Barack Obama, President, Remarks by the President at JOBS Act Bill Signing (Apr.
here, those that increase the number of shareholders of record threshold above which firms lose an automatic exemption from mandatory compliance with FPDRs, would have the opposite effect. Raising this threshold level will likely result in fewer firms going public.

The legislative history surrounding the provisions in the JOBS Act that change the threshold level of shareholders of record triggering mandatory compliance with FPDRs is quite sparse. The only official written explanation for this aspect of the JOBS Act appears indirectly in a House report on the Private Company Flexibility and Growth Act (“PCFG Act”).

The House report on the PCFG Act stated that the reason to change the shareholders of record threshold trigger was to “eliminate one impediment to capital formation for small companies.” This claim was supported by a reference to testimony from Barry Silbert, the chief executive officer of SecondMarket, Inc. Specifically, Silbert’s testimony is cited for the propositions that the 500 shareholders of record threshold “created a disincentive for private companies to hire new employees, or acquire other businesses for stock,” and “discourages companies from providing stock option-based compensation to employees.” There is no discussion of any other potential costs or benefits from changing the threshold trigger level in the House report on the PCFG Act.

Another source of legislative history related to the change in the shareholders of record levels triggering mandatory compliance with FPDRs is testimony before Congress in 2011 and 2012 about various proposed changes in federal securities regulations, such as the PCFG Act, many of which were eventually included in the JOBS Act. Hearings were held before the Senate Committee on Banking, Housing, and Urban Affairs on December 1, 2011, and March 6, 2012, before the Senate

5. 2012, available at http://www.whitehouse.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing. The provisions changing the threshold levels triggering mandatory compliance with FPDRs were not mentioned in the President’s statement. See id.


120. The section of the JOBS Act dealing with the change in threshold levels triggering mandatory compliance with FPDRs, among other similarities, is titled Private Company Flexibility and Growth. See JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).


122. See id. It should be noted that Silbert’s firm had an interest in seeing the threshold level raised. See infra note 133 and accompanying text.


124. See id.


Subcommittee on Securities, Insurance, and Investment on December 14, 2011,\(^\text{127}\) and before the House Subcommittee on Capital Markets and Government Sponsored Enterprises on September 21, 2011,\(^\text{128}\) and December 15, 2011.\(^\text{129}\)

In testimony before the Senate Subcommittee on Securities, Insurance, and Investment, Professor John Coates of Harvard Law School stated that of the various proposed changes in federal securities regulations, the provisions changing the shareholders of record trigger were “the riskiest proposals being discussed” and provided an example of “radical deregulation.”\(^\text{130}\) Despite this testimony by a leading securities regulation scholar that the threshold-changing aspects of the proposed legislation raised serious concerns, there is no evidence of further analysis of these provisions before their inclusion in the JOBS Act.

The virtually nonexistent legislative history surrounding a major change in the shareholders levels triggering mandatory compliance with FPDRs stands in stark contrast to the substantial investment made in research and analysis when these provisions were originally enacted. The paucity of a legislative history for this aspect of the JOBS Act quite naturally raises questions about which interest groups stood to gain the most from these changes and about what happened to the interest groups that had originally supported the adoption of the 1964 Amendments.\(^\text{131}\)

There appear to be two constituencies that will materially benefit when it becomes easier for firms to avoid mandatory compliance with FPDRs. First, firms that run private exchanges for the trading of the securities of firms that do not comply with FPDRs should benefit from these JOBS Act changes.\(^\text{132}\) Many more firms will probably allow their securities to be traded on these secondary private
equity markets as a result of the changes in the shareholders of record threshold levels triggering mandatory compliance with FPDRs. It is notable that Barry Silbert, the CEO of SecondMarket, Inc., not only testified before both Senate committees considering changing the shareholders of record threshold level triggering mandatory compliance with FPDRs, but also hired a lobbyist, made personal campaign contributions to Representative David Schweikert, the original sponsor of the PFCG Act legislation, and attended the presidential signing ceremony for the JOBS Act.133

The second group of firms that will benefit from an increase in the shareholders of record threshold trigger are those types of firms that have a comparatively larger number of shareholders of record. There are at least two types of firms that fall into this category: technology firms and financial institutions. Technology firms, especially those based on the West Coast or that are venture capital-backed, have an established tradition of granting permanent equity compensation to firm employees.134 One consequence of this practice is that, after some time passes or the firm grows, the firm will tend to have a larger and larger number of shareholders of record. To address concerns that granting equity-based compensation might trigger disclosure obligations, the SEC had allowed firms to exclude employee-held options from the count of shareholders of record for the purposes of determining whether a firm would be required to comply with FPDRs.135 This exemption did not, however, extend to employee holdings that were converted from options into stock. As noted above, technology firms Facebook, Google, and Microsoft had each chosen to go public, at least in part, because they could not easily avoid crossing the 500 shareholders of record threshold.136 Interest groups tied to the venture capital community were among the most ardent supporters of the JOBS Act.137 Active, public supporters of the JOBS Act included Steve Case, the former chief executive officer of America Online, and Katherine Mitchell, a recent past chairman of the National Venture Capital Association.138

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134. See Steven M. Davidoff, A Clash of Cultures Tarnishes a Romance in Silicon Valley, N.Y. TIMES, July 6, 2011, at B5 (“The convention in Silicon Valley is that once vested, options are kept by employees even if they leave.”).


136. See supra note 108 and accompanying text.

137. See Mattingly & Schmidt, supra note 117 (“[The passage of the JOBS Act] had more to do with the growing political sway of emerging technology companies and Silicon Valley venture capitalists . . . .”).

138. With respect to Steve Case’s role, see Olga Khazan, With Passage of JOBS Act, Steve Case, AngelList Founder and Others Look Forward to a Less-Regulated Start-Up
A second type of firm that tends to have a disproportionately large number of shareholders is financial institutions, which have had a history of community ownership. Bank groups had historically lobbied for a change in the shareholders of record threshold and were granted, pursuant to the JOBS Act, a change not only in the threshold level triggering mandatory compliance with FPDRs, but also in the threshold level determining when a firm could choose to end its compliance with FPDRs.139

Although objections to various aspects of the JOBS Act were voiced,140 the provisions regarding the changes in the criteria triggering mandatory compliance with FPDRs received relatively little mention at the time of the law’s passage. The constituencies that had driven for the steady expansion of the reach of mandatory compliance with FPDRs throughout the twentieth century appear now to no longer have either the interest or appetite to fight to maintain or expand the reach of FPDRs.141

A review of the history of periodic disclosure regulation in the United States illuminates part of the dynamic which had led to a steady expansion in the types of firms required to comply with FPDRs throughout the twentieth century. Firms already committed or required to provide high-quality periodic disclosures worked to expand the types of firms compelled to make such disclosures in order insure a “level playing field” with respect to disclosure obligations. More recently, this coalition appears to be breaking down, as evidenced by the passage of the JOBS Act, which benefits a comparatively small group of firms and was passed with virtually no consideration of the greater social costs such a change might impose.

Uncovering the political economy of periodic disclosure regulation in the United States, while informative, ultimately fails, however, to resolve the normative question of how best to determine when firms should be required to comply with FPDRs. Neither the proponents nor the opponents of imposing FPDRs on various World, WASH. POST (Mar. 27, 2012), http://www.washingtonpost.com/business/on-small-business/jobs-act-passes-case-any-time-theres-change-theres-going-to-be-concern/2012/03/27/gIQAJJheeS_story.html. With respect to Katherine Mitchell’s role, see supra note 117.

139. With respect to bank lobbying efforts for the JOBS Act, see Kate Ackley, JOBS Act Shows Banks Still Have Clout, ROLL CALL (Mar. 8, 2012 1:47 PM), http://www.rollcall.com/news/jobs_act_shows_banks_still_have_clout-212990-1.html. With respect to special treatment of banks and bank holding companies under the JOBS Act, see supra notes 104–05 and accompanying text.


141. One could speculate that changes both in political fundraising practices and securities trading technologies can explain this diminished influence. For example, both Langevoort & Thompson, supra note 8, at 15–16, 18, and Macey & O’Hara, supra note 109, at 570–81, note how advances in trading technology have led to a demise in the power of securities exchanges generally.
types of firms have offered arguments that facilitate a systematic evaluation of when certain firms should be required to comply with FPDRs.

II. THE ECONOMICS OF PERIODIC DISCLOSURES REGULATION

This Part provides a comprehensive and up-to-date analysis of justifications for requiring firms to make periodic disclosures. Such an analysis provides the foundation necessary to make recommendations as to how best to structure the rules used to determine when firms should be required to comply with FPDRs. The discussion below is not intended as a rejection of arguments historically used to justify securities regulation, such as the need to protect investors or to maintain confidence in securities markets. 142 Rather, the analysis below offers a way to formulate such concerns with a degree of precision that is both more amenable to empirical verification and more helpful in developing specific policy proposals.

I identify three legitimate and related justifications for requiring certain firms to make periodic disclosures. These three justifications are: (1) periodic disclosure regulation can mitigate negative spillover effects that may be produced by the trading of the securities of firms providing only limited amounts of information to investors, (2) the regulation of periodic firm disclosures can increase social welfare, if those who control the firm’s disclosure policy would otherwise adopt inefficient, opaque disclosure policies in order to facilitate self-dealing, and (3) regulating a firm’s periodic disclosures can provide redress for the systematic underdisclosure that otherwise occurs when firms are unable to realize the benefits their disclosures provide to third parties, most notably their competitors.143 Each of these justifications can be shown by the available evidence to generate positive benefits when FPDRs are imposed on a group of firms. Each of these three justifications is also germane to a determination of which firms should be required to comply with FPDRs.

Scholars have offered many justifications for imposing disclosure requirements on certain firms other than the three endorsed above. Among the notable justifications for disclosure regulation, which are not included in the analysis here of which firms should be required to comply with FPDRs, are the arguments that: (1) periodic disclosures requirements offer firms a way to make a credible commitment to ongoing accurate and timely disclosures, (2) government supervision of the regulation of periodic disclosures provides firms a way to inexpensively access public enforcement of their disclosure commitments, (3) periodic disclosure regulation helps to ensure that investments in the production of


143. One way to understand the three justifications for periodic disclosure regulation provided in this Article is to observe that each of the justifications identified here addresses a different market failure. The negative spillovers justification assumes that investors are unable to easily distinguish between high-quality and low-quality disclosure firms and that firms do not internalize the potential systemic harm caused by under disclosure. The reducing self-dealing justification assumes that insiders do not bear the full costs of adopting opaque disclosure policies. The interfirm externalities justification assumes that firms are not able to capture all of the benefits provided by their disclosures.
information about public firms are made at a more efficient level, and (4) periodic disclosure regulation provides a way to limit harms to society that might be caused by the otherwise unfettered actions of large firms. For various reasons discussed below, I do not include these four notable justifications for disclosure regulation when considering when particular firms should be required to comply with FPDRs.

