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THE CURIOUS CASE OF THE SECONDARY MARKET WITH RESPECT TO INVESTOR PROTECTION

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THE CURIOUS CASE OF THE SECONDARY MARKET WITH RESPECT TO INVESTOR PROTECTION

ADI OSOVSKY*

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I. INTRODUCTION

The primary mission of the U.S. Securities and Exchange Commission (hereinafter: the "SEC") is to protect investors.[1] However, current securities regulation clearly separates between public markets and private markets with respect to investor protection. While the federal securities laws impose strict and costly disclosure and anti-fraud requirements on issuers that offer their securities to the public, they exempt private offerings from such rigid regime.[2]

The comparatively relaxed approach toward private offerings is based on the assumption that investors in private markets are sophisticated and thus can "fend for themselves".[3] Under this assumption, and in order to decrease issuers' uncertainty regarding the application of such exemption, the SEC adopted a wealth-based safe harbor as a proxy of sophistication.[4]

This Article explores the validity of such traditional dichotomy between the public market and the private market[5] in a relatively

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1. *See The Investor's Advocate*, SEC.GOV, http://www.sec.gov/about/whatwedo.shtml (last visited Dec. 5, 2013).
2. *See infra* Part II.
3. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).
4. *See infra* Part II.
5. The dichotomy between the private and the public market, which used to be an under-theorized topic in securities regulation, has recently caught scholars' attention. *See* Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151, 152 (2013) (considering if or "when firms in the United States should be required to comply with federal periodic disclosure requirements"); Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 338 (2013) (focusing on the "question of when a private enterprise should be forced to take on public status"); A. C. Pritchard, *Revisiting "Truth in Securities" Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE L. REV. 999, 1000–01 (2013) (arguing that there is a mismatch between the dividing line under the Securities Act of 1933, which focuses on investor protection, and the dividing line under the Securities and Exchange Act of 1934, which also takes into account capital formation); Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 137 (2011) (arguing that the definition of public corporation is impoverished since it is not just a creature of Wall Street, but rather a creature of "Main Street, the media, bloggers, Congress, and the government"); William K. Sjostrom, Jr., *Rebalancing Private Placement Regulation*, 36 SEATTLE L. REV. 1143, 1143 (2013) (fearing that the current securities regulation favors capital formation while sacrificing investor protection and proposing a new civil liability provision to strengthen investor protection with respect to private placements); Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in*

new, organized secondary market for ownership interests in private companies with retail investor access—the "Secondary Market". The Secondary Market evolved shortly after the burst of the dot-com bubble in the late 1990's and since then has expanded rapidly to reach sales exceeding a billion dollars a year. It has created a platform for the trading of private company shares, thus providing investors and employees with an opportunity to sell their holdings even before the first exit event. Such liquidity also benefits private companies, who will no longer be forced into expensive initial public offerings (IPOs) to satisfy their investors' need. Moreover, private market transactions allow greater flexibility in capital formation, which may enhance productivity and job growth.

The Secondary Market, however, also raises serious questions with regard to investor protection. As this Article shows, the rapid growth of the Secondary Market has revealed conspicuous cracks in the wall traditionally separating the public and the private markets and the two markets' participants—the sophisticated investors versus the unsophisticated investors. This separation has been undermined by the ability of unsophisticated investors to participate in the private market sphere and by the erosion of the assumptions regarding the ability of the Secondary Market's participants to fend for themselves.

As opposed to private offering transactions, where both sellers and buyers are considered sophisticated, the participants in the Secondary Market are mixed. While the buyers consist of accredited investors (at least purportedly) and other sophisticated funds, the vast majority of the sellers are employees and ex-employees, who are not required to be accredited and are not necessarily sophisticated. These non-accredited investors trade in a regulatory sphere that is not designed for them, unarmed with information and having weaker weapons in their litigation arsenal.

The traditional dichotomy between public and private markets with regard to investor protection is problematic in the Secondary Market not only due to the penetration of non-accredited investors to the private market sphere, but also due to the refutation of the outdated assumption that all accredited investors can indeed "fend for themselves." Electronic marketplaces for Secondary Market transactions require that all buyers be "accredited investors" as

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Entrepreneurial Capital Raising, 98 CORNELL L. REV. 1573, 1574, 1577 (2012) (remapping the boundaries of the Securities Act of 1933 in light of recent technological changes, specifically dealing with reverse mergers and PIPE). *See generally* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179 (2012) (examining information issues—lack of information, asymmetric information, conflicts of interest and insider trading—in the Secondary Market).

defined in Regulation D.[6] Under this definition, accredited investors include natural persons with a $1 million net worth or annual income that exceeds $200,000—or $300,000 combined with spousal income—in each of the two most recent years.[7] The accreditation objective standard assumes that investors' wealth is a proxy for a determination that such investors are capable of fending for themselves, either because they are sophisticated or because they can hire a knowledgeable advisor.

As this Article shows, such assumption has been undermined by recent academic research that questions whether sophisticated investors can exercise their skills with limited information, whether wealth is a valid proxy for sophistication, and whether sophisticated investors are immune to cognitive biases that affect investment decisions.

The Article suggests that the erosion of the sophistication presumption deems the classic dichotomy between the heavily regulated public market and the lightly regulated private market artificial. It calls for a reexamination of the current regulatory regime with respect to investor protection. As explained below, such reexamination is of particular importance in light of the new Jumpstart Our Business Startup (JOBS) Act that will enable private companies to stay private longer, and the Secondary Market to thrive.

The main aim of this Article is to draw attention to what has the potential to be a very big problem. Lack of investor protection in the mostly unregulated and rapidly growing Secondary Market may have severe economic consequences in the future. Since the Secondary Market is only in its infancy, this Article will not make specific recommendations but rather will provide a new framework for analyzing investor protection in this sphere. The Article will also give rise to important questions that may assist in designing a better regulatory regime in the future.

The rest of this Article proceeds as follows. Part I introduces the traditional dichotomy in the federal securities regulation between the public market and the private market with respect to investor protection. It first describes the regulation imposed on public companies, which includes costly disclosure obligations and extensive liability exposure. Part I then describes the relatively relaxed regulation of the private market sphere, focusing on the exemption for private offerings, the transition of the regulation from sophistication to wealth, and on resale of private company shares.

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6. 17 C.F.R. §§ 230.501–230.508 (2008).

7. *See id.* § 230.501(a).

The last section of Part I describes the rules that under certain circumstances force a private company to become public and the new JOBS Act.

Part II discusses the rise of the Secondary Market. This Part, *inter alia,* analyzes the factors that have contributed to the expansion of the Secondary Market beginning in the early 2000s, and the challenges the Secondary Market faces.

Part III explores the advantages and disadvantages of the Secondary Market's promise to increase the liquidity of private company shares from the perspective of venture capitalists and employees.

Part IV, the heart of the Article, suggests that the traditional dichotomy between the public and the private market is artificial with respect to the Secondary Market. It begins by describing the erosion of the sophistication presumption as a result of the entry of non-accredited investors to the private market sphere. It then explores the limitations of individual accredited investors, and specifically addresses the problem of limited information, the doubtful correlation between wealth and sophistication, and investors' cognitive biases that may lead to inefficient decision making.

Finally, Part V offers some thoughts on the policy implications of protecting investors in the Secondary Market and suggests future research that is essential to determine the right balance between investor protection and capital formation.

II. OVERVIEW: THE PUBLIC MARKET—PRIVATE MARKET DICHOTOMY WITH RESPECT TO INVESTOR PROTECTION

A. *The Public Market Sphere: Costly Disclosure and High Liability Exposure*

"Sunlight is said to be the best of disinfectants; electric light the most efficient policeman[,]" the oft-quoted phrase by Louis D. Brandeis goes.[8] Indeed, the core of the securities regulation regime in the United States is mandatory disclosure.[9] Section 5 of the

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8. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

9. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: ESSENTIALS 23 (2008). The purpose of the Securities Act of 1933 is "[t]o provide full and fair disclosure of the character of securities sold in interstate commerce and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74.

Securities Act of 1933[10] (hereinafter: the "Securities Act") requires, *inter alia*, that public offerings be registered and approved by the SEC in a costly process that entails the disclosure of detailed information in the registration statement and the prospectus. Such information includes a detailed description of the issuer's business, properties, transactions with management, legal proceedings, and executive compensation.[11]

Once securities are registered, the Securities Exchange Act of 1934[12] (hereinafter: the "Exchange Act") requires that public companies make extensive disclosure in annual, quarterly and current reports, proxy statements and other filings with the SEC. The annual report, filed on Form 10-K, is the most comprehensive of these reports, and includes, *inter alia*, a detailed description of the company's business, risk factors, audited financial statements, biographies of its officers and directors, their compensation and the securities they hold.[13]

Of great interest to investors, analysts and competitors is Item 303 of Regulation S-K, titled Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). As per this Item, the management is required to explain the company's results of operation in the past year and "[d]escribe any known trends or uncertainties" that management "reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."[14]

The quarterly report, filed on Form 10-Q, updates the company's results and includes unaudited financial statements.[15] A supplement to the annual and quarterly reports is the current report, which must be filed on Form 8-K within four business days following certain events, for example a change in control or in directors.[16]

This disclosure system has become even more demanding in the aftermath of the Sarbanes-Oxley Act of 2002.[17] Among others,

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10. 15 U.S.C. § 77e (2012).

11. *See* 1 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK §§ 6:24–:25, at 333–34 (2005).

12. 15 U.S.C. § 78a.

13. *See* U.S. Sec. & Exch. Comm'n, Form 10-K, *available at* http://www.sec.gov/about/forms/form10-k.pdf.

14. 17 C.F.R. § 229.303(a)(3)(ii) (2008).

15. *See* U.S. Sec. & Exch. Comm'n, Form 10-Q, *available at* http://www.sec.gov/about/forms/form10-q.pdf.

16. *See* U.S. Sec. & Exch. Comm'n, Form 8-K, *available at* http://www.sec.gov/about/forms/form8-k.pdf.

17. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. § 7241).

Section 302 of the Act requires company executives to certify that they reviewed the company's annual and quarterly reports, that the reports do not contain any misstatements or omissions, and that they disclosed to the company's auditors any weakness in the financial controls.[18]

Not only does going public impose costs on a company (such as high legal and accounting fees, management opportunity costs and the costs of losing the company's confidentiality), it also subjects the "company and its officers and directors to potential civil and criminal liability . . . ."[19] A notable example of this high liability exposure is Section 11 of the Securities Act. This section imposes civil liability on the issuers, and, subject to due diligence defenses, additional persons associated with either the issuer or the distribution, for a material misrepresentation or omission in a registration statement.[20] Similarly, Section 12(a)(2) imposes liability for material misrepresentations or omissions in the prospectus.[21] Criminal liability is imposed under Section 24 for willful violation of the Securities Act.[22]

Additional liability is imposed by the Exchange Act with respect to the company's reports and proxy statements.[23] Rule 10b-5 imposes liability for untrue statements or omissions of material fact "in connection with the purchase or sale of any security";[24] Rule 14a-9 targets misstatements and omissions of material facts in connection with the solicitation of proxies;[25] and Section 32(a) imposes criminal liability for any willful violation of the Exchange Act.[26]

The philosophy behind the disclosure regime is that it provides "the best protection for investors," as it puts investors "in a position to make an informed judgment whether or not to buy."[27] However, such protection is unavailable for investors who buy unregistered securities in the private market. For the latter, as described below,

18. *See id.* § 302.

19. William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 645 (2009).

20. *See* 15 U.S.C. § 77k (2012).

21. *See id.* § 77l(a)(2).

22. *See id.* § 77x.

23. *See infra* notes 24–26..

24. 17 C.F.R. § 240.10b-5(b) (2008).

25. *See id.* § 240.14a-9.

26. 15 U.S.C. § 78ff(a).

27. Adoption of Rule 144, Securities Act Release No. 5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) 3 (Jan. 11, 1972).

mandatory disclosure, liability provisions, and other regulatory requirements are much more limited.[28]

B. *The Private Market Sphere: Lax Sophistication-Based Regulation*

1. Section 4(a)(2)—Exemption for Private Offerings

The SEC exempts certain securities transactions[29] from the registration, prospectus, and gun-jumping requirements of Section 5 of the Securities Act. Perhaps the most significant exemption, under Section 4(a)(2) of the Securities Act (formerly Section 4(2)), exempts transactions "not involving any public offering,"[30] namely, private offerings. The underlying reasoning for such exemption is that private offerings are intended for sophisticated investors, who can adequately assess the risks of an investment without the protections of Section 5 of the Securities Act.[31] The easiest cases involve institutional investors, such as large investment banks or pension funds, which have the expertise and bargaining leverage to obtain all relevant information and protect their own interests.[32] More difficult cases involve individual investors, who have different degrees of expertise and bargaining leverage, as potential purchasers in a private offering.[33] It is in these cases where defining the scope of Section 4(a)(2) exemption becomes more complicated.

Initially, the SEC adopted a functional approach in identifying a private offering by considering the number of offerees and their relationship to each other and to the issuer, the amount of units offered, and the size and manner of the offering as factors of particular importance to the scope of the exemption.[34]

Nearly two decades later, the Supreme Court, in *SEC v. Ralston Purina Co.*, adopted a test that focuses on investors' ability to fend for themselves, particularly by having access to the kind of

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28. For a survey of some of the history of the public-private dichotomy, see Langevoort & Thompson, *supra* note 5.

29. This paper focuses on exempted transactions, and not on exempted securities under Section 3 of the Securities Act.

30. *See* 15 U.S.C. § 77d(2) (2008). The recent Jumpstart Our Business Startup Act amended Section 4(2), and it is now Section 4(a)(2).

31. CHOI & PRITCHARD, *supra* note 9, at 300.

32. JAMES D. COX ET AL., SECURITIES REGULATION CASES AND MATERIALS 266 (6th ed. 2009).

33. *Id.*

34. *See* CHOI & PRITCHARD, *supra* note 9, at 300; *see generally* Securities Act Release No. 285, Fed. Sec. L. Rep. (CCH) (Jan. 24, 1935).

information that would be included in a registration statement.[35] But this test left many open questions, such as: What constitutes access to information? Is insider status a condition precedent to a private offering? Is sophistication a substitute for information? Is a sophisticated representative a factor in measuring the scope of the exemption? How is sophistication defined? Despite attempts of courts, especially the Fifth Circuit, to deal with these issues,[36] issuers faced great uncertainties regarding the application of Section 4(a)(2). In addition to these uncertainties, restrictive interpretations of Section 4(a)(2) by courts and the growing criticism of the effect that the stringent securities regulation had on small businesses[37] led the SEC to promulgate Regulation D.[38] This set of rules provides safe harbors for issuers seeking exemption from the requirements of Section 5.[39]

2. Regulation D—The SEC's Safe Harbor for Private Offerings: From Sophistication to Wealth

Regulation D consists of three exemptions: Rules 504, 505, and 506.[40] Rules 504 and 505 were promulgated on the basis of Section 3(b) of the Securities Act, which authorizes the SEC to exempt offerings that do not exceed an aggregate amount of $5 million if registration is not necessary in the public interest and for the protection of investors.[41] Rule 506, on the other hand, was promulgated on the basis of Section 4(a)(2) of the Securities Act, and it represents a nonexclusive safe harbor for this private offering exemption.[42]

The exemptions of Regulation D have a sliding-scale character.[43] Rule 506 does not limit the aggregate private offering amount and

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35. 346 U.S. 119,125 (1953).

