

Berkeley Center for Law, Business and the Economy

# Post-JOBS Act Challenges and Solutions in “Private” Secondary Trading Markets

Robert Bartlett  
UC Berkeley School of Law

2012 SEC Government-Business  
Forum on Small Business  
Capital Formation

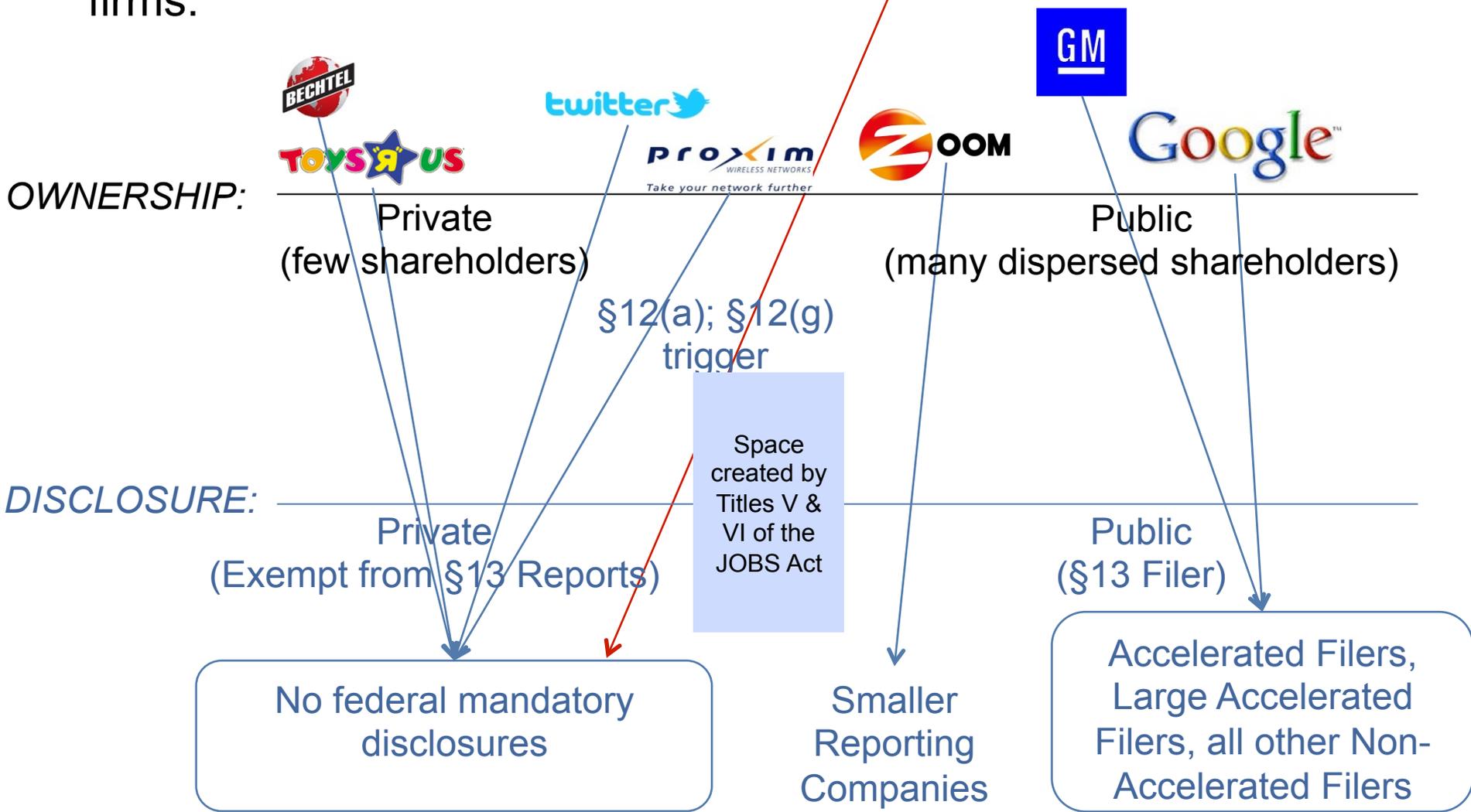
November 15, 2012



# Should the JOBS Act have considered adding some form of mandatory scaled disclosure for this new space?

## Introduction

- The conventional view of distinguishing “public” from “private” firms:



# Outline

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- Brief overview of how firms with public trading can be exempt from federal mandatory disclosure obligations.
- Some problems with this state of affairs after the JOBS Act for both investors *and issuers*.
- What the Commission can do about it.

