

## NOTE

### SMALL CAP COMPANIES AND THE DIAMOND IN THE ROUGH THEORY: DISPELLING THE IPO MYTH AND FOLLOWING THE REGULATION A AND REVERSE MERGER EXAMPLES

#### I. INTRODUCTION

##### *Myth 1<sup>1</sup>: The U.S. Is Losing Its Competitive Edge to Foreign Markets*

If you were to open a copy of the *Wall Street Journal* on February 12, 2007, you would come across an article titled *U.S. May be Losing Its Appeal to Foreign Investors, Report Warns*. Opening the same paper one month later on March 12, 2007, your eyes might be drawn to the words *Panel Urges Steps to Boost Allure of U.S. Markets*.<sup>2</sup> The headlines in early 2007 surrounding the American securities markets have primarily focused on the notion that these markets are losing the competitive edge they once held globally, specifically placing the European and Asian markets at the top of the list of competitors.<sup>3</sup> But what is the basis for this frenzy? The articles cite the decline in, or lack of, initial public offerings (“IPOs”) as one of the key indicators that the American economy is not performing well amid stiff competition abroad.<sup>4</sup> What is not found in these articles is exactly when and why IPOs, few in number and selectively carried out, became the final word on how our economy is performing. If we had more companies that have enjoyed tremendous success in IPOs, such as Starbucks entering the public market for the

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1. The original myth format is attributed to Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1972-73).

2. Greg Ip, *U.S. May be Losing Its Appeal to Foreign Investors, Report Warns*, WALL ST. J., Feb. 12, 2007, available at <http://www.ofii.org/newsroom/news/022007wsjnew.htm>; Kara Scannell, *Panel Urges Steps to Boost Allure of U.S. Markets*, WALL ST. J., Mar. 12, 2007, at A1.

3. See, e.g., Ip, *supra* note 2; Scannell, *supra* note 2, at A1, A8.

4. See *infra* notes 93-94 and accompanying text.

first time and earning tremendous returns on its IPO shares, would we say our economy was performing well?

*Myth 2: Securities Regulations Are the Sole Cause of the Decline in America's Share of IPOs*

Even if one were to concede that the American securities markets are losing investors to the appeal of foreign markets, and that IPOs are a reliable means of assessing this end, is it the American securities laws that have forced the investor's hand abroad? The current debate centers on whether the Sarbanes-Oxley Act of 2002 and domestic over-regulation are the driving forces behind the movement of many U.S. investors overseas and many foreign investors away from the U.S. markets.<sup>5</sup> Proponents of this position ask whether we need to ease up on our securities laws, specifically whether the Sarbanes-Oxley Act of 2002 is too onerous.<sup>6</sup> But could it be that there are other factors, such as the rise in class actions resulting from alleged violations of Sections 11 and 12 of the Securities Act of 1933,<sup>7</sup> as amended (the "Securities Act") and Rule 10b-5 of the Securities Exchange Act of 1934,<sup>8</sup> as amended (the "Exchange Act"), which are the more immediate causes of this downward trend? This last question, which should arise frequently in the articles covering the competitive decline of the U.S. markets, has become lost under what has ultimately become a blame-game, rooted in the need for securities law reform. On the other end of the debate is the argument that increased technology and markets abroad, combined with the lax nature of the laws governing foreign markets, are the real culprits.<sup>9</sup> However, if we look beyond the noise, does the blame really fall where it should?

*Myth 3: IPOs Are the Only (or Widely) Available Methods of Going Public*

There was a time "when the very phrase 'going public' conjured so much in the entrepreneurial imagination," including a sense of fulfilling the American Dream—of gaining the prestige of having a company's

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5. See *infra* Part III.B.1.

6. See *infra* Part III.B.1.

7. Securities Act of 1933, 15 U.S.C. § 77a (2000); Securities Act of 1933 § 11, 15 U.S.C. § 77k (2000); Securities Act of 1933 § 12, 15 U.S.C. § 77l (2000).

8. Securities Exchange Act of 1934, 15 U.S.C. § 78 (2000); 17 C.F.R. § 240.10b-5 (2006).

9. See *infra* Part III.B.2.

shares traded on a market in which all can participate.<sup>10</sup> However, in light of the rising and almost unattainable costs of IPOs,<sup>11</sup> and in recent years the unwillingness of underwriters to complete IPOs for smaller companies,<sup>12</sup> small companies are exploring alternative methods of gaining access to public markets. Among these alternatives is Regulation A, a method which has been utilized for years, and reverse mergers, which were popular in the 1980s, but fell into disuse after a series of schemes rendered it a breeding ground for fraud.<sup>13</sup> However, with a tightening of the laws surrounding the technique, the prospects of fraud have become minimal and reverse mergers have again become a promising vehicle to take small companies public.<sup>14</sup> Perhaps the American markets as a whole should follow the small business issuer example. If these alternative methods of IPOs are being successfully used to achieve public status, is it possible the American markets would benefit by exploring an increase in their use?

This Note proceeds in four parts. Part II discusses the entry of a company into the public market through what is known as the registration process. It explains how an IPO is conducted and the balancing act a company must engage in when considering going public, in light of its goals, constraints and opportunities. Part III explores the current attention to the fear that America may be losing its competitive edge to overseas markets as marked by the decline in American IPOs. Part III attempts to capture and explore the alternate theories being cited for the loss with a strong focus on the American securities laws. Part IV questions the weight placed on IPOs as a true indicator of American competitiveness and explores alternative explanations for declines in the American securities markets. It also explores how widely used IPOs are and the means of access to IPOs for smaller companies. Part v. contains recommendations for improving American competitiveness through the exploration of what I call the “diamond in the rough theory.” The theory evaluates the potential of following the lead of small business issuers in using Regulation A and reverse mergers as viable and profitable means

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10. Ian Mount, *Death of the IPO Dream*, FORTUNE SMALL BUS., Apr. 1, 2005, at 16.

11. JAMES B. ARKEBAUER, GOING PUBLIC: EVERYTHING YOU NEED TO KNOW TO TAKE YOUR COMPANY PUBLIC, INCLUDING INTERNET DIRECT PUBLIC OFFERINGS 33, 165 (1998) (Many underwriters require that the company show it is generating sales of \$10 to \$20 million annually with profits of \$1 million and has a minimum of \$4 million in tangible net assets to obtain a NASDAQ listing.).

12. See Greg Ip, Kara Scannell & Deborah Solomon, *In Call to Deregulate Business, a Global Twist*, WALL ST. J., Jan. 25, 2007, at A1.

13. See *infra* notes 260-62 and accompanying text.

14. See *infra* notes 268-70 and accompanying text.

of attaining public status. If America removes some of the reliance we place on IPOs as a mark of the success of our markets, we may find competitive gains in regulations and methods that are often overlooked. By employing alternatives to IPOs, we may find that companies closed off to public markets by the almost unattainable costs of the IPO process to all but the most affluent of companies have the potential to be the next Starbucks, Google, or Microsoft, generating new prospects for profits in the American markets—if we can only remove these “diamonds” from the “rough.”

## II. GOING PUBLIC AND THE REGISTRATION PROCESS

### A. *What Does It Mean to Be a Public Company?*

A reporting company (commonly coined a public company) is one that has issued securities that trade on at least one stock exchange or over-the-counter market or has otherwise completed a public offering of its securities.<sup>15</sup> A company whose shares are publicly traded must meet the periodic and other reporting requirements set forth in Sections 13 and 15(d) of the Exchange Act.<sup>16</sup> To effect a public offering, commonly termed “going public,” a company must register the offered securities under the Securities Act by filing a registration statement with the Securities and Exchange Commission (“SEC”) prior to making any offers or sales.<sup>17</sup>

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15. See 15 U.S.C. § 78l(g) (2000); 15 U.S.C. § 78m(a) (2000); 15 U.S.C. § 78o(d) (2000). These sections establish the periodic reporting obligations under the Securities Exchange Act of 1934.

16. See *supra* note 15.

17. Walter E. Jospin & Elizabeth Hardy Noe, *Securities Act Registration Process*, in UNDERSTANDING THE SECURITIES LAWS 2001 at 53 (Practicing Law Institute 2001). “Generally, most IPOs are filed on Form S-1.” *Id.* at 64. The rules, regulations and instructions that provide for the contents of the registration statement and prospectus are Regulation S-K, which contains uniform disclosure items applicable to filings under the Securities and Exchange Act and Regulation S-X, which governs financial statements in these filings. THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, INTRODUCTION TO THE DEAL: WHAT IS INVOLVED IN A SECURITIES OFFERING? 4 (1998) [hereinafter INTRODUCTION TO THE DEAL]. General Instruction I to Form S-1, under Regulation S-K, provides that it shall be “used for registration under the Securities Act of 1933 of securities of all issuers for which no other form is authorized or prescribed, except that this form shall not be used for securities of foreign governments or political subdivisions thereof.” 17 C.F.R. § 239.11 (2006). Form S-3, under Regulation S-K, may be used to register securities when certain qualifications are met, such as the registrant is organized under the laws of the U.S. and has its principal business operations in the U.S. and has a class of securities registered pursuant to Section 12(b) or 12(g) of the Exchange Act or is required to file reports pursuant to Section 15(d) of the Exchange Act. 17 C.F.R. § 239.13. Form S-4, under Regulation S-K, may be used for registration under the Securities Act of securities to be issued in a merger in which the applicable

*B. The Registration Process—The Road to the Public Market*

Any security to be offered or sold in the U.S. must be registered under the Securities Act unless an exemption from registration applies to the transaction or the security itself.<sup>18</sup> To initiate registration, a company must file a registration statement with the SEC.<sup>19</sup> The purpose of a registration statement is to facilitate informed investment decisions and discourage the fraudulent promotion of worthless securities.<sup>20</sup> A registration statement is generally composed of: (1) information that is required to be included in a prospectus; and (2) additional information not required to be disclosed in a prospectus.<sup>21</sup> The substance of the registration statement is set by Section 7 of the Securities Act and a range of SEC regulations.<sup>22</sup>

Registration statements require in-depth explanations of the industry in which the issuer operates, the services or products the company provides, the risk factors associated with the issuer's industry and operations, the intended use of the money received in the offering, information about officers, directors and principal shareholders, and audited financial statements for current and prior years.<sup>23</sup> After the registration statement is drafted, it must be filed with the SEC, at which time it is subject to review by the SEC's Division of Corporation Finance.<sup>24</sup> The SEC will provide the issuer with comments on the

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state law would require the solicitation of the votes or consents of all the security holders of the company being acquired, in an exchange offer for securities of the issuer to another entity, in a public reoffering or resale of any such securities acquired pursuant to Form S-4, or in more than one of the kinds of the transactions listed. 17 C.F.R. § 239.25. Form SB-1 under Regulation S-B may be used by a small business issuer to register up to \$10,000,000 of securities to be sold for cash, if they have not registered more than \$10,000,000 in securities offerings in any continuous twelve month period, including the transaction being registered. 17 C.F.R. § 239.9. Form SB-1 may be used until the company registers more than \$10,000,000 in securities under the Securities Act in any continuous 12 month period or when it no longer meets the definition of small business issuer in Rule 405 of the Securities Act. *Id.* Form SB-2 under Regulation S-B may be used by a small business issuer to register securities to be sold for cash. 17 C.F.R. § 239.10. Form 1-A, under Regulation A, is used for securities offerings made pursuant to Regulation A for an aggregate offering strictly limited to \$5 million in securities which may be sold in any twelve month period. 17 C.F.R. § 239.90; DAVID N. FELDMAN, REVERSE MERGERS: TAKING A COMPANY PUBLIC WITHOUT AN IPO 171 (2006).

18. INTRODUCTION TO THE DEAL, *supra* note 17, at 3.

19. *Id.*

20. JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 117 (5th ed. 2006).

21. INTRODUCTION TO THE DEAL, *supra* note 17, at 3.

22. *Id.*

23. COX ET AL., *supra* note 20, at 145-48.

24. For a further analysis of the registration process, including a detailed description of the SEC review procedures, the restrictions on publicity and solicitations for offers prior to and

registration statement and the issuer will file one or more amendments in response to these comments with the SEC.<sup>25</sup> When there are no further comments the registration statement is considered to be effective, subject to certain timing restrictions.<sup>26</sup> The registration statement must be declared effective before a public offering may be consummated.<sup>27</sup>

Once the registration statement has been declared effective by the SEC, the company must comply with the reporting requirements of the Exchange Act for an entire fiscal year under Sections 13 and 15(d) of the Exchange Act.<sup>28</sup> Fulfilling these requirements subjects the company to numerous additional costs, which are examined below, and include the fees of attorneys and accountants, who, due to the complexity of the process, are almost always necessary parties in the registration process.<sup>29</sup>

So what exactly is the appeal of going public? The simple answer is that going public can generate incredible wealth for a company if the offering is successful.<sup>30</sup> But public companies enjoy other benefits as

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following the effective date and prospectus delivery requirements see Securities Act of 1933 § 5, 15 U.S.C. § 77e (2000); INTRODUCTION TO THE DEAL, *supra* note 17, at 4-12.

25. INTRODUCTION TO THE DEAL, *supra* note 17, at 8.

26. *Id.* at 8 & n.8 (“As a technical matter, under Section 8(a) [of the Securities Act], a registration statement becomes effective 20 days after filing, or in the event one or more amendments are filed prior to the effective date, 20 days after the filing of the last such amendment.”). When the issuer is prepared to sell the securities they have registered in the registration statement, and no further comments are offered by the SEC, or the SEC has declared there will be no further review, the issuer and/or managing underwriters may request that the effective date be accelerated pursuant to Rule 461. *Id.*; 17 C.F.R. § 230.461 (2006).