36. *See* COX ET AL., *supra* note 32, at 271–73.

37. Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 356 (1984).

38. 17 C.F.R. §§ 501–508 (2008).

39. *Id.*

40. *See id.* §§ 230.504–230.506.

41. *See* Warren, *supra* note 37, at 361–74. The exemption under Section 3(b) had been increased tenfold in a four-year period: from $500,000 to $1,500,000 in May 1978, then to $2,000,000 in October 1978, and two years later to $5,000,000. *See* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 59 (1983).

42. *See* Warren, *supra* note 37, at 374–78.

43. COX ET AL., *supra* note 32, at 282.

the number of "accredited investors" who purchase the exempt securities.[44] Non-accredited investors are limited to thirty-five, and they must meet sophistication standards and must be given specified information.[45] Rule 505 limits the aggregate offering amount to $5 million, but, similarly to Rule 506, does not limit the number of "accredited investors"" who purchase the exempt securities.[46] Non-accredited investors must be given specified information, but unlike Rule 506, there is no sophistication requirement.[47] Rule 504 limits the aggregate offering amount to $1 million but does not limit the number of purchasers and does not require affirmative disclosure or sophistication.[48]

The term "accredited investor," which is important for the application of Rules 505 and 506, is defined in Rule 501.[49] Among the classes of accredited investors are various financial institutions, certain pension plans, organizations exceeding a certain size, an issuer's officers and directors, and certain natural persons.[50] Regarding natural persons, the SEC adopted two definitions: one based on an individual's net worth, and another based on the individual's income.

Recently, section 413(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter: the "Dodd-Frank Act") required the SEC to adjust the "accredited investor" definition pertaining to a natural person by excluding from the $1 million net worth threshold the value of the investor's primary residence.[51] Such exclusion is important, as the dollar amounts regarding a natural person's net worth have not been revised since 1982. The SEC itself noted that due to inflation and sustained growth in wealth, many more individuals meet the accredited investor's threshold than when the standards were initially set. Many of these individuals may not be able to appreciate the risks of investing in private offerings.[52] It

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44. *See* 17 C.F.R. § 230.506.

45. *Id.*

46. *Id.* § 230.505.

47. *Id.*

48. *Id.* § 230.504.

49. *Id.* § 230.501.

50. 17 C.F.R. § 230.501(a). The SEC's authority on this issue is derived from section 2(15) of the Securities Act.

51. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 § 413 (2010); Net Worth Standard for Accredited Investors, 76 Fed. Reg. 20, 5307 (Jan. 31, 2011) (codified at 17 CFR pt. 230, 239, 270, 275).

52. *See* Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733 (2009);

should be noted, however, that the SEC has not been required to change the "accredited investor" definition regarding a natural person's annual income, which has to exceed $200,000 (or $300,000 combined with spousal income) in each of the two most recent years, with a reasonable expectation of reaching the same level in the current year.

The accreditation objective standard assumes that an investor's wealth is a proxy for a determination that such investor is capable of fending for herself, either because she is sophisticated or because she can hire a knowledgeable advisor.[53] Thus, whereas under *Ralston Purina* and the line of cases that followed, "private placement purchasers had to be smart, now they need only be rich."[54]

Under this new assumption, unlike the common investor in the public market, an accredited investor does not need the protection of the Securities Act.[55] Accordingly, under Regulation D there is no mandatory disclosure to accredited investors,[56] and liability for fraud is pursuant to Section 10(b) and Rule 10b-5 of the Exchange Act, rather than the heightened liability under Section 11 of the Securities Act.[57] Indeed, many issuers choose to limit their Rule 506 offerings to accredited investors in order to avoid the affirmative disclosure requirement, as well as inquiries into the ambiguous and risky sophistication requirement.

3. Resales of Securities Purchased in Private Offerings

The private offerings exemption of Section 4(a)(2) (and Regulation D's safe harbors) is a transaction exemption for *issuers*, resulting in restricted securities as to which resale is limited.[58] "In order to make [the exemption meaningful], it was necessary for the

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Securities Act Release No. 33-8766, 72 Fed. Reg. 400, 404 (proposed Jan. 4, 2007).

53. Finger, *supra* note 52, at 747.

54. C. Edward Fletcher III, *Sophisticated Investors Under the Federal Securities Laws*, 6 DUKE L.J. 1081, 1123 (1988).

55. *See* Roberta S. Karmel, *Regulation by Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L.J. 681, 683 (2008).

56. The Rule notes that the company should consider providing accredited investors any information it provided to non-accredited investors "in view of the anti-fraud provisions of the federal securities laws." *See* 17 C.F.R. § 230.502(b)(1) (2008). In addition, the company is required to provide all purchasers, including accredited investors, "the opportunity to ask questions and receive answers concerning the terms and conditions of the offering . . . ." *See id.* § 230.502(6)(b)(3)(D)(v).

57. Karmel, *supra* note 55 at 683, 687.

58. 17 C.F.R. § 230.502(d).

SEC to create [clear] regulation for resales of securities purchased in a private [offering] . . . ."[59]

Section 4(1) of the Securities Act exempts "transactions by any person other than an issuer, underwriter, or dealer" from the requirements of Section 5.[60] Thus, a seller of unregistered securities may fall into the broad definition of an "underwriter," which includes "any person who has purchased from an issuer with a view to . . . the distribution of any security."[61] "For example, a [h]older who purchases securities from an issuer for cash and quickly resells the securities in a normal broker transaction" is probably considered an underwriter.[62] In addition, such a resale can destroy an issuer's transactional exemption, for example the private offerings exemption, since the securities have not "come to rest" in the hands of the purchaser.[63] But the courts were unclear as to how much time constitutes investment intent and what would be considered as a "distribution."[64]

To address the uncertainties of private offering investors, the SEC promulgated Rule 144.[65] A seller satisfying the conditions of such safe harbor is deemed not to be engaged in a distribution and therefore not an underwriter.[66] "The Rule initially imposed a two year holding period on purchasers in private placements, but the rule has been liberalized over the years" and now imposes a one year holding period for securities of non-reporting issuers (and six months for reporting issuers).[67] Moreover, Rule 144 neither requires that the securities be sold to an accredited investor, nor includes an explicit disclosure requirement regarding non-affiliate sellers.[68]

The intention of this liberalization of the resale requirements was "to help companies to raise capital more easily and less expensively."[69] However, it casts doubts on the consistency of these resale rules with investor protection. While purchasers of securities

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59. Karmel, *supra* note 55, at 688.

60. 15 U.S.C. § 77d(a)(1) (2012).

61. *Id.* § 77b(a)(11).

62. Rutheford B. Campbell, *The SEC's New Resale Rules: A Major Advanced in Intelligibility and Sound Policy 11*, (Jan. 28, 2010) (working paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1543955.

63. *Id.* at 12–13.

64. *Id.* at 13 n.24.

65. 17 C.F.R. § 230.144 (2008).

66. *Id.*

67. Karmel, *supra* note 55, at 10; Revisions to Rule 144 and 145, 72 Fed. Reg. 71, 546 (Dec. 17, 2007).

68. *See* 17 C.F.R. § 230.144(b)(1)(ii).

69. Revisions to Rule 144 and 145, 72 Fed. Reg. 71,546, 71,549 (Dec. 17, 2007).

under Regulation D must be accredited and thus can presumably fend for themselves, purchasers of such securities under Rule 144, who are not necessarily accredited, may not be able to protect their interests.

A more specific safe harbor is Rule 144A, which applies to resales of unregistered securities to "qualified institutional buyers" (commonly known as QIBs)—various financial institutions that meet certain financial requirements.[70] To help lure foreign issuers into the U.S. capitals market, the SEC promulgated Rule 144A in 1990.[71] It represents the SEC's perception that large financial institutions need less protection.[72] Accordingly, the Rule imposes limited information requirements and does not require a holding period.[73]

Finally, the so-called Section 4(1½) exempts control person resales from the requirements of Section 5.[74] Section 4(1½) does not exist in the Securities Act; it was created by the Eighth Circuit in *Ackerberg v. Johnson* and refers to the interpretation of an underwriter in Section 4(1) using the Section 4(a)(2) doctrine of sophistication as reflected in *Ralston Purina* and other cases.[75] In the *Ackerberg* case, the court found that the buyer was able to fend for himself. Consequently, the court held that the brokerage firm, in assisting the control person in the resale, was not an underwriter.[76] Although less certain, this exemption may be helpful in cases where a control person is unable to bring his sale within Rule 144.

C. *The Transition between Private and Public*

Usually, a company has the option whether to go public or stay private.[77] Although going public has benefits, such as access to capital and increased liquidity, it also has substantial costs, which include high fees and commissions to the underwriters, legal counsels and auditors, and later the costs of complying with an onerous disclosure system.[78] Hence, a company should conduct a

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70. *See* 17 C.F.R. § 230.144A.

71. CHOI & PRITCHARD, *supra* note 9, at 366.

72. *Id.*

73. *See* § 230.144A.

74. *See* Ackerberg v. Johnson, 892 F.2d 1328, 1335 n.6 (8th Cir. 1989).

75. *See* COX ET AL, *supra* note 32, at 380–86.

76. *Ackerberg*, 892 F.2d at 1337; *see* CHOI & PRITCHARD, *supra* note 9, at 349–51.

77. *See* Sjostrom, *supra* note 19, at 641.

78. *See generally id.* at 641–43 (describing various advantages and disadvantages of a publicly held corporation).

careful cost and benefit analysis before making the decision to go public.

However, under the Exchange Act, a company may be forced to go public in certain circumstances. As per Section 12(g)(1) of the Exchange Act, issuers with total assets exceeding $10 million and more than the minimum number of record holders of their equity securities[79] must register that class of equity securities under the Exchange Act.[80] Until recently, the holder of record threshold for issuers (other than banks and bank holding companies) was 500.[81] The new Jumpstart Our Business Startups Act (hereinafter: the "JOBS Act")[82] increased such threshold to 2,000 persons, or 500 persons who are not accredited investors.[83] Importantly, issuers may exclude employees in calculating the number of holders of record.[84] This is a dramatic increase, resulting in more than two-thirds of all public companies below this threshold.[85]

An important question in this regard is whether selling to pooled investment vehicles should count as selling to a single shareholder. Rule 12g5-1(a) of the Exchange Act suggests that it should, by counting any corporation, partnership, or trust as a single shareholder.[86] However, the Rule does not address the use of special purpose vehicles to allow investors to have access to investments in private companies.[87]

This issue was addressed in early 2011, when Goldman Sachs & Co. planned to set up a fund that would pool money from accredited

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79. The shareholders "of record" basis has been criticized as archaic. Nowadays, shares are usually held in the street names of broker-dealers, so the record no longer describes the real number of shareholders in a company. *See* Langevoort & Thompson, *supra* note 5, at 341, 349.

80. 15 U.S.C. § 78l(g)(1) (2012).

81. *Id.*

82. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

83. *Id.* at 325.

84. John Coates & Robert Pozen, *Bill to Help Businesses Raise Capital Goes Too Far*, WASH. POST, Mar. 14, 2012, http://www.washingtonpost.com/opinions/bill-to-help-businesses-raise-capital-goes-too-far/2012/03/13/gIQAVWgFCS_story.html.

85. *Id.*; Langevoort & Thompson have argued that this is "a de facto repeal of Section 12(g), rendering the shareholder threshold no longer a binding constraint in terms of requiring companies to step up to the disclosure and other obligations of the 1934 Act." Langevoort & Thompson, *supra* note 5, at 341.

86. 17 C.F.R. § 240.12g5-1(a)(2) (2011).

87. *See Is Facebook Really Worth $50 Billion?*, ECONOMIST, Jan. 8, 2011, *available at* http://www.economist.com/node/17853336?story_id=17853336&fsrc=nwl.

investors to invest in Facebook Inc.[88] But due to "intense media coverage," Goldman Sachs chose to limit this private placement to investors outside the U.S.—out of fear of breaching the general solicitation ban.[89] Although the event caught the SEC's attention and brought the threshold for registration to the fore,[90] the question of pooled investment vehicles has remained unanswered.[91]

Another important regulatory limitation that the JOBS Act relaxed pertains to general solicitation. With regard to private offerings under Section 4(a)(2) of the Securities Act, "the SEC has adhered to [the] subtextual principle [that] any 'general solicitation' of investors[—even sophisticated—] is necessarily inconsistent with the notion of a nonpublic offering."[92] This restriction was later promulgated in Rule 502(c) of Regulation D, which applies to Rule 505 and 506 offerings.[93]

Many have criticized the ban on general solicitation, arguing that it imposes a significant obstacle to fulfilling the Internet's potential and the opportunities it creates for small businesses.[94]

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88. *Id.*

89. *See A Risk Too Far*, ECONOMIST, Jan. 22, 2011, *available at* http://www.economist.com/node/17969917.

90. *See* Kathleen L. Casey, Comm'r, U.S. Sec. & Exch. Comm'n, Keynote Address at the Society of Corporate Secretaries and Governance Professionals 65th Annual Conference (June 29, 2011); *see also* Letter from Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, to Darrell E. Issa, Chairman, Comm. on Oversight & Gov't Reform, U.S. House of Representatives (Apr. 6, 2011) (describing the policy questions raised by special purpose vehicles that hold private company shares); *The Future of Capital Formation: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 16 (2011) (statement of Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm'n) ("[B]oth the question of how holders are counted and how many holders should trigger registration need to be examined."); Peter Lattman, *Stock Trading in Private Companies Draws S.E.C. Scrutiny*, DEALBOOK (Dec. 27, 2010, 10:06 PM), http://dealbook.nytimes.com/2010/12/27/stock-trading-in-private-companies-draws-scrutiny/; Julianne Pepitone, *SEC Casts Wide Net in Private Stock Trading Probe*, CNNMONEY (Feb. 28, 2011, 7:57 AM), http://money.cnn.com/2011 /02/27/technology/secondary_market/.

91. For an analysis of the question and the Facebook example, see Langevoort & Thompson, *supra* note 5.

92. Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 4 (1998).

93. 17 C.F.R. § 230.502(c).