Before discussing the justifications for periodic disclosure regulation both included and excluded from the analysis here, it is necessary to understand the costs and benefits involved when a firm commits to make periodic disclosures. This is a topic that has been considered extensively by both financial economists and legal scholars.144

The primary benefit to a firm from committing to make periodic disclosures about firm operations appears to be that such a commitment can lower the cost to the firm of raising funds from outside investors.145 Investors are willing to provide the firm funds at a lower cost in exchange for a credible commitment to make periodic disclosures because such a commitment will increase share price accuracy and reduce self-dealing by those who own the firm.146


146. These two benefits from disclosure, albeit in the context of disclosure at the time of an offering, were recognized as early as 1933. William O. Douglas & George E. Bates, The Federal Securities Act of 1933, 43 YALE L.J. 171, 172 (1933) (“Thus the effects of [the Securities Act], though important, are secondary and chiefly of two kinds: (1) prevention of excess and fraudulent transactions, which will be hampered and deterred merely by the requirement that their details be revealed; and (2) placing in the market during the early stages of the life of a security a body of facts which, operating indirectly through investment services and expert investors, will tend to produce more accurate appraisal of the worth of the security if it commands a broad enough market.” (footnote omitted)).
The way in which increased disclosure by the firm can increase share price accuracy is straightforward. Easy access to reliable and up-to-date information about the performance of the firm’s businesses will increase the price accuracy of the firm’s securities. The link between periodic disclosures and a reduction in self-dealing is more complex because a firm’s commitment to make periodic disclosures can reduce self-dealing by firm insiders in different ways. First, a commitment to make periodic disclosures can deter firm insiders from acting in a self-interested or untoward manner. Felix Frankfurter noted this potential benefit from disclosure requirements shortly after the passage of the Securities Act:

The existence of bonuses, of excessive commissions and salaries, of preferential lists and the like, may all be open secrets among the knowing, but the knowing are few. There is a shrinking quality to such transactions; to force knowledge of them into the open is largely to restrain their happening. Many practices safely pursued in private lose their justification in public.

A second way in which heightened disclosure requirements may reduce self-dealing is through the moderating effects of an improvement in share price accuracy. As noted above, more accurate, timely, and reliable disclosures lead to more accurate share prices. More accurate share prices should, in turn, reduce the opportunities insiders have to profit from exclusive access to firm information.

The costs to a firm resulting from a commitment to make periodic disclosures can be separated into four categories. The first category is the direct administrative and implementation costs of making periodic disclosures. The second category of costs includes the various distortions in a firm’s operating policy that may result from the public disclosure of firm information. One example of such distortions is provided by research by John Asker and his colleagues. Asker and his colleagues find that public firms consistently underinvest in business opportunities as


149. Frankfurter, supra note 30, at 55.

150. See supra text accompanying note 147.


compared to otherwise similarly situated firms that are private. The third category of costs to a firm from a commitment to make periodic disclosures is competitive disadvantaging, which may result when a firm reveals information that benefits the firm’s competitors to the firm’s detriment. This third category of costs is important from a regulatory perspective, because these competitive disadvantaging costs of disclosure tend to be significant from the perspective of the affected firm, but not from a social welfare perspective. One firm’s loss in competitive advantage is another firm’s gain. The fourth category of costs of periodic disclosures includes the costs that are only borne by the firm’s insiders who, with less disclosure, can benefit more from their privileged access to firm information. As with the third category, these insider costs of disclosure may be significant from a regulatory perspective, because costs to insiders from disclosures that reduce self-dealing opportunities are likely to be more than offset by gains realized by the firm’s other shareholders.

This overview of the costs and benefits of a firm’s periodic disclosures informs the discussion below of justifications for requiring these types of periodic disclosures.

A. Regulating Periodic Disclosure as a Way to Reduce Negative Spillover Effects

One justification for the regulation of a firm’s periodic disclosures is that such regulation can reduce the negative spillover effects caused by the active trading of the securities of firms providing only limited amounts of information to investors. Two different kinds of negative spillover effects from the trading of such securities may give rise to concerns that justify regulatory intervention: harms that are venue specific and harms that are economy wide.

The trading of the securities of firms providing limited amounts of information to investors could have venue-specific negative spillover effects, because of the potential difficulty in distinguishing between high-quality and low-quality firms on a particular venue. If investors either have difficulty or are unwilling to invest the resources necessary to distinguish between these two types of firms, a rational investor will pay a price for a given security traded on a particular venue based on average firm quality on that particular venue. This investor behavior reduces the incremental benefits to a firm providing higher quality disclosures, potentially imposing an uncompensated cost on firms that continue to make these high-quality disclosures. Concerns about venue-specific negative spillover effects help to explain the efforts of exchanges to exclude from their venues firms that provide investors only limited amounts of information, such as when the NYSE excluded trading of nonlisted shares in 1910.

One recent study provides information about the potential magnitude of venue-specific negative spillover effects from the trading of the securities of firms providing limited amounts of information to investors. Brian Bushee and Christian

153.  Id.
155.  See supra notes 37 and accompanying text.
Leuz studied the impact of the 1999 OTCBB Rule on the many firms affected.156 At the time of the enactment of the 1999 OTCBB Rule, many of the firms with securities traded on the OTCBB were already complying with FPDRs, while many other of the firms with securities traded on the OTCBB were not complying with FPDRs. Therefore, the implementation of the 1999 OTCBB Rule provides an opportunity to study externalities caused by the trading of the securities of firms providing different amounts of information on the same venue.

Bushee and Leuz found that the securities of firms traded on the OTCBB that had already been complying with FPDRs “experience[d] positive stock returns and permanent increases in liquidity” as a result of the requirement that previously noncompliant firms with securities traded on the OTCBB either begin to comply with FPDRs or exit the OTCBB.157 The magnitude of the positive externality observed when firms that had not previously complied with FPDRs either did so or exited OTCBB was measured by observing the impact of the announcements and implementation of the 1999 OTCBB Rule on the valuations of firms that were listed on the OTCBB and were already complying with FPDRs.158 The stock prices of the 1360 firms in this category went up, on average, over 3% in response to news of the implementation of the 1999 OTCBB Rule, providing statistically significant evidence that investors anticipated gains from this rule change for firms that were already complying with FPDRs.159

From a static perspective, the overall social welfare effects of these venue-specific negative spillover effects may not appear especially problematic. In the absence of regulatory intervention, if investors based valuations on the average level of disclosure, then some firms, those providing low-quality disclosures, may experience benefits, just as other firms, those providing high-quality disclosures, may experience losses. However, from a dynamic perspective, the consequences of venue-specific negative spillover effects become more problematic for reasons related to the dynamic referred to as the “lemons” problem.160 If investors do not distinguish between firms that make high-quality and low-quality disclosures, then firms providing high-quality disclosures will choose to exit the market rather than

158. Id. at 249.
159. Id. at 250 tbl.4 (an indication of a statistically significant positive return for the already compliant firms of 3.4% appears in the column in this table labeled “Already Compliant” and in the row labeled “Mean cumulative return-Small Cap cumulative return,” which row reflects the change in value of the various compliance subsamples after adjusting for changes in the market price for these types of firms more generally during the period under study). The suggestion of positive externalities is further supported by evidence of positive returns for the Already Compliant firms when the 1999 OTCBB Rule was implemented. Id. at 254.
160. George A. Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84 Q.J. ECON. 488 (1970) (the “lemons” problem refers to the collapse of a market in which it is difficult for purchasers to distinguish between low-quality and high-quality products, such as may occur in the market for used automobiles, if purchasers cannot determine which cars have a history of mechanical difficulties).
face an unwarranted discount. The result can be a race to the bottom that may explain the recent difficulties experienced by several exchanges in Europe geared toward raising funds for firms in a less regulated environment. Preventing such an undesirable outcome provides a legitimate justification for requiring a minimum level of periodic disclosure, at least before allowing a given firm’s securities to be traded on a particular venue.

A second type of negative spillover effect from the trading of the securities of firms that provide only limited amounts of information to investors may affect the entire economy. There are various ways in which inaccurate share prices that could result from inadequate disclosures might harm the overall economy. Concerns about the deleterious, economy-wide effects of the trading of the securities of firms making limited disclosures to investors were a motivation for federalizing the regulation of securities markets in the 1930s. Concerns about how “the performance of the securities markets affects the well-being of the economy” were also cited as an important motivation for the decision to expand the reach of FPDRs in 1964. More recently, some have hypothesized that one of the causes of the economic downturn in 2008 may have been inadequate disclosure practices. Economist Luigi Zingales, for example, noted that there was no disclosure regulation in the credit default swap market, and others have argued that the lack of transparency in the credit default swap market contributed to the downturn in 2008.

The venue-specific and economy-wide negative spillover effects from the trading of the securities of firms providing investors only limited amounts of information provide a justification not only for periodic disclosure regulation but also for compulsory periodic disclosure regulation. There are two ways in which to implement a regulatory scheme involving periodic disclosure obligations. On the one hand, firms might be given the option to elect to comply with FPDRs (an “elective” regime). On the other hand, firms might be required to comply with FPDRs (a “compulsory” regime). The topic of this Article is why and how to implement a compulsory disclosure regime because the question addressed here is when firms should be required to comply with FPDRs, rather than just be given an opportunity to comply with FPDRs.

The reasons why economy-wide negative spillover effects justify not only periodic disclosure regulation, but also compulsory periodic disclosure regulation,


163. COFFEE & SALE, supra note 142, at 2–3.


are straightforward. First, firms have no incentive to internalize potential economy-wide negative spillover effects. The reasons why venue-specific negative spillover effect may justify compulsory periodic disclosure regulation are of more recent vintage. In the past, private ordering offered a powerful tool to address many of the venue-specific negative spillover effects from the trading of the securities of firms providing limited amounts of information to investors. However, the power of private exchanges, and, therefore, their ability to dictate the disclosure policies of firms with securities traded thereon, has diminished significantly with the rapid evolution of trading technologies. Private exchanges no longer have the market power to force firms to adopt disclosure policies that internalize the costs of venue-specific negative spillover effects.

Negative spillover effects from the trading of securities providing investors only limited amounts of information that are both venue-specific and economy-wide impose tangible costs that may justify imposing disclosure requirements on at least some firms.

B. Regulating Periodic Disclosure as a Way to Reduce Self-Dealing

A second justification for the regulation of firm periodic disclosure policies arises out of the link between periodic disclosure policies and self-dealing by firm insiders. As noted above, it is generally agreed that the commitment to and subsequent practice of providing investors high-quality periodic disclosures will reduce self-dealing by a firm’s insiders.

However, arguments about why periodic disclosure policies need to be regulated in order to realize these benefits are much less well-developed. The likelihood that a commitment to make periodic disclosures will reduce self-dealing does not, by itself, provide a justification for regulatory intervention. In the absence of further complications, firms should adopt periodic disclosure policies that maximize the value of the firm by selecting the optimal trade-off between periodic disclosures and self-dealing. The argument for periodic disclosure regulation as a way to address agency costs, as it currently stands, is incomplete and cannot provide useful guidance for determining which firms should be required to comply with FPDRs to address self-dealing costs.

166. See, e.g., Zingales, supra note 165, at 395–96.
167. Mahoney, supra note 36.
168. See Macey & O’Hara, supra note 109, at 570–81.
169. Id.
170. See supra notes 146–151 and accompanying text.
171. A notable exception is Mahoney, supra note 40, at 1090–93 (arguing that requiring the disclosure of information about transactions between a firm and its agents is so common a practice that it should be made a mandatory rather than a default rule). While Mahoney is explicit about a justification for mandatory disclosure regulation as a way to reduce agency costs, the rationale he offers is not convincing. The costs of using a default rule rather than a mandatory rule in this particular context would appear to be quite minimal, undermining his argument for making disclosure mandatory for the reason he offers.
172. Incomplete forms of the argument linking a reduction in self-dealing costs to periodic disclosure regulation show up in many places. See, e.g., Choi & Pritchard, supra note 109, at 27–28.
To justify the regulation of a firm’s disclosure policy as a way to reduce self-dealing it is necessary to also show that there are persistent and widespread market failures, which allow firm insiders to benefit personally by adopting opaque disclosure policies. How those who establish the firm’s disclosure policy might personally benefit by establishing disclosure policies that involve systematic under disclosure is the crucial, unanswered question.\textsuperscript{173} While this question has received little consideration in the context of explaining why firms might adopt opaque disclosure policies to facilitate self-dealing, in other areas of research on corporate governance explanations as to how wasteful policies that facilitate self-dealing can survive and flourish has received considerable attention. The ways in which aggregate firm value can be reduced, because of the divergence between the interests of those who manage or control the firm and outside investors, has been studied in the context of: (1) the choice of a state in which to incorporate the firm,\textsuperscript{174} (2) the decision of whether to adopt anti-takeover provisions,\textsuperscript{175} and (3) the determination of executive compensation levels.\textsuperscript{176} Findings from research on how those who manage or control the firm may profitably select policies that do not maximize firm value in these other contexts can be extended to explain how firm insiders might be able to personally benefit from the adoption of opaque disclosure policies.

