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Zachary J. Gubler

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PUBLIC CHOICE THEORY AND THE PRIVATE SECURITIES MARKET*

ZACHARY J. GUBLER**

One of the most important developments in the capital markets over the past decade presents a puzzle that needs to be solved. The development is the dramatic expansion of the unregulated market for private securities in the United States. The puzzle is that public choice theory, the dominant theory for explaining the behavior of the Securities and Exchange Commission ("SEC"), fails to account for it. After all, the traditional public choice account predicts that the SEC will grow its regulatory turf, not erode it. This Article develops a theory that solves this puzzle. The argument is that the traditional public choice account overlooks an important class of cases where regulators have incentives to expand the unregulated portion of their industry. With respect to the SEC, this Article argues that, by growing the private securities market, actors at the SEC maximize support for their current and future careers in the face of uncertainty over how to reinvigorate a dysfunctional public market.

The theory developed in this Article has important implications for securities regulation and beyond. With respect to securities regulation, it suggests that any attempts to minimize the potentially high social costs of an expanding private securities market will need to take into account the effect of underlying political forces. To this end, this Article sketches the outline of a novel approach for dealing with an expanding private securities market, the centerpiece of which is an entity (independent from the executive branch and accountable to Congress) whose goal is to focus greater public scrutiny on the SEC for the purpose of

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counteracting the political forces underlying the growth of that market. This theory also has important implications for the literature on regulatory arbitrage and optimal policy-making more generally. In particular, it suggests that the conclusions drawn in this literature are misleading to the extent that they downplay or ignore the possibility that political forces may favor regulatory arbitrage and that these same political forces may cause regulators and lawmakers to avoid uncertainty in policymaking altogether, just as the SEC has sought to avoid the uncertainty associated with reform of the public securities market.

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INTRODUCTION

In early 2011, the popular social networking site, Facebook, raised \$1.5 billion by selling its securities in a private transaction to the investment bank Goldman Sachs.¹ At the time, commentators referred to this transaction as Facebook’s “private IPO”² because it served many of the same functions as an initial public offering (“IPO”) (including creating a stockpile of cash and a valuation for the company’s securities), and because the sheer size of the transaction eclipsed that of almost every initial *public* offering of an internet company in U.S. history.³ The only difference was that the Facebook deal took place in the private securities market, which falls outside of the regulatory reach of the Securities and Exchange Commission (“SEC”). In recent years, these types of large private placements of

1. Press Release, Facebook, Facebook Raises \$1.5 Billion (Jan. 21, 2011), *available at* <http://newsroom.fb.com/News/131/Facebook-Raises-1-5-Billion>.

2. Albert Wenger, *The Private IPO*, BUS. INSIDER (Jan. 3, 2011, 8:25 AM), <http://www.businessinsider.com/the-private-ipo-2011-1>; *see also* Larry Ribstein, *What Happened to IPOs?*, TRUTH ON THE MARKET (Jan. 4, 2011, 5:15 AM), <http://truthonthemarket.com/2011/01/04/what-happened-to-ipo>s (noting that Facebook’s IPO sold \$500 million in stock to one entity).

3. Prior to Facebook’s subsequent IPO in 2012, the largest internet IPO was that of Google, which raised about \$1.7 billion in 2004. *See, e.g.*, Benny Evangelista, *Time for Facebook to Prove Its Worth*, S.F. CHRON., May 4, 2012, at A1.

securities have become increasingly common. In the same month, for example, the coupon website Groupon raised \$950 million in a private placement.⁴ A few years earlier, in May 2007, Oaktree Capital Management, LLC, a U.S. hedge fund advisory firm, raised \$880 million in the private markets in what was referred to at the time as a “groundbreaking”⁵ transaction.⁶ These extraordinary transactions are but the most visible evidence of a private, unregulated market for securities in the United States that has expanded dramatically over the past decade.

This expansion of the private securities market was far from inevitable. In fact, under public choice theory, the dominant theory explaining SEC action,⁷ this development should not have happened at all. Public choice theory views laws and regulations as products that are traded in a political marketplace.⁸ Lawmakers and bureaucrats work to design these laws to benefit various interest groups whose fortunes are dependent upon a favorable legal and regulatory environment. In exchange, lawmakers receive from these interest groups career support both in their current and future jobs.⁹ In

4. See Evelyn M. Rusli & Andrew Ross Sorkin, *Groupon I.P.O. Said to Value It at \$15 Billion*, N.Y. TIMES, Jan. 14, 2011, at B1.

5. William K. Sjostrom, Jr., *The Birth of Rule 144A Equity Offerings*, 56 UCLA L. REV. 409, 410 (2008).

6. See *Oaktree Stock Sale Completed*, WALL ST. J., May 23, 2007, at C2.

7. See, e.g., Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527, 528 (1990) (referring to public choice as the theory that has gained the “most currency” in explaining SEC behavior).

8. See generally FRED MCCHESENEY, *MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION* (1997) (explaining how political extortion and rent extraction figure into politicians’ maximization of their own welfare to the detriment of the general public); Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167 (1990) (synthesizing public interest and public choice theories into a single model); Michael E. Levine, *Why Weren’t the Airlines Reregulated?*, 23 YALE J. ON REG. 269 (2006) (analyzing the effects of regulation and deregulation on the airline industry under public choice theory); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976) (analyzing and formalizing George Stigler’s model of regulation); Richard Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974) (distinguishing public choice theory from public interest and capture theories); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (analyzing when and why industries are able to use regulations and the state for their own purposes).

9. See Levine, *supra* note 8, at 273. Scholars have characterized what legislators and regulators maximize in a number of different ways, including “power,” “budget” and political “slack.” See DENNIS MUELLER, *PUBLIC CHOICE III* 360, 371, 380 (2003). This Article uses Levine’s concept of “career support” as the maxim because of both its breadth (it takes into account goals as varied as “reelection, reappointment [and] post-regulatory employment”) and its intuitive appeal. Levine, *supra* note 8, at 273.

applying public choice theory to the SEC,¹⁰ scholars have concluded that many, if not most, of the regulations that the SEC adopts appear to benefit certain groups, like securities analysts, lawyers, or large, well-established firms, which benefit from regulatory barriers that fall disproportionately on smaller, less well-heeled competitors.¹¹ The SEC creates these regulatory “rents”¹² for its current constituents, but the literature also depicts the SEC as having the capacity to grow this constituent base and the potential recipients of such rents through bureaucratic imperialism, or attempts to increase regulatory scope by wresting control over certain areas of financial regulation from other agencies.¹³ The public choice literature therefore predicts that we should see the continued growth of the public regulated securities market and the stagnation, if not diminishment, of its private, unregulated counterpart.¹⁴

10. SUSAN M. PHILLIPS & J. RICHARD ZECHER, *THE SEC AND THE PUBLIC INTEREST* 2–4 (1981); David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 311 (1987); Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & ECON. 273, 273 (1984); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 922 (1994); George J. Stigler, *Public Regulation of Securities Markets*, 37 J. BUS. 117, 117 (1964).

11. See PHILLIPS & ZECHER, *supra* note 10, at 49–51 (arguing that the principal beneficiaries of the mandatory disclosure regime are, on the one hand, lawyers who received legal fees from preparing the required disclosure and, on the other hand, securities analysts and others who, in the absence of mandatory disclosure rules, would otherwise have to pay for the same information provided under the disclosure regime); Macey, *supra* note 10, at 914 (arguing that established firms may actually welcome regulation where it creates barriers to entry for smaller competitors); Stigler, *supra* note 10, at 124 (presenting evidence that the adoption of the securities laws had little, if any, effect on the quality and performance of newly issued securities).

12. The term “rents” in this context refers to “returns to the owner of an asset in excess of the level of returns necessary for him to continue using the asset in its current employment.” MCCHESENEY, *supra* note 8, at 10. One familiar example of rents is the producer surplus that the producer enjoys from being able to sell goods at a market price that is higher than the least that they are willing to sell for. This amount is represented in a supply-demand graph by the area between the equilibrium market price and the upward sloping supply curve. When regulators adopt regulation that favors one group of firms in an industry over another, it increases the costs of production and therefore shifts the supply curve up, the effect of which is an increase in producer surplus, and therefore the rents available, for those firms that benefit from the regulation. These increased rents are considered bad rents since society is poorer for the lost exchanges of goods for which demanders were willing to pay the price of supply. See *id.* at 14–15.

13. See Macey, *supra* note 10, at 937–48 (presenting numerous examples of bureaucratic imperialism at the SEC).

14. Commentators have acknowledged this public choice implication, both explicitly and implicitly. See, e.g., ROBERTA ROMANO, *FOUNDATIONS OF CORPORATE LAW* 704 (2010) (acknowledging that the conclusion that the SEC is unlikely to permit the expansion of the private securities market follows directly from public choice theory);

Yet in reality, precisely the opposite has occurred. This Article provides an explanation for this surprising result that carries with it potential implications that extend beyond the context of the SEC. Its answer is not that public choice theory is fundamentally incorrect, but rather that the way in which it has been traditionally applied to the SEC is incomplete. Regulators and lawmakers can pursue their own interests, consistent with public choice theory, only if their actions are shielded from the view of the electorate.¹⁵ In other words, regulators and lawmakers do not simply pursue their own interests in an unfettered world, but rather they do so subject to the constraint of “political slack,” or, in other words, the space within which regulators are left to hand out regulatory rents to particular interest groups, free from the scrutiny of the public.¹⁶ Most of the time, this political slack will be significant because it is too costly for a rational electorate to monitor regulators and lawmakers. However, this is not always the case. For example, when issues are elevated to the public agenda, the costs of monitoring the lawmaking process will be relatively low, as will the political slack.¹⁷ Indeed, most financial legislation,¹⁸ including the recent Wall Street Reform and Consumer Protection Act (“Dodd-Frank” or the “Dodd-Frank Act”)¹⁹ and the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act” or “SOX”),²⁰ has been enacted during just such historical moments of extreme public scrutiny.