94. *See, e.g.*, Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 125 (1989) ("[T]he public interest is best served by deregulating the capital formation process for small business to the fullest extent possible without unduly diminishing investor protection."); Langevoort, *supra* note 92, at 25 ("Any form of general solicitation should be permissible so long as the offering is made

Such criticism turned out to be fruitful. Section 201 of the JOBS Act eliminated the solicitation ban of Rule 506, provided that all purchasers of an issuer's securities are accredited investors.[95] In July 2013, the SEC implemented the JOBS Act requirement.[96] The amendment to Rule 506 permits an issuer to engage in general solicitation provided that all purchasers of its securities are accredited investors and the issuer takes reasonable steps to verify that such purchasers are accredited investors.[97] The amendment also includes a non-exclusive list of methods that the issuer may use to satisfy the verification requirement.[98]

The JOBS Act also eliminated the ban on general solicitation with respect to Rule 144A.[99] The SEC's amendment to Rule 144A provides that securities may be offered pursuant to Rule 144A to persons other than QIBs, including by means of general solicitation, provided that such securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe to be QIBs.[100]

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available only to accredited investors."); William K. Sjostrom, Jr., *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 3–4, 34 (2004) (arguing that the prohibition on general solicitation has no ideological foundation and that "[t]he ban is simply the product of the historic statutory basis of the private placement exemptions entrenched by the over-lapping federal and state regulation of securities offerings.").

95. Pub. L. No. 112-106, sec. 102, 126 Stat. 306, 313 (2012).. Note that Section 201(a)(2) eliminates the solicitation ban of Rule 144A, provided that securities are sold only to qualified institutional buyers. *Id.* at 314. On SecondMarket's successful lobbying efforts, see *Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enter. of the H. Comm. on Fin. Serv.*, 112th Cong. (2011) (statement of Barry E. Silbert, Founder & CEO SecondMarket), *available at* http://financialservices.house.gov/uploadedfiles/092111si lbert.pdf; Phil Mattingly, *Startup SecondMarket Gets Lobbying Win in Gridlocked Congress*, BLOOMBERG (Nov. 9, 2011, 12:01 AM), http://www.bloomberg.com/news/2011-11-09/startup-secondmarket-gets-lobbying-win-in-gridlocked-congress.html.

96. Press Release, U.S. Sec. & Exch. Comm'n, *SEC Approves JOBS Act Requirement to Lift General Solicitation Ban* (July 10, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782#.VJD-dKTF8wx.

97. JOBS Act § 201, 126 Stat. at 313–14.

98. *See* Press Release, U.S. Sec. & Exch. Comm'n, *Eliminating the Prohibition on Gen. Solicitation & Gen. Adver. in Certain Offerings* (July 10, 2013), *available at* http://www.sec.gov/news/press/2013/2013-124-item1.htm. But issuers that are conducting Rule 506 offerings without the use of general solicitation are not subject to the new verification rule. *Id.*

99. JOBS Act § 201, 126 Stat. at 313.

100. *Id.*

These changes—both the increase of the holder of record threshold and the elimination of the ban on general solicitation—will enable private companies to stay private longer by giving them the opportunity to reach out to new investors without triggering the costly obligations of the public market.[101] As discussed later, the new regulatory changes are also expected to affect the Secondary Market and perhaps to give it a better chance to thrive.[102]

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This overview is intended to highlight that existing securities regulation imposes strict requirements regarding public offerings, while maintaining lax requirements regarding private offerings. Such regulation assumes that in contrast with investors in public markets, private markets investors can fend for themselves. However, the next chapter argues that the rapid growth of a secondary market for private company stocks has revealed conspicuous cracks in the wall of separation between the markets and their participants. Such cracks call for a reexamination of the current regulatory regime with respect to investor protection in the Secondary Market.

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101. The new rules with respect to the transition between private and public have been recently criticized by scholars, who have suggested different criteria. *See* Guttentag, *supra* note 5, at 151, 156–57 (suggesting three categories of companies instead of two: 1) firms that receive an automatic exemption from compliance with the disclosure rules—Guttentag presents "evidence that firms with less than $35 million in market capitalization or fewer than 100 beneficial owners should be granted an automatic exemption from mandatory compliance," 2) firms that receive a contingent exemption from compliance with the disclosure rules if they place significant restrictions on the tradability of their shares or commit to participate in an acceptable alternative disclosure regime, and 3) firms that are required to comply with the disclosure rules); Langevoort & Thompson, *supra* note 5, at 342 ("[C]ontemporary securities regulation should have two distinct tiers of companies [:] . . . smaller companies [should] face[] only core disclosure obligations [while] companies with a larger societal footprint [should face] "[f]ull publicness treatment"); Pritchard, *supra* note 5, at 5 ("[A] two-tier market for both primary and secondary transactions keyed to investor sophistication [should replace initial public offerings]. The private market would be limited to accredited investors, while the public market would be accessible to all. The transition between the two would be triggered by an easily-measured quantitative benchmark—market capitalization or trading volume—which would allow companies to elect public status after reaching that threshold.").

102. *See* Sarah McBride, *Analysis: Relaxed U.S. Securities Laws Could Boost SecondMarket*, REUTERS, (Dec. 21, 2011 2:26 PM), http://www.reuters.com/article/2011/12/21/us-secondmarket-laws-idUSTRE7BK19R20111221.

III. THE RISE OF THE SECONDARY MARKET

The Secondary Market evolved shortly after the burst of the dot-com bubble in the late 1990s.[103] Since then, it has expanded rapidly to reach sales exceeding a billion dollars a year.[104]

The Secondary Market platform enables trading of private company shares, thus creating opportunities for investors and employees to sell their interests even before the first exit event.[105]

Several factors have contributed to the proliferation of Secondary Market transactions. First, the sharp decrease in IPOs over the last decade[106] has encouraged investors to search for alternative exits.[107] Many have blamed the Sarbanes-Oxley Act of 2002 for the decrease in IPOs (and the increase in "going private" transactions), given that the Act substantially increased the disclosure, litigation, and opportunity costs of public companies.[108] Indeed, a 2008 survey

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103. Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 16 (2012).

104. *Id.*; *see also* DAN BURSTEIN & SAM SCHWERIN, *Inside the Growing Secondary Market for Venture Capital Assets*, *in* MILLENNIUM TECHNOLOGY VALUE PARTNERS, L.P., 5 (2008), *available at* http://www.mtvlp.com/files/resources/burstein.pdf ("[I]f only two to three percent of the total volume of invested capital were to change hands in secondary transactions in a given year (a very modest 'churn' factor for most financial markets), we can envision a direct secondary market of $6 billion to $12 billion on an annual basis."); HANS SWILDENS, INDUSTRY VENTURES, VENTURE CAPITAL SECONDARY FUNDS – THE THIRD OPTION 3 (2008), *available at* http://www.industryventures.com/Venture_Capital_Secondaries_White_Paper.pdf ("In 2007, direct secondary venture investment in the U.S. surpassed $1.25 billion . . ."); Jean Eaglesham, *U.S. Eyes New Stock Rules*, WALL ST. J., Apr. 8, 2011, http://online.wsj.com/article/SB10001424052748704630004576249182275134552.html (indicating that according to NYPPEX, research firm and broker-dealer, the value of transactions in private-company shares grew from $2.4 billion in 2009 to $4.6 billion in 2010).

105. *See* Ibrahim, *supra* note 103, at 15.

106. The average number of IPOs plummeted from 310 per year in the period from 1980–2000, to 102 in the years 2001–2012. Xiaohui Gao Bakshi et al., *Where Have All the IPOs Gone?*, (Aug. 26, 2013) (working paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954788&rec=1&srcabs=2184961&alg=1&pos=1; *see also* Kate Burgess et al., *A Market Less Efficient*, FIN. TIMES, Nov. 13, 2011, http://www.ft.com/intl/cms/s/0/f80462a0-0c7f-11e1-88c6-00144feabdc0.html#axzz3PBxkJZS7 (analyzing the decline in IPOs in the U.S. and in Europe).

107. *See* Ibrahim, *supra* note 103, at 2–3.

108. *See, e.g.*, William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 EMORY L.J. 141, 147 (2006); Dale A. Oesterle, *The High Costs of IPOs Depresses Venture Capital in the United States*, 1 ENTREPRENEURIAL BUS. L.J. 369, 370 (2006); Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 252 n.92 (2009); Sjostrom, *supra* note 19, at 658.

conducted by Financial Executives International found that the total average costs of compliance with Section 404 of the Act alone (which requires public companies to establish and evaluate internal control over financial reporting) were $1.6 million per U.S. accelerated filer.[109]

Others have pointed to market structure changes, and specifically the transition from fractional to decimal quoting and trading, as the cause of the decline in IPOs.[110] As the accounting firm Grant Thornton suggests, with stock spreads that are recorded in increments of $0.01 per share and lower online brokerage commissions, it becomes easier for investors to engage in speculation activity and harder for small companies to attract research and investors.[111]

In a recent article, Xiaohui Gao *et al.* suggest an alternative explanation that does not focus on a firm's choice between being public or private but rather on the choice between staying small or becoming large.[112] They argue that instead of going public, firms are being acquired in order to realize economies of scale in a larger organization.[113] In other words, IPOs have declined due to a structural shift "in the economy that has reduced the profitability of small companies, whether public or private."[114]

These explanations go beyond the explosion of the dot-com bubble in the early 2000s and the financial crisis of 2008–2009 and imply a long-term decline in IPOs. The Secondary Market offers more liquidity in this dry capital market.

Another contributor to the growth of the Secondary Market is the increase in employee incentives in the last two decades.[115] The underlying factors of the equity-based compensation trend are cash constraints (especially in young companies), employee attraction and

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109. FIN. EXECUTIVES INT'L, FEI AUDIT FEE SURVEY: INCLUDING SARBANES-OXLEY SECTION 404, 12 (2008).

110. *See* DAVID WEILD & EDWARD KIM, MARKET STRUCTURE IS CAUSING IPO CRISIS 22 (2010), *available at* https://sharespost.com/site/assets/files/3057/market_structure_is_causing_the_ipo_crisis_and_more.pdf; David Weild, *How to Revive Small-Cap IPOs*, WALL ST. J. Oct. 27, 2011, http://online.wsj.com/article/SB10001424052970203554104577001522344390902.html.

111. WEILD & KIM, *supra* note 110, at 11, 16.

112. Gao et al., *supra* note 106, at 3.

113. *Id.* at 2.

114. *Id.* at 3.

115. *See* Robert Anderson IV, *Employee Incentives and the Federal Securities Laws*, 57 U. MIAMI L. REV. 1195, 1195 (2002); Corey Rosen, *Equity Compensation: Who Gets What?*, NAT'L CTR. FOR EMP. OWNERSHIP (Apr. 2012), http://www.nceo.org/main/article.php/id/7/.

retention for the vesting or restriction period, and accounting and tax considerations.[116] Private companies began using equity options in the 1980s to compensate a broad range of employees.[117] A survey conducted by the National Center for Employee Ownership found that 77% of venture capital-backed private companies in the technology and telecommunication business provided stock options to *all* employees, while 23% provided them only to selected employees.[118]

The growth in equity compensation has caused employees to search for markets to liquidate their securities. It should be noted, however, that restrictions on the transferability of stocks, such as the restriction period during which stocks cannot be traded or a company's right of first refusal, can create an impediment for Secondary Market transactions.[119]

In addition to these factors, Secondary Market transactions were facilitated by the 2008 amendments to Rule 144 and Rule 145 of the Securities Act. As mentioned previously, these amendments simplified the requirements of resales and reduced the minimum holding period of securities purchased in a private offering.[120] The relaxation of the rules facilitates Secondary Market's transactions, which are resales of private company shares.

Finally, the Secondary Market was boosted in 2009 by the launch of two electronic marketplaces: SecondMarket[121] and SharesPost.[122] These electronic platforms make it easier for buyers and sellers of private company stocks to find one another and set an efficient price by offering a "central location for trading" and posting recent bids or providing third-party research reports.[123] They also reduce transaction costs by offering standardized sales contracts, e-signature options, and escrow services.[124]

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116. *See* Spencer E. Ante, *SecondMarket Gets Its Own Funding*, WALL ST. J. (Nov. 2, 2011), *available at* http://online.wsj.com/article/SB10001424052970203707504577012303010455414.html ("Secondary liquidity is a great way to improve retention and recruit people.") (quoting Chamath Palihapitiya, a former Facebook vice president who will take a board seat at SecondMarket).

117. *See* Exemption of Compensatory Employee Stock Option from Registration under Section 12(g) of the Securities Exchange Act of 1934, 72 Fed. Reg. 37608 (July 10, 2007) (codified at 17 C.F.R. § 240.12h-1), *available at* http://www.sec.gov/rules/proposed/2007/34-56010fr.pdf.

118. *See id.* at 37608 n.4.

119. *See infra* note 173 and accompanying text.

120. *See* Campbell, *supra* note 62, at 8.

121. SECONDMARKET, http://www.secondmarket.com (last visited Dec. 5, 2013).

122. SHARESPOST, http://www.sharespost.com/ (last visited Dec. 5, 2013).

123. Ibrahim, *supra* note 103, at 37–38.

124. *Id.* at 38.

SecondMarket was launched in 2004 by Barry E. Silbert, a former investment banker, under the name Restricted Stock Partners, Inc.[125] In April 2009, after a year of development and pilot testing, SecondMarket expanded its online trading platform in illiquid assets, such as bankruptcy claims and structured products, to include private company stocks.[126] The platform has seen rapid growth. According to SecondMarket, it "completed over $500 million in private company transactions in 2011 alone, and saw $6.1 billion in buyside demand from institutional and accredited investors."[127]

SecondMarket allows only accredited investors to trade on its platform and has developed an online accreditation and verification process.[128] Potential investors are prompted to provide their income and networth and upload supporting documentation.[129] SecondMarket then reviews the information and provides a unique one year valid I.D. to those who are verified as accredited investors.[130]

SecondMarket treats prospective buyers as "participants," highlighting the notion that these are repeat buyers.[131] In March 2011, it announced a social network platform that allows participants to interact with each other and share investment ideas.[132] The company reportedly went over the 100,000 participants mark as of May 2012, representing a 94% increase year-over-year.[133]

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125. *Company Overview of SecondMarket, Inc.*, BLOOMBERG BUSINESSWEEK (Apr. 3, 2011, 9:26 AM), http://investing.businessweek.com/research/stocks/private/snapshot.asp.

126. Press Release, SecondMarket, *SecondMarket Launches Private Company Marketplace* (Apr. 23, 2009), https://www.secondmarket.com/discover/pressreleases/secondmarket-launches-private-company-marketplace.

127. *Capturing Growth: Public Equity Investors in the Private Markets*, SECONDMARKET, (July 11, 2012), https://www.secondmarket.com/education/secondary-markets/capturing-growth-public-equity-investors-in-the-private-markets.

128. *Accreditation Verification on SecondMarket*, SECONDMARKET, http://www.secondmarket.com/education/avp (last visited Sept. 17, 2013).