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In the U.S., over-the-counter trading in stock is carried out by market makers ... This segment of the OTC market is occasionally referred to as the "Fourth Market."

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Symbol	Price	Pct Chg	\$ Volume	Share Volume	# Trades		
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**0.75** 0.00 (0.00%)

**Real-Time Best Bid & Ask**

**0.75 / 1.05** (1 X 1) [Why is size 1?](#)

Previous Close

**0.75**

Open

**N/A**

Daily Range

**N/A - N/A**

52wk Range

**3.20 - 0.75**

Volume

**0**

Dividend

**N/A**

Average Vol (3m)

**1,257**

Yield

**N/A**

Trade Time Nov 7, 2012/ Last Best Bid & Ask Update 6:30:24 EST

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**PRXM** Proxim Wireless Corp.



Common Stock

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**0.75** 0.00 (0.00%) at Nov 7, 2012 Real-Time Best Bid & Ask **0.75 / 1.05** (1 X 1) [Why is size 1?](#)

Income Statement

Balance Sheet

Cash Flow

Reporting Status: **Alternative Reporting**

View: Quarterly

**Annual**

(Values in 000s / USD)

PRXM is not currently reporting to the SEC or uploading reports through the OTC Disclosure and News Service. Financial data is not available at this time. [More information on OTC Disclosure and News Service.](#)

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# How can these “public” firms be exempt from Section 13 reporting obligations?

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- Reasons for federal exemption:
  - Firms go (or stay) beneath the Section 12 shareholder trigger to avoid Section 13 reporting obligations;
    - Much easier post-JOBS Act
  - Firms avoid selling securities in a public primary offering; and
  - Selling shareholders/dealers can rely on Section 4(1), 4(3) and 4(4) exemptions to avoid registration of resale transactions.
- It’s an increasingly important part of our capital markets—and one that is encouraged by Titles V & VI of the JOBS Act:
  - OTC “No Information” firms
    - 3,124 as of November 12, 2012
    - 2,516 based in U.S.
  - SecondMarket
    - Over \$1 billion in private stock transactions since 2008; \$6.1 billion in buy-side demand in 2011.
    - New community bank pilot program.

# Some problems with this state of affairs

- **Problem #1: Issuers remain subject to residual broker-dealer regulations and state disclosure/registration obligations that are costly for issuers without providing clear benefits to investors.**
  - **Broker-dealer regulation: Exchange Act Rule 15c2-11**
    - Unless an exception is available, Rule 15c2-11 requires that, prior to entering a quotation for an OTC security in a quotation medium, a broker/dealer have in its files specified information about the security and its issuer.
      - 16 items of information including: basic corporate details; officers and directors; capital structure; most recent balance sheet and income statement.
  - **Reasons for questioning its utility for investors:**
    - Governs only the initiation or resumption of quotations
      - Information can quickly become outdated.
    - Doesn't apply to "new" secondary markets (e.g., SecondMarket/SharesPost)
    - No public repository of the 15c-11 information
    - Scope of rule is limited by exceptions:
      - Rule 15c2-11 does not apply to an unsolicited quotation
      - Rule 15c2-11(f)(3) (the "piggyback" exception) exempts a BD from the rule if, during the 30 calendar days before a BD's submission of quotations, the security was the subject of bid/ask quotations on at least 12 days and there were no gaps of more than 4 business days during which no quotations were published.
  - **Result→Rule15c-11 has been repeatedly criticized:**