That the regulators’ maximization problem is a constrained one implies that, under certain conditions, regulators will in fact be willing

Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 187 (2002) (characterizing as “politically fanciful” a proposal under which the SEC would be required to expand the private securities market); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1066 (2009) (“My prediction is that the SEC would not, ultimately, be willing to leave issuer transparency in [the private securities market] so unregulated.”).

15. See Joseph P. Kalt & Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279, 298 (1984); Levine, *supra* note 8, at 273.

16. See MUELLER, *supra* note 9, at 384.

17. See Levine & Forrence, *supra* note 8, at 191–94.

18. See Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850–51 (1997) (cataloging securities regulations that resulted from dramatic securities market “crashes”).

19. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 2, 5, 7, 12, 15, 18, 22, & 42 U.S.C.); see also *infra* text accompanying notes 166–89.

20. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended at scattered sections of 11, 15, 18, 28, & 29 U.S.C.); see also *infra* text accompanying notes 147–71.

to permit, or even facilitate, the expansion of the unregulated portion of their industry if, by doing so, they are able to avoid the risk of public scrutiny that accompanies their next best alternative regulatory strategy. In particular, this Article finds that legislators and bureaucrats will adopt this strategy (i) where there has been an exogenous shock to the industry that changes the political dynamic and creates a deregulatory environment, and (ii) where there is considerable uncertainty about how to reverse the effects of that exogenous shock by reforming the public, regulated market. This is what the author believes has happened in the case of the U.S. securities market. In particular, the much documented decade-long decline in the market for initial public offerings²¹ has disrupted the political status quo such that smaller, upstart firms that are dominated by their larger, better-established competitors in the traditional public choice account have greater leverage in the wake of the IPO decline. As the smaller, upstart firms become more vocal about the stalled IPO market and its potential for slowing American innovation and growth, the threat of public scrutiny places pressure on the SEC to improve access to securities market services.²² By expanding the private securities market, the SEC is able to respond to the increased demand for the services provided by a securities market²³ without risking the loss of political slack that would accompany efforts to reform the IPO market. To be sure, the SEC could respond to this IPO crisis and the accompanying changes in the landscape of the political economy by simply fixing the IPO market. But that is easier said than done, especially considering that the proximate cause of the

21. See, e.g., Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 2 (2012); Claire Cain Miller, *Venture Investment Continues to Shrink*, N.Y. TIMES (July 13, 2009, 4:05 PM), <http://bits.blogs.nytimes.com/2009/07/13/venture-investment-continues-to-shrink>; Francesco Bova et al., *The Sarbanes-Oxley Act and Exit Strategies of Private Firms* 4 (working paper, May 5, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1730242; PAUL KEDROSKY, RIGHT-SIZING THE U.S. VENTURE CAPITAL INDUSTRY 4 (2009), <http://www.kauffman.org/uploadedFiles/USVentCap061009r1.pdf>; DAVID WEILD & EDWARD KIM, MARKET STRUCTURE IS CAUSING IPO CRISIS 9–14 (Grant Thornton, White Paper, June 2010), <http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf>. For example, from 1991 to 2000, the United States averaged approximately 530 IPOs per year. WEILD & KIM, *supra*, at 5. Yet, since 2001, that average has dwindled to only 126, with a mere thirty-eight IPOs in 2008 and sixty-one in 2009. *Id.* at 3.

22. “Securities market services” refers to the capital-raising and liquidity functions served by a securities market. See *infra* Part I.A.2.

23. For a brief overview of these services, see *infra* Part I.A.2.

IPO market decline is clouded by uncertainty.²⁴ Furthermore, if the SEC attempts to reform the IPO market and fails, it will likely attract an enormous amount of public scrutiny, which would eliminate the political slack that allows the SEC to pursue its own objectives of placating interest groups and growing its bureaucratic reach.²⁵ However, the SEC can avoid this uncertainty altogether, while still responding to the need for increased securities market services, by allowing or facilitating the expansion of the private securities market. In doing so, the SEC avoids the threat to its political slack that would accompany a failed attempt at IPO market reform.

The two securities markets—the public and the private—serve many of the same functions (capital raising, liquidity generation, and price creation) and therefore act as substitutes (albeit imperfect ones). But the principal insight here is that these two markets are not only substitutes in the market for capital, but in the political economy as well. For this reason, if a problem in the public market (like the recent IPO market decline) causes interest groups to demand the SEC's intervention, the SEC can placate these interest groups not solely by re-calibrating the regulatory dynamics of the public market but the private market as well. Focusing regulatory efforts on the private securities market is particularly attractive where, as in the case of the IPO market decline, it is unclear exactly how to re-calibrate the public market. The SEC's own behavior over the past decade is consistent with this updated public choice theory. The SEC has been careful not to take any action that would restrict access to the private securities market, despite requests on several occasions to do precisely that.²⁶ And, in 2011, the SEC announced that it was considering increasing access to the private securities market by raising the shareholder threshold for triggering the reporting requirements²⁷ under the Securities Exchange Act of 1934²⁸ and even organized an advisory committee to explore this option further.²⁹

24. See, e.g., KEDROSKY, *supra* note 21, at 4. For a discussion of the various theories as to the causes of the IPO decline, see *infra* notes 214–17 and accompanying text.

25. See *infra* Part II.C.2.

26. See *infra* text accompanying notes 107–20.

27. See Jean Eaglesham, *U.S. Eyes New Stock Rules: Regulators Move Toward Relaxing Limits on Shareholders in Private Companies*, WALL ST. J., Apr. 8, 2011, at A1 (reporting that the SEC is considering increasing from 499 the number of shareholders a company can have without becoming a reporting company, while at the same time relaxing the ban on general solicitations and advertising in private placements).

28. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C.A. §§ 78a–78pp (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)).

29. See Letter from Stephen M. Graham and M. Christine Jacobs, Comm. Co-Chairs, Advisory Comm. on Small and Emerging Cos., to Mary L. Schapiro, Chairman, SEC 3

Contrary to the traditional public choice account, the updated theory that this Article develops predicts that we can expect to see the continued growth of the private securities market, at least for as long as the IPO market remains in the doldrums. This analysis and prediction leads to several implications. In particular, because it excludes the public interest, the political economy forces identified here will likely lead the SEC to expand the private securities market beyond its optimal scope.³⁰ Consequently, an inefficient amount of capital will be raised in the private securities market (where disclosure and liquidity are relatively low), which will result in a sub-optimal amount of disclosure and liquidity in U.S. markets. Perhaps even more troubling, the average retail investor, who is prevented by both legal and pragmatic constraints from directly accessing the private securities market, will be “crowded-out” from investment options as that market expands.³¹

A full-blown policy proposal for dealing with these negative implications is beyond the scope of this Article. But as an example of how one might approach such policy reform, this Article sketches the outlines of a first- and second-order solution to what may be the thorniest of the three problems: the crowding-out of the retail investor from U.S. securities markets.³² A first-order solution to this problem would focus on reducing the information and monitoring costs that create political slack in the first place and lead the SEC to shy away from IPO market reform. One solution might be to establish a public interest watchdog group, independent from the executive and

(Mar. 9, 2012), <http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-020112-registration.pdf> (recommending that the SEC increase the threshold requirement). In the end, the SEC was ultimately preempted by Congress from taking this action with the adoption of the 2012 Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.A. (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)), which increased the threshold test for determining Exchange Act reporting applicability under section 12(g) from 500 to 2,000 shareholders of record. *See id.* § 501, 126 Stat. at 325 (codified at 15 U.S.C.A. § 78l(g)(1)(A) (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)). The Commission stated at the time that they were not in a position to assess whether the new JOBS Act threshold was appropriate. Letter from Mary L. Schapiro, Chairman, SEC, to U.S. Senator Tim Johnson, Chairman, Senate Comm. on Banking, Hous., & Urban Affairs, and U.S. Senator Richard Shelby, Ranking Member, Senate Comm. on Banking, Hous., and Urban Affairs (Mar. 13, 2012) [hereinafter Letter to Johnson and Shelby], <http://www.thecorporatecounsel.net/nonMember/docs/jobs-SchapirotoJohnson.pdf>.

30. That the political economy will lead to a sub-optimally large private securities market assumes that policymaking in the absence of the electorate (i.e., in the presence of slack) will lead to inefficient results. This will generally, although not always, be the case. *See, e.g., Levine, supra* note 8, at 273.

31. *See infra* Part III.A.3.