The work of Michal Barzuza on the growing number of firms that choose to incorporate in Nevada is of particular relevance to the analysis of which firms should be required to make periodic disclosures as a way to reduce the costs of adopting inefficiently opaque disclosure policies.\textsuperscript{177} Barzuza finds that firms that incorporate in Nevada, where restrictions on self-dealing are more limited, tend to be those where insider control of the firm is greater and where the power of outside investors, provided by mechanisms such as large block shareholders or institutional holders, is lesser.\textsuperscript{178} Barzuza’s findings suggest the kinds of situations in which those who control the firm are more likely to adopt opaque disclosure policies that do not maximize firm value. Extrapolating from Barzuza’s findings suggests that

\textsuperscript{173} This question is different from the market failure formally modeled in Andrei Shleifer & Daniel Wolfenzon, \textit{Investor Protection and Equity Markets}, 66 J. FIN. ECON. 3 (2002). Shleifer and Wolfenzon develop a model in which potential gains by insiders resulting from under disclosure would be accurately priced by outside investors. In the Shleifer and Wolfenzon model, insiders divert resources in an inefficient manner only because insiders are unable to contract to reliably transfer gains to outside investors.


\textsuperscript{178} Id. at 39–47.
firms for which insider control of the firm is greater or where the power of outside investors is lesser are more likely to be firms for which imposing FPDRs will increase firm value.

Whether firm’s insiders do, in fact, adopt opaque disclosure policies to facilitate self-dealing in a way that reduces firm value is an empirical question amenable to direct measurement. If requiring firms to comply with FPDRs reduces the incidence of inefficient self-dealing, then the value of the firm should increase when the firm is required to comply with FPDRs. Studies of the effects of the original passage of the Securities Act and the Exchange Act do not provide evidence of the type of gain in share prices after the imposition of FPDRs that would indicate disclosure requirements can efficiently reduce self-dealing by firm insiders.\(^{179}\) However, failing to find evidence of an effect is not the same as finding evidence that there is no effect. There are many factors that make the identification of such an effect in the context of the enactment of the original securities regulation statutes challenging, including the lack of an adequate control group against which to study the effects of the legislation’s passage and the fact that active enforcement of the legislation took place well after its passage.\(^{180}\)

Analysis of the impact of imposing FPDRs on a new group of firms as a result of the 1964 Amendments, on the other hand, supports the hypothesis that imposing FPDRs can increase a firm’s share price and, therefore, provides evidence that in the absence of mandatory disclosure regulation at least some firms will adopt value-reducing, opaque disclosure policies.\(^{181}\) Michael Greenstone and his


\(^{180}\) For a discussion of the importance of enforcement as compared with enactment, see John C. Coffee, Jr., The Law and the Market: The Impact of Enforcement, 156 U. PA. L. REV. 229 (2007).

\(^{181}\) In Michael Greenstone, Paul Oyer & Annette Vissing-Jorgensen, Mandated Disclosure, Stock Returns, and the 1964 Securities Act Amendments, 121 Q.J. ECON. 399 (2006), the authors are more equivocal about the social welfare implications of their findings than they should be. Greenstone and his colleagues argue that the share price gains they observe may be offset by losses to those who otherwise benefit from the systematic under disclosure of firm information. But this potential offsetting cost of more disclosure is
colleagues (the “Greenstone study”) measured the effects of the 1964 Amendments on the share prices of the affected firms in several ways. An event study of the share prices of the affected firms at the time of the announcement and passage of the 1964 Amendments found evidence of a 3.5% positive abnormal return surrounding these events. They also found that the affected firms experienced abnormal positive returns of between 11.5% and 22.1% in the period between the announcement of the legislation and the legislation fully going into effect, suggesting that actual gains were even greater than those initially anticipated by investors.

Another potential source of evidence that those who control a firm’s disclosure policy may adopt suboptimal disclosure policies to facilitate self-dealing comes from research on why firms exit the federal periodic disclosure regime. Christian Leuz and his colleagues collected information on firms in the United States that elected to deregister and cease their obligations to comply with FPDRs between 1998 and 2004. Leuz and his colleagues concluded from their study that “agency problems and insiders’ interests play into the decision to go dark.” Several presumed to exist based on their assumption that the market failure addressed by disclosure regulation involves the absence of adequate private contracting mechanisms. To support this interpretation of their results Greenstone et al. cite the analytic model developed by Shleifer & Wolfenzon, supra note 173, but that model is not particularly germane to the United States capital markets, where mechanisms to ensure the enforceability of private contracts are comparatively robust. Therefore, a rise in share price probably reflects net gains in firm value from imposing FPDRs, rather than just gross gains (before adjusting for insider losses) as suggested by Greenstone et al.

182. Greenstone et al., supra note 181. Similar findings based on a smaller sample of the affected securities are reported in Allen Ferrell, Mandatory Disclosure and Stock Returns: Evidence from the Over-the-Counter Market, 36 J. LEGAL STUD. 213 (2007). But see Robert Battalio, Brian Hatch & Tim Loughran, Who Benefited from the Disclosure Mandates of the 1964 Securities Acts Amendments?, 17 J. CORP. FIN. 1047 (2011). There are, however, significant problems with the Battalio et al. analysis. In his written testimony before the Senate in December of 2011, Coates identified many of shortcomings in the Battalio study. Examining Investor Risks in Capital Raising, supra note 127, at 24–25 n.2 (statement of Professor John C. Coates IV, Harvard Law School). Most problematically, the main findings of the Battalio et al. analysis appear to be premised on the incorrect assumption that failing to reject their null hypothesis of no benefit from the 1964 Amendments supports the null hypothesis that there is no such relationship.


184. Id. at 439–43.

185. A possible link between periodic disclosure and reduced self-dealing is also suggested by inter-country comparisons of securities markets. See, e.g., Luzi Hail & Christian Leuz, International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulations Matter?, 44 J. ACCT. RES. 485 (2006); Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert W. Vishny, Legal Determinants of External Finance, 52 J. FIN. 1131 (1997). However, there are number of confounding factors that make the inference less certain in the inter-country context than in the intra-country context.


187. Id. at 183.
findings in the study supported their conclusion about the link between increased amounts of self-dealing and the decision to stop complying with FPDRs. First, Leuz and his colleagues found that firms with weaker corporate governance (as indicated by fewer outside directors) and less outside monitoring (as measured by the absence of institutional investors) are more likely to deregister.188 This finding suggests that firms at which the opportunities for self-dealing are greater in the absence of compliance with FPDRs (because there are fewer other ways to protect outside investors) are the firms that are more likely to deregister. Second, they found that the relationship noted above among corporate governance, outside monitoring, and the propensity of a firm to deregister is accentuated for firms that generate more free cash flow.189 The greater a firm’s free cash flow, the more valuable the opportunities to self-deal are, and so incentives to end compliance with FPDRs are even greater. Third, outside investors have a more negative reaction, as indicated by a decline in share price, when firms that otherwise provide less protection to outside investors choose to deregister.190 If the value of self-dealing is increased by avoiding compliance with FPDRs, then, presumably, compliance with FPDRs reduces net private gains from self-dealing.

Measurable benefits from the imposition of disclosure regulation, as evidenced by the findings reported by the Greenstone study and indirectly by the findings reported by Leuz and his colleagues, indicate that one justification for periodic disclosure regulation is that such regulations can reduce inefficient levels of self-dealing. This reduction in self-dealing from periodic disclosure regulation is also a justification for the compulsory imposition of FPDRs on certain firms. Insiders who would choose suboptimal disclosure policies in the absence of compelled disclosure will certainly not voluntarily elect to comply with FPDRs, even when complying with such requirements could increase the overall value of the firm. However, because the precise mechanisms by which agents manage to avoid bearing the full costs of entering into self-dealing transactions with the firm are unclear, it will be difficult to identify the specific firms affected by this market failure.

C. Regulating Periodic Disclosure as a Redress for Positive Interfirm Externalities

A third justification for requiring firms to make periodic disclosures arises from the distortions in firm periodic disclosure policies caused by positive interfirm externalities. Positive interfirm externalities will lead firms to systematically disclose less than a socially optimal amount of information in the absence of regulatory intervention. These distortions result from a “two-audience problem.”191 Public firm disclosures are available to both the intended audience for the firm’s

188. Id. at 193 tbl.5 (Models 4, 5, 6, and 7), 195. These findings are consistent with Barzuza’s findings with respect to the types of firms that tend to incorporate in Nevada. Barzuza, supra notes 177–178 and accompanying text.
189. Leuz et al., supra note 186, at 193 tbl.5 (Models 6 and 7).
190. Id. at 201 tbl.10 (Model 4).
disclosure, the firm’s investors, and an unwanted “second” audience, the firm’s competitors.\(^\text{192}\)

The magnitude of the distortions in a firm’s disclosure policies caused by this “two-audience problem” can be observed in several ways. First, the distorting effects of positive interfirm externalities are evident when disclosure practices in private financing transactions are compared with disclosure practices in otherwise similar public transactions. Substantially less information is disclosed between parties when details are made public, as compared with when the parties to the transaction can strictly restrict third-party access to the disclosed information.\(^\text{193}\)

Evidence of the significance of the distortions in disclosure policies and firm behavior caused by interfirm externalities is also provided by research on operational differences between public firms and comparable private firms.\(^\text{194}\) Finally, the effects of firms’ concerns about disclosing competitively disadvantaging information is evident in the tendency of firms in more competitive industries to request that more of the information they file with the SEC be redacted before public distribution.\(^\text{195}\)

The implications of distortions caused by positive interfirm externalities for the efficacy of requiring firms to comply with FPDRs are more difficult to evaluate. Financial economists are equivocal about whether positive interfirm externalities justify disclosure regulation.\(^\text{196}\) Legal scholarship on the ramifications of interfirm externalities for securities regulation is also conflicted.\(^\text{197}\) For reasons I have elaborated elsewhere, my conclusion is that positive interfirm externalities do provide a sound justification for regulating a firm’s periodic disclosure practices.\(^\text{198}\) Without regulatory intervention firms will systematically under disclose, and systemic under disclosure can be harmful both because of the increased likelihood of negative spillover effects from under disclosure and because such under disclosure can exacerbate self-dealing costs.

If positive interfirm externalities justify the regulation of periodic disclosures, then the argument for making compliance with FPDRs compulsory to realize these benefits is straightforward. A large element of coordination is necessary to

\(^{192}\) Id. at 1.


\(^{194}\) Asker et al., *supra* note 152 and accompanying text, note one such difference, although there may be other causes for the differences they observe than distortions caused by positive interfirm externalities.


\(^{197}\) Merritt Fox and Roberta Romano had a lively debate as to whether the presence of positive interfirm externalities provides a sufficient justification for periodic disclosure regulation. Merritt B. Fox, *The Issuer Choice Debate*, 2 THEORETICAL INQUIRIES L. 563 (2001); Fox, *Retaining Mandatory Securities Disclosure*, supra note 144; Romano, *Empowering Investors*, supra note 179; Romano, *Need for Competition*, supra note 179.

implement a system that increases firm disclosures sufficiently to correct for positive interfirm externalities. Any individual firm would prefer to remain silent while letting all other firms provide the additional competitively valuable information necessary to address this market failure. Therefore, firms are unlikely to voluntarily elect to participate in a mandatory disclosure regime designed to provide a redress for positive interfirm externalities, even when the overall effects of increasing disclosure as a redress for this market failure are quite positive.