129. *Id.*

130. *General Solicitation Solution*, SECONDMARKET, https://www.secondmarket.com/education/landing/general-solicitation-solution (last visited Sep. 25, 2014).

131. *About Us*, SECONDMARKET, https://www.secondmarket.com/education/about-us (last visited December 3, 2014).

132. Press Release, SecondMarket, *SecondMarket Unveils Next Generation Investment Platform*, (Mar. 14, 2011), *available at* https://www.secondmarket.com/discover/pressreleases/secondmarket-unveils-next-generation-investment-platform.

133. *See* Comment Letter from Annemarie Tierney, General Counsel, SecondMarket, to SEC (May 25, 2012), *available at* http://www.sec.gov/comments/jobs-title-ii/jobstitleii-16.pdf.

SecondMarket is a registered broker-dealer and member of Financial Industry Regulatory Authority ("FINRA"), Securities Investor Protection Corporation ("SIPC"), and Municipal Securities Rulemaking Board ("MSRB").[134] As reported, the average trade on SecondMarket is $2 million,[135] but the minimum trade is much lower.[136] SecondMarket has recently partnered with AngelList, a platform for startups to meet investors, talent, and incubators, to enable accredited investors to invest "as little as $5,000, and in some cases even less," alongside larger investors.[137]

SharesPost was founded in January 2009 by Greg Brogger, a former entrepreneur and former securities lawyer.[138] According to Brogger, SharesPost attracted 7,000 registered users and hosted more than $1 million in private company share transactions in its first three months.[139] As of September 2010, SharesPost had 25,000 registered users, out of which 5,000 completed an investor suitability questionnaire and hosted more than $100 million in total transactions.[140] Six months later, the number of registered members increased to 60,000, with 16,000 members who qualified themselves as accredited investors.[141]

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134. *Company Overview*, SECONDMARKET, https://www.secondmarket.com/about-us (last visited Oct. 24, 2014).

135. Douglas MacMillan, *Facebook, Zynga Impose Fees on Private Sales of Shares*, BLOOMBERG (Oct. 11, 2010, 1:21 PM), http://www.bloomberg.com/news/2010-04-21/linkedin-zynga-may-use-stock-sale-limits-to-curb-pre-ipo-value-inflation.html.

136. *SecondMarket + AngelList: Q&A with SecondMarket Founder and CEO Barry Silbert*, SECONDMARKET BLOG, http://blog.secondmarket.com/post/38323685099/secondmarket-angellist-team-up-to-provide-investors (mentioning in a video that that the minimum trade can be "$5,000 and in some cases even less") (last visited Sept. 25, 2014).

137. *Id.*; Tomio Geron, *AngelList, with SecondMarket, Opens Deals to Small Investors for as Little as $1K*, FORBES, Dec. 19, 2012, *available at* http://www.forbes.com/sites/tomiogeron/2012/12/19/angellist-with-secondmarket-opens-deals-to-small-investors-for-as-little-as-1k/; Garett Sloane, *New Venture Capital Platform Opens Door to Small Investors*, N. Y. POST, Oct. 17, 2012, http://nypost.com/2012/10/17/new-venture-capital-platform-opens-door-to-small-investors/.

138. *SharesPost Fact Sheet*, SHARESPOST, http://sharespost.com/site/assets/files/3093/2014_march_sharespost_fact_sheet.pdf (last visited Oct. 25, 2014).

139. Pui-Wing Tam, *SharesPost Ramps Up*, WALL ST. J. BLOG (Sept. 3, 2009 6:54 PM), http://blogs.wsj.com/digits/2009/09/03/sharespost-ramps-up/.

140. Brian Deagon, *SharesPost Facilitating Trades In Private Firms*, INVESTOR'S BUS. DAILY (Sep. 1, 2010), *available at* http://news.investors.com/technology-tech-exec-qanda/090110-545710-sharespost-facilitating-trades-in-private-firms.htm.

141. Jay Yarow, *Are We Headed for Disaster with Private Stock Markets?*, BUS. INSIDER (Mar. 22, 2011, 5:27 PM), http://www.businessinsider.com/sharespost-interview-2011-3.

Initially, SharesPost was structured as a passive online bulletin board.[142] However, after being accused by the SEC of operating as a broker-dealer and paying penalties, it acquired a company with a broker-dealer license.[143]

SharesPost's model is to enable a minimum transaction size of $25,000 and thus be more accessible to retail investors.[144] The average trade is about $200,000.[145]

SharesPost charges a commission fee that ranges up to 5% or $5,000, whichever is greater, for transactions between a single buyer and a single seller, in addition to other fees such as escrow, transfer, and legal opinion expenses.[146]

Like SecondMarket, SharesPost requires that all buyers be accredited investors and be registered members with their own SharesPost account and password.[147]

The shares sold in the Secondary Market are mostly shares of high-profile, mature start-up companies.[148] Companies that had shares traded on the Secondary Market before their IPO include Facebook Inc., LinkedIn Corp. and Groupon Inc.[149] Companies trading their shares now include Twitter Inc., Pinterest, Waze, Care.com, and Stripe.[150]

Additional electronic marketplaces, such as Gate Technologies LLC,[151] have recently entered into the Secondary Market space,

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142. Order Instituting Administrative Cease-And-Desist Proceedings, Exchange Act Release No. 66594 (March 14, 2012), *available at* https://www.sec.gov/litigation/admin/2012/34-665 94.pdf.

143. Julianne Pepitone, *SEC Crackdown Ends Wild West Days of Private Stock Trades*, CNNMONEY (Mar. 15, 2012, 11:25AM), http://money.cnn.com/2012/03/14/technology/sec-sharespost-secondary-trading/index.htm.

144. Yarow, *supra* note 141.

145. Richard Teitelbaum, *Facebook Drives SecondMarket Broking $1 Billion Private Shares*, BLOOMBERG MARKETS MAGAZINE, Apr. 27, 2011, *available at* http://www.bloomberg.com/news/2011-04-27/facebook-drives-secondmarket-broking-1-billion-private-shares.html.

146. *Frequently Asked Questions for Shareholders*, SHARESPOST, https://welcome.sharespost.com/resources-and-insights/faqs/seller-faqs (last visited Sept. 17, 2013).

147. *Frequently Asked Questions for Investors*, SHARESPOST, https://welcome.sharespost.com/resources-and-insights/faqs/buyer-faqs (last visited Sept. 17, 2013).

148. *Frequently Asked Questions*, SECONDMARKET, https://www.secondmarket.com/education/faq?t=fl#q2 (last visited Dec. 3, 2014).

149. Kim-Mai Cutler, *Pinterest, Warby Parker And Stripe Are The Rising Stars of SecondMarket In A Post-Facebook IPO World*, TECHCRUNCH, http://techcrunch.com/2012/05/03/pinterest-warby-parker-and-stripe-are-the-rising-stars-of-secondmarket-in-a-post-facebook-ipo-world/ (last visited Dec. 3, 2014).

150. *Id.*

151. GATE TECHNOLOGIES, http://gatetechnologies.com/ (last visited Dec. 5,

"riding the wave of exuberance over fast-growing consumer Internet companies."[152] Wall Street trading firms, including Cantor Fitzgerald & Co. and Liquidnet, have also expanded their trading to private company shares.[153]

Despite its steady growth and rapid development, the Secondary Market is only beginning to take shape and is facing serious challenges. Big private companies like LinkedIn, Groupon Inc., Pandora Media Inc., Zynga Inc., and Facebook Inc., the giant social media company, have recently gone public.[154] Some have argued that those exits pose a significant risk to electronic marketplaces, which will now have to attract new companies into their platforms.[155]

No less important are the regulatory obstacles that exist in the Secondary Market sphere. Secondary Market transactions are resales, "since the primary distribution was from the [issuer] . . . to the initial investor."[156] Thus, parties to Secondary Market transactions have to meet the requirements of Rules 144, 144A, or the so-called Section 4(1½) regarding control person resale. As discussed in Part I(B), Rule 144A's exemption can only be available when selling to a large institution.[157] Rule 144 is available to a broader group of buyers, but it imposes a holding period on sellers and additional requirements for sales by or for affiliates.[158] Those who participate in Secondary Market trading have to assure that such requirements are met.

As discussed above, both SecondMarket and SharesPost require that all buyers be "accredited investors" as defined in Regulation D, although Regulation D does not apply to resales, and Rule 144 allows anyone to buy. Since both Section 4(1½) and Rule 144A

2013).

152. *See* Ante, *supra* note 116, at 1.

153. *See id.*

154. *See id.*

155. Facebook's IPO created tremendous buzz with respect to the future of the Secondary Market. *See id.*; *see also* Steven Russolillo, *Public Problem: Private Markets Grapple With Tech IPOs*, WALL ST. J. (Oct. 31, 2011), *available at* Factiva, Doc. No. WSJO 000020111031e7av00105; Randall Smith, *Seeking 'Second' Life After Facebook*, WALL ST. J. (Apr. 11, 2012), *available at* Factiva, Doc. No. J000000020120 412e84c0000s; Erik Sherman, *Life After Facebook: Private Investment Markets Regroup*, INC. (May 23, 2012), http://www.inc.com/erik-sherman/life-after-facebook-private-investment-markets-regroup.html; Nitasha Tiku, *The Future of SecondMarket In a World Without Private Facebook Shares*, BETABEAT (Feb. 3, 2012, 11:28 AM), http://www.betabeat.com/2012/02/03/secondmarket-facebook-ipo-barry-sil bert-02032012/.

156. *See* Ibrahim, *supra* note 103, at 39.

157. *See supra* Part I(B).

158. 17 C.F.R. § 230.144.

require some sort of accreditation or sophistication, such a requirement would add consistency to buyers' qualification. In addition, this restriction serves a strategic purpose, as accredited investors, who are considered to be sophisticated, attract less scrutiny from regulators.[159] Although limiting the types of buyers to accredited investors may make compliance easier, it reduces the number of transactions and consequently these companies' profits.

Table A. Limitation on Purchasers in Private Offerings and Resales

	Regulation D (Private Offering)	**Rule 144** (Resale)	**Rule 144A** (Resale)	**Section 4(1½)** (A Control Person Resale)
Limitations on Purchasers	Accredited Investors[160]	—	Qualified Institutional Buyers	Able to Fend for Themselves

In addition to the above Securities Act limitations, and as discussed in Part I(C), Section 12(g) of the Exchange Act restricts the number of shareholders in private companies.[161] The holder of record threshold, which triggers a costly disclosure regime, gives private companies a strong incentive to limit the transferability of their shares and keep the number of their shareholders below the maximum threshold.[162] Understanding these considerations, SecondMarket has given companies full control of the trading of their shares in the Secondary Market by tailoring a program to fit

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159. Telephone Interview with Adam Oliveri, Head of the Private Company Market, & Aishwarya Iyer, Public Affairs, SecondMarket (Apr. 11, 2011).

160. Rule 504 does not require that buyers be accredited investors. 17 C.F.R. § 230.504. Under Rule 505, accredited investors are excluded from the limitation that the number of purchasers would not exceed thirty-five. 17 C.F.R. § 230.505. Under Rule 506, non-accredited investors must be sophisticated. 17 C.F.R. § 230.506.

161. *See supra* Part I(C).

162. *See* Brad Stone, *Silicon Valley Cashes Out Selling Private Shares*, BLOOMBERG BUSINESSWEEK (Apr. 2, 2011), *available at* http://www.businessweek.com/magazine/content/11_18/b4226070179043.htm (describing restrictions on transferability imposed by tech companies, such as charging fees for each sale of company shares, exercising the companies' right of first refusal, and giving restricted stocks instead of regular stock options).

the needs of every company, which can help decide who is eligible to buy or sell, how often the market is open, and what information to disclose.[163]

Although the new higher threshold under Section 12(g) substantially eases the monitoring burden on private companies, there is still a limit to the growth of private companies, and consequently, a limit to the trading volume in the Secondary Markets.

IV. THE PROMISE OF THE SECONDARY MARKET: INCREASED LIQUIDITY

A. Venture Capitalists (VCs)

The Secondary Market's main purpose is to increase the liquidity of shares and other interests that are not traded on a stock exchange or on the over-the-counter ("OTC") market. In the start-up sphere, the Secondary Market creates "a new path to liquidity" for investors such as VCs, who no longer have to wait for a traditional exit path such as an IPO or a sale of the start-up company.[164]

An early exit opportunity can be extremely valuable to investors in start-up companies.[165] The investment in such early stage companies is risky since it is characterized by uncertainties, information asymmetry, and opportunism.[166] It is extremely difficult to predict the profitability of a company at its early stages, especially if the scientific or technological basis and the quality of its management are still in the fog. Although entrepreneurs themselves face such uncertainties, they still have a substantial informational advantage, even if they choose to share some of the information with investors.[167] The concern for the investor is opportunism, which is derived from the option-like stake of the entrepreneur in the company.[168] Usually, the potential loss to the entrepreneur is small,

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163. *See* Erin Griffith, *SecondMarket Pivoted After Facebook's IPO. Now, Volume Is Higher Than Ever*, FORTUNE (July 25, 2014), http://fortune.com/2014/07/25/secondmarket-pivoted-after-facebooks-ipo-now-volume-is-higher-than-ever/ ("The company controls the rules, the price, who can sell and how much, not the external broker or some buyer that is scalping around for shares.").

164. Ibrahim, *supra* note 103, at 46–47.

165. *See* Ronald Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1075–76 (2003).

166. *See id.* (describing the risks associated with investing in early stage companies).

167. *Id.* at 1077–81.

168. *Id.* at 1077, 1083.

while the potential upside is large.[169] This may lead to the entrepreneur's willingness to take excessive risk—a willingness that is not shared by the investors.[170] Such opposing interests lead to conflict in issues such as risk level and timing of an exit event.[171]

To overcome, or at least mitigate uncertainties, information asymmetry, and opportunism, contracts between start-up companies and VCs include some special terms.[172] The most prominent provisions include staged investment, control rights granted to VCs, and controls on the compensation structure of the entrepreneur and the management team.[173]

To reduce their risk and in order to be able to monitor the development of the start-up company, VCs often invest in increments, as per milestones identified by the parties in advance.[174] This staged investment approach also incentivizes the entrepreneurs to meet the identified milestones in time, since a default may have "severe consequences," such as termination of the investment or investment at a lower valuation.[175]

Another common contractual tool that purports to reduce opportunism is granting control rights to VCs.[176] These rights are usually disproportionate to the VCs' holding stakes in the start-up company, and "include the right to hold board seats, the right to veto certain major management decisions, and shareholder voting rights."[177]

The compensation of the entrepreneur and management team is structured such that the management members get a relatively low salary, which is sometimes complemented by stock options that vest gradually after four or five years.[178] This structure is designed to incentivize entrepreneurs and management members to stay in the company and do their best in anticipation to reaping substantial

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169. *Id.* at 1084.
170. *Id.*
171. *Id.*
172. *Id.*
173. *Id.*
174. *See* Gilson, *supra* note 165, at 1073.
175. MICHAEL KLAUSNER & KATE LITVAK, *What Economists Have Taught Us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 60 (Michael Whincop ed., 2001).
176. *See* Gilson, *supra* note 165, at 1083.
177. KLAUSNER & LITVAK, *supra* note 175, at 63.
178. *Id.* at 62; Gilson, *supra* note 165, at 1083–84.

profit in the future,[179] thus aligning their interests more closely with those of the investors.