"[T]he quoting broker-dealer is commanded by regulation to stuff the information into its files where, in all likelihood, it will never again see the light of day. Rule 15c2-11 is a rule of darkness." - R. Cromwell Coulson, CEO Pink Sheets, LLC (June 10, 2005)

# Some problems with this state of affairs

- Problem #1: Issuers remain subject to residual broker-dealer regulations and state disclosure/registration obligations that are costly for issuers without providing clear benefits to investors.
  - State Disclosure/Registration Obligations:
    - Section 18 preemption of state registration/disclosure laws is limited to “covered securities.” These include:
      - Securities listed on a major stock exchange.
      - Securities sold in Section 4(1) and 4(3) transactions *if the issuer is subject to Section 13 or 15(d) of the Exchange Act.*
    - Upshot→most OTC transactions will be subject to state registration & disclosure obligations absent an exemption.
      - Primary resale exemptions:
        - Rely on an unsolicited broker transaction (almost all states)
        - Rely on an isolated non-issuer transaction exemption or private resale transaction exemption (most states)
        - Rely on a manual exemption for resale (37 states; not California)
          - Common manuals: Standard & Poor’s and Mergent.

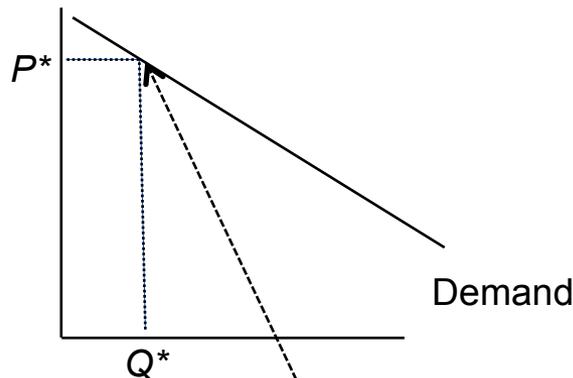
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- **Problem #1: Issuers remain subject to residual broker-dealer regulations and state disclosure/registration obligations that are costly for issuers without providing clear benefits to investors.**
  - **State Disclosure/Registration Obligations:**
    - **Reasons for questioning whether this is optimal for investors and issuers:**
      - Complexity of complying with exemptions from registration across multiple states.
        - What is an “isolated” transaction? Has a firm complied with states’ differing manual requirements? Has a firm complied with idiosyncratic non-manual state laws (e.g., CA)?
      - Do these exemptions still make sense with robust OTC markets? If not, might certain states choose to limit their availability?
        - Example: Decision by many states to abandon or modify the manual exemption (originally articulated in §402(b)(2)(A) of the Uniform Securities Act of 1956).

“The principal state concern is that a manual listing is not necessarily a sign of quality, and indeed may be misleading in that respect. The trend away from the manual exemption is likely to continue, either by elimination or the setting of qualitative limitations.” Cohn, Stuart R., 1 Sec. Counseling for Small & Emerging Companies § 16:8 at 2 (2011)
      - Are issuers and investors even complying with blue sky laws in OTC resale transactions? ***And if not, are buyers in these markets holding rescission rights that have been properly priced in the market?***
        - *The Corporate Counsel* (March-April 2011): “Companies [on Sharespost and SecondMarket] often ignore the blue sky stuff, i.e., they don’t require that counsel’s opinion address these matters.”

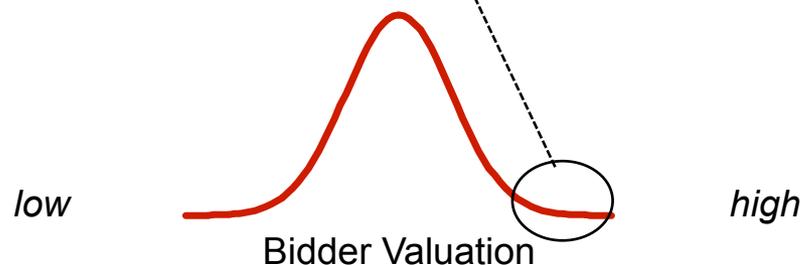
# Some problems with this state of affairs