32. *See infra* Part III.B.

answerable to Congress, whose objective would be to increase public scrutiny of the SEC. To that end, this panel would be expected to monitor the SEC and translate its actions, and inactions, into a simple periodic report that would inform the public of the impact of SEC decision-making on the retail investor.³³ A second-order solution would focus on how to provide the average retail investor with greater access to the private securities market. This Article suggests one approach: increasing mutual fund participation in that market by relaxing rules that limit such funds' investment in illiquid securities.³⁴

The Article proceeds as follows. Part I explains how the federal securities laws create both a public (regulated) market and a private (unregulated) one and how the private securities market has grown dramatically over the past decade, which is a development that the traditional public choice account of SEC decision-making fails to predict. Part II develops an updated public choice theory that accounts for an expanding private securities market, the central insight of which is that an expansion of the private securities market allows the SEC to maximize its bureaucratic support in the face of uncertainty over how to reinvigorate a dysfunctional public securities market. Part III considers the implications of this updated public choice account, the central one being that the political economy actually favors the continued expansion of the private securities market, at least as long as the IPO market continues to languish. This Article considers how this prediction, and the theory that underlies it, sheds light on the law's treatment of retail investors. It also considers the implications of this updated public choice theory beyond the SEC. The Article ends with a brief Conclusion.

I. THE SHIFTING PUBLIC-PRIVATE DIVIDE IN U.S. SECURITIES MARKETS

In order to understand how the traditional public choice account of SEC behavior fails to explain the expansion of the private, unregulated securities market, it is first necessary to understand how the federal securities laws give rise to this unregulated market. In addition to providing an overview of this legal landscape, this Part also compares the public, regulated securities market to its private, unregulated counterpart, a comparison that is integral to the updated public choice account that is developed in Part II. Finally, this Part concludes by setting forth the evidence supporting the primary

33. See *infra* text accompanying notes 265–69.

34. See *infra* text accompanying notes 272–77.

observation—on which this Article is built—that over the past decade, the private securities market has undergone a significant expansion.

A. Overview of the Structure of this Divide

1. Legal Landscape of the U.S. Securities Market

The Securities Act of 1933³⁵ (“Securities Act”) was enacted in direct response to the market crash of 1929.³⁶ The Securities Act “was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing.”³⁷ To this end, the Securities Act adopted a registration rule making it unlawful for any person to offer or sell a security unless the transaction is registered with the SEC.³⁸ A violation of this registration requirement (contained in section 5 of the Securities Act and often referred to by that section reference) gives rise to a claim of rescission of the transaction and may justify money damages if the “registration statement”—the disclosure that is filed with the SEC and made publicly available through the SEC’s computerized EDGAR system—contains a material falsity or omission.³⁹

This registration requirement was subsequently supplemented by disclosure requirements in the Securities Exchange Act of 1934 (“Exchange Act”).⁴⁰ Under the Exchange Act, any securities issuer that is subject to the registration requirement of section 5 of the Securities Act is also obligated to make periodic disclosures under the Exchange Act.⁴¹ And even if a securities offering falls outside of the

35. Act of May 27, 1933, ch. 38, Title I, 48 Stat. 74 (codified as amended at 15 U.S.C.A. §§ 77a-77bbb (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)).

36. H.R. REP. NO. 73-85, at 2-3 (1933) (stating the reasons for passage of the Securities Act).

37. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (citing H.R. REP. NO. 73-85, at 1-5).

38. Act of May 27, 1933, ch. 38, Title I, § 5, 48 Stat. at 77 (codified as amended at 15 U.S.C.A. § 77e (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)).

39. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* §§ 7.2-7.3 (5th ed. 2005). The provisions that give rise to the rescission and damages remedies are contained in sections 12(a)(1) and (11), respectively, of the Securities Act. *See* 15 U.S.C. §§ 77l(a)(1), 77k (2006).

40. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C.A. §§ 78a-78pp and scattered statutes of 15 U.S.C.A. § 77 (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)).

41. 15 U.S.C. § 78o(d) (2006).

purview of section 5, an issuer might nevertheless be swept into the Exchange Act's disclosure regime if the issuer is deemed significant enough, as measured by the size of its shareholder base.⁴²

These registration and disclosure requirements effectively create a public securities market in the United States, accessible by virtually anyone with a stockbroker or, in a web-based world, an online brokerage account. But just as the federal securities law regime creates a public securities market, it also creates a private one. This is because section 4(2) of the Securities Act says that section 5's registration requirement does not apply to "transactions by an issuer not involving any public offering."⁴³ This provision has generated a complicated line of case law,⁴⁴ including a watershed United States Supreme Court opinion,⁴⁵ but the distinction between private and public offerings nevertheless remains murky. For this reason, the SEC has created regulatory safe harbors that, if complied with, ensure that a given transaction will fall within the exemption for private offerings.⁴⁶ For offerings of any economic significance,⁴⁷ the most commonly relied-upon safe harbor is Rule 506 of Regulation D.⁴⁸ This rule exempts an issuer from section 5's registration requirement if the issuer, among other things, limits the offering principally⁴⁹ to "accredited investors"⁵⁰ (which is a measure of investor

42. Section 12(g) of the Exchange Act, as recently amended by the JOBS Act, requires a company to register its securities under the Exchange Act if it has \$10 million or more in total assets and a class of equity securities "held of record" by 500 or more persons who are not "accredited investors" or 2000 or more persons generally. 15 U.S.C.A. § 78l(g)(1)(A) (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012).

43. *Id.* § 77d(a)(2).

44. *See, e.g.,* JAMES D. COX ET AL., SECURITIES REGULATION 271–73 (2009) (analyzing a line of Fifth Circuit cases dealing with the underlying issues of the private placement exemption).

45. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 124–27 (1953) (holding that whether an offering of securities is exempt from section 5 of the Securities Act as a private placement turns on the extent to which the offerees both have access to the type of information that would be included in a registration statement and are capable of "fending for themselves" with respect to investing).

46. *See* HAZEN, *supra* note 39, §§ 4.20–4.22.

47. Rules 504 and 505 of Regulation D also provide exemptions from section 5; however, these provisions are limited to relatively small offerings (\$1 million and \$5 million, respectively). *See* 17 C.F.R. §§ 230.504(b)(2), 230.505(b)(2)(i) (2012).

48. *Id.* § 230.506.

49. It is permissible to include some non-accredited investors in the offering as long as the issuer "reasonably believes" that such investors number no greater than thirty-five. *See id.* § 230.505(b)(2)(ii).

50. The definition of "accredited investor" includes (i) institutional investors such as banks, insurance companies, and mutual funds; (ii) individual investors with net worths in excess of \$1 million, annual incomes in excess of \$200,000, or joint annual incomes in excess of \$300,000; and (iii) executive officers and directors of the issuer. *See id.* § 230.215.

sophistication) and avoids a “general solicitation.”⁵¹ Moreover, the issuer must take reasonable steps to prevent resales of the securities from violating the section 5 registration requirement.⁵² As long as an issuer satisfies these conditions, the offering is deemed a private one and is exempt from the strictures of the Securities Act.⁵³ In addition, provided the issuer maintains the size of its shareholder base below the regulatory maximum for purposes of the disclosure requirement—which was recently increased from 500 to 2,000⁵⁴—it also escapes the disclosure requirements of the Exchange Act.⁵⁵

2. Practical Landscape: The Private Securities Market as a Substitute for the Public Market

The private securities market⁵⁶ serves many of the same functions as its public counterpart and therefore can be thought of as a substitute (albeit an imperfect one) for the public securities market. The argument made in Part II is that these markets are substitutes not just for business purposes but for political purposes as well. In other words, the substitutability of the private and public markets is integral to the updated public choice account that is developed in Part II and therefore merits some discussion here. The substitutability of these two markets is best illustrated by comparing them along three dimensions: capital raising, capital liquidity, and market price

51. *Id.* §§ 230.502(c), 230.506(b)(1). Under the SEC’s own interpretation of the “general solicitation” provision, a Rule 506 offering must be limited to those with whom the issuer or someone acting on its behalf has a preexisting, substantive relationship. *See* William K. Sjostrom, Jr., *Relaxing the Ban: It’s Time To Allow General Solicitation and Advertising in Exempt Offering*, 32 FLA. ST. U. L. REV. 1, 13–14 (2004).

52. Although resales are generally exempt from section 5, a purchaser may run afoul of the registration requirement if it resells the security within too short a period of time after the initial purchase and is thereby deemed an underwriter under section 2(a)(11) of the Securities Act. *See* 15 U.S.C. § 77b(a)(11) (2006) (defining the term “underwriter,” among other things, as “any person who has purchased from an issuer with a view to . . . the distribution of any security”); *id.* § 77d(a)(1) (stating that transactions undertaken by “underwriters” are not exempt from section 5’s registration requirements). Under SEC interpretation, anyone who sells restricted (or unregistered) securities is presumed to be an underwriter unless the sale is made in compliance with the regulatory safe harbor contained in Securities Act Rule 144. *See* 17 C.F.R. § 230.144(b) (2012).

53. *See* 17 C.F.R. § 230.506(a) (2012).

54. *See* JOBS Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012) (codified at 15 U.S.C.A. § 78l(g)(1)(A) (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)).

55. *See supra* note 42 and accompanying text.