27. INTRODUCTION TO THE DEAL, *supra* note 17, at 3.

28. Section 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(d) (2000).

Each issuer which has filed a registration statement containing an undertaking which is or becomes operative under this subsection as in effect prior to August 20, 1964, and each issuer which shall after such date file a registration statement which has become effective pursuant to the Securities Act of 1933, as amended, shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 78m of this title in respect of a security registered pursuant to section 78l of this title.

*Id.* (internal citations omitted). The duty to file under this subsection shall also be automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class to which the registration statement relates are held of record by less than three hundred persons. *Id.*

29. *See infra* Part II.E.

30. To be sure, the prospects of wealth are far from speculative. *See, e.g.*, CHRISTOPHER BYRON, *MARTHA INC.: THE INCREDIBLE STORY OF MARTHA STEWART LIVING OMNIMEDIA* 352 (2003) (discussing that Martha Stewart’s IPO of Martha Stewart Living Omnimedia in October 1999, which would have generated \$614.7 million if it traded at the \$18 it was originally priced at, actually traded at \$37.25 the day of the IPO, instantly bringing her individual net worth to \$1.27 billion); *see also* JAMES J. CRAMER, *CONFESSIONS OF A STREET ADDICT* v. (2002) (describing the

well. Public companies have an easier time attracting investors than private companies because ownership interests in public companies are easier to turn into cash or, in other words, are more liquid.<sup>31</sup> Because of this liquidity, public companies can use their stock to gain additional financing and to attract experienced executives, by offering stock as part of a compensation package, whose expertise may prove crucial in meeting or even exceeding the company's goals for growth.<sup>32</sup> Thus, for suitable companies, a public offering can allow a company to grow and expand in ways that private companies simply cannot.

### C. *The IPO—The Traditional Choice for Public Market Debut*

The IPO is perhaps the most ubiquitous term in public offering talk. An IPO is the first offering sale of a corporation's shares to public investors.<sup>33</sup> IPOs are initiated to assist the company in generating capital, and often companies who engaged in IPOs list on public stock exchanges.<sup>34</sup> The term only applies to the first offering of an issuer's shares, and any further offerings by the same issuers are called secondary offerings.<sup>35</sup> The registration process for an IPO is the same as that described above.<sup>36</sup>

An IPO begins with the decision of a company to go public. Management then searches for investment bankers to underwrite the stock offering, which involves buying all the public shares at a predetermined price and then reselling them to the public.<sup>37</sup> The hope is that the shares will be sought with great demand. The underwriters then help the company prepare the prospectus and lawyers will typically help draft the registration statement.<sup>38</sup> The proposed stock sale is then publicized in the financial press in what are commonly termed tombstone ads, due to their heavy print and black borders.<sup>39</sup> The underwriters and management may also choose to engage in a "road

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success of his IPO of *TheStreet.com* and how this "red-hot deal" would be "putting literally hundreds of thousands of dollars into the pockets of whomever we gave it to").

31. ROBERT W. WALTER, COMPLETING A SMALL BUSINESS IPO 1-7 (2006).

32. Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes-Oxley*, 41 WILLAMETTE L. REV. 707, 710-11 (2005).

33. Citi.com, Selling New Stock, [http://web.da-us.citibank.com/cgi-bin/citifi/scripts/infrastructure/article.jsp?BV\\_UseBVCookie=yes&BS\\_Id=LBP-9&M=S](http://web.da-us.citibank.com/cgi-bin/citifi/scripts/infrastructure/article.jsp?BV_UseBVCookie=yes&BS_Id=LBP-9&M=S) (last visited Oct. 17, 2007).

34. *Id.*

35. *Id.*

36. *See supra* Part II.B.

37. Citi.com, *supra* note 33.

38. *Id.*

39. *Id.*

show” by which the company travels to inform people about the upcoming offering and gain interest for the shares.<sup>40</sup> Any solicitations for offers or sales of these shares however are prohibited until the SEC declares the registration statement effective.<sup>41</sup> The day before the actual sale, underwriters price the issue, which means they set the price they will pay for each share.<sup>42</sup> When the stock begins trading the next day, the price can either rise or fall depending on demand and whether investors agree with the price set by the underwriters.<sup>43</sup>

The IPO process can take upward of nine to twelve months depending on the size and complexity of the offering.<sup>44</sup> Ultimately, determining whether a company is suitable for a public offering depends on how the company’s goals fit within the benefits and risks spectrum of going public. It is important to note that due to the current costs of public offerings and maintaining public status, going public using traditional means may not even be an option worth considering for smaller companies.<sup>45</sup> The following section provides an overview of the benefits, costs and risks of going public, and being public.

#### D. *The Benefits of Public Status*

When we hear about companies going public, we are often focused on the companies that enter the market with more success than ever imagined, such as Martha Stewart, Google, and Starbucks.<sup>46</sup> The decision to go public, however, involves more time, money and preparation than one would imagine. Thus, the decision cannot be made lightly and the outcome can be the beginning of a bright future or can be the end of a dream for the company endeavoring on this journey. The benefits of achieving public status, however, are numerous and include:

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40. FRANKLIN A. GEVURTZ, *BUSINESS PLANNING* 602 (3d ed. 2001).

41. INTRODUCTION TO THE DEAL, *supra* note 17, at 3.

42. Citi.com, *supra* note 33.

43. *Id.*

44. FELDMAN, *supra* note 17, at 24.

45. Item 10 of Regulation S-B, defines small business issuer “as a company that meets all of the following criteria: (i) has revenues of less than \$25,000,000; (ii) Is a U.S. or Canadian issuer; (iii) Is not an investment company and is not an asset-backed issuer (as defined in § 229.1101 of this chapter); and (iv) if a majority owned subsidiary, the parent corporation is also a small business issuer.” 17 C.F.R. § 228.10 (2006).

46. See *supra* note 30 and accompanying text; Douglas MacMillan, *Google’s Historic IPO Run: Beatable*, BUSINESSWEEK, Aug. 16, 2007, available at [http://www.businessweek.com/technology/content/aug2007/tc20070816\\_081016.htm?campaign\\_id=rss\\_tech](http://www.businessweek.com/technology/content/aug2007/tc20070816_081016.htm?campaign_id=rss_tech); Steve James, *Glare of Publicity Key in IPO Success*, REUTERS, Dec. 7, 2003, available at <http://www.personal.psu.edu/txp14/pdfs/reuters%2012-7-03%20media.pdf>.

### 1. Increased Capital

A public offering can generate millions, and in some cases even billions, of dollars in funding for a company.<sup>47</sup> This funding can be used to fulfill a number of a company's goals that can include consummating a merger.<sup>48</sup> Publicly traded stock is commonly used as consideration in merger transactions, for advancing research opportunities, and stimulating growth.<sup>49</sup> As a result of the increased value in their stock, companies may choose to offer stock in lieu of cash when engaging in a merger or acquisition as stock-for-stock acquisitions are generally eligible to receive more favorable tax treatment than transactions involving cash-for-stock.<sup>50</sup>

### 2. Liquidity for Stockholders

Following the offering to the public, and after a short period of time known as the "lock up period," executives and other employees can begin to sell the stock they have accumulated (subject to any restrictions under the securities laws such as Rule 10b-5, which governs insider trading).<sup>51</sup> This liquidity benefit is much higher than that of private issuers as there are more "outs," meaning the stock can be sold with more ease.<sup>52</sup> The benefit is not temporary, but rather continues throughout the life of the company as equity compensation will likely continue to be paid to directors, executives and employees.<sup>53</sup> Additionally, liquidity can provide leverage for a company seeking to hire and/or retain talented employees and managerial staff as equity compensation is often a common component of an executive compensation package.<sup>54</sup>

### 3. Enhanced Ability to Raise Equity

If a company's stock has performed well on the public market after the company engages in a going public transaction, the company may decide to undergo additional stock offerings to raise capital.<sup>55</sup>

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47. "In 2004, the average amount raised through an IPO was approximately \$190 million, with seven IPOs bringing in over a billion dollars each." Rose, *supra* note 32, at 712.

48. *See id.*

49. *Id.* at 712-13.

50. *Id.* at 713; 26 U.S.C. § 368 (2000) (Internal Revenue Code provision defining different classes of reorganization by stock or otherwise).

51. 17 C.F.R. § 240.10b5-1 (2006); Rose, *supra* note 32, at 710-11 (the lock up period "is generally set by contract between the shareholder and the issuer").

52. Rose, *supra* note 32, at 710.

53. *Id.* at 711.

54. *Id.*

55. Jospin & Noe, *supra* note 17, at 53.

#### 4. Less Dilution

In a public offering, a company can demand a higher price for its stock than it would be able to in a private offering.<sup>56</sup> Existing owners of the company can give up less of their control, in the form of shares owned, to receive the same amount of funding as they would in a private offering.<sup>57</sup>

#### 5. Company Prestige

A company that undergoes a public offering will become a part of the public eye and will attract the attention of financial analysts. While this may entail negative implications, it presents the company with an opportunity to enhance its credibility and attract new shareholders.

[L]enders and suppliers may believe public companies to be better credit risks, and thus may be inclined to offer better contract terms to those companies. Because public companies are often deemed to be more stable, potential customers may be more willing to contract with or purchase goods and services from public companies than private companies.<sup>58</sup>

However, it is important to note that smaller companies often receive less coverage and may not reap as many of the “publicity benefits” that a larger company would.

Fame, publicity and profit are common only to very few of those issuers who undergo the IPO process.<sup>59</sup> The rest either are not met with the success that few IPOs have enjoyed or are dissuaded from the process by the numerous costs and risks associated with the IPO process and the subsequent maintenance a public company requires. The next section outlines these costs and risks.

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56. GEVURTZ, *supra* note 40, at 587.

57. Michael A. Woronoff & Jonathan A. Rosen, *Understanding Anti-Dilution Provisions in Convertible Securities*, 74 *FORDHAM L. REV.* 129, 134-35 (2005) (“Dilution connotes a decrease in something. As applied to equity securities, there are two potentially relevant dilution concepts: percentage dilution, a decrease in the percentage of the entity an investor owns, and economic dilution, a decrease in the economic value of the investor’s investment in the entity.”). Dilution occurs through the issuance of new shares of a company or the issuance of securities convertible for common stock of a company. *Id.*

58. Rose, *supra* note 32, at 713.

59. There were only seven well-publicized and highly profitable IPOs in 2006. *See infra* note 215 and accompanying text.

*E. The Price of Publicity*

## 1. The Expense

An IPO is an extremely costly undertaking. Costs can vary considerably depending upon an individual company's history, size and complexity. At a minimum, legal costs can range anywhere from \$150,000 to \$300,000, accounting fees anywhere from \$20,000 to \$75,000 and audit fees from \$30,000 to \$200,000.<sup>60</sup> Additionally, printing fees can run between \$20,000 and \$60,000.<sup>61</sup> Underwriter commission and expenses usually vary between five percent and ten percent of the proceeds of the offering and represent the bulk of the expense.<sup>62</sup> Consequently, the total cost to take even a small company public through an IPO can surpass \$2 million.<sup>63</sup> If the company plans to trade its stock on a stock exchange or quotation system, its costs will increase.<sup>64</sup>

## 2. Costs of Remaining Public

Once a company completes a public offering, it must comply with the federal securities law disclosure requirements.<sup>65</sup> The Exchange Act requires public companies to file periodic reports with the SEC, including the obligation to file quarterly Form 10-Q reports and annual Form 10-K reports, to comply with complex rules relating to solicitation of proxies under Section 14, to distribute an annual report to stockholders and to publicly disclose any material developments, which occur in the interim of 10-Q and 10-K filings, on a Form 8-K.<sup>66</sup> All of

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60. ARKEBAUER, *supra* note 11, at 31; COX ET AL., *supra* note 20, at 159. These numbers are based on a 1995 estimate and thus do not account for increased prices over the past decade.

61. ARKEBAUER, *supra* note 11, at 32.

62. Jospin & Noe, *supra* note 17, at 54.

63. Wes Raffel, *Is Going Public Worth the Cost?*, VENTURE CAPITAL J., May 2005, at 49.

64. Application fees are usually required for the stock exchange or quotation system and filing fees for the SEC, NASD, and possible fees for state securities administrators. *See* ARKEBAUER, *supra* note 11, at 33; 69 AM. JUR. 2D *Securities Regulation—Federal* § 389 (1993) (The NASD is a self-regulatory organization which “provides regulation of broker-dealers in a manner generally similar to that imposed upon exchange members and associates by registered national securities exchanges. The NASD provides for rules concerning the qualification and examination of members and persons associated with members, establishing different qualifications and examinations for various types of principals and registered representatives.”).

65. INTRODUCTION TO THE DEAL, *supra* note 17, at 12.

66. Rose, *supra* note 32, at 714-15 (explaining events that prompt a Form 8-K filing including: “significant acquisitions, the loss of key employees . . . termination of the company’s relationship with a major customer”); *see also* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,559, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319 at 83,697 (Aug. 15, 2000)

these filing will require significant effort from the company's attorneys and accountants, and the expense can range from an estimated \$225,000 to \$500,000 annually.<sup>67</sup> Company insiders and investors who hold large amounts of the company's stock will be subject to the reporting requirements of Section 16 of the Exchange Act and must file forms with the SEC.<sup>68</sup> The issuer will also "incur costs in creating and managing an insider trading prevention program."<sup>69</sup>

### 3. Increased Exposure to Securities Law Actions

The officers, directors and major stockholders of a public company could each face civil and/or criminal liability in the process of going public and once they have gone public. Section 11 of the Securities Act sets forth a private cause of action against the issuer by any person who bought securities covered under the registration statement.<sup>70</sup> Section 11(a) provides that an issuer and any party who signed or assisted in preparing a registration statement on its behalf may be held accountable for any material misstatements or the omission of any material information in the registration statement.<sup>71</sup> Section 12(1) establishes a cause of action against an issuer for securities sold in violation of Section 5 of the Securities Act, or in other words, has sold securities that were not registered.<sup>72</sup> Section 12(2) establishes a cause of action against an issuer who has sold a security by prospectus or other communication and such communication contains material misstatements or omissions.<sup>73</sup> These sections are extremely user-friendly as they are intent irrelevant and reliance does not need to be demonstrated in most cases.<sup>74</sup> Rule 10b-5 of the Exchange Act prohibits "trading by the company, its insiders or

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(estimating that on average issuers will make five filings per year under Regulation FD; one disclosure per quarter plus one additional disclosure per year).