There are, however, aspects of the positive interfirm externalities justification for requiring periodic disclosures that present special challenges when this justification for periodic disclosure regulations is relied upon to inform policy decisions about which firms should be required to comply with FPDRs. First, it is difficult to directly measure the benefits of providing a redress for this market failure. The gains from disclosure regulation aimed at correcting for positive interfirm externalities do not flow immediately and directly to the firm being required to make the additional disclosures. Therefore, these gains cannot be measured in the same way that, for example, the reduction in inefficient levels of self-dealing was measured by the Greenstone study.199

A second challenge in determining which firms should be required to comply with FPDRs in order to correct for positive interfirm externalities is that the social costs from the under disclosure that can result from positive interfirm externalities are only produced in conjunction with another market failure. Even if firms systematically disclose less than the socially optimal amount of information because of positive interfirm externalities, such under disclosure need not cause social harms. Rather, the resulting under disclosure will only generate social costs when, for example, the resulting under disclosure increases agency costs as firms adopt disclosure policies that simultaneously reduce the release of competitively disadvantaging information and facilitate self-dealing.200

To identify firms that will benefit from periodic disclosure regulation as a way to redress positive interfirm externalities, it is necessary to consider not only distortions in disclosure policies caused by concerns about disclosing competitively disadvantaging information, but also whether the firm will cause negative spillover effects or suffer from increased self-dealing costs as a consequence of the systemic under disclosure caused by positive interfirm externalities.

D. Other Common Rationales for Disclosure Regulation

The three justifications for a compulsory mandatory disclosure regime discussed above do not exhaust the list of reasons why periodic disclosure requirements might be imposed on a firm. In this Section, I briefly review four additional arguments that have been offered to justify the regulation of firm disclosures and explain why I choose not to rely on these arguments to inform the analysis of when certain firms should be required to make periodic disclosures.

199. Greenstone et al., supra note 181.
200. See Guttentag, Accuracy Enhancement, supra note 145 (providing an analytic model formalizing this observation).
The four justifications briefly reviewed below are: (1) requiring periodic disclosure requirements offer firms a way to make a credible commitment to ongoing, accurate, and timely disclosures; (2) government supervision of the regulation of periodic disclosures provides firms a way to inexpensively access public enforcement of their disclosure commitments; (3) the regulation of periodic disclosures helps to ensure that investments in the production of information about public firms are made at a more efficient level; and (4) periodic disclosure regulation provides a way to limit harms to society that might be caused by the otherwise unfettered actions of large firms.

With respect to justifications based on the ways in which disclosure regulation can provide firms a means to make their disclosure commitments more credible, scholars, including John Coffee, Joseph Franco, and Edward Rock, have noted that a firm’s disclosure commitments will be more credible if the firm can commit to a mandatory disclosure regime from which exit is costly. Rock uses the apt metaphor of a lobster trap to describe how such a mechanism works best. The lobster trap is easy for the lobster to enter but difficult for the lobster to exit. Rock observes that the mandatory disclosure regime in the United States has such a design: once a company begins to comply with FPDRs in the United States, it is quite difficult for the company to exit the mandatory disclosure system.

Evidence that periodic disclosure regulation can provide this credible commitment benefit can be gleaned from several sources. First, research findings of gains realized by firms which elect to cross-list their securities in a regime with more robust securities regulations suggests that mandatory disclosure regulation provides value as a credible commitment device. Securities prices are higher, and the cost of capital is lower for otherwise comparable firms, when a firm’s securities are cross-listed on a securities exchange with a higher level of mandatory disclosure.

Another source of evidence of the credible commitment value of a mandatory disclosure regime is provided by research on the effects when barriers to exit from a mandatory disclosure regime are lowered. Fernandes and his colleagues studied the effects of lowering barriers to exit when the SEC modified Rule 12h-6 in 2007.


204. Evangelos Benos & Michael S. Weisbach, Private Benefits and Cross-Listings in the United States, 5 EMERGING MARKETS REV. 217 (2004). There are, however, limitations in concluding that the benefits from cross-listing arise solely from the effects of making the commitments to future disclosures more credible. Cross-listing can also signal a firm’s quality and provide the firm access to a larger pool of capital.
to make it easier for foreign firms complying with FPDRs to end their reporting obligations in the United States.\textsuperscript{205} They found that the share prices of firms “located in countries with poor disclosure environments” declined as a result of the adoption of this rule.\textsuperscript{206} If increasing the ease with which firms can exit from a mandatory disclosure regime can lower a firm’s value, then, presumably, a mandatory disclosure regime can increase firm value by making exit more expensive.

The benefit a mandatory disclosure regime can provide by offering firms a way to make a credible commitment to periodic disclosures is not included in the analysis below of when to require firms to comply with FPDRs because this credible commitment benefit can be realized without compelling participation. Unlike lobsters, firms presumably can make an informed and welfare-maximizing decision as to whether to enter into a mandatory disclosure regime that is difficult to exit.

A second benefit from mandatory disclosure regulation, which is related to the credible commitment benefit, arises from the fact that mandatory disclosure requirements are often enforced, at least to some degree, by a public entity. Publicly enforced mandatory disclosure requirements can benefit investors by providing a relatively simple way to gain access to public enforcement of their disclosure commitments.\textsuperscript{207} There are two ways in which public enforcement of periodic disclosure requirements might benefit investors. First, public enforcement may be more efficient than private enforcement because of various economies of scale in enforcement technologies.\textsuperscript{208} Second, in a legal environment where the private enforcement of contracts is difficult or expensive, public enforcement can

\textsuperscript{205} Prior to the amendment of Rule 12h-6 in 2007 foreign firms were only able to deregister a class of securities if they met the test established in Rule 12h-6 for deregistration. Rule 12h-6 had only allowed deregistration if a firm had: (1) fewer than 300 United States shareholders of record, or (2) fewer than 500 United States shareholders of record and less than $10 million in assets. The amendment in 2007 to Rule 12h-6 also allowed foreign firms to deregister if trading in United States markets was a sufficiently small (less than 5%) share of the worldwide trading volume in the security over the preceding twelve-month period. Nuno Fernandes, Ugur Lel & Darius P. Miller, Escape from New York: The Market Impact of Loosening Disclosure Requirements, 95 J. Fin. Econ. 129, 131–32 (2010).

\textsuperscript{206} Id. at 130.

\textsuperscript{207} Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, What Works in Securities Law?, 61 J. Fin. 1 (2006); Hans B. Christensen, Luzi Hail & Christian Leuz, Capital-Market Effects of Securities Regulation: Hysteresis, Implementation, and Enforcement (Univ. of Chicago Booth Sch. of Bus., Working Paper No. 12-04, 2011). For a more general consideration of the relationship between the quality of legal enforcement and securities markets, see, for example, Hail & Leuz, supra note 185; La Porta et al., supra note 185.

\textsuperscript{208} For example, when the use of force is required or there are natural monopolies with respect to the development of enforcement technologies, public enforcement is likely to be more efficient than private enforcement. For a review of various arguments about situations in which public enforcement is superior to private enforcement, see A. Mitchell Polinsky & Steven Shavell, The Economic Theory of Public Enforcement of Law, 38 J. Econ. Literature 45, 46 (2000).
provide a more reliable way for firms to make their commitment to periodic disclosures credible.

But, as with the credible commitment justification for disclosure regulation, the benefits a mandatory disclosure regime might provide by facilitating access to public enforcement can be realized without requiring firms to comply with FPDRs. In the absence of other market failures, the decision of whether to participate in a mandatory disclosure regime in order to access public enforcement of a firm’s disclosure commitments is best left to the firm.

A third argument for mandatory disclosure regulation identified by scholars, but not included in the analysis here, is that, in the absence of such regulation, information about the firm will either be underproduced or overproduced. The argument that disclosure regulation is useful in deterring either the underproduction or overproduction of information about the firm has a distinguished pedigree and continues to be cited in securities regulation textbooks. According to this argument, information about the firm might be underproduced because such information is a public good, which investors can gain access to regardless of whether they have purchased the firm’s securities. Public goods are typically underproduced without regulatory intervention. Conversely, information about the firm may be overproduced from a social welfare perspective to the extent investors expend resources to gain informational advantages over other investors without benefitting the productive economy.

While concerns about market failures in the production of information about the firm are theoretically sound, it is unclear, in practice, how a regulator could calculate whether too much or too little information is produced as a result of these two potential market failures, which point in opposite directions. Similarly, it is difficult to specify how this market failure should be used to determine which firms should be subject to mandatory periodic disclosure obligations, given uncertainty about the direction and magnitude of these market failures. Because of these practical difficulties and uncertainties, I choose to exclude market failures in the production of information about the firm from the list of justifications used to determine which firms should be required to comply with FPDRs.

A fourth argument for mandatory disclosure regulation identified by other scholars, but not included in the analysis here, is that disclosure regulation can help to mitigate the harms to society that might otherwise be caused by large,

211. JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 181–82 (3d ed. 2011).
213. Easterbrook & Fischel, supra note 144, at 681–82; Guttentag, Imposing Disclosure Requirements, supra note 144, at 128; Romano, Empowering Investors, supra note 179, at 2367 n.20 (“The economic theory underlying the argument concerning information production is ambiguous, however: Capital markets can overproduce information as well as underproduce it.”).
214. But see Coffee, supra note 209, at 731–32.
unregulated firms. Cynthia Williams has shown that part of the motivation for the original passage of securities regulation legislation in the 1930s was concern about the harms to society that large firms might cause and the hope that requiring periodic disclosures could “inculcate a greater sense of public accountability into corporate management.” 215 Williams goes on to argue that the historical roots of securities regulation as a means to promote corporate social transparency justify including provisions in mandatory disclosure requirements that facilitate public discourse about the impacts on society of corporate activities. 216 One could argue that this justification for federal securities regulation could also be used to inform the determination of which firms should be required to comply with FPDRs. Following such an approach, the potential social harms that a particular firm might cause would be one criteria for determining whether the firm should be required to comply with FPDRs.

More recently, Langevoort and Thompson have similarly observed that “some portion of what we call securities regulation is really an instinct about the accountability of large, economically powerful institutions that is only loosely coupled with orthodox notions of investor protection.” 217 Langevoort and Thompson go on to argue benefits to society from the greater transparency that flow from mandatory disclosure regulation could inform the determination of which firms should be subject to the mandatory disclosure regime. Their specific recommendation is that only firms with a “large public footprint” should be required to comply with those aspects of the mandatory disclosure regime that are aimed at achieving these broader purposes of affecting the behavior of large public firms. 218 Langevoort and Thompson, therefore, propose that benefits to society from the greater transparency that flows from mandatory disclosure regulation should inform the determination of which firms should be subject to the mandatory disclosure regime. 219

Mandatory disclosure regulation may cabin the power and influence of large firms. However, both the types of information disclosed to achieve these larger societal purposes and the criteria for establishing the relevant firms to be subject to these disclosure requirements do not align well with the other criteria relevant to determining which firms should be required to comply with FPDRs discussed above. 220 A better solution to address the relationship between disclosure rules and these larger societal objectives would be to treat these objectives and the information required to be disclosed to ameliorate these problems as providing the basis for an alternative disclosure scheme. 221 For example, concerns about the

216. Id. at 1209–35.
217. Langevoort & Thompson, supra note 8, at 4.
218. Id. at 43.
219. Id.
220. See supra Parts II.A, II.B, and II.C.
221. This proposal is consistent with Langevoort and Thompson’s recommendation for a two-tiered disclosure regime, supra note 8, except that the proposal here does not require that the socially relevant disclosure obligations be applied only to a subset of firms already required to comply with FPDRs.
political influence of corporations would be more effectively addressed by requiring firms to disclose political contributions above a given dollar amount rather than by linking such a disclosure obligation to whether a firm is otherwise required to comply with FPDRs. Because of the mismatch between the other purposes served by requiring compliance with FPDRs, which are tied to the financial well-being of the firm and the capital markets, and the goal of constraining the social influence of large firms, considerations of how disclosure regulation can curb the influence on society of certain firms are excluded from the list of justifications used to determine which firms should be required to comply with FPDRs. This completes the discussion of the justifications for the regulation of a firm’s periodic disclosure policies. Three related justifications are shown to provide a sound basis for determining which firms must comply with FPDRs. Other arguments identifying potential benefits provided by mandatory disclosure regulation are not helpful in determining which firms should be required to comply with FPDRs.