56. This Article is interested in the market consisting of securities of companies that are not subject to the reporting requirements of the Exchange Act. By “private company” or “private securities market,” this Article means a non-reporting company or the market consisting of those companies.

efficiency. These three functions are referred to in this Article as “securities market services.”

a. Cash Infusions for Aggressive Growth

A major benefit of entering a securities market is that it provides a source of capital for companies that need a cash infusion in order to grow their businesses, whether organically or through acquisitions.⁵⁷ A securities market links up those who demand capital (the firms) with those who are willing to provide such capital (the investors). Both the public and private securities markets perform this same function. To be sure, differences exist between the two markets. But with respect to capital infusion, the size of the securities offering that the relevant market can bear is becoming less of a distinguishing characteristic. While the public market is obviously bigger and therefore can support larger offerings, the private securities market is no longer inaccessible for offerings of significance. Companies make private offerings that raise several hundreds of millions of dollars,⁵⁸ and it appears that the market has now reached the billion-dollar neighborhood with the offerings of Facebook, which raised \$1.5 billion, and Groupon, which raised \$950 million.⁵⁹ Rather, the main difference between the two markets is simply in the composition of the investors who participate in them. Whereas the private securities market consists principally of sophisticated investors,⁶⁰ the public markets have an array of investors from diverse backgrounds, both sophisticated and unsophisticated.

b. Liquidity for Investor Exit

When a company makes a securities offering, it participates in a market in which those securities can be traded freely.⁶¹ This market liquidity is crucial because it allows company insiders who have been issued securities as part of their compensation, from the CEO to the rank-and-file employees, to sell those securities for cash. Liquidity is

57. See, e.g., Sjostrom, *supra* note 5, at 432.

58. See *infra* note 94 and accompanying text.

59. See Press Release, Facebook, *supra* note 1; Rusli & Sorkin, *supra* note 4.

60. Most offerings in the private market will be carried out pursuant to Rule 506 of Regulation D, which limits the offering to “accredited investors,” or possibly Rule 144A, which limits the offering to qualified institutional buyers. See *supra* notes 35–55 and accompanying text. While non-sophisticated investors may end up with these private securities through resales under Rule 144, see *infra* notes 66–69 and accompanying text, as a practical matter, resales are made to investors who would also be considered “sophisticated.”

61. See, e.g., Sjostrom, *supra* note 5, at 432.

of particular importance for the venture capitalists who initially bankroll the pre-offering company because it provides them a much-needed opportunity to exit from their investment. Without an exit opportunity, venture capitalists would be reluctant to provide capital in the first place, and the company would have a difficult time obtaining funding. Thus, the liquidity function of securities markets plays a crucial role in creating a venture capital market and thereby in enabling innovation.⁶²

The private securities market contains two features that make it less liquid than its public counterpart, one legal and the other structural. The legal impediment is that, unlike in the public market where securities are traded freely, securities traded in the private market are “restricted securities,” meaning that they are subject to constraints on their transferability.⁶³ Under section 5 of the Securities Act, not just the issuer’s initial sale, but *every* sale of securities must be registered with the SEC or otherwise benefit from a statutory exemption.⁶⁴ For resales of securities, the relevant statutory exemption is section 4(1), which exempts from registration “transactions by any person other than an issuer, underwriter, or dealer.”⁶⁵ For a resale, the most significant hurdle in applying this exemption is the term “underwriter,” which the Securities Act defines very broadly to mean, among other things, “any person who has purchased from an issuer with a view to . . . the distribution of any security.”⁶⁶

Because of the uncertainty surrounding this definition, parties will typically rely on one of two resale exemptions promulgated by the SEC: Rule 144 or Rule 144A. Which of these two exemptions applies depends on the type of buyer purchasing the securities at issue and the amount of time that the seller has held those securities. Rule 144 applies to any buyer but only applies to restricted securities the seller has held for at least one year.⁶⁷ Thus, it does not allow security holders of private companies to resell immediately, or even in the

62. See Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 245 (1998).

63. Under Rule 144, “restricted securities” includes securities acquired from an issuer in a non-public offering. 17 C.F.R. § 230.144(a)(3)(i) (2012).

64. See Sjostrom, *supra* note 5, at 418.

65. 15 U.S.C. § 77d(a)(1) (2006).

66. *Id.* § 77b(a)(11).

67. 17 C.F.R. § 230.144(d)(1)(ii). This holding period is only six months for exempt resales of companies that are reporting companies under the Exchange Act. *Id.* § 230.144(d)(1)(i). However, this Article is primarily concerned with the market for securities of non-reporting companies. See *supra* note 56 and accompanying text.

near term. By contrast, there is no holding requirement under Rule 144A. Rather, Rule 144A creates a limitation on buyers, requiring that restricted securities be offered and sold only to “qualified institutional buyers” (“QIBs”),⁶⁸ which include institutions that own and invest on a discretionary basis at least \$100 million in the securities of entities other than affiliates.⁶⁹ In other words, Rule 144A only applies to purchasers of restricted securities that (a) are relatively large investment funds and (b) trade in securities of entities that do not have a control relationship with the fund. Thus, while the private securities market provides firms with liquidity, the law surrounding resale of restricted securities make these securities less freely tradable than securities in the public market.

In addition to legal constraints on liquidity, the private securities market also exhibits a structural constraint, in that it has traditionally lacked the benefit of developed exchanges, such as the New York Stock Exchange (“NYSE”) or the NASDAQ. Stock exchanges are important as both organizers of markets and generators of information.⁷⁰ As a market organizer, stock exchanges connect those who demand capital with those who supply capital.⁷¹ As an information generator, stock exchanges allow parties to keep track of historical stock prices while at the same time providing ready access to current prices.⁷² A stock market without stock exchanges is like the mortgage market prior to the Internet. To be sure, there was a market for mortgages prior to the Internet. But the market was far from efficient. The potential homeowner did not necessarily know the identities of even a small fraction of the total universe of mortgage lenders, and she did not know the prices, either historical or current, of those mortgage products. But with the advent of the Internet, and sites like Lending Tree and Google Mortgages, the potential homeowner has access to an almost dizzying array of mortgage lenders and price information.⁷³

In recent years, the private stock market has undergone a similar change with the emergence of private stock exchanges that perform many of the same functions as the NYSE or NASDAQ. These stock

68. 17 C.F.R. § 230.144A(d)(1).

69. *Id.* § 230.144A(a)(1)(i).

70. See Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2546–47 (2006).

71. See *id.* at 2546.

72. See *id.* at 2547.

73. See, e.g., Tom Brown & Lacey Plache, *Paying with Plastic: Maybe Not So Crazy*, 73 U. CHI. L. REV. 63, 73–74 (2006) (discussing how technological changes, including the Internet, have transformed consumer lending).

exchanges are populated largely with entrepreneurs and private company employees who want to sell the common stock they receive in consideration for their services to their companies.⁷⁴ Venture capitalists are playing an increasingly prominent role on these exchanges, as the exchanges provide a potentially “new exit” from the preferred stock that they received in exchange for their investment in the company.⁷⁵ And there are reports that these exchanges are preparing to accommodate not only secondary market trading—or, in other words, resales of previously issued securities—but primary market trading as well, thereby providing a means by which private companies will actually be able to make initial “private” offerings of securities through the use of these private exchanges.⁷⁶ These developments will only make the private securities market more liquid, making it a closer substitute for the public market.

c. A Market Price for Purposes of Governance, Compensation and Acquisition

Not only does a new market for securities create liquidity, but it also establishes a market price.⁷⁷ This is important for purposes of governance, compensation, and acquisition. With respect to governance, a market price provides management with feedback on how well it is running the company so as to maximize shareholder value.⁷⁸ As a measure of the value that shareholders place on the company, the market price also allows the board of directors to make use of performance-based compensation,⁷⁹ either by using the company’s stock itself as a form of compensation or through the use of “phantom stock,” which is a compensation scheme that mimics the payoffs of a particular security without requiring the actual transfer of

74. See Ibrahim, *supra* note 21, at 117–18.

75. See *id.*

76. Jay Yarow, *Are We Headed for Disaster with Private Stock Markets? We Talk to SharesPost CEO David Weir*, BUS. INSIDER (Mar. 22, 2011, 5:27 PM), <http://www.businessinsider.com/sharespost-interview-2011-3>.

77. See, e.g., Sjoström, *supra* note 5, at 433.

78. See generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (discussing how increased stock market liquidity and increased informativeness of stock prices bolstered the historical shift to a shareholder maximization standard in corporate governance).

79. See generally LUCIAN A. BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* (2004) (offering a critical analysis of current executive compensation practices and offering solutions for tying these practices more closely to performance).

that security.⁸⁰ Finally, a market price provides the company with a currency—its own securities—with which it can pursue acquisitions to grow the company.⁸¹

Because the accuracy of a market price depends heavily on market liquidity, analysis of the private securities market's substitutability for its public counterpart along this "market price dimension" mirrors the one conducted above for market liquidity. Thus, as in the discussion of market liquidity, the most important variable in evaluating how good the private securities market is at establishing a market price is private securities exchanges.⁸² As these exchanges become more prevalent and better established, the private securities market becomes an increasingly closer substitute for its public counterpart.

This brief overview demonstrates that although the private securities market is not a perfect substitute for the public market, it is increasingly becoming a closer one. Through the Rule 144A equity offering, the selling company can sell stock to QIBs without the transferability constraints that apply to other unregistered securities. And all restricted securities (provided that they have "come to rest"⁸³ if not Rule 144A securities) have become easier to transfer with the rise of private securities exchanges.