67. GEVURTZ, *supra* note 40, at 604.

68. See Exchange Act Rule 16a-3, 17 C.F.R. 240.16a-3; COX ET AL., *supra* note 20, at 920 (stating Section 16(a) "is a reporting obligation, imposed on officers, directors, and 10 percent shareholders, to file with the SEC forms that indicate holdings in the issuer's stock upon achieving insider status." The form that must be filed with the SEC is a Form 3. "Thereafter, most purchases or sales by the insider have to be reported by the end of the second business day following the transaction on Form 4. . . . This 'real time' reporting of insider transactions is a product of the Sarbanes-Oxley Act of 2002, stemming from concern that many insiders bailed out of company stock in advance of discovery that the company had not been honest in its financial reporting, without the public being aware of these trades until much later.").

69. Rose, *supra* note 32, at 714-15.

70. 15 U.S.C. § 77k (2000).

71. *Id.*; INTRODUCTION TO THE DEAL, *supra* note 17, at 13-14.

72. INTRODUCTION TO THE DEAL, *supra* note 17, at 15; 15 U.S.C. § 77l.

73. INTRODUCTION TO THE DEAL, *supra* note 17, at 14.

74. COX ET AL., *supra* note 20, at 482, 485, 520.

their ‘tippees’ in the company’s stock during a time when all material information regarding the company is not available to the public.”<sup>75</sup> An issuer may also expose itself to liability if its stock is sold short by insiders or by failing to comply with the Securities laws, including mandatory periodic filings.<sup>76</sup>

#### 4. Pressure to Maintain Growth Pattern

Once a company is public, it is subject to considerable external pressure that often manifests itself as demands on “management to maintain or exceed financial expectations” and predictions.<sup>77</sup> Companies that cannot continue the predicted or expected patterns of growth may lose the talent of employees and executives who were attracted to the growth potential of the company going public and may “decide to cash out entirely as soon as possible following the IPO.”<sup>78</sup>

#### 5. Takeover Exposure and Loss of Control

If a majority of the shares of a company are held by the public, the company is at risk of being controlled by these outside owners. This is especially true for publicly held entities where control can be further diluted by subsequent public offerings and acquisitions, and existing owners can be displaced by public ownership.<sup>79</sup>

#### 6. Decreased Flexibility

Because going public inevitably includes an increase in the amount of stockholders of the company’s shares and may often include more formalized board procedures and additional directors, the decision making process becomes increasingly more complex and time consuming.<sup>80</sup> The company will likely lose its ability to act quickly when making important decisions such as mergers and further issuances of stock, as shareholder and board approval may be required.<sup>81</sup>

#### 7. Dependence on Market Conditions

The IPO market is cyclical in nature as it experiences upturns and downturns based on numbers of investors, public confidence, the

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75. Jospin & Noe, *supra* note 17, at 54.

76. *Id.*

77. *Id.* at 55.

78. Rose, *supra* note 32, at 711.

79. Jospin & Noe, *supra* note 17, at 55.

80. *Id.*

81. *Id.*

economy and many other factors.<sup>82</sup> As a result, market conditions play a significant role in evaluating the body of investors who will be receptive to the public offering and in assessing the timing and price of the company's offering.<sup>83</sup> When a company decides to engage in an IPO, strategic entry into the market is vital to the success of even the strongest public offering.<sup>84</sup> The implications of this for smaller companies are even more severe. Since smaller companies tend to have fewer shares available on the market, a shareholder may have difficulty finding a buyer. The shareholder of a smaller company will thus find a "wider bid-ask spread, resulting in less-efficient pricing."<sup>85</sup>

#### 8. Management Focus

The public offering process utilizes a significant amount of management's time, commonly termed distraction costs.<sup>86</sup> "[D]uring the registration, some 75 percent of the CFO's time, about 40 percent of the CEO's time, and 20 percent of other senior officers' time will be devoted to matters related to the offering."<sup>87</sup> If the company engages in a "road show," a common practice in IPOs by which officers travel to various cities and try to entice potential investors to buy their stock, the time management spends devoting to the going public process will increase, and oversight of the core business by management will usually be negatively affected.<sup>88</sup> Further, post-IPO management distraction is inevitable as they are much more answerable to shareholders in public companies as financial results are publicly known and changes in

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82. COX ET AL., *supra* note 20, at 138; Jospin & Noe, *supra* note 17, at 56.

83. Jospin & Noe, *supra* note 17, at 56.

84. *Id.*

85. Rose, *supra* note 32, at 712; see Stanislav Dolgoplov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 88-89 & n.26 (2004) (noting the bid-ask spread is the difference between the market makers "sell" and "buy" prices respectively).

There are three basic measures of the bid-ask spread. First, the quoted spread is the difference between the bid and ask prices quoted simultaneously. Second, the effective spread is the difference between the actual bid and ask prices executed at the same time, as many transactions occur inside the quoted spread. Finally, the realized spread is the difference between the actual bid and ask prices for trades separated by a specified period of time, which represents a profit or loss of a liquidity provider in the course of transacting at the initial and subsequent prices.

*Id.* (internal citations omitted).

86. COX ET AL., *supra* note 20, at 159.

87. *See id.*

88. Jospin & Noe, *supra* note 17, at 57.

performance often need to be explained.<sup>89</sup> These costs and risks often serve as a deterrent for issuers seeking to take their company public.

The first question a company must answer when determining whether to go public is if the benefits and risks inherent to IPOs are consistent with the company's goals, financial position, time constraints and available personnel. The previous paragraphs outline only an estimate of the costs of undertaking an IPO and the pricing will differ depending on the size of the company, the offering and the fees charged by the major players involved in the process: the underwriters, lawyers and accountants. The decision must be made with an eye on reality rather than potential glory as the IPO method benefits only few companies who decide to use it as a means to attain the public status and increase capital. Despite the fact that they are few in number, the number of IPOs are regarded as a pervasive tool for evaluating the affluence of the American economy.

### III. THE DEBATE OVER THE CURRENT STATE OF U.S. MARKETS ON A GLOBAL SCALE

#### A. *The Decline of IPOs in American Markets*

There has been much "hand-wringing" over the current condition of America's capital markets and their growth ability both domestically and internationally.<sup>90</sup> The recent concerns are based on observations that foreign competitors have been absorbing a larger portion of the "public market pie" than in past years, despite America's reputation as one of the leading financial centers in the world.<sup>91</sup> The reasons for the downward trend in foreign investments in the U.S. and the increase in American investments abroad remain a subject of discussion, but the focus of the blame seems to be the American regulatory process.<sup>92</sup>

Specifically, it has been noted by advocates of the U.S. economic decline theory that IPOs are a crucial indicator of the well-being of the American economy and so it follows that the decline in the market for

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89. David Feldman, *Reverse Mergers + PIPES: The New Small-Cap IPO*, in PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY 251 (Steven Dresner ed., 2005).

90. *Down on the Street*, THE ECONOMIST, Nov. 25, 2006, at 69.

91. *See id.* at 69; *Ip*, *supra* note 2.

92. *See Down on the Street*, *supra* note 90, at 69-70; James Surowiecki, *The Financial Page Over There*, THE NEW YORKER, Feb. 5, 2007, at 29.

IPOs in the U.S. means our economy is not performing well.<sup>93</sup> As further evidence of this theory, supporters warn that the American IPO market has experienced declines not only domestically but internationally as well.<sup>94</sup> The argument posits that companies that were once praying for entrance to America's exchanges in hopes of generating the most promising of revenues are now turning to markets that are closer to home to go public.<sup>95</sup> This decline, it is advanced, becomes magnified when the number of American firms being taken out of public ownership by private-equity firms is factored into the equation.<sup>96</sup>

The White House has reported in the Economic Report of the President released in February 2007 that there are troubling indications that the "U.S. may be losing its traditional appeal as a [lead] destination for foreign investment."<sup>97</sup> Additionally, in January 2007, New York Mayor Michael Bloomberg and Senator Charles Schumer released a study arguing that "New York City's financial dominance was being eroded, thus putting tens of billions of dollars and tens of thousands of jobs at risk."<sup>98</sup> The Bloomberg and Schumer report also warned that five years ago the NYSE dwarfed the London and Hong Kong exchanges in terms of value of IPOs of stock; in 2006, it has been beaten by both.<sup>99</sup> Further, the Committee on Capital Markets Regulation ("CCMR"), a group of bankers, academics and investors formed in 2006 and headed by Hal Scott, a Harvard Law School professor, released an interim report on November 30, 2006 after researching a range of issues related to maintaining and improving the competitiveness of the U.S. capital markets.<sup>100</sup> The Committee warns that the global competitive position of the U.S. markets is waning dramatically, citing that only five percent of

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93. See *Down on the Street*, *supra* note 90, at 70 (coarsely describing that "[t]he loudest sucking sound has been in the market for initial public offerings, a crucial barometer of financial wellbeing").

94. See Ip et al., *supra* note 12, at A17; *Down on the Street*, *supra* note 90, at 70; Surowiecki, *supra* note 92, at 29.

95. *Down on the Street*, *supra* note 90, at 70; Surowiecki, *supra* note 92, at 29.

96. *Down on the Street*, *supra* note 90, at 70.

97. Ip, *supra* note 2; ECONOMIC REPORT OF THE PRESIDENT 181 (Feb. 2007), available at [http://www.whitehouse.gov/cea/2007\\_erp.pdf](http://www.whitehouse.gov/cea/2007_erp.pdf).

98. Surowiecki, *supra* note 92, at 29.

99. See *Down on the Street*, *supra* note 90, at 70; Kara Scannell & Deborah Solomon, *Business Wins Its Battle to Ease a Costly Sarbanes-Oxley Rule*, WALL ST. J., Nov. 10, 2006, at A1 (citing evidence, in further support of this point, that of the top twenty IPOs in 2006, only three occurred in the U.S., while in 2002, nine of the top twenty IPOs took place in the U.S.).

100. See *Down on the Street*, *supra* note 90, at 69; COMM. ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION vii (Nov. 30, 2006), available at [http://www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf) [hereinafter INTERIM REPORT].

the value of global initial public offerings was raised in the U.S. last year, compared to fifty percent in 2000.<sup>101</sup> Not surprisingly, the Interim Report also proclaims regulatory burden and Section 404 of Sarbanes-Oxley as heavy factors behind the so-called decline.<sup>102</sup> Likewise, the U.S. Chamber of Commerce established an independent, bipartisan Commission on the Regulation of U.S. Capital Markets in the Twenty-First Century, whose findings were released on March 13, 2007, evaluating the competitive position of American capital markets and making recommendations to revive the American market as a global leader.<sup>103</sup> These reports have become the focus of the current debate of the state of America's competitiveness and have sparked an outcry of blame.

The underpinnings of the debate focus on the decline in America's shares of IPOs. What the Schumer and Bloomberg report "calls 'the most dramatic illustration' of this slide toward disaster is a statistic that may seem rather esoteric: in recent years, the number of foreign companies choosing to go public in New York has plummeted, with Europe and Asia snapping up much of the business."<sup>104</sup> Champions of the theory that the U.S. is losing its competitive edge advance similar statistics. First, that America's share of "global IPOs" is now only a third of what it was in 2001, and in 2005 twenty-four of the twenty-five largest global IPOs were held outside the U.S., a number which has greatly added to concerns.<sup>105</sup> Second, that America's share of IPO proceeds has also collapsed since the later 1990s. In 1999, "the peak of the U.S. IPO boom," the NYSE and NASDAQ secured fifty-seven percent of global IPO proceeds, which marked a significant increase from the thirty-nine percent of proceeds America realized in 1990, and by last year America's share plummeted to eighteen percent.<sup>106</sup> And third, it is claimed that the global market is reaping these benefits. Hong Kong, it is alleged, enjoyed the biggest increase, "snag[ing] 16% of world IPO proceeds in 2006 compared with zero in 1990."<sup>107</sup> And the

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101. INTERIM REPORT, *supra* note 100, at x, 2.

102. *Id.* at 5. The Interim Report is also unique in that it cites the rise of class action "litigation [as] a factor to be seriously considered" when discussing the decline in the economic position of the United States on a global scale. *Id.*

103. U.S. CHAMBER OF COMMERCE, COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY: REPORT AND RECOMMENDATIONS 1 (2007), available at <http://www.uschamber.com/publications/reports/0703capmarketscomm.htm> [hereinafter CHAMBER OF COMMERCE REPORT].