- Problem #2: Absence of issuer disclosures reduces the reliability of published “market” prices, particularly on SecondMarket/SharesPost where share volume is restricted.
  - One worrisome possibility:
    - Limiting the supply for a security with a downward sloping demand curve +



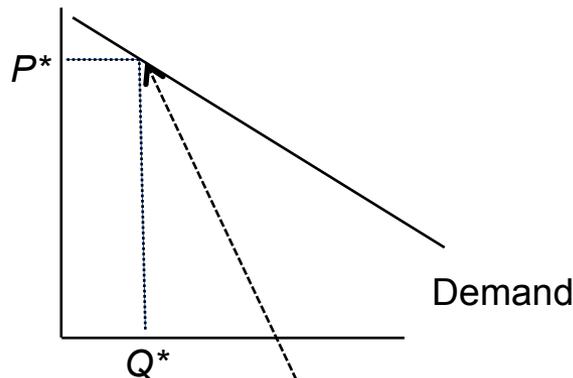
Market price is sensitive to tail density populated by valuation “optimists”

- Heterogenous valuations among bidders:



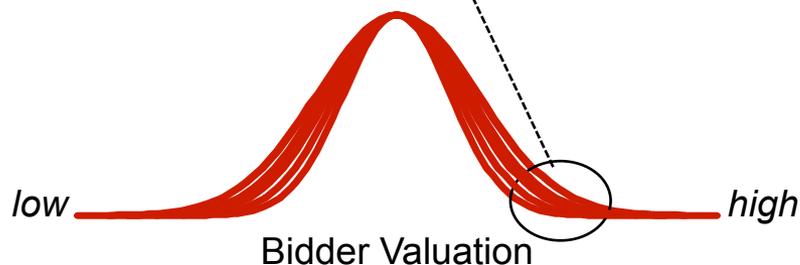
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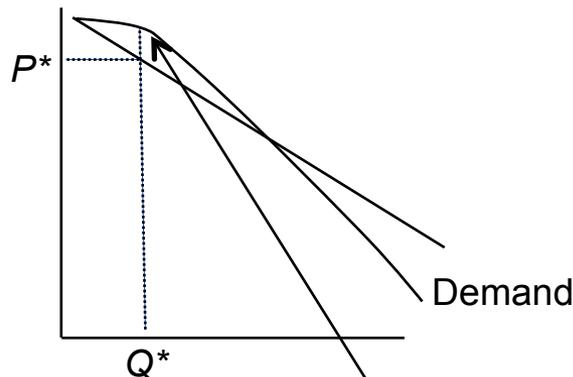
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...which may become more extreme with information asymmetry