III. WHICH FIRMS SHOULD BE REQUIRED TO MAKE PERIODIC DISCLOSURES

This Part of the Article builds on the historical review and economic analysis provided above to generate specific recommendations as to how and why to rewrite the rules used to determine which firms must comply with FPDRs in the United States.

A. Restructuring the Rules Determining Which Firms Are Required to Make Periodic Disclosures

My first recommendation about how to rewrite the rules used to determine which firms must comply with FPDRs has to do with how best to structure these rules. The structure of the rules currently used to determine which firms must comply with FPDRs is not sufficiently flexible to address important differences between firms. The current system should be redesigned to separate firms into one of the following three categories with respect to periodic disclosure obligations: (1) firms that receive an automatic exemption from compliance with FPDRs (an existing category), (2) firms that receive a contingent exemption from compliance with FPDRs (a new category), and (3) firms that are required to comply with FPDRs (an existing category).

The historical review in Part I of this Article illuminated the extent to which the rules currently used to determine which firms must comply with FPDRs were shaped by political pressure from firms already providing high-quality disclosures to establish a level playing field among otherwise comparable firms. One consequence of this history is that policy in this area is based on the premise that firms should be forced to comply with FPDRs, if they are otherwise similar to firms

222. This example is provided as a hypothetical and is not intended as a statement about what current reporting requirements are or might be with respect to corporate political contributions.
already complying with FPDRs. The most comprehensive consideration to date of the rules used to determine which firms must comply with FPDRs, the Special Study commissioned by Congress that preceded the 1964 Amendments, took for granted the premise that comparable firms should be subject to similar disclosure obligations.223

Starting from the premise that a level regulatory playing field needs to be maintained naturally leads to a system in which there are only two categories of firms with respect to mandatory compliance with FPDRs. One group of firms, those that resemble firms that are already making high-quality disclosures, is required to make comparable periodic disclosures. The other group of firms, which do not resemble firms already making high-quality disclosures, is free to do as it pleases with respect to periodic disclosure policies.

There are, however, two problems with using similarities between firms as the criteria for determining which firms must comply with FPDRs. First, such an approach is static and, therefore, requires finding a measure of firm comparability that is reliable and not easily manipulated. The shareholders of record criteria, which has been used both before and after the passage of the JOBS Act, is particularly problematic in this regard. Shareholders of record is an increasingly indirect and easy to manipulate measure of the number of a firm’s beneficial owners.224

Other measures, such as the firm’s market capitalization or the trading volume of a firm’s securities, would be more difficult to manipulate than the shareholders of record criteria. Both of these alternatives were considered when the Special Study recommendations about what criteria to use to trigger mandatory compliance with FPDRs were originally made225 and have recently sparked renewed interest.226 Switching to a less easily manipulated measure of firm comparability would be a

223. Special Study, supra note 67, pt. 3, at 2 (“[T]he present chapter is devoted primarily to scope rather than need.”). The Special Study essentially carried out an analysis of the attributes of firms that were already complying with FPDRs, and determined how these criteria could best be matched with the attributes of firms that at that time were not required to comply with FPDRs.

224. Langevoort & Thompson, supra note 8, at 12, 21–23. See also Spurring Job Growth Through Capital Formation While Protecting Investors: Hearings Before the S. Comm. on Banking, Hous., and Urban Affairs, 112th Cong. 13 (2011) (statement of Professor John C. Coffee, Jr., Columbia University Law School), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=a96c1be1-b064-4b01-a8ad-11e86438c7e5&Witness_ID=7e083b8d-fb60-4cfa-9d1f-a716e166c309 (“The real problem is that the ‘shareholder of record’ concept is archaic and can be gamed.”).

225. See supra note 87 and accompanying text.

226. Sjostrom has argued for use the volume of trading in a firm’s securities as a metric. Sjostrom, supra note 9. This is an idea that Langevoort and Thompson have also endorsed. Supra note 8, at 26–27. In his testimony before Congress, Coffee recommended switching to a trigger based on the value of a firm’s “public float.” Spurring Job Growth Through Capital Formation While Protecting Investors, supra note 224, at 28 (statement of Professor John C. Coffee, Jr., Columbia University Law School); see also infra note 236.
partial solution to the problem of using a static measure to determine when firms are comparable enough to trigger mandatory disclosure requirements.227

There is, however, a more intractable problem with using similarities between firms as the basis for determining which firms must comply with FPDRs. The efficacy of such an approach depends upon there being a fair degree of homogeneity among firms. If firms are similar both in terms of some observable metric and the costs and benefits of making periodic disclosures, then setting threshold levels based on a typical or average company may provide an effective way to develop policy. However, to the extent that there is not a high correlation between the observable features of various firms and the costs and benefits of periodic disclosures for those various firms, no criterion or set of criteria can provide an adequate means of distinguishing firms in a way that efficiently imposes periodic disclosure obligations.

This problem of heterogeneity between firms with respect to the costs and benefits of periodic disclosures, even if the firms share superficial similarities, is likely to be significant. One could look at, for example, two firms with securities traded at similarly high volumes. In one case a combination of high trading volume and limited periodic disclosures might be associated with significant market failures from negative spillover effects, wasteful levels of self-dealing, and positive interfirm externalities. The same combination of high trading volume and limited periodic disclosures might not be problematic at all in a second case, perhaps because the trading of the securities of this second firm takes place on a specialized exchange open to only very sophisticated investors with substantial capital reserves, and the investors in this second firm are powerful and sophisticated enough to prevent the firm from adopting wasteful, opaque disclosure policies that facilitate self-dealing. For this second company there would not be a sound argument for requiring compliance with FPDRs, even though the firm’s shares were traded at the same high-volume levels as the first firm.

In summary, the two problems endemic to the current structure of the rules requiring compliance with FPDRs are: (1) difficulty in identifying a reliable measure of firm comparability, and (2) differences between firms with respect to the costs and benefits of periodic disclosure policies that do not correlate with any observable firm characteristics. Both of these problems are evident in the threshold triggering mandatory compliance with FPDRs in force both before and after the passage of the JOBS Act.

Prior to the passage of the JOBS Act, the criteria used to determine which firms must comply with FPDRs were clearly both underinclusive and overinclusive. Most notably, there certainly were firms with more than $10 million in assets and more than 500 shareholders of record that, nonetheless, faced none of the market failures that would justify regulatory intervention in the firm’s periodic disclosure practices. As a hypothetical example, suppose the securities of a particular firm had been issued with severe restrictions on the tradability of the firm’s shares, ameliorating any concerns about negative spillover effects from the trading of this firm’s

227. Some of the ways in which a trigger based on the volume of trading in a firm’s securities could be evaded are discussed in Langevoort and Thompson, see supra note 8, at 27.
Suppose further, that the shares of this particular firm were privately issued to investors after balanced negotiations between the firm and a sophisticated representative of the collective investor interests, ameliorating concerns about the costs of wasteful self-dealing facilitated by opaque disclosure policies. Despite these obvious mitigating factors, under the rules established by the 1964 Amendments such a firm would still be required to comply with FPDRs.

Conversely, after the passage of the JOBS Act, it is reasonable to expect that many firms with fewer than 2000 shareholders of record (particularly once many employee shareholders are excluded from the count) will adopt periodic disclosure policies that impose social costs because of the various effects of those market failures that justify regulatory intervention into firm periodic disclosure policies. The trading of the securities of firms with fewer than 2000 shareholders of record could easily generate negative spillover effects. Many firms with fewer than 2000 shareholders of record would appear to also be of the type that might adopt socially wasteful, opaque disclosure policies to facilitate self-dealing. Both of these problems would likely be exacerbated by distortions in firm disclosure policies resulting from positive interfirm externalities because even firms with fewer than 2000 shareholders of record would reasonably expect that competitors could find a way to access disclosures intended only for the firm’s investors.

Moreover, these observations about the underinclusive nature of the JOBS Act criteria triggering mandatory compliance with FPDRs probably understate the problem. Firms had already begun to master the art of avoiding the 500 shareholders of record threshold. Given the facility with which firms can control the number of their shareholders of record, after the JOBS Act changes, there will be little impediment from firms acting as they please in terms of issuing shares through private offerings and facilitating tradability without concern about triggering an obligation to comply with FPDRs. Many of the documented gains that can be provided by requiring compliance with FPDRs will likely be sacrificed.

A disclosure regime in which firms are, instead, separated into three categories with respect to compliance with FPDRs would be more dynamic and more capable of addressing unobserved differences between firms with respect to the costs and benefits of periodic disclosures.

The general contours of the new three-category system for determining which firms must comply with FPDRs would be as follows. Firms would only be granted

228. See infra notes 276, 278 and accompanying text.
229. See supra Part II.
230. The findings of negative venue-specific spillover effects reported in Bushee and Leuz, see supra note 156, were all produced by firms with less than 500 shareholders of record.
231. See supra note 106 and accompanying text.
232. Examining Investor Risks in Capital Raising, supra note 127 (statement of Professor John C. Coates IV, Harvard Law School); supra note 130 and accompanying text. This is probably why Coates considered the change in the JOBS Act of the shareholders of record thresholds triggering mandatory compliance with FPDRs especially problematic.
an automatic exemption from compliance with FPDRs under circumstances when it is quite unlikely the harms from systematic under disclosure are significant.\textsuperscript{233} The calculation for determining which firms should be granted this automatic exemption from compliance with FPDRs using the new three-category system would be different from the calculation currently used to determine when to grant an automatic exemption. The current calculation requires estimating the point at which the benefits from periodic disclosure regulation exceed the costs for the typical or average firm. As a result of applying this new calculation, many fewer firms would receive an automatic exemption from mandatory compliance with FPDRs than is currently the case. But firms not granted an automatic exemption from compliance with FPDRs would now be allowed to take specified ameliorative measures to minimize the societal costs from persistent under disclosure, and, by doing so, avoid mandatory compliance with FPDRs. Crafting the appropriate ameliorative measures requires identifying specific ways in which the several market failures that otherwise justify regulating periodic disclosures can be mitigated. Potential ameliorative measures might involve either strict restrictions on the tradability of the firm’s shares or having firms commit to a viable alternative periodic disclosure regime. Firms that do not qualify for an automatic exemption and that do not take acceptable ameliorative steps would be required to comply with FPDRs.

More details about how to implement the proposed new three-category system for determining which firms must comply with FPDRs are provided below.

\textit{B. Criteria for Granting an Automatic Exemption from Periodic Disclosure Requirements}

The first step in specifying how to implement the three-category mandatory disclosure regime proposed in this Article is to determine the conditions under which firms should receive an automatic exemption from compliance with FPDRs. Recall that under the three-category mandatory disclosure regime an automatic exemption would be granted only in circumstances where the best available evidence suggests that none of the three legitimate justifications for imposing periodic disclosure requirements on a particular firm is likely to justify the costs of regulatory intervention.