104. See Surowiecki, *supra* note 92, at 29.

105. See *id.*

106. Ip et al., *supra* note 12.

107. *Id.*

studies echo these conclusions. According to the Chamber of Commerce Report, the fact that foreign companies engaging in IPOs have chosen to list in countries such as the United Kingdom and not the United States is grounds for concern.<sup>108</sup>

In addition to hearing warning bells that the U.S. market for IPOs is dwindling, those who fear an IPO exodus point out that since 1996, there has been a steady decline in the number of companies listing on U.S. exchanges.<sup>109</sup> The U.S. market share for worldwide listings, they emphasize, has dropped nineteen percent since 1997 while foreign exchanges have enjoyed an increase in their listings during this period.<sup>110</sup> Indeed, the data does hint at Europe and Asia enjoying increased listing as investors and companies stray from U.S. markets and exchanges.<sup>111</sup> Contributing to this alleged trend is the fact that U.S. investors, who “bought a record of \$21.2 billion of foreign stocks in [November 2006]” alone,<sup>112</sup> are less demanding that foreign companies list in the U.S. before they purchase shares.<sup>113</sup> For example, Mitchells & Butlers PLC, a British operator of taverns, delisted from the NYSE in 2005.<sup>114</sup> The company cited low volume of trading (less than one percent of the total) as not meriting the annual \$1 million cost of periodic filing requirements and auditor fees flowing from the Sarbanes-Oxley Act of 2002.<sup>115</sup> Mr. Mills, indirect owner of about \$10 million in Mitchells & Butlers shares, believed that the stock was easier to trade at home and that all evidence of American markets improving was speculative.<sup>116</sup>

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108. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 19.

109. *Id.*

110. *Id.*

111. *Id.*

112. James J. Cramer, *The Bush-Proof Portfolio*, NEW YORK, available at <http://nymag.com/news/businessfinance/bottomline/27337/index.html> (last visited Oct. 17, 2007).

113. Ip et al., *supra* note 12.

114. *See id.*

115. *See id.* (noting that Mitchells & Butlers investors “want to go where the liquidity is”).

116. *See id.*; see also Aaron Pressman, *IPOs Are Looking Tasty Again*, BUSINESS WEEK ONLINE, Dec. 25, 2006, [http://www.businessweek.com/magazine/content/06\\_52/b4015047.htm](http://www.businessweek.com/magazine/content/06_52/b4015047.htm).

The once-moribund market for initial public offerings heated up in 2006, giving savvy investors an opportunity to beat the market by a wide margin. IPOs gained 24% through Dec. 8, vs. a 13% gain for the Standard & Poor’s 500-stock index, according to Renaissance Capital in Greenwich, Conn., as the amount of money raised jumped 19%, to \$38 billion. . . . The slow but steady return of technology IPOs is expected to continue. Tech and telecom stocks generally did well in 2006, helping push open the IPO window, says Dan Genter, president of RNC Genter Capital Management in Los Angeles. The S&P 500’s tech index gained almost 25% from mid-July through Dec. 8. . . . A few companies that have filed to go public in early 2007 look promising. Francis Gaskins, editor of IPODDesktop.com, likes Supermicro Computers Inc., a computer-server maker that has been profitable for 17 straight years and boasts solid

*B. Theories of Decline: Regulatory Costs, Privatization and Improvements in Foreign Markets*

1. Regulatory Costs

The regulatory system in America has received much of the blame for the decline in American competitiveness. Specifically, the 2002 Sarbanes-Oxley Act, which toughened up corporate regulation following the Enron and WorldCom scandals, has been touted as being implemented and interpreted in ways that create new risks to our economy and have forced companies to spend more on accountants than research.<sup>117</sup>

Section 404 of the Sarbanes-Oxley Act has itself been cited as one of the fundamental sources of America's declining competitiveness.<sup>118</sup> Section 404, often classified as one of the most contentious parts of the act, requires an annual internal control report which must be certified by auditors and must be personally signed off by two executives of a company.<sup>119</sup> Section 404 has alleviated some of the concerns associated

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growth. Time Warner Inc. (TWX) is expected to spin off its cable unit, but Gaskins says he'll wait to see how the unit is valued relative to the roughly \$3,000 per subscriber figure for rivals.

*Id.*

117. *Down on the Street*, *supra* note 90, at 70; Surowiecki, *supra* note 92, at 29 (arguing "that overzealous regulation—as epitomized by the Sarbanes-Oxley Act, the anti-fraud law passed after the Enron and WorldCom scandals—is making the U.S. an increasingly unalluring place to do business"); Michael Schroeder, *SEC Orders New Disclosures on Company Earnings*, WALL ST. J., Jan. 16, 2003, at A2 ("Responding to recent corporate scandals . . . federal securities regulators ordered new disclosure rules to clamp down on an accounting practice that companies have increasingly used to paint rosy financial results. . . . The changes were ordered by Congress under the Sarbanes-Oxley Act, a sweeping corporate accounting-overhaul law . . .").

118. *See Down on the Street*, *supra* note 90, at 70. *But see* Christopher Cox, Chairman, Securities and Exchange Comm'n, Remarks to the U.S. Chamber of Commerce's First Annual Capital Markets Summit: Securing America's Competitiveness (Mar. 14, 2007), available at <http://www.sec.gov/news/speech/2007/spch031407cc.htm> [hereinafter *Securing America's Competitiveness*].

[I]t is wrong to conflate the implementation problems of 404 with the entirety of the Sarbanes-Oxley Act. While it's a handy whipping boy, overall the law has had important positive effects. It may fairly be credited with correcting the most serious problems that beset our markets just a few years ago. It has played a significant and valuable role in restoring integrity to our markets. Remember where we were, and what happened. We needed decisive action. Sarbanes-Oxley delivered.

*Id.*

119. *See Securing America's Competitiveness*, *supra* note 118; Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262 (Supp. 2004).

with the Enron and WorldCom debacles, but the majority view seems to be the regulation “is being implemented too zealously.”<sup>120</sup>

After Sarbanes-Oxley was introduced, auditing expenses ballooned and while they have since fallen some, for a large firm, accounting fees can still top several million dollars a year.<sup>121</sup> Audit fees for Standard & Poor’s 500 (“S&P 500”) companies rose sixty-three percent to \$4 billion in 2004 from \$2.5 billion in 2002, the same year Sarbanes-Oxley was enacted.<sup>122</sup> Companies on average spent \$3.8 million each in fiscal year 2005 to conform with Section 404.<sup>123</sup> Small and large issuers alike “have complained that the way Section 404 is interpreted is overly broad and requires them to spend many hours and millions of dollars documenting things which have nothing to do with the integrity of their financial statements.”<sup>124</sup>

The Chamber of Commerce report noted that its goal was not to restate the arguments that were being explored by the SEC that Sarbanes-Oxley was one of the forces behind the decrease in U.S. competitiveness, but devoted a few pages to the discussion of the implications of the rule.<sup>125</sup> The report distinguished between the direct costs of Sarbanes-Oxley, specifically the implementation and maintenance costs associated with Section 404, and the indirect costs, which include the promotion of adversarial relationships between issuers and their auditors and the marketing benefits foreign market centers have been able to derive from Sarbanes-Oxley.<sup>126</sup> It was found that foreign markets have, with some success, benefitted from broadcasting the

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120. *Down on the Street*, *supra* note 90, at 70.

121. *See id.*

122. Scannell & Solomon, *supra* note 99, at A1; Irene Leech, *Investing for Your Future Unit 4: Ownership Investments*, available at <http://www.investing.rutgers.edu/unit04.html> (last visited Oct. 17, 2007) (Standard & Poor’s 500 is an index used “to assess the general activity of the stock market . . . [it] includes 400 industrial companies, 40 financial institutions, 40 public utilities, and 20 transportation firms . . .”).

123. Scannell & Solomon, *supra* note 99.

124. *Id.* (further noting that “[s]ome companies say auditors are interpreting the [Sarbanes-Oxley] rules so literally that they are asking management to account for such things as who has access to an office key”).

125. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 32-34.

Further, although beyond the scope of this Commission’s work, the Commission believes that nationalistic and noneconomic factors also play a meaningful role. For example, IPOs of Chinese state-owned enterprises may prefer to be centered in the Hong Kong markets. Even if these Chinese entities are listing in regional markets, the fact that they are not listing in the United States deprives American investors of opportunity.

*Id.* at 17.

126. *Id.* at 33.

actual costs and burdens imposed on American reporting companies.<sup>127</sup> It was also reported that foreign markets have touted the speed with which Sarbanes-Oxley was adopted as a “knee-jerk reaction to two well-publicized bankruptcies”<sup>128</sup> and implied that such responses arouse questions about the American regulatory response to future problems.<sup>129</sup> The report stated that the SEC has announced that reviews of Section 404 of Sarbanes-Oxley are in place and have strongly hinted that the burden of this regulation will be eased, especially for smaller firms.<sup>130</sup> The report deferred to the SEC in making recommendations about Sarbanes-Oxley, but emphasized a refining of the rules “to ensure the best practical balance of costs and benefits.”<sup>131</sup>

The notion that IPOs are declining, however, is a matter of perception. Despite the headlining of figures that America’s IPO share is down compared to the global market, a recent report by Thomson Financial evidences the virility of the U.S. IPO market.<sup>132</sup> The study found that “foreign IPOs accounted for 16% of the 208 IPOs in the U.S. last year,” undoubtedly the highest in their twenty year review.<sup>133</sup> In addition, foreign IPOs taking place in the U.S. in 2006 raised \$10.6 billion of the \$45.3 billion in IPO offerings priced domestically, representing twenty-three percent of IPO money raised that year, which is the highest percentage since 1994.<sup>134</sup> Thomson Financial also reported there were more foreign IPOs held by the U.S. in 2006 “than at any time in the past 20 years, which hardly signals a regulation-induced flight.”<sup>135</sup>

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127. *Id.*

128. *Id.*

129. *Id.*

130. *See Down on the Street*, *supra* note 90, at 70.

131. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 34. Among the principal recommendations listed in the report are: to “modernize the federal government’s regulatory approach to financial markets,” to “[c]onvince public companies to stop issuing earnings guidance, to “[c]all on . . . policy-makers to address the serious challenges facing the public company audit profession,” to give the SEC the flexibility to address issues relating to the implementation of Sarbanes-Oxley by making Sarbanes-Oxley part of the Securities Exchange Act of 1934, to “[f]acilitate the ability of employers . . . to offer retirement savings plans,” and to “[e]ncourage employers to sponsor retirement plans through . . . a simpler, consolidated 401(k)-type program.” *Id.* at 146.

132. Roel C. Campos, Commissioner, SEC, Speech in London, England on SEC Regulation Outside the U.S. (Mar. 8, 2007), *available at* <http://www.sec.gov/news/speech/2007/spch030807rcc.htm>.

133. *Id.*

134. *Id.*

135. Kit R. Roane, *Is Wall Street Losing Its Luster?*, U.S. NEWS & WORLD REPORT, Mar. 12, 2007, at 40, *available at* [http://www.usnews.com/usnews/biztech/articles/070304/12wall\\_2.htm](http://www.usnews.com/usnews/biztech/articles/070304/12wall_2.htm).

Furthermore, IPOs are being assigned an unjustifiable weight in analyzing the competitive state of the U.S. markets. Joseph P. Borg, the President of the North American Securities Administrators Association, has refuted the “recent reports suggesting that U.S. capital markets are losing their competitiveness due to increased regulation” and has reaffirmed the role of investor protection that is the “cornerstone” of America’s securities laws.<sup>136</sup> Specifically, he notes that the Committee on Capital Markets Regulation and the Commission on the Regulation of U.S. Capital Markets in the Twenty First Century are short-sighted and “use an appeal to fear that the sky is falling in an attempt to obstruct” the regulation that promises investor and market confidence and protection.<sup>137</sup> As far as the appeals to fear that the U.S. is losing its competitive position, Borg points to the fact that Wall Street experienced record profits in 2006 and thus far in 2007 as evidence that the U.S. economy is not losing ground in the global marketplace.<sup>138</sup> This view becomes strengthened by the fact that the Securities Industry and Financial Markets Association reported that the securities industry’s 2006 pretax profits nearly doubled what they were in 2005 and hit their highest level ever.<sup>139</sup> The trade group reported the 2006 pretax net income for the industry rose from \$17.1 billion in 2005 to \$33.1 billion, an eighty-eight percent increase.<sup>140</sup> In light of the above data, it becomes clear that the conclusions of the reports that allege the U.S. is losing its competitive position need to be viewed with a skeptical eye. The reports should be reevaluated to portray a more realistic picture of the global state of American markets, one that does not place an undue reliance on the number of IPOs in the U.S.

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136. Press Release, North American Securities Administration Association, NASAA Challenges Reports That ‘Over-Regulation’ Has Harmed U.S. Capital Market Competitiveness (Mar. 22, 2007), available at [http://www.nasaa.org/NASAA\\_Newsroom/Current\\_NASAA\\_Headlines/6408.cfm](http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/6408.cfm).

137. *Id.*

138. Joseph Borg, President, North American Securities Administrators Ass’n, Speech at the NASAA Symposium: Protecting Investors and the Integrity of Financial Markets (Mar. 22, 2007), available at [http://www.nasaa.org/NASAA\\_Newsroom/Speeches/6405.cfm#](http://www.nasaa.org/NASAA_Newsroom/Speeches/6405.cfm#) (noting that “Wall Street has a large overseas stake in those foreign markets as well”).

139. David Enrich, *Securities Industry 2006 Pretax Profit \$33.1B, Up 88 Percent*, DOW JONES NEWSWIRE, Apr. 2, 2007, available at <http://www.easybourse.com/Website/dynamic/News.php?NewsID=172759&lang=fra&NewsRubrique=2&pageliste=3> (additionally stating that “[t]he huge 2006 profits were propelled in part by Wall Street firms’ trading arms, which posted \$43 billion in revenue, up 85 percent from \$23.3 billion in 2005, according to SIFMA. Underwriting revenue rose 18 percent to \$23.6 billion from \$20 billion a year earlier.”).