Although these contract provisions seem to be successful,[180] they are not perfect in eliminating uncertainties, information asymmetry, and opportunism. When such problems arise, the possibility of an early exit gives investors leverage: a valuable ability to threaten to withdraw their money in an attempt to resolve such conflicts or improve the investment's terms. An early exit also enables investors to actually cash out their investment and reinvest the money in a different company.

In addition, this cash recycling creates a valuable opportunity to recycle non-cash contributions, such as investors' advice and guidance. The ability to recycle non-cash contributions will be especially beneficial when the mature company has already gained experience and reputation, while the new company needs both cash and managerial assistance and guidance.[181]

The investment of the proceeds in a different company, or even several companies, may also allow investors to diversify their portfolios. Such diversification may reduce the risk associated with investing in untraded start-up company stocks.[182]

Given the advantages of investors' ability to exit, and in light of the recent decline in IPOs, the new form of early exit offered by the Secondary Market seems like an appealing alternative. However, there is one disadvantage and at least one problem in increasing the liquidity of start-up company shares through the Secondary Market.

The disadvantage of increased liquidity of start-up company shares is that it may reduce investors' supervision of such companies, and, consequently, may reduce the value of VCs' services. The problems associated with the risky investment in start-up companies have created strong incentives for VCs to monitor and supervise their portfolio companies. Indeed, VCs devote many hours to visiting the companies' headquarters, speaking with the

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179. KLAUSNER & LITVAK, *supra* note 175, at 62; Gilson, *supra* note 165, at 1083–84.

180. KLAUSNER & LITVAK, *supra* note 175, at 54–55 (referring to the high volume of funds invested with VCs and to the effectiveness of invested money in stimulating patents as an indication of the success of VCs contracts).

181. *See id.* at 58 ("By investing in companies that he advises, the VC in effect bonds the quality of his advice. To the extent that this advice is most valuable to a young company, the fact that the VC recycles cash from one young company to another allows him to continue using that cash to bond his advice to firms for which this advice is most valuable."); Gilson, *supra* note 165, at 1075–76.

182. *See* Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291 (1994).

companies' representatives, attracting new investors, evaluating strategies, and recruiting new management candidates.[183] This tight supervision explains VCs' preference to invest in companies that are geographically close to them.[184]

The data show that VCs' monitoring efforts bear fruit as they add value to the investment.[185] However, giving VCs an opportunity to sell their portfolio companies' shares at any time may reduce their incentives to monitor.[186] VCs may prefer to save the monitoring costs, knowing they would be able to sell their shares at any point.[187]

Darian Ibrahim argues that the concern of reduced incentives to monitor is mitigated by the fact that VCs often "sell only partial positions,"[188] but selling even partial positions may affect VCs' incentives, as they have less skin in the game.

The problem with the Secondary Market as a "new exit" path is that it does not create liquidity for every start-up company's shares. As mentioned above, the companies whose shares are traded on the Secondary Market are usually mature and well known. In Usha Rodrigues' words, "[a] major investor looking to liquidate thousands of shares of an early stage start-up would flood the market, thus automatically depressing the price. Moreover, the exploited VC would face a clear lemons problem, raising questions as to the motivation for selling."[189]

This problem, as well as reduced incentives to monitor as discussed above, cast doubt on the benefit and the usefulness of the

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183. Michael Gorman & William A. Sahlman, *What Do Venture Capitalist Do?*, 4 J. BUS. VENTURING 231, 242 (1989).

184. KLAUSNER & LITVAK, *supra* note 175, at 57; *see also* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (MIT Press 1999) (finding that the probability of a VC to sit on a company's board is related to proximity); Malcolm Baker & Paul A. Gompers, *The Determinants of Board Structure at the Initial Public Offering*, 46 J. L. & ECON. 569, 579 (2003) (finding that "the probability of venture capital financing is related to location of the firm").

185. KLAUSNER & LITVAK, *supra* note 175, at 55 ("The data show that VCs add value in screening investments, monitoring their portfolio companies, and facilitating the professionalization of these companies' management.").

186. *See* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3392 (2012–2013).

187. *See id.* ("By converting venture capital investment into something akin to an option, secondary markets might decrease venture capitalists' incentives to nurture and monitor the internal workings of their fledgling portfolio companies.").

188. Ibrahim, *supra* note 103, at 31.

189. Rodrigues, *supra* note 186, at 3410. For a contractual alternative for creating liquidity, which was adopted by Conduit Inc., see Ronen Shilo, *Fairness For Shareholders Who Bust Their Butts*, TECHCRUNCH (Sep. 22, 2012), http://techcrunch.com/2012/09/22/fairness-for-shareholders-who-bust-their-butts/.

Secondary Market to VCs, at least with respect to early stage companies.

B. Employees

Like VCs, employees can also benefit from increased liquidity. The Secondary Market has the potential to assist current and ex-employees in selling their shares to get cash when it is needed. Since exercising options costs money and has tax consequences, exercising and selling part of the issued shares on the Secondary Market can be a good way to finance the additional exercise of options. This path may be especially beneficial for ex-employees, who have a limited period of time—typically ninety days after the employee leaves the job—to exercise their options.[190] Those ex-employees usually need cash to exercise their options in the short window until their expiration.[191] In many public companies, employees can do a "cashless exercise" or "same-day-sale," where exercise and sale are done in a single transaction and the employee just receives the difference.[192] However, this cannot be done in private companies.[193] Although some private companies allow employees to give back to the company some of the exercised shares at their fair market value, selling part of the shares on the Secondary Market would probably be more profitable for employees.[194]

Unlike in the case of VCs, there seems to be no disadvantage with respect to increased liquidity for employees and ex-employees. Employees usually do not monitor the company, and the concern of them leaving the company after a short period of time is mitigated by the vesting requirements.

However, the lack of liquidity for early staged companies discussed earlier exists with respect to employees as well. For many employees in immature start-up companies, the Secondary Market will not be a very useful option. In such cases, other solutions should be considered.[195]

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190. *See* Max Schireson, *Startup Stock Options Explained*, MAX SCHIRESON'S BLOG (Aug. 23, 2011), *available at* http://maxschireson.com/2011/08/23/startup-stock-options-explained/.

191. *Id.*

192. *Id.*

193. *Id.*

194. *Id.*

195. For example, there are companies that offer funding in exchange for participation in the upside if the shares gain value. *See, e.g.*, THE EMPLOYEE STOCK OPTION FUND, http://www.esofund.com/ (last visited Sept. 6, 2013).

V. THE INCONSISTENCY OF THE SECONDARY MARKET WITH THE PRIVATE-PUBLIC DICHOTOMY

A. *The Erosion of the Sophistication Presumption: Entry of Non-Accredited Investors to the Private Market Sphere*

As opposed to private offering transactions, where both sellers and buyers are considered sophisticated, participants in the Secondary Market are mixed. The typical buyers are sophisticated investment funds and strategic buyers (both institutions and individuals), who yearn for access "to the most significant growth companies of tomorrow."[196] According to SecondMarket's third quarter report for 2011, accredited investors made up the largest share of buyers with 63% by dollar amount and 51.8% by number of transactions, followed by asset managers (22.3% and 27.7%, respectively), hedge funds (7.8% and 0.6%, respectively), VC funds (5.1% and 17.5%, respectively), broker dealers (1.3% and 1.2%, respectively), and secondary funds (0.4% and 1.2%, respectively).[197]

The sellers in the Secondary Market are entrepreneurs, VCs, large financial institutions and employees who hold start-up common stocks and search for liquidity. As of December 31, 2012, employees constituted the majority of sellers with 74.7% of total eligible sellers, followed by former employees (20.9%), investors (4.0%), and a small number of founders (0.4%).[198]

Such data show that Secondary Market's participants are not homogeneous. While the buyers consist of accredited investors (at least purportedly) and other sophisticated funds, the vast majority of the sellers are employees and ex-employees, who are not required to be accredited, and are not necessarily sophisticated. Indeed, it is common in private start-up companies to give equity-based compensation to all employees, and not only to selected executive

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196. *See* Business Wire, *SharesPost Launches to Bring Private Company Stock Liquidity to Early Stage Investors* (June 16, 2009, 9:00 AM), http://www.businesswire.com/news/home/20090616005461/en/SharesPost-Launches-Bring-Private-Company-Stock-Liquidity#.VGAWA1PF9vA [hereinafter "*SharesPost Launches*"]; *see also* Ibrahim, *supra* note 103.

197. *See* Erick Schonfeld, *Private Stock Transactions Up 73 Percent On SecondMarket*, TECHCRUNCH (Oct. 26, 2011), http://techcrunch.com/2011/10/26/private-stock-transactions-up-73-percent-this-year-on-secondmarket/.

198. Kim-Mai Cutler, *Employees Made Up Nearly Two-Thirds of Private Stock Sellers on SecondMarket Last Year*, TECHCRUNCH, http://techcrunch.com/2013/01/30/employees-made-up-nearly-two-thirds-of-private-stock-sellers-on-secondmarket-last-year/ (last visited Dec. 3, 2014).

personnel.[199] Most of those who receive equity-based compensation do not have access to the company's information and they "are just as much members of the investing "public" as any of their neighbors in the community."[200]

Thus, as opposed to accredited investors, who are presumably able to fend for themselves, the non-accredited sellers in the Secondary Market cannot. Not only are these investors unarmed with the kind of information that is available in the public market, but they also have weaker weapons in their litigation arsenal. Instead of the heightened liability of Section 11 of the Securities Act that targets misrepresentations in the registration statement, they may only use Rule 10b-5 under the Exchange Act. Under this Rule, they must prove, *inter alia*, scienter, reliance, and causation—none of which are elements of a Section 11 claim. In addition, reliance by itself would be more difficult to prove in the absence of efficient market.[201]

B. *The Limitations of Individual Accredited Investors*

The traditional dichotomy between public and private markets with regard to investor protection is problematic in the Secondary Market not only due to the penetration of non-accredited investors into the private market sphere, but also due to the refutation of the outdated assumption that all accredited investors can indeed fend for themselves. Such assumption has been undermined by recent academic research that questions whether sophisticated investors can exercise their skills with limited information, whether wealth is a valid proxy for sophistication, and whether sophisticated investors are immune to cognitive biases that affect investment decisions.

1. Limited Information

As discussed earlier, the disclosure requirements regarding private offerings and resales of private company securities are much narrower than the requirements imposed on public offerings. Consequently, the Secondary Market provides limited disclosure to investors who buy or sell shares of private companies.

As was reported, companies that are traded on SecondMarket have been required to disclose two years of audited financial since

199. *See* Rosen, *supra* note 115 and accompanying text.

200. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (referring to employees as purchasers).

201. *See* Basic Inc. v. Levinson, 485 U.S. 224, 241–47 (1988); Cammer v. Bloom, 711 F. Supp. 1264, 1273 n.10 (D.N.J. 1989).

2010.[202] In 2011, SecondMarket's CEO stated that in trades where the sellers are insiders, the company requires the disclosure of financial statements, a capitalization table, and risk factors.[203] The CEO said there was a "lower level of requirement" if the seller is not an insider.[204] He also stated that SecondMarket encourages, and will start requiring, a minimum disclosure of financial statements.[205]

SharesPost requires disclosure of even less information and provides only research reports it prepares and posts on its website.[206] These reports vary in quality, and may have undisclosed conflicts of interest.[207] Moreover, they are not as extensive as a prospectus would be for a publicly traded company.

Unlike SecondMarket, SharesPost discloses previous transaction prices on its website.[208] However, this information "may be of limited value if the other offers and transactions were also made without the information necessary to accurately price the stock."[209]

The limited disclosure and information available to investors on both platforms raises the question whether accredited investors (who are assumed to be sophisticated) can actually fend for themselves when provided with such limited information.[210] Since private

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202. *See* J. J. Colao, *'An Abomination That Should Stop': What's The Problem With Secondary Markets?*, FORBES (Jun. 29, 2012, 8:58 AM), http://www.forbes.com/sites/jjcolao/2012/06/29/an-abomination-that-should-stop-whats-the-problem-with-secondary-markets/2/; Steven M. Davidoff, *Private Markets Offer Valuable Service But Little Disclosure*, N.Y. TIMES DEALBOOOK (Nov. 22, 2011, 4:37 PM), http://dealbook.nytimes.com/2011/11/22/private-markets-offer-valuable-service-but-little-disclosure/ ("SecondMarket changed its business model in 2010 to require companies to provide two years of audited financials and other information to potential bidders. The exception is Facebook, the most actively traded stock on SecondMarket. For Facebook, there is no information requirement. Shareholders fly blind, relying on anything they can glean from almost anywhere but the companies themselves."); *see also* Teitelbaum, *supra* note 145 (reporting that companies can disclose "[a]s much or as little as they want[—]SecondMarket provides its customers only the financial data that firms are willing to provide").

203. *A New Vision for Capital Markets*, STAN. TECH. VENTURES PROGRAM ENTREPRENEURSHIP CORNER (Apr. 13, 2011), http://ecorner.stanford.edu/authorMaterialInfo.html?mid=2698, at 35:55–36:38.

204. *Id.*

205. *Id.*

206. Davidoff, *supra* note 202.

207. Pollman, *supra* note 5, at 209.

208. *Sharespost Private Company Share Prices Now on Bloomberg*, BLOOMBERG (Nov. 9, 2011), *available at* Factiva, Doc. No. INVWK00020111118e7bq000qw.

209. Pollman, *supra* note 5, at 210.

210. *See* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 991 (2006).

offering securities do not trade in well-developed markets, investors cannot rely on the pricing in those markets and must make their own assessment of risk and return.[211]

The importance of full information was stressed in *Doran v. Petroleum Management Corp.*, where the court said:

> . . . there must be a sufficient basis of accurate information upon which the sophisticated investor must be able to exercise his skills. Just as a scientist cannot be without his specimens, so the shrewdest investor's acuity will be blunted without specifications about the issuer. For an investor to be invested with exempted status he must have the required data for judgment.[212]

Indeed, it is the accredited (sophisticated) investor in particular who can utilize information and benefit from more disclosure.[213]

Some have argued that sellers have incentives to disclose information voluntarily,[214] and that investors perform due diligence before investing.[215] However, individual accredited investors, and especially non-accredited investors such as employees, may not have the same access to information as institutional investors and other sophisticated funds. Moreover, the incentives of some sellers to

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211. Friedman, *supra* note 182, at 297.