Two criteria that have been used in the past as a basis for granting firms an automatic exemption from compliance with FPDRs, firm size and the number of a firm’s shareholders, are reconsidered here in light of the new way of calculating when firms should be granted an automatic exemption from compliance with FPDRs. An automatic exemption from compliance with FPDRs might also be provided when the trading volume of a firm’s securities remains below a given

\textsuperscript{233} Receiving this automatic exemption from mandatory compliance with FPDRs does not mean that these firms, or their disclosures, would or should be entirely unregulated. For example, other aspects of securities regulation would and probably should still apply, such as restrictions on insider trading. See Pollman, \textit{supra} note 109, at 30–31. There might also be certain periodic disclosure requirements that are still appropriate for these firms that are somewhat lesser than traditional FPDRs, but consideration of such disclosure requirements is beyond the scope of this Article.
level, but such an approach is likely to be overly restrictive and evidence is not readily available to estimate what such a minimal trading threshold should be.\textsuperscript{234} Another intriguing alternative not explored further is that the age of the firm could be used to determine which firms are required to comply with FPDRs, a possibility suggested by the work of Jeff Schwartz, and indirectly endorsed as a valid criterion for determining periodic disclosure obligations in the definition under the JOBS Act of an “emerging growth company” as those firms which have offered equity publicly for the first time within the past five years.\textsuperscript{235}

1. Firm Size

I first consider whether there is a specific firm size below which it would be appropriate to continue to grant firms an automatic exemption from compliance with FPDRs. I reach two conclusions about how firm size threshold levels for granting an automatic exemption from mandatory compliance with FPDRs should be changed under the three-category mandatory disclosure regime proposed in this Article. First, market capitalization is a better measure of firm size than asset value for the purposes of determining when to grant an automatic exemption from mandatory compliance with FPDRs.\textsuperscript{236} Second, I recommend that firms with a

\textsuperscript{234} Sjostrom has argued for use the volume of trading in a firm’s securities as a metric, Sjostrom, \textit{supra} note 9, as have Langevoort and Thompson, \textit{supra} note 8, at 26–27. Some of the concerns about over-restrictiveness of using trading volume to determine which firms should be granted an exemption from compliance with FPDRs is suggested by the hypothetical example \textit{infra} Part III.B.1.


\textsuperscript{236} Market capitalization refers to the value of the firm’s equity capital based on the trading value of the firm’s shares. In most cases, the market capitalization of a firm is equal to the price of one share of the firm’s stock times the total number of shares outstanding. ROBERT B. DICKIE, \textit{FINANCIAL STATEMENT ANALYSIS AND BUSINESS VALUATION FOR THE PRACTICAL LAWYER} 3 (2d ed. 2006).

A firm’s “public float,” the market value of the firm’s shares not held by firm affiliates or insiders, is an alternative indicator of firm size. \textit{COFFEE & SALE}, \textit{supra} note 142, at 144. Coffee has recommended using a firm’s public float as a basis for determining which firms are required to comply with FPDRs. \textit{Spurring Job Growth Through Capital Formation While Protecting Investors}, \textit{supra} note 224, at 13 (statement of Professor John C. Coffee, Jr., Columbia University Law School). There are tradeoffs in using a firm’s public float, instead of its market capitalization, as a basis for triggering mandatory compliance with FPDRs. One of the benefits of using a measure of public float is that public float is already in use elsewhere in the securities regulation scheme to differentiate between large and small companies. \textit{See, e.g.}, \textit{COFFEE & SALE}, \textit{supra} note 142, at 144. A firm’s public float also provides information about the extent to which outside investors may be harmed by problems with the firm’s disclosure policies. Finally, determining a firm’s market capitalization may be difficult in a context where shares are rarely or privately traded. The disadvantage of public float is that, to the extent firm size is a useful indicator of the relative costs and benefits of periodic disclosure regulation for a typical firm, market capitalization provides the more direct measure of firm size.
market capitalization of less than $35 million be granted an automatic exemption from mandatory compliance with FPDRs.

The first step in determining the appropriate firm size threshold below which to grant an automatic exemption from compliance with FPDRs is to consider how firm size interacts with each of the three legitimate justifications for requiring companies to comply with FPDRs (as well as with the unstated fourth assumption that regulatory intervention is never costless). In terms of direct links to the market failures justifying mandatory periodic disclosure regulation, firm size would not appear to be an especially promising criterion for determining which firms should be granted an automatic exemption from required compliance with FPDRs.

There is no obvious direct connection between a firm’s size and negative spillover effects from the trading of the securities of firms providing investors only limited amounts of information. The active trading of the securities of very small firms, if these firms provided insufficient amounts of information to investors, could on a marginal basis have quite harmful impacts both on valuations at a particular trading venue and for the economy as a whole. Conversely, the trading of the securities of even a very large firm could presumably be sufficiently segregated from other markets and the economy as a whole to prevent the possibility of the types of negative spillover effects that might justify periodic disclosure regulation.

Nor is there a self-evident link between firm size and the social costs of self-dealing resulting from firms adopting opaque disclosure policies. Firms both large and small may be sufficiently well-governed so as to ensure that their disclosure policies maximize the value of the firm. If anything, one implication from research on when agency costs distort public firm policy choices in other arenas, such as the choice of the firm’s state of incorporation, is that smaller firms, rather than larger firms, would be more likely to suffer from costly self-dealing, and, therefore, smaller firms may be a more appropriate target for mandatory disclosure regulation.

In terms of possible links between firm size and distortions resulting from positive interfirm externalities, on the one hand, small firms might find it easier to disclose information to investors in a sufficiently confidential manner, so as to avoid distortions resulting from positive interfirm externalities. On the other hand, information that is material is more granular for a smaller firm, and, therefore, potentially more valuable to a firm’s competitors, meaning the risks of distortions to avoid competitively disadvantaging disclosures might be greater for smaller firms. In summary, implications from direct links between firm size and the three market failures that justify periodic disclosure regulation are ambiguous.

There is, however, an important indirect link between firm size and legitimate justifications for requiring compliance with FPDRs, because the costs of periodic disclosure regulation are more likely to be fixed than the gains from periodic disclosure regulation, which are more likely to vary with firm size. If the gains from periodic disclosure regulation vary with firm size more than costs, then there

237. The three legitimate justifications for periodic disclosure regulation are discussed in Part II of this Article.
238. See supra notes 174–78 and accompanying text.
will be a size below which firms are simply too small for potential gains from requiring compliance with FPDRs to justify the costs of compliance.\(^{239}\)

This hypothesis about the cost structure of a typical firm’s periodic disclosures, which justifies considering firm size in order to determine which firms must comply with FPDRs, is supported by some of the findings in the Bushee and Leuz study of the impacts of the 1999 OTCBB Rule.\(^{240}\) Bushee and Leuz analyzed how firms with securities traded on the OTCBB responded when they were required to either comply with FPDRs or move trading of their securities to a different venue.\(^{241}\) Bushee and Leuz found that the median market capitalization of firms that chose to comply with FPDRs rather than exit the OTCBB market (the 826 “Newly Compliant” firms) in response to the rule change were significantly greater than those of the firms that made the opposite choice and exited the OTCBB rather than comply with FPDRs (the 2677 “Noncompliant” firms).\(^{242}\) The median market capitalization for the firms that were Newly Compliant was $34.5 million, as compared to $1.4 million for firms that were Noncompliant (both amounts in 2011 dollars).\(^{243}\) Market capitalization was also shown by Bushee and Leuz in a regression to be a statistically significant indicator of how a firm would respond to the 1999 OTCBB Rule.\(^{244}\) A logical explanation for such dramatic differences in market capitalization between the firms that chose to remain on the OTCBB by complying with FPDRs and the firms that instead chose to exit the OTCBB is that the relative costs of complying with FPDRs are much higher for lower-valued firms.

The Bushee and Leuz study of the effects of the 1999 OTCBB Rule also provides an opportunity to compare market capitalization and firm asset values as measures of firm size for the purpose of determining the relative costs and benefits of periodic disclosure regulation.\(^{245}\) Bushee and Leuz provide information about

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239. Guttentag, *Accuracy Enhancement*, supra note 145, at 626 (“If the costs of regulation do not increase in a linear manner with firm size, then perhaps this analysis does suggest that firm size is a valid criteria for determining which firms to regulate.”). See also Cox & Baucom, *supra* note 10, at 1845.

240. There is also evidence that certain aspects of FPDRs, such as the additional disclosure obligations required pursuant to the passage of Sarbanes Oxley Act, fell disproportionately on smaller firms. Stephen M. Bainbridge, *Corporate Governance and U.S. Capital Market Competitiveness* 24 (UCLA Sch. of Law, Law-Econ Research Paper No. 10-13, 2010), available at http://papers.ssrn.com/abstract=1696303.

241. See Bushee & Leuz, *supra* note 156 and accompanying text.

242. *Id.* at 243, 246.


244. *Id.* at 246–47 (Panel B).

245. Research by Leuz and colleagues on firms that elected to deregister from compliance with FPDRs between 1998 and 2004 is also suggestive of the usefulness of market capitalization, as compared to asset value as a measure of the relative costs and benefits of periodic disclosure regulation. Leuz et al., *supra* note 186. The median market capitalization of firms that chose to “go dark” was $5.1 million and the median book value of this group was $20.9 million, whereas the median market capitalization was $74.4 million.
both the market capitalization and asset values for the cohorts of firms affected by
the 1999 OTCBB Rule. The median asset values of the Newly Compliant firms and
the Noncompliant firms were almost identical ($1.4 million for the Newly
Compliant firms, as compared to $1.5 million for the Noncompliant firms, in 2011
dollars).

Yet, as noted above, the median market capitalizations of these two
groups of firms were dramatically different ($34.5 million for the Newly
Compliant firms, as compared to $1.4 million for the Noncompliant firms).
Differences in
market capitalization proved to be a much better indicator than asset value of a
firm’s choice of whether to comply with FPDRs, suggesting that market
capitalization is a much better indicator than asset value of a firm’s private costs
and benefits of complying with FPDRs.

Findings of the effects of the 1964 Amendments in the Greenstone study and of
the 1999 OTCBB Rule by Bushee and Leuz also provide guidance as to a specific
minimum size threshold below which firms could reasonably be granted an
automatic exemption from mandatory compliance with FPDRs under the three-
category mandatory disclosure regime proposed in this Article. Recall that the
Greenstone study found that, on average, the imposition of the 1964 Amendments
increased the share prices of the firms required to comply with FPDRs, because of
the new law.

The Greenstone study provided information about the market
capitalizations and asset values of the firms studied. Particularly relevant to the
question of whether there is a minimum size below which mandatory compliance
with FPDRs would be inefficient were findings with respect to the group of 240
firms that were not subject to any federal disclosure regulation prior to the
enactment of the 1964 Amendments, but that, after the passage of the 1964
Amendments, were required to comply with FPDRs. The median market
capitalization reported by the Greenstone study of these “Newly Compliant” firms
was $68 million (in 2011 dollars).

This information provided by the Greenstone study suggests one size threshold
below which firms could reasonably be granted an automatic exemption from
compliance with FPDRs. A market capitalization of $68 million could be used to
specify the size below which firms might be granted an automatic exemption from
a requirement to comply with FPDRs, because this is the median size of the firms
that Greenstone and his colleagues found earned a positive abnormal return when
required to comply with FPDRs.