140. *Id.*

The alleged wounds that American securities regulations have been inflicting on the U.S. markets not only have been claimed to be impacting U.S. public markets globally, but domestically as well. The cost and intrusiveness of American regulations, it is thus advanced, are to be blamed for the shift of investments from the U.S. to overseas markets, the decline in IPO numbers and the movement, or remaining of, many companies in the private sphere. Overzealous American regulations have additionally been cited as the driving force behind the growing number of private equity backed companies being sold privately.<sup>141</sup>

The costs and regulatory hurdles to go public in the U.S. today are driving venture-backed companies away from our capital markets system. . . . It's easier for private-equity firms to recoup their entire investment by selling to another private-equity firm, rather than the small portion they typically sell in an IPO.<sup>142</sup>

More of corporate America has been taken out of public ownership by private-equity firms in the first ten months of 2006 than the previous five years combined, spending a total of \$178 billion.<sup>143</sup> In other words, what is being furthered as an explanation for the decline in IPOs is that foreign companies, who are wary of America's arduous regulations, are shunning America. This is said to signal a grim future, in which foreign firms stray from investing in the U.S. and, eventually, American companies potentially abandon the American exchanges to list their shares elsewhere.<sup>144</sup> However, the buying of public companies by the private sector "is not merely a U.S. trend but a global one" as well.<sup>145</sup> Between 1996 and 2002, private-equity buyouts comprised two percent of all domestic mergers and acquisitions and three percent of all such

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141. See Ip et al., *supra* note 12, at A17.

142. *Id.* (internal citations omitted).

143. See *Down on the Street*, *supra* note 90, at 70. *But cf.* Dennis K. Berman & Henny Sender, *Big Buyout Firm Prepares to Sell Stake to Public*, WALL ST. J., Mar. 17, 2007, at A1 (analyzing the advanced stages of the IPO undertaking by Blackstone Group, a "lucrative partnership that has grown rich taking public companies private" and noting that the offering of roughly 10% of its management company would conservatively value the entire enterprise at \$40 billion). Blackstone and several of its rival companies have been said to be exploring IPOs "in the wake of the successful stock-market listing of hedge fund Fortress Group in January." *Id.* at A1, A4.

144. Surowiecki, *supra* note 92, at 29.

145. Ip et al., *supra* note 12, at A17. *But cf.* Michael Wolff, *Serious Money*, VANITY FAIR, May 2007, at 108 (noting that "private equity is now going public" and that the private equity "bubble" has dangerously expanded leaving the question of whether the private equity mass-movement will survive).

global transactions. Between 2002 and 2006, the percentage increased to eleven percent in the U.S. and ten percent globally.<sup>146</sup>

## 2. The Foreign Markets Fast-Track

The growth of foreign markets and the increased appeal of these markets as suitable and profitable targets of investments have been only a minor focus with regard to the decline in American competitiveness. It is often offered in conjunction with the theory that Sarbanes-Oxley is too demanding and needs to be scaled back in order to save America's competitive face. The argument advanced by Treasury Secretary Henry M. Paulson, Jr. is that as U.S.-listed companies are adapting to Sarbanes-Oxley, new listing rules for public companies, and regulatory and enforcement action, global capital markets are evolving, developing and becoming major competitors for U.S. markets.<sup>147</sup> Advances in technology, regulation and capital abroad, have made foreign markets increasingly more suitable mediums for investing. The lower costs of trading in Foreign countries have allowed them to develop "vibrant local securities markets . . . in multiple financial centers."<sup>148</sup> As a result, it is advocated, the U.S. has experienced a steady decline in its share of global capital markets and new challenges to the historical dominance the U.S. enjoyed in the global marketplace have emerged.

The Chamber of Commerce report notes that the last two decades have been marked by a globalization of securities markets, with corporations, accounting firms, investment bank firms, law firms and stock exchanges being internationalized.<sup>149</sup> With globalization comes what I like to call the "twenty-four-hour desk" by which trading in the U.S., Hong Kong and London can ensure twenty-four-hour coverage of the markets.<sup>150</sup> Globalization has increased competition and many foreign exchanges, like the one in Hong Kong, are now more liquid than before, but also have much tougher regulations, ironically modeled on those of the U.S. The Chamber of Commerce warned that the U.S. "lacks an overall vision for how its legal and regulatory framework should respond to these new [international] market developments."<sup>151</sup>

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146. Ip et al., *supra* note 12, at A17.

147. Henry M. Paulson, Jr., United States Treasury Secretary, Opening Remarks at Treasury's Capital Markets Competitiveness Conference at Georgetown University (Mar. 13, 2007), available at <http://www.ustreas.gov/press/releases/hp306.htm>.

148. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 11.

149. *Id.* at 2.

150. Ip et al., *supra* note 12, at A17.

151. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 11.

However, globalization of U.S. markets is by no means a new phenomenon. “[G]lobalization of the markets far precedes America’s regulatory reforms,” which were enacted after the Enron scandals.<sup>152</sup> A report by Goldman Sachs showed that America’s share of the world equity market capitalization has been declining since the 1970s, a time which predated many of the regulations being blamed for the so-called current decline in American competitiveness.<sup>153</sup> Additionally, the report noted that America has never dominated the market as a global foreign exchange and rather “[t]hat crown belongs to London.”<sup>154</sup>

While globalization may be enhancing foreign markets, it is important to note that it is possible that a number of the firms listing overseas are “dodgy” companies that could serve to harm rather than help the American markets.<sup>155</sup> It is said that with global markets rapidly changing, if the U.S. were to succumb to attacks on regulations such as Sarbanes-Oxley without further inquiry into the true economic position of our markets, it would be to show the world that America is giving a green light to regulatory reform and is in essence inviting foreign companies “to take advantage of the regulatory void.”<sup>156</sup> Thus, globalization of the markets may not mean that the U.S. position as a leader in capital markets is declining, but rather globalization may mean more secure markets around the world, a notion consistent with the purpose behind the securities laws.<sup>157</sup>

### C. *The Scope of the IPO and Small Business Issuers*

The cost of IPOs often serves as a barrier to going public for smaller companies who cannot afford to expend the money on underwriters, accountants and other key players in the process.<sup>158</sup> London and Hong Kong have proven less costly than America in going public transactions as investment banks charge half the commission to bring a company public than they do in the U.S.<sup>159</sup> This commission comprises a significant amount of money for when the going public

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152. See Roane, *supra* note 135, at 41.

153. *Id.*

154. *Id.*

155. *Id.* at 40 (noting that “[t]here are an awful lot of dodgy companies that are being floated overseas that would never been allowed over here . . . [a]nd that is a good thing”).

156. *Id.* at 41.

157. *Id.*

158. See *supra* Part II.E.

159. See Surowiecki, *supra* note 92, at 29.

transaction is considered as a whole, investment bank fees represent most of the company's cost outlays during the process.<sup>160</sup>

Because many of these fees and the costs of compliance associated with Sarbanes-Oxley are fixed, big companies can incur them with greater ease.<sup>161</sup> As a result, some small firms have turned to listing on the London Stock Exchange's Alternative Investment Market ("London's AIM") for young stocks, organized in the 1990s with the goal of assisting small startup companies.<sup>162</sup> London's AIM is subject to much less government oversight of firm operations, accounting and disclosure than the London Stock Exchange or America's main markets, but this has not stopped the exchange from rapid growth.<sup>163</sup> London's AIM foreign listings, not all of which are IPOs, "have skyrocketed to 306 from 31 in 2000."<sup>164</sup> In fact, fifty American firms have listed on AIM and most have done so since 2004, and hundreds of other American firms have said they are considering doing so.<sup>165</sup>

AIM's success is viewed as evidence that smaller companies have been seeking a haven from U.S. securities rules.<sup>166</sup> For example, Protonex Technology Company, a Massachusetts maker of fuel-cell power systems, went public on London's AIM in 2006. Scott Pearson, Protonex's CEO, noted "it would have cost three times as much to list in the U.S., in large part due to legal and auditing costs related to Sarbanes-Oxley."<sup>167</sup> Many of London's AIM companies probably could not have listed on a U.S. exchange even before Sarbanes-Oxley, either because they did not qualify or were too small to be considered by U.S. underwriters and investors.<sup>168</sup>

Seemingly, the closed doors of many underwriters and investors to smaller companies, combined with increased regulatory costs, may be a driving force behind the movement of small companies from domestic exchanges to international ones. And while the revenues generated from these smaller companies in isolation may not seem to have a large impact on the market, the proceeds that American exchanges are losing

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160. See *supra* note 62 and accompanying text.

161. *Id.*

162. Ip et al., *supra* note 12, at A17.

163. *Id.*

164. *Id.*

165. *Down on the Street*, *supra* note 90, at 70.

166. Ip et al., *supra* note 12, at A17.

167. *Id.*

168. *Id.*

to foreign exchanges from these smaller companies are left out of the equation of the theory of American capital market decline.<sup>169</sup>

Smaller companies have also experienced a decline in coverage of their stock since banks have been forced by former New York Attorney General (now Governor) Elliot Spitzer to tighten up their research procedures in light of recent scandals.<sup>170</sup> The center of the scandals was the discovery of five prominent Wall Street investment banks that illegally compensated competitors to publish client research without disclosing such arrangements.<sup>171</sup> The SEC's complaints against the firms were settled for \$1.4 billion.<sup>172</sup> While the goal of the SEC's aggressive penalties was to set a precedent where research is separated from banking in order to make the information more transparent, the effects on small business are likely to include increased difficulty in getting analyst coverage and access to capital markets.<sup>173</sup>

The theories advanced for the decline in domestic IPO performance and the simultaneous increase in the global share of IPOs tell only half the story. The reliance on overly strict regulation and the place it occupies at the forefront of the list of theories as to decreased American competitiveness is misleading. The regulatory system alone is not the driving force behind the decline in American investment and IPOs. There is no doubt that Sarbanes-Oxley has room for improvement, but it is not "a harbinger of doom for America's capital markets," and we should be wary of any reports that support this view.<sup>174</sup> Considerations regarding Sarbanes-Oxley regulations and costs "in the decision of many companies to go private have probably been overstated,"<sup>175</sup> and while the U.S. regulatory burden has risen, the same is true of most countries which have become America's most daunting competitors.<sup>176</sup> Further, the implications that flow from observing the decline in IPOs post Sarbanes-Oxley in isolation from the performance of the economy as a whole and from other prevalent factors driving U.S. investment abroad are that the U.S. economic position is viewed in an overly pessimistic manner. While it is true that the American markets need to take action to

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169. *Id.*

170. *Down on the Street*, *supra* note 90, at 70.

171. Matt Krantz, *SEC: Investment Banks Paid Rivals for Research*, USA TODAY, Apr. 28, 2003, available at [http://www.usatoday.com/money/industries/brokerage/2003-04-28-fees\\_x.htm](http://www.usatoday.com/money/industries/brokerage/2003-04-28-fees_x.htm).

172. *Id.*

173. Thor Valdmanis, *Few Believe \$1.4B Deal Will Change Wall St.*, USA TODAY, Apr. 29, 2003, at B1.

174. Surowiecki, *supra* note 92, at 29.

175. Ip et al., *supra* note 12, at A17 (internal quotations omitted).

176. *Id.*

ensure that they remain competitive in an ever-changing and rapidly growing global market place, it does not logically follow that increases in IPOs alone will ensure this.

American securities markets need a new strategy. Regardless of whether the American markets are in decline or are performing at par, the conversation surrounding IPOs needs to change from one of significant financial indicator to simply a factor in the equation of capital market performance. The plausibility of gaining a competitive edge by increasing the number of IPOs undertaken in the U.S. is marginal at best. Moreover, the notion that the naked tally of IPOs reveals a robust market is flawed. IPOs are extremely costly and are often only best suited for those companies that already have the financial means to fund the offering. Perhaps, if we look in the one place that is often the most overlooked, small capital company performance and methods of gaining public access, we may find “diamonds.”

#### IV. THE IPO INDICATOR: A MEASURE OF ECONOMIC HEALTH WITH UNDUE RELIANCE

##### A. *Misplaced Reliance on the Dwindling Numbers of Domestic IPOs as Conclusive Evidence of a Downward Spiral in American Competitiveness*

To state that IPOs are conclusively declining and effecting a death trap for American market stamina would subject the speaker of such statement to a Section 11 or 12 liability equivalent for misleading speech, if there were one.<sup>177</sup> And even if the numbers of domestic IPOs are moving downward, IPOs are not, in isolation, a conclusive measure of economic well being.<sup>178</sup> The year 2006 marked “the richest year in Wall Street history.”<sup>179</sup> The top five U.S. financial firms, all based in New York, reported more than \$60 billion in net income last year.<sup>180</sup> Furthermore, there is little evidence that foreign countries are shying

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177. See 15 U.S.C. § 77k (2000); 15 U.S.C. § 77l (2000).

178. Deepak Gopinath, *IPOs Shun U.S. Exchanges While Wall Street Collects Record Fees*, BLOOMBERG.COM, Feb. 20, 2007, [http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aFO7N\\_Ngeuzc](http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aFO7N_Ngeuzc) (noting that Rob Nichols, President of the Financial Services Forum, stated: “IPO data doesn’t tell the whole story. It would be disingenuous to link IPOs to Sarbanes-Oxley exclusively.”).

179. *Id.*

180. *Id.*

away from American IPOs, rather foreign markets are improving, but this does not in turn mean that U.S. markets are declining.<sup>181</sup>

Even if one were to concede that the U.S. has seen a decline in IPO percentages, the small number of IPOs suggests that maybe they should not be regarded as having the ultimate impact on the performance of our markets. The volume of IPOs is trivial as compared to other classes of trading transactions.<sup>182</sup> In 2006, there were only seven “mega IPOs” in America.<sup>183</sup> Those who reaped the benefits of these IPOs were the issuers, underwriters and investors involved in the process. Regardless of how we categorize the impact of IPOs on American markets, the larger issue seems to be the blame the so-called decline in IPOs has induced. The many fingers pointing to regulatory burden are viewing the situation as a still picture, rather than properly as a collage. While it is purported that Sarbanes-Oxley is fueling an American market decline, a look at some of the statistics suggest there is evidence to the contrary. The post Sarbanes-Oxley period in America has enjoyed an inflow of foreign market participants as evidenced by “the thirty-four foreign IPOs in 2006 equaled the total in 2005 and represented the highest level since SOX was enacted.”<sup>184</sup> And while much of the debate focuses on Section 404 of Sarbanes-Oxley, there is evidence that the spike in accounting fees for larger public companies was not a direct result from compliance with this provision.<sup>185</sup> Non-accelerated filers, companies not yet mandated to satisfy Section 404, also had auditing costs increase forty-two percent.<sup>186</sup> Further, class actions and the almost unattainable costs of IPOs have been chilling the market for these offerings for years. The equation cannot be said to be complete without an analysis of how class actions and investment bank interests have pushed the pendulum in American markets.