But even this brief comparison of the substitutability of these two markets would be incomplete if it ignored the costs that companies avoid by selling securities in the private instead of the public market.⁸⁴ These costs fall into two main groups: compliance costs and liability costs. When a company sells securities in the public market, it must prepare and file annual, quarterly, and current reports under the Exchange Act.⁸⁵ This compliance task requires companies to hire expensive lawyers and accountants, in addition to company

80. DAVID L. SCOTT, *WALL STREET WORDS* 274 (3d. ed. 2003) (defining the term "phantom stock plan"); *see also* Sjostrom, *supra* note 5, at 434 (discussing phantom stock as a form of compensation).

81. *See, e.g.*, Sjostrom, *supra* note 5, at 433.

82. *See supra* notes 61–76 and accompanying text.

83. This term refers to the requirement that a purchaser hold its restricted securities for a certain period of time before reselling them in order to avoid being deemed an "underwriter" under section 4(1) of the Securities Act. *See* Rutheford B. Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*, 52 WASH. & LEE L. REV. 1333, 1352 (1995). Under the Rule 144 safe harbor, the securities holder can satisfy this requirement if, among other things, he holds the securities for one year (or six months if the issuer is currently a reporting company and has been one for at least ninety days). 17 C.F.R. § 230.144(d)(1)(i)–(ii) (2012).

84. *See, e.g.*, Sjostrom, *supra* note 5, at 435–41.

85. *See* HAZEN, *supra* note 39, § 9.

employees that must spend part or all of their time on compliance issues.⁸⁶ All of this manpower represents real costs, which only increased with the passage of the Sarbanes-Oxley Act.⁸⁷ In addition to compliance costs, a company selling securities in the public market also exposes its officers and directors to potential civil and criminal liability that is not present in the private market. This liability risk stems from a number of rules, including prohibitions on (i) misstatements, omissions, or misleading information included in any one of a variety of public SEC filings;⁸⁸ (ii) deficiencies in the company's internal controls; and (iii) trading in the company's stock on the basis of material, nonpublic information⁸⁹ or within six months of a previous trade.⁹⁰

Thus, from the perspective of the company in need of additional capital, the contemporary private securities market in the United States bears an increasingly close resemblance to the public securities market with respect to these securities market services. At the same time, the private securities market lacks the compliance and liability costs of its public counterpart. It therefore follows from these facts that, as a theoretical matter, companies should be increasingly inclined to choose the private securities market over the public alternative for securities market services, leading to an expansion of the private securities market. What is particularly surprising is that the SEC has allowed, if not encouraged, this expansion to take place.

86. See Thomas E. Hartman, *The Continued Costs of Being a Public Company*, THE CORPORATE BOARD, Nov./Dec. 2007, at 14, <http://www.foley.com/files/Publication/2bcb1a4ca-f838-4199-bda2-2075ac886724/Presentation/PublicationAttachment/59583483-7683-4d22-9080-265167fb4fec/CostPublicHartman.pdf>.

87. See, e.g., William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private,"* 55 EMORY L.J. 141, 150 (2006) (reporting that, among companies converting from public to private in 2004, average compliance costs doubled as a result of SOX); Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. ACCT. & ECON. 116, 116 (2007) (finding that firms went private in increasing numbers following passage of SOX); Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-US Companies Cross-Listed in the US*, 13 J. CORP. FIN. 195, 195 (2007) (finding that foreign firms that cross-list in the United States and are subject to SOX experienced a significant decrease in stock price following passage of the legislation as compared to foreign cross-listed firms that are not subject to SOX); Ivy Xiyang Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, 44 J. ACCT. & ECON. 74, 74 (2007) (finding that the U.S. stock market reacted overwhelmingly negatively to the passage of SOX).

88. See HAZEN, *supra* note 39, §§ 7.3, 7.6.

89. See *id.* § 12.17.

90. See *id.* § 13.2.

B. *The Expanding Private Securities Market*

All available evidence suggests that the private securities market has undergone a dramatic expansion in recent years. Surprisingly, the SEC has not merely permitted this expansion, but it has taken steps to facilitate it as well. The evidence of an expanding private securities market is both anecdotal and formal. Anecdotally, we have seen the recent emergence of private offerings that were simply unheard of a decade ago. Traditionally, the private securities market lacked both the depth and breadth to act as a viable alternative to its public counterpart with respect to capital raising, share liquidity, and market price efficiency—the securities market services discussed previously.⁹¹ However, in recent years, that conventional wisdom has been turned on its head with private placements of a size and complexity that were virtually unknown until recently. These transactions include private offerings conducted by Facebook, Groupon,⁹² Oaktree Capital Management, LLC,⁹³ and many others.⁹⁴ The emergence of private exchanges, which enable this onslaught of private securities market activity, is itself evidence of a market that is experiencing dramatic growth.⁹⁵

In addition to this anecdotal evidence, there is also more formal evidence of an expanding private securities market. Between 1991 and 1995, venture capitalists funneled approximately \$28 billion into start-up companies, investments that resulted in about 2,600 IPOs over that period.⁹⁶ By contrast, since the end of the dot-com bubble in 2000, venture capital funds have invested over \$208 billion into start-up companies, and yet less than 1,100 of those investments have led to IPOs.⁹⁷ Thus, although venture capitalists have raised almost ten

91. See, e.g., William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 649–55 (2009) (explaining that the disadvantages of a company's decision to remain private consist primarily of "constraints on capital raising and share illiquidity").

92. See Press Release, Facebook, *supra* note 1; Rusli & Sorkin, *supra* note 4.

93. See *Oaktree Stock Sale Completed*, *supra* note 6.

94. Between 2002 and 2007, there were roughly eighty-three private placements that were structured as Rule 144A offerings. See Jack Gage, *Don't Peek*, FORBES (Jan. 7, 2008 12:00 AM), <http://www.forbes.com/forbes/2008/0107/032.html>. These transactions raised on average \$282 million in capital. *Id.* Nonetheless, as Professor Sjostrom first noted, the size of Oaktree's Rule 144A offering marked a turning point in this market. See Sjostrom, *supra* note 5, at 412 ("[U]p until the announcement of the Oaktree deal, a Rule 144A equity offering was unheard of as an IPO alternative for a U.S. company.").

95. See *supra* notes 72–76 and accompanying text (describing the emergence of the private securities exchanges).

96. See WEILD & KIM, *supra* note 21, at 4, 6.

97. See *id.* at 4.

times the amount of money over the past decade that they raised in the four-year period prior to the dot-com bubble, the number of IPOs conducted during this decade is only half of what it was during the earlier period. The venture-capital backed firms are simply staying private for longer. Consistent with this observation is the fact that the number of public corporations in the United States in 2009 was half of what it had been in 1997.⁹⁸ In fact, this number declined by over twenty-one percent just between 2008 and 2009.⁹⁹ Finally, the expanding private securities market is being fed by domestic and foreign companies. For example, data suggest that between 2005 and 2007 alone the amount of equity raised by foreign issuers in the private securities market in the United States, as a percentage of equity raised in the public market, increased more than threefold.¹⁰⁰

The fact that the private securities market has undergone a rapid expansion in recent years is in itself evidence that the SEC has permitted this expansion to occur. After all, the SEC could at any juncture have adopted regulations to slow this growth. Furthermore, there is evidence not just that the SEC has permitted the expansion of the private securities market but that it has actively facilitated its growth. Indeed, in response to a letter to Republican Congressman Darrell Issa, SEC Chairman Mary Schapiro acknowledged the Agency's role in facilitating the expansion of the private securities market.¹⁰¹ Perhaps the most obvious examples of this facilitation are the steps the SEC has taken over the past fifteen years to make it easier to resell restricted securities under Rule 144. Recall that securities purchased in the private market are "restricted" and cannot be resold, unless the seller either follows the elaborate procedures set forth in section 5 or, more likely, avails herself of an exemption.¹⁰² The most common exemption, Rule 144, permits the resale of

98. Gerald F. Davis, *The Twilight of the Berle and Means Corporation*, 34 SEATTLE U. L. REV. 1121, 1134 (2011).

99. *See id.*

100. Press Release, Comm. on Capital Mkts. Regulation, Committee on Capital Markets Regulation Completes Survey Regarding the Use by Foreign Issuers of Private Rule 144a Equity Market (Feb. 13, 2009), available at <http://capmktsreg.org/2009/02/committee-on-capital-markets-regulation-completes-survey-regarding-the-use-by-foreign-issuers-of-the-private-rule-144a-equity-market/> ("In the period from 2000 to 2005, we estimate that foreign issuers raised on average 6.8% as much equity via Rule 144A ADRs as they raised in the U.S. public market. After spiking to 80.8% in 2006, the ratio declined to 24.0% in 2007.").

101. Letter from Mary Schapiro, SEC Chairman, to U.S. Congressman Darrell Issa, Chairman, Comm. on Gov't Oversight and Reform (Apr. 6, 2011), <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf>.

102. *See supra* notes 62–66 and accompanying text.

restricted securities by anyone other than the issuer, provided that the seller has held the securities for at least one year prior to resale.¹⁰³ Although this current incarnation of Rule 144 places meaningful constraints on resales of restricted securities, it is the least restrictive version of the Rule that has existed since the Rule's adoption in 1972. Over the past fifteen years, the SEC has reduced Rule 144's holding period twice: first, in 1997, from three years to two,¹⁰⁴ and second, in 2007, from two years to one.¹⁰⁵ By restricting Rule 144's holding period, the SEC increased the liquidity of restricted securities and therefore made it more attractive to raise capital in the private securities market.