There are several reasons, however, to suspect that the median size of the Newly
Compliant firms reported by the Greenstone study provides too high an estimate of
the size below which firms should be granted an automatic exemption from
compliance with FPDRs. First, the Newly Compliant firms Greenstone and his
colleagues reported on earned a significantly positive return from regulatory

and the median asset value was $71.4 million of the control sample (all amounts in 2011
dollars). For firms that chose to “go dark,” market capitalization rather than asset value is
more suggestive of the costs and benefits of complying with FPDRs.

246. Bushee & Leuz, supra note 156 at 245–46. For conversion, see CPI Inflation
Calculator, supra note 243.

247. See Bushee & Leuz, supra note 156, at 245–46. For conversion, see CPI Inflation
Calculator, supra note 243.

248. Greenstone et al., supra note 181.

249. Id. at 420. For conversion, see CPI Inflation Calculator, supra note 243.
intervention. The share price of a Newly Compliant firm increased, on average, between 11% and 22% as a result of compliance with FPDRs. These gains suggest that the firm for which the marginal benefit of compliance with FPDRs was zero would be smaller than the size of the median Newly Compliant firm. Second, the Greenstone study's analysis is only designed to measure gains from one of the three potential sources of benefit from requiring compliance with FPDRs. Benefits from requiring compliance with FPDRs in order to reduce negative spillover effects and from providing redress for positive interfirm externalities will not show up in the Greenstone study measures of the share price effects on a particular group of firms when those firms are required to comply with FPDRs.

Third, the amounts the Greenstone study reported are median values. Median values need not be the same as the level at which the marginal benefit from regulatory intervention equals the marginal cost, and, further, under the three-category mandatory disclosure regime proposed in this Article, firms should only be granted an automatic exemption from compliance with FPDRs when the risks of social harms from under disclosure are quite low.251 Much has changed in securities markets and securities regulation since the 1964 Amendments were enacted, posing yet another concern with extrapolating a minimum size below which firms may be granted an automatic exemption from compliance with FPDRs from the work of the Greenstone study. On the one hand, information is significantly less expensive to produce and cheaper to distribute than it was when the 1964 Amendments were enacted.252 Provisions are also now in place that are specifically designed to lessen the disclosure burden of FPDRs on smaller firms.253 On the other hand, the amount of information required to be disclosed has steadily increased, which would suggest that the costs of imposing periodic disclosure requirements has increased since 1964, presenting an argument for expanding the scope of the automatic exemption beyond what might have been efficient in 1964.254

250. Greenstone et al., supra note 181, at 399.
251. It is generally difficult to derive complete information about a distribution from a single point estimate, such as a median value. A more detailed analysis of the Greenstone et al. data in which firms are segregated into different size cohorts similar to that provided in Ferrell would be informative. See Ferrell, supra note 182, at 233–34 tbls. 4 & 5, 241. With respect to how to determine which firms should receive an automatic exemption, see supra note 233 and accompanying text.
252. For a prescient article on these developments, see Donald C. Langevoort, Information Technology and the Structure of Securities Regulation, 98 HARV. L. REV. 747 (1985).
253. The current rules for reduced disclosure obligations of smaller companies are contained in Smaller Reporting Company Regulatory Relief and Simplification, SEC Release No. 33-8876, 17 C.F.R. 210 (Jan. 4, 2008) (these rules are available for firms with less than $75 million in public equity float, or, for companies without a calculable public equity float, if their revenues were below $50 million in the previous year). For a discussion of efforts to reduce the disclosure burdens on smaller firms, see Schwartz, supra note 109, at 35–36.
The Bushee and Leuz study of the impact of 1999 OTCBB Rule offers another data point with which to estimate the appropriate minimum size below which firms should be granted an automatic exemption from compliance with FPDRs under the three-category mandatory disclosure regime proposed in this Article.\textsuperscript{255} The regulatory change Bushee and Leuz analyze is both more recent and involved a larger number of firms than the Greenstone study (approximately 3500 firms were directly affected by the 1999 OTCBB Rule that Bushee and Leuz study, as compared with about 1000 firms directly affected by the 1964 Amendments in the study by Greenstone and his colleagues).\textsuperscript{256}

Bushee and Leuz in their study of the effects on share prices of the firms affected by the 1999 OTCBB Rule found that the effect on the share prices of the decision of the Newly Compliant firms to comply with FPDRs was not different from zero at a statistically significant level.\textsuperscript{257} To the extent an inference can be drawn from this null finding, it appears that share prices of Newly Compliant firms benefited from their decision to comply with FPDRs (perhaps by reductions in self-dealing opportunities and perhaps by continued access to the now more valuable OTCBB venue) to a sufficient degree to offset the anticipated incremental new costs of complying with FPDRs.\textsuperscript{258} Recall that the median market capitalization of the Newly Compliant firms was $34.5 million (in 2011 dollars).\textsuperscript{259} Thus, for firms with a market capitalization of $34.5 million, the costs and benefits from the firm’s private perspective of complying with FPDRs might be roughly comparable (and, again, median values provide only an imprecise indication of what the experience of the marginal firm would be). Because this calculation does not include the other benefits of requiring compliance with FPDRs, such as those from providing redress from distortions caused by economy-wide negative spillover effects or positive interfirm externalities, these size levels are conservative (high) estimates of the optimal level below which an automatic exemption from mandatory compliance with FPDRs might be efficiently granted.

Putting together these inferences from the findings in the Greenstone study and the Bushee and Leuz study suggests that firms with a market capitalization below $35 million could reasonably be granted an automatic exemption from compliance with FPDRs on the basis of their size alone under the three-category mandatory disclosure regime proposed in this Article.

\textsuperscript{255} Bushee & Leuz, supra note 156.
\textsuperscript{256} Id. at 244; Greenstone et al., supra note 181, at 420.
\textsuperscript{257} Bushee & Leuz, supra note 156, at 250. This contrasts with findings of a statistically significant positive effect on share price from the rule’s implementation for firms with shares listed on the OTCBB that were already complying with FPDRs. This also contrasts with a statistically significant negative effect on share price for those Noncompliant firms that chose to exit the OTCBB. Id. at 261.
\textsuperscript{258} Among the challenges in reaching a conclusion from this null finding is that there may be some selection effects leading firms to choose to comply with FPDRs for reasons correlated with, but independent of, firm size.
\textsuperscript{259} See supra note 243 and accompanying text.
2. Number of Shareholders

The number of a firm’s shareholders, as suggested by the number of a firm’s shareholders of record, had been, until the passage of the JOBS Act, a crucial determinant of whether a firm would be required to comply with FPDRs. It was the likelihood of crossing this threshold level of shareholders of record that led Facebook, Google, and Microsoft to go public. The use of shareholders of record as a proxy for the number of a firm’s beneficial owners is clearly problematic. But, more generally, it is unclear why the number of a firm’s shareholders, no matter how this number is measured, should play a crucial role in determining which firms are required to comply with FPDRs, other than the fact that the number of a firm’s shareholders has an intuitive appeal as a metric of the extent to which a firm is public.

The framework developed in this Article provides new tools helpful in determining when the number of a firm’s shareholders should trigger mandatory compliance with FPDRs. Two of the three legitimate justifications for requiring compliance with FPDRs, the possibility that firms will adopt opaque disclosure policies to facilitate wasteful self-dealing and that distortions in disclosure policies caused by positive interfirm externalities, increase as the number of the firm’s shareholders increases. Consideration of these potential market failures can be used to generate specific guidance as to what extent the number of a firm’s shareholders should be used to determine which firms are granted an automatic exemption from compliance with FPDRs.

First, the larger the number of a firm’s shareholders, the more difficult it will be to solve the various collective action problems that may contribute to a situation where insiders can benefit from adopting opaque disclosure policies. To the extent that wasteful levels of self-dealing are enabled by collective action problems faced by investors, the relevant issue is the number of investors at which collective action problems become significant. There is no research directly on point, but related research suggests that collective action challenges would certainly be a problem with group sizes in excess of fifty or one hundred members.

260. See supra notes 109–111 and accompanying text.
261. See supra note 108 and accompanying text.
262. See supra note 224 and accompanying text.
263. Recall that the first proposal for determining which firms should be required to comply with FPDRs suggested by William O. Douglas in 1938 used only a firm’s size as the triggering criterion. See supra note 75 and accompanying text.
264. If there are many shareholders, at least some investors will be tempted to free-ride on the efforts of other investors to improve the firm. See, e.g., Sanford J. Grossman & Oliver D. Hart, Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation, 11 Bell J. Econ. 42 (1980).
266. The relevance of this relationship between group size and collective action problems is complicated by the fact that there must be other market failures involved as well that allow insiders to profit by adopting opaque disclosure policies that facilitate self-dealing. Even in the face of collective action problems, markets should penalize, not reward, insiders who
The likelihood that a firm’s disclosure policies will be distorted by positive interfirm externalities also increases as the number of shareholders entitled to receive the firm’s disclosures increases, because the only way to avoid distortions from positive interfirm externalities is to assure the firm that disclosed information will be made available only to the firm’s investors, and not the firm’s competitors. Such an assurance is easier to provide if the number of shareholders is small. One can make an educated guess about the group size at which concerns about revealing competitively disadvantaging information will distort a firm’s disclosures, even if the science on when a group becomes sufficiently large that a reasonable expectation of confidentiality disappears is imperfect. One suggestive finding is evidence of the concerns firms have about disclosing confidential information to their own investment bankers. John Asker and Alexander Ljungqvist find that firms will avoid using the same investment bank as other firms in their industry “in order to avoid commercially sensitive information leaking to rival firms.”267 The effects of this reluctance can be observed, despite both legal and business considerations that discourage investment banks from sharing information with the firm’s competitors. It would appear to be very unlikely that a firm could distribute information to more than one hundred ultimate investors without entertaining serious concern that this information would eventually become available to the firm’s competitors.

Both in attempting to assure that a firm’s disclosure policies limit self-dealing opportunities and that distortions from positive interfirm externalities are minimal, the appropriate threshold level below which to grant an automatic exemption from required compliance with FPDRs is probably, at most, one hundred beneficial shareholders.268

To summarize, under the three-category mandatory disclosure regime proposed in this Article, firms should be granted an automatic exemption from compliance with FPDRs if either their market capitalization is below $35 million or if they have fewer than one hundred beneficial shareholders. For firms of a larger size or with a greater number of shareholders, the best available evidence suggests the costs of complying with FPDRs are unlikely, on average, to exceed the many benefits of requiring compliance with FPDRs. Therefore, these levels are conservative (high) measures of when firms should be granted an automatic

select suboptimal disclosure policies. The precise link between the number of shareholders and firm disclosure policies that do not unduly facilitate self-dealing remains open. Some evidence is provided by findings of generally higher agency costs for firms that have fewer institutional investors and less monitoring. See Barzuza, supra note 177, at 40–41; Leuz et al., supra note 186, at 193. With respect to the limitations of our understanding of the relationship between group size and the ability to overcome collective action problems, see Amy R. Poteete & Elinor Ostrom, Heterogeneity, Group Size and Collection Action: The Role of Institutions in Forest Management, 35 DEV. & CHANGE 435 (2004).


268. The appropriate method for determining the precise number of a firm’s beneficial shareholders, particularly when there are multiple layers of ownership, is a nettlesome issue, which Langevoort and Thompson have thankfully begun to address. See Langevoort & Thompson, supra note 8, at 21–23.
exemption from compliance with FPDRs under the three-category mandatory disclosure regime proposed in this Article.

C. Criteria for Granting a Contingent Exemption from Periodic Disclosure Requirements

The final step in calibrating the three-category mandatory disclosure regime proposed in this Article is to describe what a firm with over $35 million in market capitalization and more than one hundred beneficial shareholders would be required to do to qualify for the new contingent exemption from a requirement to comply with FPDRs. Even firms that are large or have many shareholders can take steps to minimize the potential social harms from persistent under disclosure. It would be a mistake to force these firms to comply with FPDRs if appropriate ameliorative steps are taken. Each of the three justifications for imposing periodic disclosure requirements on a firm is caused by a market failure that an individual firm can take steps to mitigate in a variety of ways.