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181. Campos, *supra* note 132.

182. COX ET AL., *supra* note 20, at 138.

183. See *infra* note 215 and accompanying text.

184. Campos, *supra* note 132.

185. David M. Katz, *Post-404, Fees Spiked 66 Percent: Study*, CFO.COM, Feb. 15, 2007, [http://securities.stanford.edu/news-archive/2007/20070215\\_Headline102581\\_Katz.html](http://securities.stanford.edu/news-archive/2007/20070215_Headline102581_Katz.html) (explaining that “[b]etween 2003 and 2005, the first three years in which many companies had to comply with Sarbanes-Oxley’s internal control provision, they saw their audit and audit-related fees soar by 66 percent” but the research indicates “that there are a number of reasons audit fees have increased that have nothing to do with Section 404”).

186. See *id.* (quoting “a study of thousands of corporate annual reports” and reporting that “companies required to comply with [Section] 404 saw their audit and audit-related fees increase from a total of \$5.1 billion in the first pre-compliance year to \$8.5 billion in their second year of compliance . . . [and] total fees that non-accelerated filers shouldered rose from \$1.8 billion to \$2.1 billion.”).

*B. A Challenge to Convention: Alternative Explanations for Increased Global Market Competition Relative to U.S. Markets*

“Investor protection is a cornerstone of all strong and successful capital markets and is the hallmark of the U.S. capital markets.”<sup>187</sup> In light of this statement by the Chamber of Commerce it is thus ironic that the headlines of 2006 and 2007 have called for a regulatory retreat, which could in turn reduce protections for investors and decrease scrutiny of financial firms.<sup>188</sup> In his speech in London on March 8, 2007, SEC Commissioner Roel C. Campos expressed concern over the applause the idea of “light touch” standards as a means of promoting markets has received.<sup>189</sup> Promoting lower standards of regulation means less protection and not only does this contradict the goals of securities law, it also proves less appealing to investors seeking to list their shares with a sense of security.

It is reported that significant non-U.S. investors intend to continue to invest hundreds of billions of dollars in domestic markets because they “love the protections rendered by Sarbanes-Oxley.”<sup>190</sup> And if Sarbanes-Oxley is driving investors away from U.S. markets, then why is it that the standards demanded by the act are being emulated on a global level?<sup>191</sup> To thus say that Rule 404 of Sarbanes-Oxley is to be blamed for the alleged loss in U.S. competitiveness is to grossly oversimplify the problem. Many of the investors that are claimed to be fleeing the American markets are actually doing just the contrary, and in large part the protections of Sarbanes-Oxley are keeping these investors put. This Note now turns to sources other than Sarbanes-Oxley whose influences on the market have been well-documented: class actions and underwriter compensation.

1. The Class Action Conundrum

One of most unique aspects of the U.S. capital markets is the broad availability for individuals to recover damages for a wide array of violations of U.S. securities laws through private lawsuits. While many countries authorize private parties to institute lawsuits to recover

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187. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 28.

188. Campos, *supra* note 132.

189. *Id.*

190. *Id.*

191. *Id.*

damages pertaining to capital market activities, none compare in terms of the size and scale of claims allowed by U.S. investors.<sup>192</sup> The costs of such a system are often disproportionate to its benefits.<sup>193</sup> To illustrate this point, take the number of civil penalties in the U.S. as compared to one of its market competitors, the United Kingdom Civil penalties amounted to \$4.74 billion in the U.S. during 2004, an amount which easily trumps the \$40.48 million in penalties imposed in the United Kingdom.<sup>194</sup> The hardest hit fell on issuers in the U.S. who incurred \$3.5 billion in liability.<sup>195</sup> And the trend has continued. Securities class action settlements reached a record high of more than \$18 billion in 2006.<sup>196</sup> Oftentimes, class actions are simply settled to avoid the expense of litigation and the burden on management's time even when management has done nothing wrong.<sup>197</sup> The system has for years been touted as costly, arbitrary and unpredictable.<sup>198</sup>

While there is some evidence that the amount of securities class action filings have dropped, specifically noting the thirty-eight percent drop in 2006, there is warning that this trend is not permanent as whatever has prompted the decrease may not be built into the system.<sup>199</sup> Whether or not the decline represents what will happen in 2007, the impact of securities class actions as a deterrent to American market entrance is well documented.<sup>200</sup> Exposure to class action lawsuits,

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192. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 29 (noting that few European nations have "group actions" comparable to U.S. class actions).

193. *Id.*

194. *Id.*

195. *Id.*

196. Press Release, Institutional Shareholder Services, Institutional Shareholder Services Ranks Top 50 Plaintiffs' Law Firms for 2006 (Mar. 6, 2007) (on file with author) (noting additionally that the "trend appears to be driven by more institutional investors participating in the securities litigation process . . . [and] serving as lead plaintiffs in U.S. class action cases").

197. A 'Shadow' Critique of Competitiveness, *Futures*, SEC. INDUS. NEWS, Feb. 26, 2007, [http://securities.stanford.edu/news-archive/2007/20070226\\_Headline102625\\_Writer.html](http://securities.stanford.edu/news-archive/2007/20070226_Headline102625_Writer.html) (offering as evidence that U.S. class action lawsuits produce more benefits than burdens the fact that "[t]he rate for directors and officers (D&O) liability insurance is six times higher in the United States than in Europe").

198. See, e.g., J. Scott Colesanti, *The Private Securities Litigation Reform Act of 1995: Did the "Rushed Debate" Really Spell the End of Securities Claims and RICO?*, 26 SEC. REG. L.J. 139, 139-41 (1998) (stating the Private Securities Litigation Reform Act of 1995 was inspired by the abuses of the class action process, that the Act has not reduced lawsuits and arguing that "perhaps the Act's proper focus should have been the fact that accountants, brokerage houses, and corporate directors were being *joined* in lawsuits, regardless of the case's disposition").

199. Pamela A. MacLean, *Class Action Decline in '06 May Not Be a Trend*, NAT'L L.J., Jan. 8, 2007, at 6, available at [http://securities.stanford.edu/news-archive/2007/20070108\\_Headline102326\\_MacLean.html](http://securities.stanford.edu/news-archive/2007/20070108_Headline102326_MacLean.html).

200. See *supra* notes 192-93, 196 and accompanying text.

specifically claims under Sections 11 and 12 of the Securities Act and Rule 10b-5 of the Exchange Act, have been a cost that foreign companies have been unwilling to bear in exchange for a U.S. listing.

## 2. The Influence of the Affluent: Investment Banks and the Overseas Push

The attack on the strict regulations in the U.S. has been voiced the loudest by those who seek to benefit from regulatory removal.<sup>201</sup> IPOs are in essence bought by those who can afford their undertaking. Further, underwriters who are key players in the IPO process saw their best year in terms of profits in 2006.<sup>202</sup> How then can we say IPOs are such a trustworthy economic indicator?

While arguments that the U.S. is losing its competitive edge become more and more prevalent, investment banking firms are by no means accompanying the U.S. market downstream. Between “one-quarter and one-third of the revenue stream for large global securities firms now flows from foreign markets.”<sup>203</sup> Even the smaller investment firms have access to foreign capital markets.<sup>204</sup> The result, Wall Street firms win no matter where the deals are made.<sup>205</sup> For example, Merrill Lynch played a role in the Industrial & Commercial Bank of China IPO, which yielded \$401 million in fees.<sup>206</sup> Additionally, according to Bloomberg, “[i]nvestment banks earned \$41.7 billion in fees underwriting securities and advising on mergers in Europe and Asia last year, almost 40 percent more than the \$29.9 billion” generated in the U.S.<sup>207</sup> So while the investment banks have been at the forefront of the

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201. See, e.g., Blair Nicholas & Niki Mendoza, *The “Committee on Capital Markets Regulation” . . . A Wolf in Sheep’s Clothing?*, INSTITUTIONAL INVESTOR ADVOCATE, Third Quarter 2006, at 3 (arguing there is reason to challenge the independence of the independent, bipartisan Committee on Capital Markets Regulation who put out the Chamber of Commerce report, as the committee is heavy on CEO and other executive and directors of investment management companies and accounting firms, a lobbyist for major banks, investment banks and insurers, and does not include any former or current members of the SEC, nor does it include any institutional investors or members of the securities litigation plaintiffs’ bar).

202. See *supra* notes 138-40 and accompanying text.

203. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 23 (stating “[o]ne industry leader has noted that the goals for his institution were to target a balance of securities sales at 60% international and 40% domestic within the next three years”).

204. *Id.*

205. Gopinath, *supra* note 178 (furthering this point by adding that “[t]he likes of Citigroup and Goldman Sachs profit from underwriting stocks the world over. Although none of the 10 biggest stock offerings of 2006 were done in New York, New York-based firms played a role in all of them, sharing the \$1.7 billion in fees those sales generated.”).

206. *Id.*

207. *Id.*

argument that the U.S. is losing its standing as a leader in the global marketplace, and have advocated for a relaxation of the securities laws in order to protect jobs, the banks themselves have contributed to the problem. Investment banks have facilitated in pricing the U.S. out of the global IPO market by charging more in the U.S. to underwrite stocks than anywhere else in the world.<sup>208</sup> The seven percent standard commission of underwriting an IPO is a far cry from the fixed commissions that used to be common practice in the U.S.<sup>209</sup> And when the SEC abolished fixed commissions in 1975, the common sentiment was that which it is today, that Wall Street was doomed.<sup>210</sup>

In the face of increased costs of IPOs, it would only make sense that companies will seek to find where the lowest underwriter fees are charged. This is clearly not the U.S. If Wall Street is true to their word about keeping U.S. markets competitive, perhaps the best place to start would be to lower rates at home. However, this is by no means the sole solution to the problem. Perhaps only a baby step, for even with lower costs, smaller companies will likely find that the doors to IPO access remain closed. It is here, with an eye on the small-cap “diamonds,” that American markets need to explore new ways to ensure access to public markets as many of our foreign counterparts, such as the London Stock Exchange, have already done.<sup>211</sup>

#### V. THE DIAMOND IN THE ROUGH THEORY AS A PROPOSAL FOR BOOSTING AMERICA’S COMPETITIVE POSITION: FOLLOWING THE SMALL BUSINESS ISSUER LEAD

“Small business drives much of the economic activity, innovation and job creation” domestically.<sup>212</sup> However, the cost of capital for small business, especially in the U.S., often stunts their development, growth and capital formation.<sup>213</sup> Businesses too small to enter the public market have fewer options to raise the capital they need to expand and become new players in the public markets.<sup>214</sup> Despite the fact that IPOs are often

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208. *Id.* (noting that “[i]n the U.S., investment banks charged fees averaging 4.4 percent of the value of stock sales in 2006” and an average of 2.3 percent in Europe).

209. *Id.*

210. *Id.*

211. *See supra* Part III.C.

212. CHAMBER OF COMMERCE REPORT, *supra* note 103, at 27 (noting that “small businesses have generated 60% to 80% of net jobs annually over the last decade . . . [and] made up 97% of exporters and produced 28.6% of the known export value in FY 2005”).

213. *Id.*

214. *Id.* (“Likewise, indirect cost increases disproportionately affect smaller firms. . . [D]irector fees for small public firms increased approximately 61% from 1998 to 2004,

unattainable for small-cap companies, small-caps are entering the public market with increasing numbers by employing non-traditional methods of going public such as Regulation A and reverse mergers. As compared to the seven “mega IPOs” of 2006, there were thirty-five Regulation A filings from November 2005 to June 2007 and 179 reverse merger transactions in 2005.<sup>215</sup> Reverse mergers totaled \$1.31 billion in market capitalization during the first quarter of 2006 alone. Perhaps it is time we pay more attention to these small-cap issuers in an effort to raise U.S. competitiveness.

### A. *Alternative Methods to the IPO: Regulation A and Reverse Mergers*

#### 1. Regulation A

Regulation A is a method of bringing small-cap private companies public using a shorter form of filing than the registration statements used in an IPO.<sup>216</sup> The form provides a hybrid process by which small companies may make a public offering of securities officially exempt from registration under the Securities Act but still subject to SEC review.<sup>217</sup> Regulation A applies to offerings to an unlimited number of investors, whether accredited or non-accredited, and offerings pursuant to the exemption are currently capped at \$5 million during any twelve month period.<sup>218</sup> The regulation further requires the issuer to complete

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amounting to \$3.19 per \$1,000 of sales. For large firms, the director fees rose to \$0.32 per \$1,000 in net sales.”).

215. Hoovers, Inc., Hoovers IPO Scorecard, [http://www.hoovers.com/business-information/pageid\\_15824-global-corp-press-index.shtml](http://www.hoovers.com/business-information/pageid_15824-global-corp-press-index.shtml) (last visited Oct. 22, 2007); SEC Filings.com, Form 1-A, <http://www.secfilings.com> (last visited Oct. 22, 2007); FELDMAN, *supra* note 17, at 2.

216. Regulation A, 17 C.F.R. § 230.251 (2006); *see supra* note 17 and accompanying text.

217. Wayne Simon, *Recent Developments Concerning Small Company Capital Formation*, 27 BEVERLY HILLS BAR J. 74, 75 (1993).