Furthermore, the SEC has resisted calls to make it more difficult for companies to escape the public market for the refuge of the private one. Recall that under section 12(g) of the Exchange Act, a company must register its securities and comply with the Act's disclosure requirements if it has \$10 million or more in total assets¹⁰⁶ and a class of equity securities "held of record" by the threshold number of shareholders.¹⁰⁷ Thus, if a public company has any desire to escape the scrutiny of the public market and seek refuge in the private one (a process referred to as "going dark"), it faces what appears to be a significant hurdle in having to make sure that it has fewer than that threshold number of security holders. However, it turns out that this hurdle is much less onerous than it first appears, because the SEC has interpreted the term "held of record" in section 12(g) narrowly to mean only those shareholders listed on the corporate records.¹⁰⁸ This interpretation is particularly narrow because the vast majority of shareholders of public companies are not shareholders listed on the corporate records.¹⁰⁹ Rather, they are

103. See *supra* notes 67–69 and accompanying text.

104. See Revision of Holding Period Requirements in Rules 144 and 145, 62 Fed. Reg. 9,242, 9,242 (Feb. 28, 1997) (codified at 17 C.F.R. pt. 230).

105. See Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates, 72 Fed. Reg. 36,822, 36,844 (July 5, 2007) (codified at 17 C.F.R. pts 230, 239).

106. 17 C.F.R. § 240.12g-4(a)(1)(ii) (2012). Although section 12(g)(1) provides for a total asset threshold of \$1 million, the SEC has exempted companies from registration under section 12(g) if their total assets do not exceed \$10 million. See *id.* § 240.12g-1.

107. The current shareholder threshold, as set out in the JOBS Act, is 500 or more persons who are not "accredited investors" or 2,000 or more persons generally. 15 U.S.C.A. § 78l(g)(1)(A) (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012). Prior to the JOBS Act, the applicable threshold was 500 security holders. Law of Aug. 20, 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565, 566–67.

108. See 17 C.F.R. § 240.12g5-1(a) (2012).

109. See Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1236–40 (2008).

shareholders who hold their stock in what is referred to as a “street name,” meaning that it is held through custodians such as banks and brokerage firms who themselves hold the shares through accounts at a depository company called, predictably, the Depository Trust Company (“DTC”).¹¹⁰ It is the DTC, not the “beneficial owner” of the stock, listed as the registered holder in the corporate records.¹¹¹ This custodial holding structure obviates the need for individuals to actually hold physical stock certificates and therefore is essential to the efficient settlement and clearing of the modern securities industry.¹¹² But it also means that under SEC rules, a company could theoretically have thousands of shareholders and yet still qualify to leave the public markets and “go dark” because it counts fewer than 500 shareholders listed on the corporate records.¹¹³

Beginning in 2003, investors have repeatedly petitioned the SEC to adopt a broader definition of the term “held of record,” as the statute permits.¹¹⁴ Under these investors’ proposals,¹¹⁵ the SEC would interpret that term to include any “beneficial owners” of stock held in street name. The “beneficial owner” standard would effectively look through the custodial holding structure of DTC and count as “holders of record” those shareholders who have the right to exercise control over a given security.¹¹⁶ Thus, under this proposed “beneficial owner” test, the hypothetical company with thousands of shareholders but fewer than 500 on the corporate record books would be qualified to go dark. Nevertheless, the SEC has repeatedly declined this invitation to broaden the definition of the “held of record” language, and in so

110. *Id.*

111. *See id.*

112. *See id.* at 1236–37.

113. *See, e.g.,* Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 140 (2009).

114. The statute allows the SEC to define the terms “total assets” and “held of record.” *See* JOBS Act, Pub. L. No. 112-106, § 502, 126 Stat. 306, 326 (2012) (codified at 15 U.S.C.A. § 78l(g)(5) (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)). As the codifications section of the 2012 Supplement Pamphlet describes, section 502 of the JOBS Act, the section of the public law making this change to subparagraph (A) of section 12(g)(5), “was incapable of execution, since there is no subpar. (A) in subsec. (g)(5).” The cite to the U.S.C.A. is preserved for consistency’s sake pending resolution of this matter.

115. *See, e.g.,* Letter from Anthony Chiarenza to Elizabeth M. Murphy, Sec’y, SEC (Apr. 1, 2009), <http://www.sec.gov/rules/petitions/4-483/4483-27.pdf>; Letter from Lawrence J. Goldstein to Mary L. Schapiro, Chairman, SEC (Mar. 26, 2009), <http://www.sec.gov/rules/petitions/4-483/4483-24.pdf>; Petition from Stephen J. Nelson to Jonathan Katz, Sec’y, SEC, (July 3, 2003), *available at* <http://www.sec.gov/rules/petitions/petn4-483.htm>.

116. The SEC defines a “beneficial owner” of a security to include anyone who exercises voting or investment power with respect to a security. *See* 17 C.F.R. § 240.13d-3 (2012).

doing, has refused to narrow the scope of the private securities market.¹¹⁷ Finally, in 2011, the SEC announced that it was considering increasing access to the private securities market by raising the shareholder threshold for triggering the Exchange Act's reporting requirements.¹¹⁸ To that end, the SEC organized an advisory committee that ended up recommending an increase in the threshold test,¹¹⁹ but the SEC was ultimately preempted by Congress from taking this action with the adoption of the 2012 JOBS Act, which increased the threshold test for determining section 12(g) Exchange Act reporting applicability from 500 to 2,000 record shareholders.¹²⁰

Thus, not only has the SEC allowed the private securities market to expand dramatically, taking a laissez-faire attitude to the market in general and the private securities exchanges in particular, but it has undertaken affirmative actions, and considered others (before being preempted by congressional action) that expanded or would have expanded the private securities market. The question is: Why? This question becomes all the more puzzling when considered in light of public choice theory's prediction of how the Commission will act.

II. PUBLIC CHOICE THEORY AND THE PRIVATE SECURITIES MARKET

A. *The Traditional Public Choice Account of the SEC: Regulatory Rent Creation and the Expanding Regulatory Scope*

Public choice theory aims to explain legislative and regulatory outcomes by applying the rational actor model of economics to the

117. Notably, in February 2011, the Division of Corporation Finance met with a number of investors, including the author of the original petition for the beneficial ownership interpretation, perhaps in reaction to the Facebook transaction. Memorandum from Steven Hearne, Special Counsel, Div. of Corp. Fin. of the SEC (Feb. 10, 2011), <http://www.sec.gov/rules/petitions/4-483/4483-29.pdf>.

118. See Eaglesham, *supra* note 27 (reporting that the Commission is considering increasing from 499 the number of shareholders a company can have without becoming a reporting company while at the same time relaxing the ban on general solicitations and advertising in private placements).

119. Letter from Stephen M. Graham and M. Christine Jacobs, Comm. Co-Chairs, Advisory Comm. on Small and Emerging Cos., to Mary L. Schapiro, Chairman, SEC 3 (Mar. 9, 2012), <http://www.sec.gov/info/smallbus/acsec/acsec-recommendation-020112-registration.pdf>.

120. See JOBS Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012) (codified in 15 U.S.C.A. § 78l(g)(1)(A) (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)). The Commission stated at the time that they were not in a position to assess whether the new JOBS Act threshold was appropriate. Letter to Johnson and Shelby, *supra* note 29.

lawmaking process.¹²¹ The theory conceives of this process as a market for legal rules.¹²² The suppliers of these legal rules are lawmakers (legislators and regulators), and the consumers are the group likely to be affected by the lawmaking in question.¹²³ Lawmakers supply legal rules in exchange for a currency, which is often stylized as career support.¹²⁴ This career support may take a variety of forms, including help in achieving reelection, reappointment or post-regulatory employment,¹²⁵ or simply continued relevance.¹²⁶

Thus, public choice theory views legal rules as the reflection of a political bargain struck between lawmakers and various interested groups. Public choice theory has been used to explain a variety of different types of regulatory action¹²⁷ in many contexts.¹²⁸ But beginning with George Stigler's Nobel Prize-winning work in the late 1960s–1970s,¹²⁹ public choice theory has been closely associated, in particular, with the SEC.¹³⁰ Under this traditional account, the SEC is beholden to certain small, cohesive groups that benefit from

121. See, e.g., MUELLER, *supra* note 9, at 1 (“Public choice can be defined as the economic study of nonmarket decision making, or simply the application of economics to political science. The subject matter of public choice is the same as that of political science: the theory of the state, voting rules, voting behavior, party politics, the bureaucracy, and so on. The methodology of public choice is that of economics, however.”).

122. See *supra* note 8 and accompanying text.

123. See *supra* notes 8–13 and accompanying text.

124. See, e.g., Levine, *supra* note 8, at 273.

125. Levine, *supra* note 8, at 273.

126. See Macey, *supra* note 10, at 914 (“[A]n agency that has been rendered obsolete by exogenous changes in the form of technological development or new marketplace developments will find that it must provide favors to discrete constituencies in order to preserve some measure of support for its continued existence.”).

127. See, e.g., MCCHESENEY, *supra* note 8, at 22–23, 61 (regulatory forbearance); Haddock & Macey, *supra* note 10, at 312 (regulatory action); Jarrell, *supra* note 10, at 273 (reversal of regulatory action).