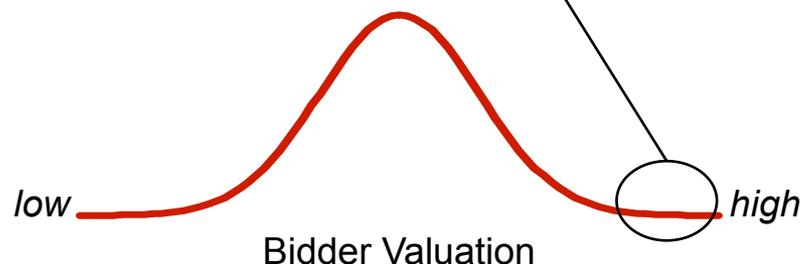
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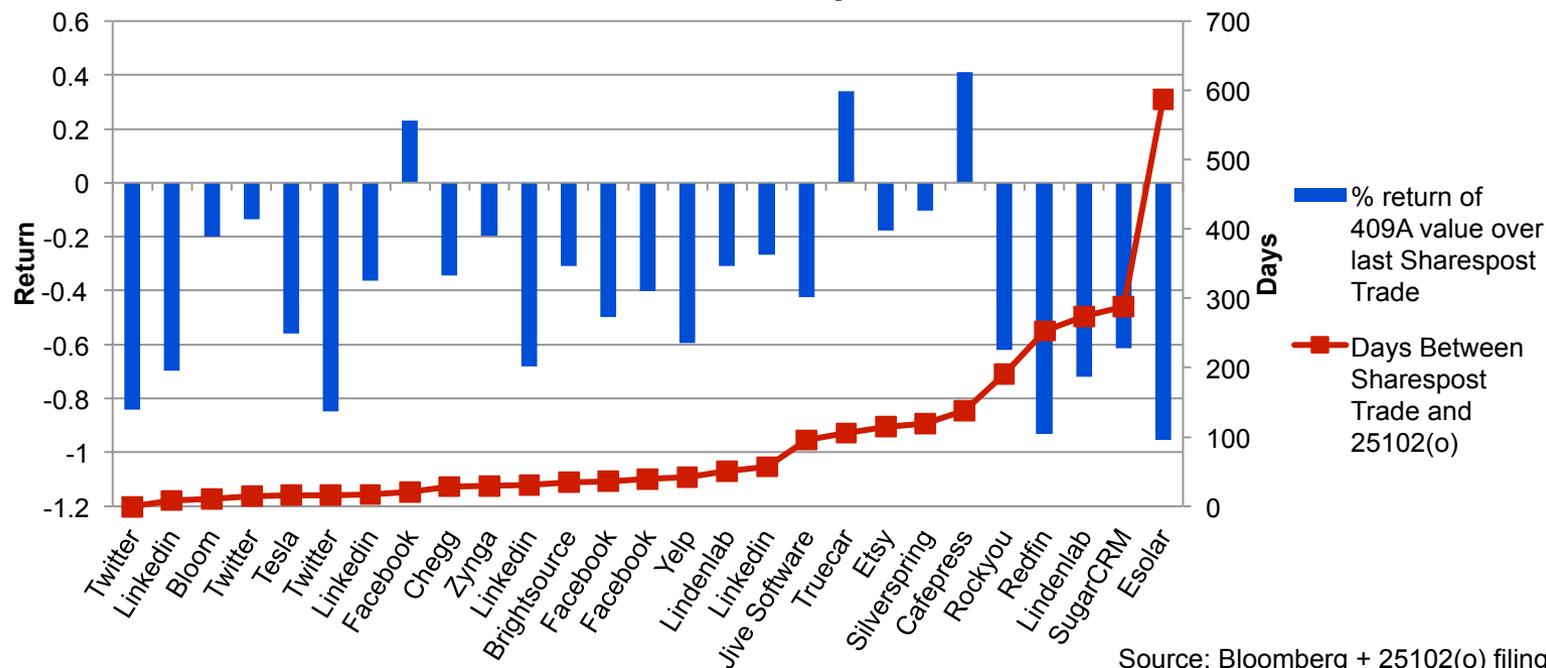


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# Some problems with this state of affairs

- Problem #2: Absence of reliable issuer disclosures reduces the reliability of published “market” prices, particularly on SecondMarket/Sharespost where share volume is restricted.
  - Evidence that these markets might over-price private company shares?