212. Doran v. Petroleum Management Corp., 545 F.2d 893, 903 (5th Cir. 1977); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673 (1984) ("Fraud reduces allocative efficiency. So too does any deficiency of information. Accurate information is necessary to ensure that money moves to those who can use it most effectively and that investors make optimal choices about the contents of their portfolios."); Paredes, *supra* note 210, at 992 ("[E]ven sophisticated investors may not be able to protect their own interests if they do not have the information they need or want about the issuer or cannot feasibly understand it.").

213. *See* Fletcher, *supra* note 54, at 1125–26 ("[T]he scheme requires registration of securities offered to *unsophisticated* investors, thus ensuring that people who do not read prospectuses receive copies of them, but exempts securities offered to *sophisticated* investors who would read and benefit from prospectuses if they received them. A legal structure that creates such anomaly demands reconsideration.").

214. *See, e.g.*, CHOI & PRITCHARD, *supra* note 9, at 313 (mentioning that there is an incentive for issuers to disclose information voluntarily in the offering circular); STEVEN A. ROSS, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177, 183 (Franklin Edwards ed., 1979); Easterbrook & Fischel, *supra* note 212, at 683; Paul R. Milgrom, *Good News and Bad News: Representation Theorems and Applications*, 12.2 BELL J. ECON. 380 (1981).

215. Paredes, *supra* note 210, at 207.

provide full disclosure may be limited when there are competitors who can benefit from the disclosure,[216] or when manager and shareholder interests are not aligned.[217] Indeed, historic evidence suggests that "[b]efore 1900, the amount of financial information voluntarily disclosed by most corporation . . . was 'meager'".[218]

In addition, the information asymmetry argument, at its simplest level, is that in the absence of mandatory disclosure regime, the party who has an information advantage may omit or misrepresent material information.[219] As described by Joel Seligman, a leading authority on securities law, the Securities Act and the Exchange Act were passed after major securities fraud waves, and, after 1934, misrepresentations were still prevalent among small firms that were not subject to the mandatory disclosure system.[220] Moreover, an SEC study, which sought to determine, *inter alia*, which companies whose shares were traded on the OTC market should be required to disclose information, found that 93% of

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216. Pollman, *supra* note 5, at 207.

217. *See* John C. Coffee Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722 (1984) (arguing that management "will still have an interest in acquiring the shareholders' ownership at a discounted price, at least so long as it can engage in insider trading or leveraged buyouts").

218. Seligman, *supra* note 41, at 18. In his article, Seligman rebuts Benston's argument that even before 1934, corporations voluntary disclosed sufficient information to enable investors to make informed investment decisions. *See* George Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973).

219. Seligman, *supra* note 41, at 9 (describing this argument and later examining whether it indeed justifies the mandatory disclosure system); *see also* Stephen M. Bainbridge, *Mandated Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1032 (2000) ("At its simplest level, the information asymmetry argument is that, 'in the absence of a compulsory corporate disclosure system some issuers will conceal or misrepresent information material to investment decisions.'") (quoting Seligman, *supra* note 41); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future*, 51 DUKE L. J. 1397, 1415–16 (2001) (showing that "deceptive financial reporting by corporations remains a serious problem").

220. Seligman, *supra* note 41, at 23, 33. Seligman rebuts Benston's argument that there was little fraud or misrepresentation before 1933, explaining that Benston searched only for express misrepresentations in financial statements and ignored instances such as fraudulent omissions in textual portions of prospectuses, which were, at least post World War II, more prevalent. *See id.* at 12–14. *But see* Easterbrook & Fischel, *supra* note 212, at 693 ("Just as we do not say that recent frauds show that the securities laws are ineffective or undesirable, so the proponents cannot rely on the bare existence of fraud in the 1920s.").

reported securities fraud cases involved companies that were not subject to the mandatory disclosure regime.[221]

In the Secondary Market, going public and the mandatory disclosure associated with it exposed questionable accounting tactics in the cases of Groupon and Zynga, two notable companies whose shares had been traded on SecondMarket and SharesPost.[222] "That this came up only after the firms filed to go public shows the value of transparency, standardized reporting, and government oversight—all of which are lacking on SharesPost and SecondMarket."[223]

Indeed, the information asymmetry is particularly problematic given the uncertainties and high risks associated with investments in private start-up companies. As Jill Fisch observes, "[c]ompanies with small capitalizations present disproportionate risks of both business failure and fraud. These risks may be magnified by Internet-based securities transactions."[224] One commentator stated that "secondary markets have the potential to generate fraud on an Enron-like scale."[225]

Regarding business failure, studies have shown that "approximately 80 percent of new businesses will either fail or no longer exist within 5 to 7 years of formation due to a lack of financial depth, a lack of management expertise, an unworkable business idea, or some combination of these factors."[226] Even sophisticated VC funds, which follow strict processes for selecting their private investments and actively monitor the companies in which they invest, predominantly fail.[227]

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221. REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc No. 95, Part 3, at 10 (1963).

222. Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 559 (2012).

223. *Id.*

224. Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 58 (1998); *see also* Ibrahim, *supra* note 103, at 5.

225. Vivek Wadhwa, *Secondary Markets and the Next Big Fraud*, THE WASHINGTON POST, June 1, 2011, *available at* http://www.washingtonpost.com/national/secondary-markets-and-the-next-big-fraud/2011/05/31/AGHVXFGH_story.html.

226. Report to the Chairman, Comm. on Small Business, U.S. Senate, *Small Business: Efforts to Facilitate Equity Capital Formation* 19 (Sept. 29, 2000), *available at* http://www.gao.gov/archive/2000/gg00190.pdf.

227. *Id.* at 19 (citing a study by the National Association of Seed and Venture Funds, according to which only 10% of VC investments meet their expected rate of return).

A significant risk of fraud and self dealing is added to these business risks.[228] For example, when Rule 504 was eased in the 1990s, it was

> used by nefarious promoters to distribute up to $1 million of securities in New York to a select favored group, followed promptly by boiler-room promotions that artificially drove up the secondary market price until such time as the initial purchasers could sell their shares at a handsome profit, leaving the gullible crop of new investors with suddenly deflated shares and irrecoverable losses.[229]

Another advantage of disclosure is that it reduces transactional costs by standardizing information and saving duplicative work of negotiating and gathering the relevant information.[230]

From a broader perspective, equal access to relevant information promotes fairness in markets and accuracy of prices, both of which enhance investors' confidence. Indeed, significant research shows that disclosure and other regulatory requirements enhance capital formation.[231]

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228. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, COLUM. BUS. L. REV. 1 (2012).

229. SEC, Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7644, 1999 WL 95490, at *2 (Feb. 25, 1999).

230. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 593–95 (1984) (discussing the costs of acquisition, processing and verification).

231. *See* Luis A. Aguilar, Comm'r, *U.S. Sec. & Exch. Comm'n, Investor Protection is Needed for True Capital Formation* (Mar. 16, 2012), *available at* http://www.sec.gov/news/speech/2012/spch031612laa.htm; *see also, e.g.*, Coffee, *supra* note 217, at 722 ("[E]ven in efficient capital market, there remains information that the rational investor needs to optimize his securities portfolio[, and] [s]uch information seems best provided through a mandatory disclosure system."); Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 337 (2006) ("[T]he empirical evidence plainly demonstrates great economic value from our relatively stringent system of governmental securities regulation."); Merritt B. Fox, Randall Morck, Bernard Yeung, & Artyom Durnev, *Law, Share Price Accuracy, and Economic Performance: The Empirical Evidence*, 102 MICH. L. REV. 331, 334 (2003) ("Contrary to the arguments advanced by opponents of mandatory disclosure, the empirical evidence presented here suggests that [regulatory requirements enhance the efficiency of the real economy]."); Michael Greenstone, Paul Oyer, & Annette Vissing-Jorgensen, *Mandated Disclosure, Stock Returns and the 1964 Securities Acts Amendments*, Q. J. ECON. (May 2006) ("[E]mpirical findings suggest that mandatory disclosure laws may provide access to equity on more favorable terms for entrepreneurs."). For an overview of common rational for disclosure regulation, see Guttentag, *supra* note 5.

Despite these arguments in favor of mandatory disclosure, which do not exhaust the list of disclosure justifications, the evidence showing whether disclosure is indeed beneficial is mixed.[232] But even if one is convinced that mandatory disclosure can be beneficial, it still has limits and costs. The costs include direct costs, such as compliance, dissemination, litigation, competitive disadvantage and opportunity costs, and indirect costs, such as changing profitable courses of action, information overload and other cognitive biases.[233]

The limits relate *inter alia* to the fact that many of the participants in the Secondary Market are individuals who do not necessarily have the tools to analyze financial disclosure.[234] As discussed below, even sophisticated investors who have the tools to understand financial disclosure may ignore or misread the information due to various biases such as overconfidence, greed, and social interactions. These limits are reinforced in the Secondary Market, where there is almost no analyst coverage and no price discovery to guide investors.

Unfortunately, this discussion cannot lead to a definitive conclusion regarding the need for additional disclosure in the Secondary Market. A careful cost-benefit analysis should be

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232. *See* Benston, *supra* note 218, at 49–50 (arguing that "stockholders of corporations that did not disclose gross income in 1929 fared better than those who held stock in the disclosure corporations"); Easterbrook & Fischel, *supra* note 212, at 714 (concluding, "We are left, for the moment at least, with logical argument rather than proof. And the logical arguments are themselves inconclusive.").

233. *See* PETER H. HUANG, *Regulating Irrational Exuberance and Anxiety in Securities Markets*, *in* THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR 523 (Francesco Parisi & Vernon L. Smith ed., 2005) ("Mandatory disclosure might be at best, an impotent, and at worst, a socially harmful regulatory policy if the majority of investors experience cognitive biases and utilize heuristics in the processing of information and/or feel irrational exuberance and anxiety before and during their investing process."); Easterbrook & Fischel, *supra* note 212, at 707–09; Omri Ben-Shahar & Carl. E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 651 (2010–2011) (describing why disclosure is problematic, focusing on law makers, disclosers, and disclosees); Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599, 604 (2012) (suggesting that disclosure is problematic since it works at the individual level, while decision making is social in nature).

234. *See* HUANG, *supra* note 233, at 519–20 ("Some legal scholars believe and argue that the investing public is neither the actual nor intended audience for the disclosures that federal securities laws mandate. Instead, these commentators feel that professional analysts are the intended audience of much of the accounting and financial disclosures that federal securities regulations mandate. Professional analysts filter that information onto the investing public.").

conducted to determine whether the benefits of more information exceed the costs.[235]

2. Dubious Correlation between Wealth and Sophistication

Legal scholars,[236] commentators, and investors[237] have all been critical of the SEC's wealth-based accredited investor standard.[238] Under such standard, for example, an individual who inherits an art collection worth an estimated $1 million and has no debt would be considered as an accredited investor. But does this wealth indicate that he can fend for himself? Is such inheritor more sophisticated than a Harvard MBA graduate who is still paying his student loans?[239]

As Gilbert Warren III, a leading scholar on securities law, explains, both the net worth and the income criteria are problematic: "[A]n investor accredited solely by virtue of net worth may base his net worth computation on liberally appraised illiquid assets or on the assets of a spouse. An investor accredited solely by income or amount of purchase may actually be insolvent at the time of purchase."[240]

Moreover, the net worth and the income criteria were set in 1982, and since then have not been properly adjusted for inflation. As mentioned earlier, following the requirement of section 413(a) of the Dodd-Frank Act, the SEC excluded from the $1 million net worth threshold the value of the individual's primary residence. However, the SEC has not been required to change the "accredited investor" definition regarding a natural person's annual income. One dollar in 1982 has the same buying power as $2.38 in 2012,[241] suggesting that

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235. *See id.* at 696.

236. *See, e.g.*, COX ET AL., *supra* note 32, at 285; Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 280 (2000); Fletcher, *supra* note 54, at 1084; Friedman, *supra* note 183, at 294; Marc Steinberg, *The "Accredited" Individual Purchaser Under Regulation D: Time to Up the Ante*, 29 SEC. REG. L.J. 93 (2001); Warren, *supra* note 37, at 382.

237. *See, e.g.*, Nathan J. Greene, *The SEC's Latest Hedge Fund Rulemaking: More than 600 Comment Letters Later*, BANKING & FIN. SERVICES POL'Y REP. 1, 4 (2007); SEC Comment Letter from Bruce A. Broussely (Apr. 10, 2007), *available at* http://www.sec.gov/comments/s7-25-06/s72506-612.htm; SEC Comment Letter from David Patch (Apr. 13, 2007), *available at* http://sec.gov/comments/s7-25-06/s72506-613.pdf.

238. Finger, *supra* note 52, at 733.

239. *Id.* at 733–34.

240. Warren, *supra* note 37, at 382.

241. *See* U.S. Dep't of Labor, Bureau of Labor Statistics, CPI Inflation Calculator, http://data.bls.gov/cgi-bin/cpicalc.pl (enter "1.00" in the "$" field, select

in order to meet the original intent the threshold should have been more than doubled since 1982.[242]

As Robert B. Thompson and Donald C. Langevoort, leading authorities in the securities area, articulated the problem in a recent article:

> By the mid-2000s, such status would attach to many upper-middle-class professionals. And because retirement savings count toward net worth, the increasing reliance on IRAs, 401(k) accounts, and other tax-advantaged savings programs pushed many current and future retirees into that status as well, even if their incomes never came close to two hundred thousand dollars a year and they were depending on that wealth to see them through the rest of their lives.[243]

As per the SEC's estimation, "at least 8.7 million U.S. households, or 7.4% of all U.S. households, qualified as accredited investors in 2010, based on the net worth standard in the definition of 'accredited investor.'"[244]

Whatever the threshold may be, the more substantive question is, to what extent does wealth correlate with sophistication? It is quite clear that not all wealthy investors are sophisticated enough to fend for themselves. Indeed, only a small fraction of accredited investors has significant levels of direct holdings of individual securities,[245] which suggests that the vast majority are inexperienced.

Although wealthy investors can probably afford professional advice, they frequently fail to seek it.[246] And even if they do seek professional advice, this may assist the unsophisticated investor only to the extent that the advice is genuine and serves the investor's interests.[247] It has been demonstrated, however, that professional

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"1982" in the first "in" field, and select "2012" in the second "in" field) (last visited Apr. 22, 2012).

242. *See* Sjostrom, *supra* note 19, at 667.

243. Thompson & Langevoort, *supra* note 5, at 1615.

244. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Release No. 33-9415 (July 10, 2013) (codified at 78 Fed. Reg. 4471 (July 24, 2013)) (the Adopting Release).

245. *Id.* at 75.