128. See generally ROBERT E. BALDWIN, *THE POLITICAL ECONOMY OF U.S. IMPORT POLICY* (1985) (trade policy); Nathaniel Beck, *Elections and the Fed: Is There a Political Monetary Cycle?*, 31 AM. J. POL. SCI. 194 (1987) (monetary policy); Richard S. Higgins & Fred McChesney, *Truth and Consequences: The Federal Trade Commission's Ad Substantiation Program*, 6 INT'L REV. L. & ECON. 151 (1986) (the FTC); Levine, *supra* note 8 (airline regulation); Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265 (1990) (federalism) [hereinafter Macey, *Federal Deference*]; Jonathan R. Macey, *Judicial Preferences, Public Choice, and the Rules of Procedure*, 23 J. LEGAL STUD. 627 (1994) (civil procedure); William F. Shughart II & Fred McChesney, *Public Choice Theory and Antitrust Policy*, 142 PUB. CHOICE 385 (2010) (antitrust law).

129. See Stigler, *supra* note 10, at 117.

130. See, e.g., PHILLIPS & ZECHER, *supra* note 10, at 21–24; Macey, *supra* note 10, at 915–16, 922.

increased regulation¹³¹ or, in other words, regulatory rents.¹³² The most obvious of these beneficiaries are lawyers who receive legal fees from preparing the required disclosure and securities analysts who, in the absence of mandatory disclosure rules, would otherwise have to pay for the same information provided under the disclosure regime.¹³³ But perhaps less obvious is that these beneficiaries also include large, well-established firms. Because of their size, these firms are better able to absorb the increased costs of regulation than are smaller, upstart firms. The larger firms therefore view regulation as a means of protecting their market position by relying on regulatory costs to deter these smaller competitors from entering the market or going public.¹³⁴ The evidence suggests that the Sarbanes-Oxley Act may be an example of such legislation. The business community split over the Senate bill that eventually became SOX, reflecting the division between large and small companies.¹³⁵ The large companies, represented by the Business Roundtable, supported the Senate bill, whereas the small companies, represented largely by the Chamber of

131. Central to public choice theory in general is the notion that the public will, as a general matter, rationally decide not to participate in the political bargain between lawmakers and the electorate because the relatively high costs of doing so outweigh the comparatively small benefits. See, e.g., Levine & Forrence, *supra* note 8, at 189; Levine, *supra* note 8, at 272–73. Thus, the theory goes, the size of the political bargaining table is much smaller than it otherwise would be if the public were involved in the lawmaking process. See, e.g., Jonathan R. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 230–32 (1986) (discussing the influence of special interest groups on legislation); Levine, *supra* note 8, at 273 (noting that “self-regarding regulators can ‘sell’ policies to special interests in return for career support”). Moreover, it follows from this “rational apathy” argument that legal rules themselves will tend to reflect not the interests of the public as a whole but rather the interests of small, cohesive groups. See Macey, *supra* note 10, at 920–21.

132. See *supra* note 12 and accompanying text.

133. See PHILLIPS & ZECHER, *supra* note 10, at 22–23. The observation that individuals other than securities investors seem to reap most of the benefits of disclosure requirements can be traced to Stigler’s early work, in which he presented evidence suggesting that the creation of the securities disclosure regime and the establishment of the SEC had little, if any, effect on the quality and performance of newly issued securities. See Stigler, *supra* note 10, at 124. In the early 1980s, Susan Phillips and Richard Zecher expanded on Stigler’s work to offer a public choice interpretation of the securities disclosure regime, arguing that its principal beneficiaries were, on one hand, lawyers who received legal fees from preparing the required disclosure and, on the other hand, securities analysts and others who, in the absence of mandatory disclosure rules, would otherwise have to pay for the same information provided under the disclosure regime. PHILLIPS & ZECHER, *supra* note 10, at 49–51.

134. See, e.g., MCCHESENEY, *supra* note 8, at 11; Macey, *supra* note 10, at 914 (“[F]irms in a particular industry often will welcome new regulatory efforts . . . because new regulation can protect existing firms by creating barriers to entry.”).

135. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1564 (2005).

Commerce, did not.¹³⁶ Empirical research conducted since the passage of SOX suggests that the interest groups' predictions were correct: the legislation has placed a disproportionately high burden on small companies.¹³⁷

But under this traditional account, the SEC is not limited to creating regulatory rents for a fixed universe of constituents that might benefit from increased regulation. Rather, the bureaucratic imperialism theory suggests that the SEC will also attempt to attract new constituents and therefore a new group of potential beneficiaries of securities regulation and that it will do so by competing with other agencies over regulatory turf.¹³⁸ For example, Jonathan Macey has highlighted the SEC's attempts to characterize as "securities" financial instruments that would otherwise be regulated by other agencies, thereby bringing them within the Commission's wheelhouse.¹³⁹ Another example of such turf wars comes from the SEC's battles, prior to the recent financial crisis, with the Comptroller of the Currency over whether the Commission has "regulatory authority over commercial banks' activities as broker-dealers."¹⁴⁰ Finally, scholars have pointed to examples of SEC turf-grabbing in the financial regulation debates prior to passage of the Dodd-Frank Act, including the SEC's request for the authority to regulate credit default swaps and for a more clearly defined role in supervising the brokerage arms of investment banks.¹⁴¹

Therefore, the traditional public choice account of SEC behavior depicts the SEC as facing strong incentives to promulgate rules that will benefit its current constituents and to engage in bureaucratic imperialism in an effort to acquire new constituents that can similarly benefit from such increased regulation. But regardless of whether the SEC is focusing on its current or future constituents, in this traditional account, the SEC is focused on increasing regulation. The necessary

136. *See id.*

137. *See, e.g.,* Carney, *supra* note 87, at 145; James S. Linck, et al., *The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors*, 22 REV. FIN. STUDS. 3287, 3289 (2009) (finding significant increases in the costs of directors among smaller firms); M. Babajide Wintoki, *Corporate Boards and Regulation: The Effect of the Sarbanes-Oxley Act and the Exchange Listing Requirements on Firm Value*, 13 J. CORP. FIN. 229, 231–32 (2007) (finding that smaller firms experienced a greater decrease in market value with the passage of regulations under SOX requiring the use of independent directors).

138. *See* Macey, *supra* note 10, at 939, 941–43.

139. *See id.*

140. *See id.* at 940.

141. *See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 504 (2009).

implication of this traditional public choice account is that the SEC will expand its regulatory scope and generate more regulation than we would expect if the Commission were solely focused on the public interest.

The problem, however, is that this public choice view of the SEC is fundamentally at odds with the notion that the Commission would allow, let alone actively facilitate, the expansion of the private securities market. Commentators have explicitly acknowledged as much,¹⁴² and the underlying logic of this conclusion is straightforward and intuitive: the private securities market falls outside of the SEC's regulatory scope, and therefore, according to the traditional public choice account, the SEC gains nothing (and forfeits potential benefits) when firms take advantage of this unregulated market. It therefore stands to reason, under this logic, that the SEC will make efforts to avoid the expansion of the private securities market.

Yet, despite its support from both authority and logic, it is precisely this public choice implication that creates the puzzle at issue here: while the traditional public choice account predicts a stagnant, if not receding, private securities market, we have already seen, contrary to this prediction, that the SEC has allowed the private securities market to expand significantly over the past decade and appears poised to facilitate its continued growth. How can we explain this conflict between theory and reality? Since little disagreement exists over the general proposition that the private securities market has experienced a significant expansion over the past decade, the solution to the puzzle seems to lie not with a rethinking of the empirics but with public choice theory itself. In short, the theory appears to be either incorrect or incomplete.

B. Evaluating the Traditional Public Choice Account of the SEC in Light of the Financial Crisis

The debate over public choice theory's validity has largely reflected the debate over the rational actor model more broadly. While there is little benefit in re-hashing that longstanding debate here,¹⁴³ it is worthwhile to examine how the recent financial crisis might alter that debate, if at all. It is possible that evidence emerging

142. See *supra* note 14.

143. For an example of that debate within the context of the SEC, compare Macey, *supra* note 10, at 921–35 (discussing the SEC's struggle against obsolescence), with Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527, 529–35 (1990) (discussing the inner-directed behavior of bureaucracies such as the SEC).

from the financial crisis only emboldens the criticisms of public choice theory. However, upon further analysis, the evidence from the financial crisis actually leads to the opposite conclusion: that criticism of the rational actor model is less compelling when applied in the political context and particularly when applied to the SEC.

Many, although not all,¹⁴⁴ analyses of the financial crisis hypothesize that sophisticated actors under-estimated, or simply failed to understand, the risks inherent in very complicated financial products, thereby effectively questioning the rationality of these actors and the continued viability of the rational actor model.¹⁴⁵ Even some prior defenders of the rational actor model adopted this view,¹⁴⁶ dealing a particularly personal blow to the already embattled economic theory.

Yet, it is important to point out that not all situations are necessarily going to test rationality to the same degree. Just because economic actors may have failed the rationality test (quite dramatically, to be sure) when assessing the risks of structured financial products, this does not necessarily mean that they will also fail the rationality test when assessing the political risk of agency action. Indeed, political risk seems much less complicated to assess than the financial risk created by these complex financial products.