I propose two pathways for firms to receive a contingent exemption from mandatory compliance with FPDRs in this Article.269 One pathway for firms to receive a contingent exemption would be for the firm to place significant restrictions on the tradability of the firm’s shares. An alternative pathway for firms to receive a contingent exemption would be for the firm to commit to participate in an acceptable alternative disclosure regime. Either pathway would provide a legitimate alternative to mandatory compliance with FPDRs. Providing precise specifications for each of these two pathways will be challenging, because the deleterious effects from a single firm under-disclosing information to investors is difficult to measure, whether produced by negative spillover effects, the costs of wasteful self-dealing, or the repercussions from under disclosure caused by positive interfirm externalities. This is a policy area where some element of experimentation and learning may be necessary.

1. Restrictions on Tradability

One pathway for firms to receive a contingent exemption from mandatory compliance with FPDRs would be for the firm to place significant restrictions on the tradability of the firm’s shares. An example of such restrictions would be restrictions that only allow shareholders to transfer their securities to family members, affiliates, or back to the firm.270

A restriction on the tradability of a firm’s securities is likely to mitigate, either directly or indirectly, each of the three market failures that otherwise justify regulating a firm’s periodic disclosure practices. Most directly, negative spillover

269. There may also be other pathways to achieve a similar ameliorative result, such as limiting trading of a firm’s securities to a particular venue and carefully controlling who can participate in trading on that venue. Considering such alternatives in detail is beyond the scope of this Article.

270. Schwartz notes that such a restriction would not be as onerous as it might seem, because many privately-held firms are owned solely by family members. See Schwartz, supra note 109, at 70–71.
effect from the trading of the securities of firms providing only limited amounts of information to investors would be eliminated, if trading of the firm’s securities is prohibited. Tradability restrictions should also help to reduce the extent to which opaque periodic disclosure policies are adopted to facilitate wasteful self-dealing. Measures that heighten the costs of exit, such as a restriction on tradability, will increase returns to investors from monitoring the firm. Restrictions on tradability should also mitigate the distortions in disclosure policies that can result from positive interfirm externalities, because restrictions on tradability make it more likely that disclosures provided to securities holders will remain confidential.

There is historical precedent for allowing firms to avoid mandatory disclosure obligations by restricting the tradability of the firm’s shares. Bundling a commitment to provide adequate amounts of information with the right to trade securities is consistent with policies implemented by private trading venues, such as by the NYSE in 1910.271 Firms had also in the past used restrictions on share tradability as a form of private securities regulation.272

Firms in the United States likely already have the power to restrict the transferability of their securities in this manner. According to an analysis by Jonathan Macey and Maureen O’Hara, a share transfer restriction placed in the firm’s articles of incorporation is enforceable, so long as the transfer restrictions are “reasonable under the circumstance[s].”273 Avoiding compliance with FPDRs would seem to provide such a reasonable basis for imposing restrictions on share tradability. In fact, in response to the growth of secondary markets for private equity, some firms have already voluntarily begun to issue securities with substantial restrictions on transferability.274

A restriction on the tradability of the firm’s shares will not be without costs. Firm shareholders, and therefore firms themselves, benefit from the ability to trade the firm’s shares.275 However, there is not an affirmative requirement for any firm to restrict the tradability of its shares under the three-category mandatory disclosure regime proposed in this Article. Moreover, not all firms would even be required to restrict tradability or take an alternative ameliorative measure in order to avoid mandatory compliance with FPDRs under this proposal. Complying with FPDRs or providing an adequate substitute is only required of firms that are sufficiently large and their shareholders sufficiently numerous that there is prima facie evidence that, on average, the benefits of regulatory intervention into the firm’s periodic disclosure policies outweigh the costs.

2. Alternative Disclosure Regimes

A second way in which firms might receive a contingent exemption from compliance with FPDRs would be for the firm to commit to participate in an acceptable alternative disclosure regime. The possibility that firms might receive a

271. See supra note 37 and accompanying text.
272. See supra note 25 and accompanying text.
275. Id. at 22–24.
contingent exemption from compliance with FPDRs by participating in an alternative disclosure regime has had several proponents in the past, including Stephen Choi, Andrew Guzman, and Roberta Romano. There are many alternative disclosure regimes that might be suggested as legitimate substitutes for mandatory compliance with FPDRs. These various alternative disclosure regimes can be separated into two broad categories.

First, there are regulatory regimes that are generally similar to the FPDRs system. A disclosure regime generally similar to the FPDRs system would require disclosure of: (1) audited historical financial information, prepared in accordance with established accounting standards that includes an explanation of the accounting methods employed, (2) details of transactions between the firm and firm insiders, (3) restrictions on exit from the disclosure regime, and (4) a principles-based obligation to disclose additional material financial information as necessary to make the information already disclosed not misleading. Examples of alternative disclosure regimes that fall into this first category are: disclosure requirements complied with by firms with operations based outside of the United States, the pared-down version of the FPDRs that can be used by emerging growth companies pursuant to the JOBS Act, and the pared-down version of the FPDRs that can be used by smaller reporting firms. Disclosure obligations required in connection with certain employee stock option distributions also fall into this first category, except that the financial information provided to employees does not need to be audited. There are no compelling reasons, based on the market failures identified in this Article, to require mandatory compliance with FPDRs for firms that commit to provide periodic disclosures pursuant to one of the disclosure regimes in this first category of alternative disclosure regimes.

The second broad category of alternative disclosure regimes is those that require substantially less disclosure than is required pursuant to FPDRs. The most notable examples of this second category of disclosure requirements are the rules stipulating the information a firm must provide when an affiliate wishes to sell

276. Stephen J. Choi & Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 S. Cal. L. Rev. 903 (1998); Romano, Empowering Investors, supra note 179.
277. Many firms with operations primarily outside the United States comply with International Finance Standards, which are established and maintained by the International Accounting Standard Board. See IFRS (2012), http://www.ifrs.org/Home.htm.
278. For example, the JOBS Act exempts firms that are determined to be emerging growth companies from the obligations created by Section 404(b) of the Sarbanes-Oxley Act of 2002 that auditors verify the absence of any material weakness in a firm’s internal control systems. JOBS Act, Pub. L. No. 112-106, § 103, 126 Stat. 306, 310 (2012). The reduced disclosure obligations under the JOBS Act for emerging growth companies are available to firms with less than $1 billion in revenue that have issued securities publicly for the first time within the past five years. See supra note 235 and accompanying text.
279. See supra note 253.
280. See supra note 99; Schwartz, supra note 109, at 37–38.
281. This conclusion is not the same as providing a sweeping endorsement of issuer choice with respect to periodic disclosure regimes, because the list of acceptable alternatives is restricted, and there may be legitimate reasons to require firms to comply with FPDRs other than the market failures considered in this Article.
shares that are not registered. In order for these types of affiliate sales to proceed, firms are required to disclose basic information about the nature of the business and the management team. The most far reaching of these minimal disclosure obligations is that the issuer makes available its “most recent balance sheet and profit and loss and retained earnings statements,” and the same for two preceding fiscal years, if the issuer was in existence.

Alternative disclosure regimes in which firms would provide substantially less disclosure than would be required if a firm were to comply with FPDRs, such as those disclosures required when affiliates sell unregistered shares, are more problematic as a substitute for FPDRs. There are reasons to be skeptical that a substantially lesser disclosure regime will successfully address market failures in the periodic disclosure of information about the firm that justify requiring compliance with FPDRs. One example of the shortcomings of this type of lesser disclosure is the absence of a requirement to disclose details of transactions between the firm and firm insiders. FPDRs specifically require disclosure of any such transactions with a value in excess of $120,000 for good reason. Required disclosure of information about transactions between the firm and its agents is crucial to reducing self-dealing costs, and reductions in wasteful self-dealing are one of the legitimate justifications for imposing disclosure requirements on certain firms. The reasons to require mandatory compliance with FPDRs would be poorly served if firms were allowed to substitute the disclosures required in conjunction with affiliate sales of unregistered equity for FPDRs.

Allowing firms to avoid mandatory compliance with FPDRs by restricting share tradability or by committing to an acceptable alternative disclosure regime in the manner described above would provide a helpful degree of flexibility missing from the structure of the system currently used to determine which firms must comply with FPDRs.


The suitability of rules regarding disclosure in conjunction with sales of unregistered securities by affiliates as a substitute for FPDRs is of particular interest because the SEC clearly has the authority to require these types of disclosures for equity sales by nonaffiliates, as well, and only recently eliminated these disclosure obligations for nonaffiliate sales of unregistered securities after only a one-year holding period. With respect to SEC authority to require these types of disclosures in the context of nonaffiliate sales, the language of Rule 144(c)(2) actually imposes such obligations, and it is only subsequent interpretations that freed nonaffiliate investors from these obligations. Revisions to Rules 144 and 145, SEC Release No. 33-8869, 17 C.F.R. §§ 230.II.B.2, 239.II.B.2 (Feb. 15, 2008), available at http://www.sec.gov/rules/final/2007/33-8869.pdf. Even without new legislation, the SEC could use these rules as a basis for implementing virtually all of the recommended changes in the federal periodic disclosure regime suggested in this Article.

283. 17 C.F.R. § 240.15c2-11 (2011). The issuer is required to make publicly available information specified in paragraphs (a)(5)(i) to (xiv), and paragraph (a)(5)(xvi) of Exchange Act Rule 15c2-11. See id. The specific financial information disclosure requirements cited in the text are in paragraphs (a)(5)(xii) to (xiii). See id.


285. See, e.g., Mahoney, supra note 40.
CONCLUSION

This Article provides a comprehensive analysis of periodic financial disclosure regulation in the United States in order to better understand when firms should be required to comply with FPDRs.

The analysis begins with a review of the history of periodic disclosure regulation in the United States. Understanding the origins of the rules used to determine which firms must comply with FPDRs does not resolve the normative question of how to determine when firms should be required to comply with these requirements. This leads to the second Part of this Article, which provides an up-to-date and comprehensive analysis of the economic justifications for requiring firms to comply with FPDRs. Recent findings had not previously been integrated into the scholarship on mandatory periodic disclosure regulation.

The final Part of this Article builds on the historical and economic analysis in the first two Parts to generate specific policy recommendations about when firms should be required to comply with FPDRs. The first conclusion is that changing from a two-category to a three-category system for determining when firms should be required to comply with FPDRs will allow firms more latitude to select periodic disclosure practices that are appropriate given their particular costs and benefits of disclosure. To implement this new three-category system firms should be granted an automatic exemption from compliance with FPDRs, if either: (1) the firm’s market capitalization is below $35 million, or (2) the firm has fewer than one hundred beneficial shareholders. Firms that exceed these threshold levels should be allowed to choose between: (1) complying with FPDRs, (2) placing substantial restrictions on the tradability of the firm’s securities, or (3) committing to an acceptable alternative periodic disclosure regime.

Securities markets are steadily evolving, and securities regulations need to be appropriately updated and modified to reflect these changing circumstances. Companies like Facebook should not be compelled to go public, because of an antiquated system of securities regulation. Nor should firms, by manipulating the uninformed fiat of Congress, be able to easily avoid a disclosure regime that is of proven value. Scholars can assist legislators and regulators in this process by carefully delineating: the history of a regulation, the legitimate purposes served by the regulation, and how best to realize these purposes in the face of changing market realities. The goal of this Article is to provide such an analysis with respect to the rules used to determine when firms should be required to comply with FPDRs.