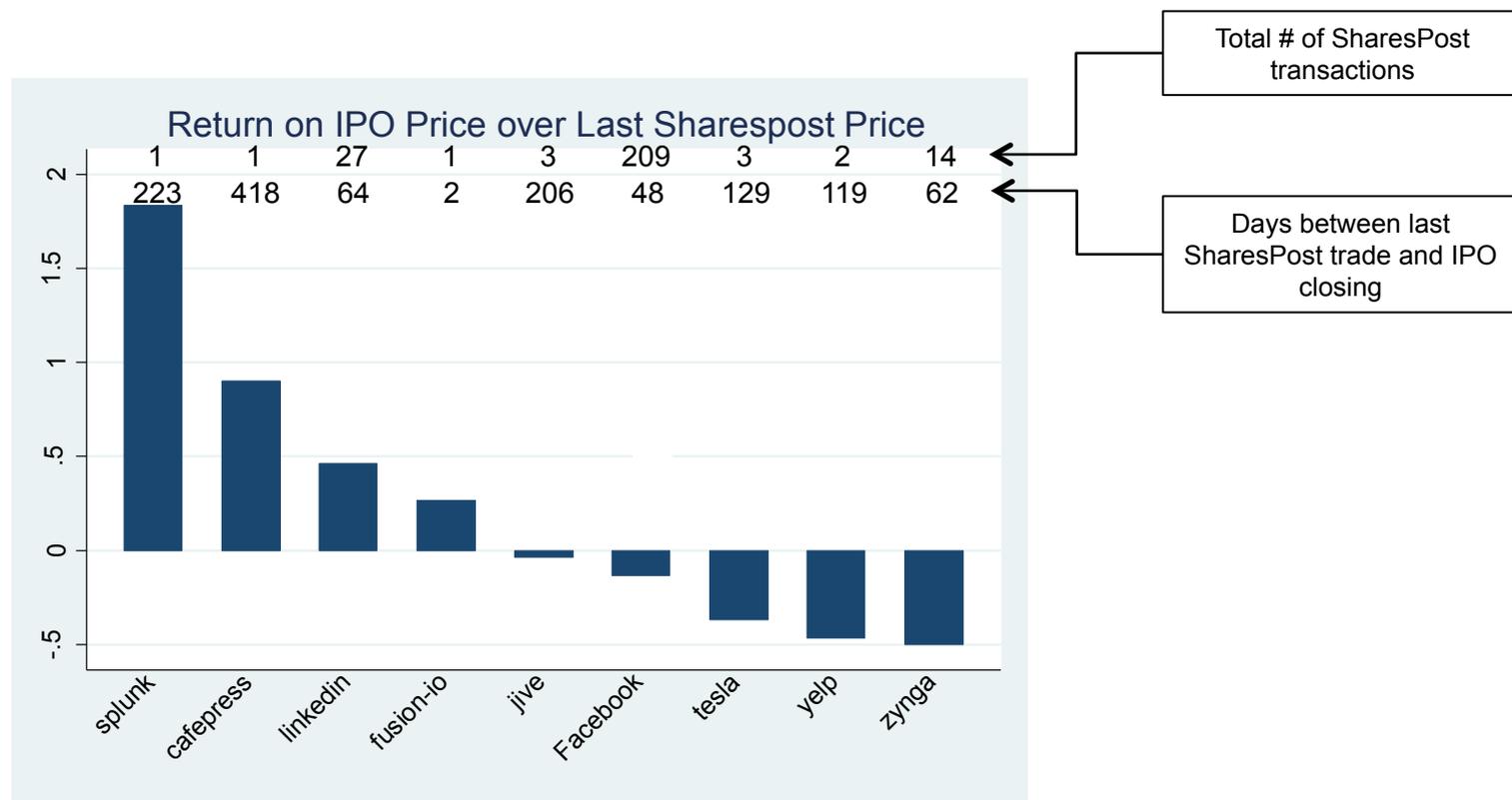
Comparison of Internal 409A Common Stock Valuation Vs. Prior SharesPost Trade Price, by Firm



Source: Bloomberg + 25102(o) filings

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# What can the Commission can do?

- A uniform system of federal scaled disclosure for smaller firms—even those exempt from Section 13 reporting obligations—may be preferable for issuers, investors, and broker-dealers than the current haphazard system of state-based regulation.
- Two possible rule-making approaches:
  - Create real disclosure through reforming Rule 15c2-11
    - Eliminate piggyback exception
    - Make 15c2-11 information periodic and easily available
    - → Might diminish concern among states concerning the absence of disclosure in OTC markets
  - Rely on Section 18 of the '33 Act to preempt state regulation of resale transactions conditional on the delivery of scaled disclosure:
    - §18(b)(3):
      - Define “qualified purchaser” in terms of “disclosure or access”, with disclosure being scaled for non-reporting companies trading in specific venues.
    - §18(b)(4):
      - Create alternative §13 reports that, if voluntarily filed with the SEC, would create federal preemption for §4(1) and §4(3) transactions.
- Regardless of these reforms, the Commission (and the IRS) should be cautious when using disclosed secondary prices in SecondMarket & SharePost as proxies for common stock “fair value” when considering cheap stock/409A issues.