218. 17 C.F.R. § 230.251; Regulation D, 17 C.F.R. § 230.501(a) (defining accredited investor as “any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of securities to that person” any bank or “any savings and loan association or other institution . . . whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company . . . any investment company [subject to certain limitations];” any employee benefit plans as defined in the section; private business development company as defined in the section; “[a]ny director, executive officer, or general partner of the issuer of securities being offered or sold or any director, executive officer or general partner of a general partner of that issuer;” “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000;” “[a]ny natural person who has an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;” “[a]ny trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities

and file a Form 1-A with the SEC, known as the offering statement, at least ten days before the offering is to commence.<sup>219</sup> The offering statement is the Regulation A equivalent of a registration statement and asks the issuer to provide much of the same information including risk factors, plan of distribution, pending litigation, tax aspects, officers and key personnel. Regulation A provides for investor protection by requiring, unlike other exemptions, that a mandatory disclosure document, known as the offering circular, be placed in the investor's hand.<sup>220</sup> This affords many of the same investor protections as Form S-1 (the form most commonly used in IPOs) as the offering circular requirement closely resembles the traditional prospectus and mandates that detailed company information and descriptions of the potential and current risks of investing in the company be provided to investors. Offering circulars, like the prospectus, must also be distributed by the issuer and/or broker-dealers to prospective and actual purchasers of the issuer's stock.<sup>221</sup>

Form 1-A is a shortened registration form designed to make the costs involved in its preparation less burdensome. Unlike an IPO, once the Form 1-A offering statement has been filed, oral offers may be made, written offers may be made under Securities Act Rule 255, printed advertisements may be published and radio or television broadcasts may be made provided that:

[T]hey state from whom a Preliminary Offering Circular or Final Offering Circular may be obtained, and contain no more than the following information: (1) The name of the issuer of the security; (2) The title of the security, the amount being offered and the per unit offering price to the public; (3) The general type of the issuer's

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offered;" and "any entity in which all of the equity owners are accredited investors."); *see also* Simon, *supra* note 217, at 75 ("Formerly, Regulation A allowed the sale of only \$1,500,000 by or on behalf of the issuer in any one year, including no more than \$100,000 to \$500,000 by or on behalf of anyone other than the issuer or its affiliates.").

There is a proposal pending for two new rules, Rules 509 and 216, to define a new category of accredited investor called an accredited natural person, which would include "any natural person who . . . owns as least \$2.5 million in investments." Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 8766 Fed. Sec. L. Rep. (CCH) ¶ 87,736 at 84,041 (proposed Dec. 27, 2006). For a further analysis of the proposed rules see generally *id.*

219. Simon, *supra* note 217, at 76; 17 C.F.R. § 230.251(d)(1) (which provides "[e]xcept as allowed by § 230.254, no offer of securities shall be made unless a Form 1-A offering statement has been filed with the Commission").

220. 17 C.F.R. § 230.251(d)(2).

221. *Id.* § 230.251(d)(2)(ii).

business; and (4) A brief statement as to the general character and location of its property.<sup>222</sup>

However, securities may not be sold until the SEC qualifies (the equivalent of IPO effectiveness) the Form 1-A offering statement and the investor has received both the preliminary and final offering circulars.<sup>223</sup>

The benefits of a Regulation A offering are numerous. The offering circular is more streamlined than a full registration statement and does not require audited financial statements.<sup>224</sup> This greatly reduces costs as the fees associated with accountants, lawyers and underwriters make up the true expense of an IPO.<sup>225</sup> There is no limitation on the number of purchasers under a Regulation A offering and additionally, the securities offered are not restricted and can be freely resold.<sup>226</sup> This is a huge advantage as oftentimes potential purchasers may be warded off when they hear the sale involves restricted securities, as the liquidity of such stock is lesser. Stock issued under the regulation can be traded on public markets, but the company is required to file a Form 10-SB with audited financials before it is deemed a full reporting company and the stock can only trade on the Pink Sheets until then.<sup>227</sup>

Regulation A is also unique in that it allows an issuer to “test-the-waters”—to evaluate demand for the issuer’s stock even before an offering is effected.<sup>228</sup> This provision is found in Securities Act Rule 254, which “allows companies contemplating a Regulation A offering to solicit indications of interest from potential investors without first preparing a formal offering statement.”<sup>229</sup> In theory, if sufficient number

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222. *Id.* § 230.251(d)(1)(ii)(C). Further, “[a]fter the Form 1-A offering statement has been qualified, other written offers may be made, but only if accompanied with or preceded by a Final Offering Circular.” *Id.* § 230.251(d)(1)(iii). Securities Act Rule 255 provides, among other things, that “prior to qualification of the required offering statement but after its filing, a written offer of securities may be made if . . . [t]he outside front cover page of the material bears the caption ‘Preliminary Offering Circular,’ the date of issuance, and the following statement . . . in boldface type ‘An offering statement pursuant to Regulation A relating to these securities has been filed with the Securities and Exchange Commission.’” *Id.* § 230.255(a). For a complete list of qualifications of written statements see Securities Act Rule 255. *Id.*

223. *Id.* § 230.251(d)(2).

224. FELDMAN, *supra* note 17, at 171.

225. Lisa A. Mondschein, Note, *The Solicitation and Marketing of Securities Offerings Through the Internet*, 65 BROOK. L. REV. 185, 193-96 (1999).

226. *Id.*

227. FELDMAN, *supra* note 17, at 171.

228. Mondschein, *supra* note 225, at 194 (further noting that the testing the waters concept was introduced in 1992 pursuant to the Small Business Initiatives Release).

229. Simon, *supra* note 217, at 76. Rule 254, also known as the “testing the waters” provision provides that:

of investors do not express interest, the company can learn that fact without incurring the expenditures to qualify the Form 1-A and prepare the preliminary and final offering circulars. On the other hand, if investors do express sufficient interest, the issuer will then proceed with full-scale compliance with Regulation A before actually engaging in the offering but will have the safety of knowing there will be demand for their shares once the offering is effected.<sup>230</sup>

Regulation A is not without restriction. Under Rule 251, there must be a six month dividing line between an issuer's offerings under the provision to ensure that they will not be integrated.<sup>231</sup> If an issuer does not follow this, there is a danger that it will exceed the \$5 million cap on Regulation A offerings and be violative of Section 5 of the Securities Act. Further, if a company has already undertaken a public offering under Form S-1, they are not permitted to use the exemption.<sup>232</sup> In practice this makes sense. Most issuers who will avail themselves of Regulation A do not have the money to fund a Form S-1 offering, and Regulation A is meant to benefit the small players in the market. Furthermore, the restriction that investment companies such as mutual funds may not use the exemption makes sense for the same reasons. Finally, the \$5 million cap on offerings is in gross, not net, and can be a rather small amount of capital when the fees for undertaking the offer are taken into account. But regarding the amount as small or large really depends on the size of the issuer.

The lesser expense, the ability to test the waters and the usual lack of underwriter involvement inherent in Regulation A, in contrast to IPOs, have attracted small issuers for years and was enacted for this purpose.<sup>233</sup> The benefits of the provision should be further explored in talks about U.S. competitiveness. While "the SEC has proposed to extend the scope of the testing-the-waters rule to registered IPOs,"<sup>234</sup> it remains a wonder that this has not occupied a place in the debate over

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An issuer may publish or deliver to prospective purchasers a written document or make scripted radio or television broadcasts to determine whether there is any interest in a contemplated securities offering. Following submission of the written document or script of the broadcast to the Commission . . . oral communications with prospective investors and other broadcasts are permitted. The written documents, broadcasts and oral communications are each subject to the antifraud provisions of the federal securities laws. . . . No sale may be made until qualification of the offering statement.

17 C.F.R. § 230.254(a) to (b) (2006).

230. 17 C.F.R. § 230.254 (2006).

231. *Id.* § 230.251(c).

232. *Id.*

233. Mondschein, *supra* note 225, at 194.

234. *Id.* at 195.

U.S. competitiveness. Such a proposal could allow foreign issuers and smaller issuers, skeptical of the costs of the IPO process, to evaluate the prospects of profit before enduring the expense. Further, rather than entering into an IPO with a significant risk of loss, the process could allow companies to get a “sneak-preview” of the benefits of going public and allow a more concrete risk benefit analysis.

Another proposal excluded from the debate is the SEC’s contemplation of raising the \$5 million cap on Regulation A to \$20 million, which began in 2003.<sup>235</sup> Imagine the growth potential this could have on smaller companies, both foreign and domestic. Companies like Mastercard, which raised \$2.6 billion in one of the “mega IPOs” of 2006, may be found in the small companies that are often left out of the equation on improving the U.S. competitive position. If we can remove these companies from the “rough” of restraints that are placed upon them when seeking public market access, is it not possible they may be the “diamonds” the U.S. market is looking for to raise competitiveness?

## 2. Reverse Mergers

A reverse merger is a transaction by which a private operating corporation or private company completes a business combination with a shell corporation whose stock has previously been offered to the public, or has otherwise become subject to the reporting requirements of the Exchange Act.<sup>236</sup> The shell corporation typically was either formed with no business operations to function as a shell company or is the dormant remnants of a now sold or defunct business that is still public.<sup>237</sup> The private company’s shareholders generally receive between 65 and 95 percent of the stock of the public shell. Securities Act Rule 405 and Exchange Act Rule 12b-2 define shell company as: “a registrant, other than an asset-backed issuer . . . that has: (1) No or nominal operations; and (2) Either: (i) No or nominal assets; (ii) Assets consisting solely of cash and cash equivalents; or (iii) Assets consisting of any amount of cash and cash equivalents and nominal other assets.”<sup>238</sup>

The prevalence of reverse mergers in both U.S. and foreign markets has increased in the past five years beginning with the dot-com “bust” in

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235. UNITED STATES SECURITIES AND EXCHANGE COMMISSION, FINAL REPORT: 2003 CONFERENCE ON FEDERAL-STATE SECURITIES REGULATION 4 (2003), available at <http://www.sec.gov/info/smallbus/ffedst2003.htm>.

236. See, e.g., SEC v. M & A West, Inc., No. C-01-3378, 2005 WL 1514101, at \*2 (N.D. Cal. June 20, 2005); FELDMAN, *supra* note 17, at 20.

237. FELDMAN, *supra* note 17, at 20.

238. 17 C.F.R. § 230.405 (2006); 17 C.F.R. § 240.12b-2 (2006).

2000 which significantly halted the IPO market.<sup>239</sup> In 2000 there were 46 reverse merger transactions and by 2004 this number jumped to 168.<sup>240</sup> There were 179 reverse merger transactions closed in 2005.<sup>241</sup> While reverse mergers are commonly utilized by smaller, unknown companies, a few reverse merger transactions have caught the public eye. One of the most high-profile reverse mergers was the NYSE merger into Archipelago Holdings in a deal worth \$9 billion.<sup>242</sup> In 1970, Ted Turner's combination with once publicly traded Rice Broadcasting evolved into the entity now known as Turner Broadcasting Systems.<sup>243</sup> America West Holding Corporation's (parent of America West Airlines) merger with US Airways Group (parent of US Airways) in September 2005 was also completed using the reverse merger technique.<sup>244</sup> But even the less publicized deals have enjoyed great success. In February 2005, an investor group raised "\$46.5 million contemporaneous with the acquisition of a public shell company called Sports Entertainment Enterprises, Inc." and an "85 percent interest in Elvis Presley's name, image and likeness" as well as the operations of Elvis's Graceland home.<sup>245</sup> The company, CKX, Inc., has continued its pattern of success as evidenced by its acquisition of the proprietary rights to *American Idol*.<sup>246</sup>

So what exactly is the appeal of a reverse merger? The answer is simple—going public through a reverse merger allows a private company to go public typically at a lesser cost, in a smaller time frame

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239. See, e.g., Chris O'Brien, *It Turned on a Dime . . . Or \$2 Trillion Technology Investors, Badly Burned, Remain Wary*, MERCURY NEWS, Mar. 10, 2005, at A1 (explaining that the Dot Com Bust began on March 10, 2000, when the "Nasdaq composite index, bellwether of the tech economy, peaked at 5,048.62 . . . [and] [i]n the following weeks, shareholders began dumping tech stocks and didn't stop for two years." Investors lost trillions of dollars and began suing insiders who cashed out billions. The era was also marked by numerous accounting scandals and newer companies finding it very "difficult to raise money from cautious stock market investors."); FELDMAN, *supra* note 17, at 2 ("The numbers of closed reverse mergers has increased fourfold since 2000." In 2000, 46 reverse merger transactions successfully closed and by 2005 this number increased to 179.).

240. FELDMAN, *supra* note 17, at 2.

241. *Id.*

242. Andrew Dolbeck, *Alternative Offerings: Going Public with Reverse Mergers & SPACs*, WKLY. CORP. GROWTH REP., May 22, 2006, at 1.

243. Turner Hughes Corp., Reverse Mergers, <http://www.turnerhughescorp.com/reverse-mergers.php> (last visited Oct. 22, 2007).

244. Tom Van Riper, *US Airways Seen With 'Low-Hanging Fruit' to Pick*, FORBES.COM, Oct. 10, 2005, <http://www.forbes.com/markets/equities/2005/10/10/us-airways-energy-1010markets09.html>.