246. Warren, *supra* note 37, at 382.

247. *See, e.g.*, Lauren E. Willis, *Against Financial Literacy Education*, 94 IOWA L. REV. 197, 247 (2008); Samuel Issacharoff, *Disclosure, Agents, and Consumer Protection* 56 (New York University Law and Economics, Working Paper No. 228, 2010), *available at* http://lsr.nellco.org/cgi/viewcontent.cgi?article=1232&context=nyu_lewp.

advisers are often tempted to select those securities that produce a collateral benefit for them—a practice that raises concerns of biased advice.[248]

Another argument that can be raised to support the wealth criterion is that wealthy investors can absorb losses. But the intricate policy question is whether wealthy, but unsophisticated, investors should be sacrificed in order to promote capital formation. In addition, big losses, even if incurred by wealthy investors, may have negative externalities.

Section 413(b)(2)(A) of the Dodd-Frank Act requires the SEC to undertake a review of the accredited investor definition as such term applies to natural persons, not earlier than four years after the enactment of the Dodd-Frank Act.[249] In a recent letter to Scott Garrett (R., N.J), the Chairwoman of the SEC, confirmed that "[c]ommission staff . . . has begun a comprehensive review of the accredited investor definition."[250] It remains to be seen if and how the SEC will balance capital formation, investors' access to investment opportunities, and investor protection.

3. Cognitive Biases

A fundamental principle of the standard neo-classical economic approach is that "all human behavior can be viewed as involving participants who maximize their utility from a stable set of preferences and accumulate an optimal amount of information and other inputs in a variety of markets."[251] In other words, the standard economic approach assumes that people are fully rational "selfish calculating machine[s]," and always make intelligent choices.[252]

Behavioral economics challenges this assumption by using other social sciences such as psychology and sociology, as well as biology and neuroscience.[253] They explore the behavior of "real people," as

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248. *See* HOWELL E. JACKSON, *The Trilateral Dilemma in Financial Regulation*, *in* OVERCOMING THE SAVINGS SLUMP: HOW TO INCREASE THE EFFECTIVENESS OF FINANCIAL EDUCATION AND SAVINGS PROGRAMS 82 (Annamaria Lusardi ed., 2008).

249. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413, 124 Stat. 1376, 1577 (2010) (codified at 15 U.S.C. § 77b).

250. Letter from Mary Jo White, SEC Chair, to Scott Garrett, Chairman of the Subcommittee on Capital Markets and Government Sponsored Entities (Nov. 15, 2013), *available at* https://www.scribd.com/doc/185441459/Letter-From-Chair-White.

251. GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR 14 (1976).

252. Samuel Bowles & Herbert Gintis, *Walrasian Economics in Retrospect*, Q. J. ECON. 1411, 1413 (2000).

253. *See* COLIN F. CAMERER & GEORGE LOEWENSTEIN, *Behavioral Economics:*

opposed to the theoretical "*homo economicus*," and raise questions about people's rationality in their decision making.[254] While neo-classical economists analyze people's behavior in a social vacuum, behavioral economists emphasize the complexity of human beings, their emotions, and the affect of the environment on them.[255]

In the financial sphere, research in behavioral economics shows that investors make various judgment errors pertaining to the degree of risk they take and their asset allocation.[256] Such deviations from the maxims of economic rationality turn out to be highly pervasive and systematic.[257] Behavioral economists have tried to map the various judgment errors identified in lab experiments and in the field.[258] I will focus only on a few judgment errors that seem particularly relevant to the trading in the Secondary Market.

Past, Present, Future, in Advances in Behavioral Economics (Colin F. Camerer et al. ed., 2004); Bowles & Gintis, *supra* note 252, at 1414.

254. For an overview on the development of the field, see CAMERER & LOEWENSTEIN, *supra* note 253.

255. *See* J. L. BAXTER, BEHAVIORAL FOUNDATIONS OF ECONOMICS 6 (1993).

256. *See, e.g.*, RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 120–21 (Yale University Press) (2009); Stephen Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003).

257. ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 10 (2000).

258. Common judgment errors include reliance on rules of thumb, such as the "1/n" heuristic, which means putting the same number of eggs in each basket (*see, e.g.*, Shlomo Benartzi & Richard H. Thaler, *Naive Diversification Strategies in Defined Contribution Savings Plans*, 91 AM. ECON. REV. 79 (2001)); loss aversion, which is the tendency of people to hate losses more than they love gains (*see, e.g.*, AMOS TVERSKY & DANIEL KAHNEMAN, *Loss Aversion in Riskless Choice, A Reference-Dependent Model, in* CHOICES, VALUES AND FRAMES 143 (Daniel Kahneman & Amos Tversky eds., 2000)). Loss aversion may explain the disposition effect, which is the tendency of investors to hold losses too long and sell winning investments too early (*see, e.g.*, Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence*, 40 J. FIN. 777 (1985)); the endowment effect, which is the tendency of people to demand a higher price to sell an object than they would be willing to pay to buy that same object (*see, e.g.*, Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39 (1980)); anchoring and the status quo bias, which is the tendency of people to base their decision on an initial estimate that is later insufficiently adjusted (*see, e.g.*, Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124 (1974)); or on a particular suggestion point, even when the costs of switching are very low (*see, e.g.*, William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988)). For a broader list of investors' biases, see, for example, NICHOLAS BARBERIS & RICHARD R. THALER, *A Survey of Behavioral Finance, in* HANDBOOK OF THE ECONOMICS OF

First, there is the optimism bias, which relates to overconfidence.[259] People tend to be overly optimistic about their own probability of facing a bad outcome. For instance, most people think that their chances of having an auto accident are significantly lower than the average person's chances of experiencing this event.[260] In addition, although it is well known that approximately 50% of marriages in the U.S. end up in divorce, almost all couples believe that the chances their marriage will end in divorce are approximately zero—even those couples who have already been divorced.[261]

Investors, and particularly men,[262] also tend to be overconfident and overly optimistic about their knowledge, experience, or skills.[263] Unfortunately, overconfidence may lead to excessive trading and poor performance and can be even more risky with respect to the trading on the Secondary Market, where there is limited information.[264] The Facebook example illustrates this bias, since investors—optimistic and confident about their projections and knowledge—were willing to buy Facebook shares on the Secondary Market just before the company's IPO for a price that was higher than the IPO price and much higher than the price in the months following the IPO. Although the Facebook example suggests overpricing of shares, which can harm buyers, overconfidence may also lead investors to sell too early, thus harming sellers.

FINANCE (George Constantinides, Milt Harris & Rene Stolz eds., 2003); GARY BELSKY & THOMAS GILOVICH, WHY SMART PEOPLE MAKE BIG MONEY MISTAKES AND HOW TO CORRECT THEM (2010); H. Kent Baker & John F. Nofsinger, *Psychological Biases of Investors*, 11 FIN. SERV. REV. 97 (2002); Daniel Kahneman & Mark Riepe, *Aspects of Investor Psychology*, 24 J. PORTFOLIO MGMT. 52 (1998).

259. *See, e.g.*, David M. DeJoy, *The Optimism Bias and Traffic Accident Risk Perception*, 21 ACCIDENT ANALYSIS & PREVENTION 333 (1989).

260. *Id.*

261. Heather Mahar, *Why Are There So Few Prenuptial Agreements?*, (Harvard Law Sch. John M. Olin Ctr. for Law, Econ. & Bus. Discussion Paper Series, Paper No. 436, 2003), *available at* http://lsr.nellco.org/harvard_olin/436.

262. Brad Barber & Terrance Odean, *Boys Will Be Boys: Overconfidence and Common Stock Investment*, 116 Q. J. ECON. 261 (2000).

263. *See, e.g.*, BELSKY & GILOVICH, *supra* note 258, at 155–82 (referring to overconfidence as "the ego trap"); Brad M. Barber & Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 54 J. FIN. 773, 785–88 (2000); Don A. Moore & Terri R. Kurtzberg, *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 ORG. BEHAV. & HUM. DECISION PROCESSES 95 (1999); John R. Nofsinger, *Do Optimists Make the Best Investors?*, 64 CORP. FIN. REV. 11 (2002).

264. *See* Terrance Odean, *Do Investors Trade Too Much?*, 89 AM. ECON. REV. 1279–98 (1999).

Another common bias that affects investors is the familiarity bias.[265] Research shows that people tend to prefer familiar things, and this can explain investors' preference for familiar stocks,[266] such as their employer's stocks and national stocks (the "home bias").[267] Investors tend to believe that familiar stocks are less risky than unfamiliar stocks and even safer than a diversified portfolio.[268]

As discussed above, the shares that are traded on the Secondary Market are mostly shares of mature, well-known companies, which may create fertile grounds for the familiarity bias.[269] Indeed, the fact that the most traded shares on the Secondary Markets were Facebook shares before its IPO more than hints that investors who trade on the Secondary Market have a preference for the familiar. One Secondary Market investor explained that he was making investment decisions "going by gut . . . [y]ou're saying 'I like the product. I think the company's doing well. The news that I read on TechCrunch or AllThingsD[igital] or any one of these technology blogs, it all looks good.'"[270]

Finally, ego, envy, and greed also affect investors' decisions.[271] Investors are attracted to exclusive investments, as they like the feeling of being one of a few who are offered the opportunity to invest in something new or exotic.[272] The Secondary Market, being an exclusive club that is available only for accredited investors, reinforces such feelings. Indeed, many investors poured money into Facebook before its IPO, feeling lucky for being able to invest

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265. *See* BARBERIS & THALER, *supra* note 258, at 1099–1100; Baker & Nofsinger, *supra* note 258, at 101.

266. *See* BARBERIS & THALER, *supra* note 258, at 1099–1100; Baker & Nofsinger, *supra* note 258, at 101.

267. *See* Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 AM. ECON. REV. 222, 222 (1991).

268. AMOS TVERSKY & DANIEL KAHNEMAN, *Rational Choice and the Framing of Decisions*, *in* CHOICES, VALUES AND FRAMES 209 (Daniel Kahneman & Amos Tversky eds., 2000); Amos Tversky & Itamar Simonson, *Context-dependent Preferences*, 39 MGMT. SCI. 1179, 1179 (1993).

269. *See* BARBERIS & THALER, *supra* note 258, at 1099–1100; Baker & Nofsinger, *supra* note 258, at 101.

270. Ilya Marritz, *Hunting for Hot Stocks, Some Investors Head to Private Markets*, WNYC NEWS (Apr. 30, 2012), http://www.wnyc.org/story/204945-hunting-hot-stocks-some-investors-head-private-markets/.

271. *See generally* BELSKY & GILOVICH, *supra* note 258 (discussing the "ego trap").

272. *See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockholders and Sophisticated Customers*, 84 CALIF. L. REV. 627, 652 (1996) (mentioning the strategy of brokers to present an investment as an exclusive one to attract customers).

through the Secondary Market, just to discover later that the IPO price was lower.[273]

These three biases mostly relate to overpricing, suggesting that sellers such as employees can only benefit from the trading on the Secondary Market. However, one can imagine indirect harm to employees, who may rely on the valuations on the Secondary Market in connection with their compensations or other personal transactions, just to discover later that such valuations were inflated. Moreover, as opposed to the examples mentioned above, other biases suggest that sellers may be selling shares on the Secondary Market too early. Indeed, studies have found that individual investors tend to sell stocks that have increased in value too early and hold on to stocks that have decreased in value (the "disposition effect").[274]

Social interactions also affect investors' decision making.[275] It has been demonstrated that investors' social environment[276] and the media[277] influence investment decisions. Professors of Finance Brad Barber and Terrance Odean found that the Internet also significantly affects investors' trading.[278] They analyzed 1,607 investors who switched from phone-based to online trading during the 1990s.[279] They found that after going online, these investors traded more actively, more speculatively, and less profitably than before.[280] The authors suggest that overconfidence plays a significant role in online trading.[281] These results may be of importance to

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273. Investors acted in the same way during Facebook's IPO. *See* Kirsten Grind, *The Seven Deadly Sins of Investing*, WALL ST. J (Aug. 31, 2013), http://online.wsj.com/article/SB10001424127887324906304579037163080446646.html ("In the run-up to Facebook's initial public offering in May 2012, financial advisers say they were slammed with calls from clients who wanted to get in on the stock before it made its debut. The fact that there were a limited number of shares available to retail investors only drove the frenzy, advisers say.").

274. *See* Shefrin & Statman, *supra* note 258, at 778.

275. *See* Baker & Nofsinger, *supra* note 258, at 109.

276. *See* Esther Duflo & Emmanuel Saez, *Participation and Investment Decisions in a Retirement Plan: The Influence of Colleagues' Choice*, 85 J. PUB. ECON. 121, 145 (2002).

277. *See* JOHN R. NOFSINGER, INVESTMENT BLUNDERS OF THE RICH AND FAMOUS – AND WHAT YOU CAN LEARN FROM THEM 172 (2002) ("Most of the time, the media exacerbates our bias toward storytelling and away from formal investment analysis.").

278. *See* Brad M, Barber & Terrance Odean, *Online Investors: Do the Slow Die First?*, 15 REV. FIN. STUD. (SPECIAL ISSUE) 455, 456 (2002).

279. *Id.*

280. *Id.*

281. *Id.*

investors in the Secondary Market, which is primarily an online market.

It has become evident that even mood and emotions are dominant in the decision making processes of investors.[282] Indeed, even the weather affects investment decisions.[283] Saunders found a significant correlation between the weather in New York City and stock indexes. Specifically, higher cloud cover is associated with lower returns.[284] Likewise, economists David Hirshleifer and Tyler Shumway examined the relation between morning sunshine and market index stock returns at 26 stock exchanges internationally in the years 1982–1997 and found that sunshine is significantly correlated with daily stock returns.[285] Similarly, Mark Kamstra *et al.* found a significant effect of seasonal affective disorder ("SAD") on stock market returns around the world.[286]

Although it is still unclear whether these judgment errors can be diminished by cognitive abilities, education, or experience,[287] it is

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282. *See* Baker & Nofsinger, *supra* note 258, at 102. For discussions on the effect of emotions on economic behavior and the perception of risk see Eric J. Johnson & Amos Tversky, *Affect, Generalization, and the Perception of Risk*, 45 J. PERSONALITY & SOC. PSYCHOL. 20, 20–21 (1983); George F. Loewenstein, *Emotions in Economic Theory and Economic Behavior*, 65 AM. ECON. REV. 426, 430 (2000); George F. Loewenstein et al., *Risk as Feelings*, 127 PSYCHOL. BULL. 267, 270 (2001).

283. *See* Edward M. Saunders, Jr., *Stock Prices and Wall Street Weather*, 83 AM. ECON. REV. 1337, 1337 (1993).