245. FELDMAN, *supra* note 17, at 2.

246. *Id.*

and with less stock dilution than through an IPO.<sup>247</sup> In a recent study comparing IPOs and reverse mergers as alternative methods of going public, it was found that reverse merger deals were completed with a mean duration of “92 days compared to 287 days for the IPO sample.”<sup>248</sup> It is not surprising, in light of the increased costs and decreased access to IPOs, that private firms choosing the reverse merger path were significantly smaller with a median value for total assets of \$2.19 million, as compared to a median value of \$41.72 million for companies opting to go public through an IPO.<sup>249</sup> The study also reported that companies undergoing reverse mergers exhibited “higher asset growth rates and are closer to their inception date” than companies utilizing IPOs.<sup>250</sup> It is also noted that insiders in reverse mergers forfeit a smaller ownership percentage and this may further suggest that such owners have no intention to “cash out” when the company goes public.<sup>251</sup> Lastly, the “underpricing of the stock, calculated as the return on the first trading day, appears to be significantly lower for the reverse merger deals.”<sup>252</sup>

While this study greatly supports the current exploration of reverse mergers by smaller companies looking to gain access to public markets where obstacles such as the high prices of IPOs have prevented such access, the method is not without its critics. It has been argued that “[w]hile shell corporations may appear to be an attractive alternative to a registered public offering, the true cost of merging with a shell corporation is usually significantly *greater* than a conventional initial public offering.”<sup>253</sup> The significant problems in going public by merging with, or transferring assets to, a public shell corporation include the high cost of due diligence, the problem of obtaining free-trading stock and

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247. *Id.* at 23-24 (noting “reverse mergers can be completed for under \$1 million” while IPOs cost several million to complete and can be completed in about three to four months, while IPOs take a minimum of nine months to complete).

248. Ioannis V. Floros & Kuldeep Shastri, *A Study of Reverse Mergers: Questionable Shortcuts to the Public Markets or Viable Solutions?*, THE REVERSE MERGER REP., at 32 (2006) (The study “analyzed a sample of 181 firms using reverse mergers and a matched sample of firms using IPOs over the time period starting in 1991 and ending in 2004 in order to understand why companies chose the reverse merger path to become public.”).

249. *Id.*

250. *Id.*

251. *Id.* (noting “[s]pecifically, the median decrease in percentage insider ownership is 19.10% for the reverse merger sample while that for the IPO sample is 22.46%”).

252. *Id.*

253. Mark T. Hiraide, *Appendix 10-B: The “Shell Game”: Dangers of Merging with Public Shell Companies*, in REPRESENTING START-UP COMPANIES 10-31, 10-31 (2006) (emphasis added).

SEC scrutiny.<sup>254</sup> Specifically, critics correctly argue that one of the more difficult tasks is evaluating the “cleanliness” of the shell company as it is often difficult to tell whether the shares held by the public are actually held by bona fide stockholders or nominees controlled by the promoters of the shell.<sup>255</sup> If the latter is true, the market price of the shares can be easily manipulated and the stock price following a merger can thus be artificially inflated.<sup>256</sup>

Critics also cite the transferability of stock as a reason to avoid the reverse merger technique. In a reverse merger transaction “shell promoters often attempt to transfer unrestricted stock to the new owners and their affiliates.”<sup>257</sup> The NASD and the SEC have often viewed promoters of shells and their transferees as underwriters of the shares that are issued.<sup>258</sup> What this means is that re-sales of certain stock issued in reverse merger transactions are prohibited under Rule 144 of the Securities Act, as underwriters are explicitly exempt from availing themselves of Rule 144.<sup>259</sup>

Finally, if reverse mergers provide smaller companies with less costly access to public markets as compared to IPOs, why is it that the words “reverse merger” produce hesitancy in the minds of even the most savvy of businesspeople and lawyers? The 1970s and 1980s were marked by a general lack of regulation of both reverse mergers and the use of shell companies, and thus reverse mergers became easy grounds for fraudulent activity.<sup>260</sup> A number of schemes were initiated using shell companies whereby new public shells would be formed for the sole purpose of raising money from public investors and removing that money in the form of fees, salaries and other “benefits” for running the shell.<sup>261</sup> Such practices tainted the reverse merger name and most investors looked away from any company intending to engage in a reverse merger transaction.<sup>262</sup>

In 2005, likely in response to the rising numbers of reverse merger transactions, the SEC promulgated rules aimed to protect investors by deterring fraud and abuse in the use of reporting shell companies in

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254. *Id.* at 10-31 to 10-32.

255. *Id.* at 10-31.

256. *Id.*

257. *Id.* at 10-31 to 10-32.

258. *Id.* at 10-32.

259. *Id.*; Rule 144, 17 C.F.R. § 230.144 (2006).

260. FELDMAN, *supra* note 17, at 21.

261. *Id.*

262. *Id.* at 22.

transactions such as reverse mergers.<sup>263</sup> Among the changes the SEC implemented were: (1) the prohibition of the use of Form S-8 by shell companies; (2) the increased disclosure necessary to register securities pursuant to a stock option or employee benefit plan; and (3) the requirement that in a transaction where a shell company ceases to be a shell company, the surviving entity must disclose the information that would be required under a Form 10 or Form 10-SB (for small businesses) in a Form 8-K.<sup>264</sup> For a reverse merger transaction, this Form 8-K filing must take place within four days following the completion of the reverse merger as opposed to the seventy-one days companies were given prior to these rules to file a Form 8-K with audited financial statements following a reverse merger transaction.<sup>265</sup> The purpose behind the four day limitation is to ensure that shell companies provide investors with adequate information to make informed investment decisions. Further, it was believed by the SEC that obtaining audited financial statements would deter abuse and further the goals of protecting investors.<sup>266</sup>

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263. Use of Form S-8, Form 8-K and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234 (July 21, 2005) (to be codified at 17 C.F.R. pts. 230, 239, 240, 249).

The rules and rule amendments we are adopting today do not address the relative merits of shell companies. We recognize that companies and their professional advisors often use shell companies for many legitimate corporate structuring purposes. Similarly, our definition and use of the term 'shell company' is not intended to imply that shell companies are inherently fraudulent. Rather, these rules target regulatory problems that we have identified where shell companies have been used as vehicles to commit fraud and abuse our regulatory processes.

*Id.*

264. *Id.* at 42,238; FELDMAN, *supra* note 17, at 134-35 (The disclosures that must be made under the Form 8-K following a transaction where a shell company ceases to be such include "all the information that would be in a prospectus for a traditional IPO: two years of audited financial information . . . full business description, risk factors, affiliate (related party) transactions, executive compensation, comparative period-to-period analysis of financial results, description of capital stock, discussions of securities offerings . . . material contracts . . . , charter, bylaws . . . , biographical information . . . on all officers and directors and their ownership information as well as 5 percent shareholders."). Form S-8 is a registration statement that may be used by companies subject to the requirement to file reports pursuant to Section 13 or 15(d) of the Exchange Act and is not a shell company and has not been a shell company for at least sixty calendar days and if it has been a shell company has filed current Form 10 information with the Commission at least sixty days before reflecting its status as an entity that is not a shell company. 17 C.F.R. § 239.16b (2006). For further qualifications of use of Form S-8 registration statements see General Instruction A. See United States Securities and Exchange Commission, Form S-8, General Instruction (A), available at <http://www.sec.gov/about/forms/forms-8.pdf>.

265. See United States Securities and Exchange Commission, Form 8-K, General Instruction (B)(1), available at <http://www.sec.gov/about/forms/form8-k.pdf>; Aden R. Pavkov, *Ghouls and Godsenders? A Critique of "Reverse Merger" Policy*, 3 BERKELEY BUS. L.J. 475, 504-05 (2006).

266. Use of Form S-8, Form 8-K and Form 20-F by Shell Companies, 70 Fed. Reg. at 42,239.

In an attempt to remove the opportunity for abusive schemes, the new rules forbid the use of Form S-8 by shell companies. The prohibition continues for any former shell company until sixty calendar days after it files, upon completion of a transaction in which it ceases to be a shell company, information equivalent to that required by Form 10 or Form 10-SB in connection with the registration of a class of securities. The SEC holds the view that the sixty-day period will afford employees and the market the opportunity to absorb all relevant information in the company's disclosures.<sup>267</sup>

And it seems to have worked. The increased use of reverse merger transactions by both domestic and foreign small-cap companies seems to suggest a revitalized view of the benefits of the method. Specifically, Chinese companies and German biotechnology companies have been availing themselves of the technique to go public in the U.S. with increasing numbers.<sup>268</sup> For example, in May 2006, a private German biotech company engaged in a reverse merger with, and was taken over by, publicly held U.S. biotech company CancerVax, creating a transatlantic company that listed on NASDAQ under the name Micromet.<sup>269</sup> Chinese companies further regard reverse mergers as preferable to a traditional IPO since it allows the company a more predictable foray into U.S. public markets. In August 2006 alone, generally a calm month for trading activity, Chinese companies completed eleven reverse mergers in the U.S. and five more were announced.<sup>270</sup>

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267. Pavkov, *supra* note 265, at 506.

In 1999 the SEC released a rule proposal that sought to curb a fraudulent scheme perpetrated by shell companies: the issuance of securities to 'employees,' who were actually only advisers or consultants to the company on Form S-8. Although ultimately never adopted by the SEC, the rule would have prohibited the use of Form S-8 by shell companies, which merited consideration since securities registered on Form S-8 become effective immediately upon filing without SEC review. The argument against Form S-8 usage by shell companies was that they have no legitimate need for easy security registration since they have no underlying business in which the employees could share an economic interest. Not surprisingly, shell company promoters could argue that the economic business of the company was to acquire other operating companies.

*Id.* at 500-01. They would thus be allowed to use Form S-8 and it explicitly excludes business combination related shell companies from the prohibition. *Id.*

268. Barbara A. Jones, *Business Combinations With Chinese Companies Pose Challenges for Due Diligence and Ongoing Reporting Obligations*, METROPOLITAN CORP. COUNS., Dec. 2006, at 65; Henning Mennenoeh, Peter Kohl & Wolfgang Kircher, *German Biotechs Embrace Reverse Mergers*, GENETIC ENGINEERING NEWS, Aug. 2006, at 14.

269. Mennenoeh et al., *supra* note 268, at 14.

270. Jones, *supra* note 268, at 65.

Access to U.S. capital markets facilitates raising capital. While there may still be some kinks to work out when it comes to investor protection in reverse merger transactions, the lesson to be derived is that perhaps small-business issuers are onto something. If American markets make public access more widely available by exploring the reverse merger technique and its potential to entice domestic issuers to go public in the U.S., perhaps the so-called American competitive crisis can be partly reduced. Beyond this, however, small capital companies may be the key to ensuring that the U.S. markets remain afloat in an ever expanding sea of global competition. If the Regulation A and reverse merger techniques provide alternative means of breaking the barriers to public access for those who cannot afford to engage in the IPO process, it is likely that observance of and improvements to these methods will lead America to more cost-effective ways to expand participation in its public markets. However, until America decides to dig for “diamonds,” these techniques will remain in the “rough” of potential instead of reality.

## VI. CONCLUSION

Although the debate on the competitive state of the U.S. remains far from resolved, it is necessary to recognize that the reliance on IPOs as the sole market measure of competitiveness is misleading and that regulation alone is not driving investments from U.S. soil. The reports on this topic are thus incomplete. IPOs must be viewed in conjunction with other economic indicators and the impact of securities regulation must be considered in light of other driving forces such as the tremendous number of securities class action lawsuits and the costs of access to public markets.

The solution to ensure America remains competitive, in light of improved and increased investments abroad, will encompass a variety of techniques that may very well include regulatory reform, but this is not the only answer. Perhaps if we stray from viewing IPOs, few in number and which benefit even fewer companies, as a measure of economic health, we may become open to more innovative strategies to ensure an inflow of capital to American markets from both domestic and foreign sources. This will include focusing on small-cap companies, as many of our foreign competitors, including the London AIM exchange, have already begun to do. By viewing smaller companies as the potential to be “diamonds,” and studying the techniques these companies have used

to gain access to public markets, we may very well find solutions in places we never would have thought to look.

If the SEC follows through with its proposal to increase the cap on Regulation A transactions from \$5 million to \$20 million, the number of companies that will avail themselves of this exception will increase exponentially from the thirty-five Regulation A offerings, which occurred from late 2005 to 2007.<sup>271</sup> This would represent a substantial step in widening access to, and involvement in, U.S. public markets for both domestic and foreign issuers, the goal which all of the reports analyzed in this Note agree upon. Thinking out of the box should guide the work that needs to be done. If we keep placing the blame on the regulatory rules that protect investors, rather than exploring other possible reasons for the decline in U.S. competitiveness, we may very well revert back to a stage where American markets are riskier and thus not as enticing as one would hope. With an eye on investor protection, America should take an innovative step to ensure it remains a key player in the global markets, and removing the small-cap “diamonds” from the “rough,” by exploring and improving the non-conventional methods of Regulation A and reverse mergers to gain access to public markets, may be a great place to start.

*Gariel Nahoum\**

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271. See *supra* note 235 and accompanying text.

\* J.D. candidate, 2008, Hofstra University School of Law. I wish to dedicate this Note to my mother, Diana, who is my “muse,” my greatest inspiration and a source of love and support unlike any other, and to my incredible brother Michael whose faith in me and in life brings a smile to my face every morning. I would like to thank Dean Miriam Albert for her brilliant insight and for making this Note possible. I owe a great deal of gratitude to Professor Scott Colesanti for inspiring me to find my “voice” as a legal writer, and for his endless hours of guidance and assistance with research. A warm thank you to David Feldman, a truly wonderful mentor and friend, for passing his unsurpassed knowledge of reverse mergers onto me. A sincere thanks to Arthur and my grandmother, Shirley, for giving me the wings to pursue my dreams; to Ashley, Curtin, Diana, Erica, Irina, Jill, Laura, & Lauren; and to Stephen, for his constant encouragement, selflessness and love. Finally, a huge thank you to the members of the *Hofstra Law Review* and especially Erick Rivero, Emin Guseynov, Stefanie Hyder, Stephanie Restifo, Renato Matos, Irina Boulyjenkova, Kathleen Dreyfus Bardunias, Ella Govshtein, Joshua Wolf, and Heather Moros for all their hard work and dedication.