284. *Id.*

285. David A. Hirshleifer & Tyler Shumway, *Good Day Sunshine: Stock Returns and the Weather*, 58 J. FIN. 1009, 1009 (2003). *But see* Walter Kramer & Ralf Runde, *Stocks and the Weather: An Exercise in Data Mining or Yet Another Capital Market Anomaly*, 22 EMPIRICAL ECON. 637, 638 (1997) (finding that "any weather effects are extremely nonrobust to the way that we classify the data"); Mark A. Trombley, *Stock Prices and Wall Street Weather: Additional Evidence*, 36 Q. J. BUS. & ECON. 11, 12 (1997) (finding that Saunders' study on New York weather-related stock improvements could not be replicated).

286. Mark J. Kamstra, et al., *Winter Blues: A SAD Stock Market Cycle*, 93 AM. ECON. REV. 324, 324 (2003).

287. *See, e.g.*, BARBERIS & THALER, *supra* note 258, at 1068 (explaining that "the effect of learning is often muted by errors of application" and that "[e]xpertise, too, is often a hindrance rather than a help" since experts have been found to be overconfident in their predictions); Colin Camerer & Robin Miles Hogarth, *The Effects of Financial Incentives in Experiments: A Review and Capital-Labor Production Framework*, 19 J. RISK & UNCERTAINTY 7, 7 (1999) (concluding that while incentives can reduce biases, "*no* replicated study has made rationality violations disappear purely by raising incentives"). *But see* Mark Kelman, *Law and Behavioral Science: Conceptual Overviews*, 97 NW. U. L. REV. 1347, 1380 (2003) ("[V]iolations of rationality precepts seem to disappear rather quickly when people have the opportunity to make decisions again[,] [especially] . . . when those who will have the

now obvious that sophisticated investors are not immune to biases.[288] For example, researchers have found a strong disposition effect among professional mutual fund managers,[289] high loss aversion of Chicago Board of Trade proprietary traders,[290] and significant effect of word-of-mouth communications on investment decisions.[291] There is also evidence that emotions are important in the decision making of professional securities traders.[292]

These biases have consequences that affect more than a handful of sophisticated investors. Taking the Facebook example again, the company's prospectus shows that Facebook "assigned a 50% weighting to private market valuations in pricing its IPO,"[293] meaning that it used investors' inflated valuations to justify its IPO pricing.

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chance to repeat the decision making process are rewarded if they behave the way rational choice theorists believe the normative decision maker should behave, and are penalized if they do not."); John A. List, *Does Market Experience Eliminate Market Anomalies*, 118 Q. J. ECON. 41, 42–43 (2003) (showing experimental evidence that market experience significantly eliminates the endowment effect). With respect to cognitive abilities, see Brad Barber & Terrance Odean, *The Behavior of Individual Investors*, (2011) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1872211 (referring to papers that suggest that "cognitive abilities play an important role in investor outcomes," but concluding that "smarter investors outperform others . . . mak[ing] good stock picks, but only good enough to cover their trading costs").

288. *See, e.g.*, CHOI & PRITCHARD, *supra* note 9, at 32 ("Even institutional investors may suffer from their own irrationalities, such as loss aversion."); THALER & SUNSTEIN, *supra* note 256, at 124–25 ("Even the most sophisticated investors can sometimes find the decision about how to invest their money daunting, and they resort to simple rules of thumb."); Kahneman & Riepe, *supra* note 258, at 54 ("[O]verconfidence should be expected, for both experts and non-experts."); Sjostrom, *supra* note 19, at 677 ("[R]ecent events have demonstrated that sophisticated investors are not immune from making terrible investment decisions.").

289. *See, e.g.*, Li Jin & Anna Scherbina, *Disposition Effect Among Mutual Fund Managers*, HARV. BUS. SCH. (Nov. 2004), *available at* http://www.ccfr.org.cn/cicf2005/paper/20050130151256.PDF.

290. Joshua D. Coval & Tyler Shumway, *Do Behavioral Biases Affect Prices?*, 60 J. FIN. 1, 3 (2005) (finding that full time traders whose livelihood depends on their ability to trade effectively "are far more likely to take on additional afternoon risk following morning losses than morning gains").

291. *See* Robert J. Shiller & John Pound, *Survey Evidence on Diffusion of Interest and Information Among Investors*, 12 J. ECON. BEHAV. & ORG. 47, 47 (1989).

292. *See* Andrew W. Lo & Dmitry V. Repin, *The Psychophysiology and Real-Time Financial Risk Processing*, 14 J. COGNITIVE NEUROSCIENCE 323, 330 (2002).

293. Colao, *supra* note 202.

Indeed, investors' judgment errors have economic consequences; some are minor, but others can be fatal.[294] They can seriously harm investors' wealth, which may have broader negative externalities.[295]

Such findings about investors' biases also blur the line between unsophisticated investors in need of regulatory protection, and sophisticated investors, who allegedly do not need such protection. If sophisticated investors as well make judgment errors that lead to inefficient market outcomes, however, a regulatory intervention may be justifiable.[296]

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The emerging Secondary Market offers new exit options to investors who need them. It also benefits private companies, who will no longer be forced into expensive IPOs to satisfy their investors' need.[297] Moreover, private market transactions allow greater flexibility in capital formation, which enhances productivity and job growth. However, the democratization of Secondary Market transactions exposes non-accredited investors to new risks and uncertainties. The current regulatory approach, which separates the public market and the private market with respect to investor protection, leaves these investors exposed to risks that even sophisticated investors find difficult to evaluate.

VI. THE FUTURE OF THE SECONDARY MARKET: THOUGHTS ON POLICY IMPLICATIONS AND FURTHER RESEARCH

As described above, the Secondary Market is almost unsupervised, corresponding with the presumption that sophisticated investors are able to fend for themselves. However, this Article shows that, in the Secondary Market space, the sophistication presumption has been eroded, deeming the difference between the heavily regulated public market and the lightly regulated private market artificial. Unfortunately, this erosion is not just theoretical. Many investors are now exposed to new risks with less protection, creating potential for a big financial problem.

Given the infancy of the Secondary Market, it is difficult at this point to draw specific implications with regard to investor protection.

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294. HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 5 (2002).

295. *Id.* at 6.

296. *See* Sjostrom, *supra* note 19, at 677 ("If, however, bad decision making by sophisticated investors poses systemic risk, additional regulation may be justified, not specifically to protect the sophisticated but to protect the markets and economy generally.").

297. Ibrahim, *supra* note 103, at 13.

However, this Article sets out important questions that may assist in designing a better regulatory regime in the future.

An important factual question is to what extent the Secondary Market includes both accredited and non-accredited investors. It may be reasonable to assume that many of the *sellers* are non-accredited employees and ex-employees. But perhaps a more important question is whether, and how many, non-accredited *buyers* participate in this emerging market, albeit the regulatory restrictions. Indeed, the existence of non-accredited (non-wealthy) investors, who cannot protect themselves, may justify regulatory intervention.

Another set of questions pertains to the limitations of the participants in the Secondary Market. The first question is whether these participants, even if accredited, can benefit from more disclosure, and how such a regime would affect the market. As discussed above, there are good arguments in favor of more disclosure in the Secondary Market, but it is hard to determine whether such disclosure would be beneficial and effective.

One element of disclosure that may be both beneficial and effective in the Secondary Market is price transparency. Although they may be inaccurate, previous bids and actual prices can help less sophisticated parties estimate, even if roughly, share prices, and reduce the risk of these transactions. As mentioned above, SharesPost already discloses previous transaction prices, but SecondMarket does not.[298] A central reporting system that gathers information from all marketplaces and allows a comparison is required.

Additionally, the doubtful correlation between wealth and sophistication also raises difficult questions. As discussed previously, both the net worth and the income criteria have to, at least, be properly adjusted for inflation. But is wealth a good proxy for sophistication in the Secondary Market sphere? Are there better alternatives for such an objective test?[299]

If not all wealthy investors are sophisticated enough to fend for themselves, what justifies the current limited protection of accredited investors? Is it only the fact that "they can afford to lose money"?[300] Is it that private offerings encourage capital formation,

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298. *See supra* note 202.

299. *See* Fletcher, *supra* note 54, at 149–53 (suggesting a set of criteria that may be helpful in determining an investor's level of sophistication); *see also* Choi, *supra* note 236, at 333–34 (proposing "to license investors and to tailor regulatory protection based on investor knowledge").

300. *See* Friedman, *supra* note 182, at 301 ("It seems inappropriate for our legal structures to encourage modern-day entrepreneurial Robin Hoods who take from the

productivity, and job growth?[301] Or is it just the result of thin regulatory resources?[302] Here, too, a serious cost and benefit analysis is needed to determine whether this entrepreneurial approach can still be justified today, in the aftermath of dramatic events such as the financial crisis of 2008–2009 and the Madoff scandal. Such an analysis is complicated, since it involves social and economic externalities, and perhaps mostly political choices, as Langevoort and Thompson suggest.[303]

Lastly, there is the issue of cognitive biases, suggesting that even sophisticated investors make judgment errors that may result in inefficient market outcomes. Since the application of behavioral economics in legal policy making is still a relatively new trend, it is important first to identify the predominant biases of sophisticated investors and their impact on investment decisions. Although there is a growing body of research that tries to identify investors' biases, more studies are needed to fill in some of the gaps in this relatively new field.

A common criticism of behavioral finance is that

> the sheer number of biases that have been identified, together with the absence of precision about which bias, or combination of biases, are operative in particular circumstances, leaves too many degrees of freedom in assigning causation.[304]

Indeed, some biases can even offset one another. For example, the endowment effect may cause investors to require too high price for their shares and miss a good offer, while loss aversion may cause them to sell too low, fearing the risk of losing an offer more than valuing the chance of a higher offer.[305] There is still much ambiguity about the magnitude and the effect of cognitive biases on investment decisions.

Examining investor protection through the rationality lens is probably the most challenging, as it has the most far-ranging

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rich not to give to the poor, but instead to give to themselves.").

301. *See, e.g.*, Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 8, 10 (2007) (arguing that SEC regulations make capital formation difficult for small businesses that plan on making a public offering); Langevoort, *supra* note 92, at 1.

302. This is the view of Langevoort & Thompson, *supra* note 5, at 363.

303. *Id.* at 373.

304. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 731 (2003).

305. *See id.* at 731–32.

implications. Behavioral economics can be applied to every investment decision, not just the decisions of Secondary Market participants. Taken seriously, "any legal concept that relies in some sense on a notion of reasonableness . . . will need to be reassessed . . . ."[306] Thus, behavioral economics should be used "thoughtfully and cautiously."[307] Its application should be slow and should be based on broader research and more concrete conclusions.

All of these questions have become paramount in light of the new JOBS Act. As mentioned previously, the JOBS Act, by increasing the threshold for registration and enabling solicitation, enables companies to stay private longer and the Secondary Market to thrive. Relaxing regulation, which reduces compliance costs, can boost the economy, but it can also lead to more financial problems and fraud.[308] In the words of Thompson and Langevoort, "[w]hat JOBS does is open those investors to a new world of aggressive selling, including that via the internet."[309]

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306. Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV 630, 634 (1999).

307. Bainbridge, *supra* note 219, at 1028; *see also* CHOI & PRITCHARD, *supra* note 9; Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence*, 91 GEO. L.J. 67, 127 (2002) (arguing that "legal scholars who have no training in the social sciences or who have only a superficial understanding of behavioral decision theory should refrain from the unaided application of behavior decision theory to the law," but noting that interdisciplinary studies should be encouraged).

308. The JOBS Act was criticized by the SEC and other institutions and scholars. *See, e.g.*, Letter from Mary Schapiro, SEC Chairman, to Tim Johnson, Chairman, and Richard C. Shelby, Ranking Member, U.S. Senate Comm. on Banking, Hous., & Urban Affairs (March 13, 2012), *available at* www.aicpa.org/Advocacy/Issues/DownloadableDocuments/404b/3-13-12_SEC_Chm_Schapiro_Letter_to_Johnson.pdf; Letter from Council of Institutional Investors to Senators Johnson and Shelby (March 1, 2012), *available at* www.thecorporatecounsel.net/nonMember/docs/jobs-03-01-12-CouncillettertoBankingComonCapFormationBill(Final).pdf; Letter from AFSCME, et al. to Senators Johnson and Shelby (March 5, 2012), *available at* www.consumerfed.org/pdfs/PublicInterestSenateCapitalFormationBillsLetter3-5-12.pdf; Letter from AARP to Harry Reid, Senate Majority Leader, (March 7, 2012); *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 10 (2011) (statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School); *Examining Investor Risks in Capital Raising: Hearing before the Subcomm. on Sec., Ins., & Inv. of the Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 1–2 (2011) (statement of Professor John C. Coates IV, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School); Coates & Pozen, *supra* note 84.

309. Thompson & Langevoort, *supra* note 5.

I doubt whether Congress, which passed this appealingly named Act so quickly, fully considered all the evidence and normative aspects of the Act.[310] It would be necessary in a few years to reassess the benefits of the JOBS Act with new evidence and research as well as the lax regulatory regime with respect to the Secondary Market.

More generally, regulators, scholars, and policy makers would have to take into consideration the fading dichotomy between the public and the private market with respect to investor protection and decide whether such classic dichotomy should be preserved albeit with the changes discussed in this Article or whether a new model should be adopted. This requires a delicate balance between capital access and investor and markets protection, a task that should be based on rich empirical data and detailed cost-benefit analysis.

VII. CONCLUSION

The Secondary Market is only beginning to take shape; it is rapidly developing and still largely unregulated. Therefore, analyzing its inner workings and its current and potential effect on capital markets is especially challenging. Not only is the Secondary Market a treasure trove for legal scholars due to its novelty, it also implicates questions that are paramount to the U.S. economy. Secondary Market transactions may encourage capital formation, productivity and job growth, but lack of investor protection can harm investors, their relatives, and the economy as a whole. Finding the right balance is a complex mission that requires much thought and deliberation.

By focusing on the classic dichotomy between the public market and the private market, this Article proposes a new framework to analyzing investor protection. The Article suggests that such a dichotomy is artificial with regard to the Secondary Market due to the penetration of non-accredited and unsophisticated participants to such market and in light of serious doubts as to investors' ability to fend for themselves. These insights may not yield obvious answers, certainly not a detailed regulatory scheme, but hopefully

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310. *See* Steven M. Davidoff, *From Congress, a Law Befitting a Sausage Factory*, N.Y. TIMES, April 3, 2012, *available at* http://dealbook.nytimes.com/2012/04/03/from-congress-a-law-befitting-a-sausage-factory/ ("Congress simply doesn't understand financial markets and instead legislates to the political winds. . . . Congress would have been better off leaving it to the S.E.C. to design and run such an experiment . . . ."); *see also* Langevoort & Thompson, *supra* note 5, at 366–68 (describing how best to assess the costs and benefits with setting the threshold for public company registration).

new lines of thinking will emerge, leading to more research that is essential in this area of the law.[311]

311. *See* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 139 (2002) ("There are many vexing problems in securities law that might benefit from consideration of fresh possibilities, which generate new lines of thinking if not obvious answers.").