Of course, the financial crisis called into question not only the rationality of economic actors, but also incentive alignment within firms.¹⁴⁷ A similar critique has been leveled at the SEC.¹⁴⁸ After all, if regulators at lower levels of the SEC have different incentives than regulators at higher levels, then the motivation to maximize political slack and curry favor with interest groups may not be effectively

144. See, e.g., RAGHURAM G. RAJAN, *FAULT LINES* 142–44 (2010); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L. J. 247, 249–54 (2010) (proceeding on the assumption that the outsize risk-taking involved in the financial crisis was due in large part to distorted incentives created by compensation packages that reward short-term results).

145. See, e.g., Nicola Gennaioli et al., *Neglected Risks, Financial Innovation and Financial Fragility*, 104 J. FIN. ECON. 452, 454 (2012).

146. Compare, e.g., RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* 75–82 (2009) (arguing that novel trading instruments and communication problems between risk analysts and traders combined with other systemic problems to cause the 2008 financial crisis), with Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1551 (1998) (critiquing application of behavioral economics to the law and advocating for using rational-choice economics instead).

147. See, e.g., RAJAN, *supra* note 144, at 142–44; Bebchuk & Spamann, *supra* note 144, at 247.

148. See, e.g., Langevoort, *supra* note 143, at 528–29.

transmitted from one level of the organization to another. And to the extent that the financial crisis provides evidence of incentive misalignment in firms, it may also provide evidence of such incentive misalignment at the SEC. The problem, however, is that the analogy between a firm and an agency like the SEC is imprecise. Whereas there is little question that management and shareholders in a firm have different goals at times, it is far less obvious that this is true of different regulators working for the same agency. Indeed, these regulators would seem to be similarly situated, united in a desire to succeed both in their current position and to secure potentially more lucrative jobs afterward, typically with industry players that were the target of the Agency's regulatory mandate. A recent report by the nonprofit Project on Government Oversight shows that the SEC's "revolving door" is not just theoretical, identifying hundreds of former SEC employees at all levels of the organization who landed post-SEC jobs at prestigious firms in the consulting, securities, and legal industries.¹⁴⁹ In order to secure these jobs, it helps to placate industry players while still at the Agency, thereby facilitating the process of regulatory rent creation described previously. And in order to flourish at these post-SEC jobs, it helps to have grown the Agency's breadth and depth while employed there, thereby facilitating bureaucratic imperialism, and in the process ensuring the continued relevance of the Agency and the value of one's own expertise as a former bureaucrat.

Thus, it is far from clear that the financial crisis provides evidence that undermines public choice theory's validity. In fact, the opposite may be true. Jonathan Macey has argued that when administrative agencies outlive their relevance (as he claims is the case with the SEC¹⁵⁰), public choice criticisms lose traction.¹⁵¹ In

149. PROJECT ON GOV'T OVERSIGHT, REVOLVING REGULATORS: SEC FACES ETHICS CHALLENGES WITH REVOLVING DOOR 2-3 (May 13, 2011), <http://pogoarchives.org/m/fo/revolving-regulators-20110513.pdf>.

150. Macey contends that the threat of obsolescence that the SEC faces comes from two different sources: advancements in financial technology and increased competition from alternative sources of securities regulation. See Macey, *supra* note 10, at 921, 934. With respect to advancements in financial technology, there are new financial products that make markets more "complete" by creating new ways to hedge risk. See, e.g., Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 232-33 (2008). There are also new entities like hedge funds that arbitrage away discrepancies in prices across markets. See Macey, *supra* note 10, at 927-37. In addition to these new technologies that risk rendering the SEC redundant, the SEC faces an existential threat, Macey argues, from other regulators who may fill the same role as the SEC and may even do it better. See *id.* at 934-36. Macey points to stock exchanges, which impose their own set of rules on

particular, he argues that when an agency is threatened with obsolescence, the internal institutional biases that may threaten an agency's "rationality" (or, in other words, its sensitivity to the effects of its actions on factors like agency budget, power, and influence) disappear under a shared goal of survival.¹⁵² Similarly, when the agency's continued existence is jeopardized, the incentive misalignment that may normally prevent the agency from pursuing its self-interest diminishes as bureaucrats at all organizational levels become focused on maintaining the agency's relevance.¹⁵³

The reason that the financial crisis may actually bolster public choice theory's validity is because it arguably left the SEC even more threatened by obsolescence, to use Macey's term, than it was before. Although there is no consensus on the causes of the crisis, one view held by many, and repeated early and often, is that the SEC was essentially "asleep at the switch" prior to 2008.¹⁵⁴ This view only gained momentum when the Madoff scandal came to light, which revealed that the Commission had failed to put a stop to the largest Ponzi scheme in U.S. financial history despite several opportunities to do so, including through a whistleblower who had spoon-fed the Agency its case.¹⁵⁵ Moreover, these doubts about the Commission's competency soon proved to have real-world effects as the regulatory overhaul cut back the SEC's authority and power in significant ways.¹⁵⁶

Thus, the fallout from the financial crisis appears to strengthen Macey's case that the SEC is an agency on the road to obsolescence and is therefore an agency to which the traditional public choice criticisms do not apply. Notwithstanding Macey's argument, even if these criticisms did apply to the SEC, they would still need to be

exchange-traded companies as part of the price of membership. *See id.* at 934–35. Securities regulators on the state level may also threaten to topple the SEC from its privileged perch. *See id.* at 935–36.

151. *See* Macey, *supra* note 10, at 921–27.

152. *See id.* at 917–18.

153. *See id.* at 921–27.

154. John C. Coffee, Jr., *Commentary: Where Was the SEC?*, CNNPOLITICS.COM (Dec. 17, 2008), <http://www.cnn.com/2008/POLITICS/12/16/coffee.madoff/> (stating that "considerable evidence suggests [the SEC] was asleep at the switch" with respect to the Madoff fraud); *see also* Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 785–86 (2009) ("The SEC has been the target of relentless criticism ranging from claims that it mishandled derivatives regulation, oversight of securities firms, and market risk, to assertions of delays and blunders and possible industry capture at the Division of Enforcement.").

155. *See* Coffee, *supra* note 154.

156. *See* Davidoff & Zaring, *supra* note 141, at 504.

reconciled with the evidence advanced by Stigler and Phillips and Zecher that public choice theory does in fact do a good job explaining a considerable amount of otherwise puzzling behavior on the part of the SEC.¹⁵⁷ For these reasons, rather than discarding public choice theory altogether in the face of the puzzle of an expanding private securities market, it is useful to consider how the traditional public choice account of SEC action might be incomplete.

C. An Updated Public Choice Account of SEC Behavior

The argument made below is that the private securities market acts as a substitute for its public counterpart not only in the market for capital-raising, but also in the market for bureaucratic career support—the political economy. For this reason, the SEC will sometimes, although not always, manage to satisfy its constituents' demands for a particular regulatory outcome by focusing on the private, rather than the public, securities market. From the SEC's perspective, this strategy is attractive because reforms to the private securities market are more likely to fly under the radar of public scrutiny than reforms of the public market.¹⁵⁸ The SEC therefore has greater space in which to pursue its own interests, consistent with the predictions of public choice theory. In other words, the private market may offer greater political slack than the public one. When the risk of losing political slack through reforms of the public market is particularly high, the SEC will find it preferable to instead focus reforms on the private market.

This is roughly the state of political play with the dramatic contraction in the market for initial public offerings over the past decade. While this phenomenon has received considerable attention, particularly among industry participants, no consensus exists with respect to its ultimate causes. The uncertainty regarding the appropriate regulatory response to the IPO contraction presents a thorny political problem for the SEC, since any reform of the public market is likely to attract considerable public scrutiny, particularly if the attempted reform fails to jumpstart the IPO market. The solution that the SEC has decided on is to instead expand the private securities market, which it does by allowing the market to grow organically and without impediment, and also by raising the possibility of rules that would formally expand the scope of the market. This approach allows the Commission to curry favor with

157. See *supra* notes 125–41 and accompanying text.

158. See *infra* Part II.C.2.b.

special interests without running the risk of attracting public scrutiny. Thus, rather than a puzzle challenging the core of public choice theory, the expanding private securities market is actually further evidence of the political economy at work.

1. The Importance of Political Slack in Public Choice Theory

Public choice theory presupposes that agencies are able to implement policies that benefit special interests at the expense of the general polity. In some sense, this proposition is quite remarkable in and of itself. Imagine, for example, a large board meeting where the chairman of the board is somehow able to ignore the views of all but a few of the people sitting around the directors' table. As implausible as this image might appear at first blush, it is actually quite reasonable when the size of that directors' table grows by several orders of magnitude to accommodate the views of the members of the polity as a whole. As a general matter, most of the electorate will find the information necessary to monitor public officials too expensive to be worth acquiring, and consequently, public officials will be insulated (at least most of the time) from influence of the general electorate.¹⁵⁹ In the political economy literature, this space within which regulators are left to hand out regulatory rents to particular interest groups, free from the scrutiny of the public, is referred to as political slack.¹⁶⁰

Thus, regulators cannot pursue their own interests if they are subjected to political scrutiny, and therefore political slack is a precondition for the operation of the economic theory of regulation.¹⁶¹ Alternatively, one might think of the regulators' objective function as a constrained maximization problem, where the constraint is political slack. Just as the firm will maximize its profit function subject to a budget constraint,¹⁶² the regulators will maximize their own interests, subject to the minimum level of political slack necessary to execute the rent transfer implicit in this story. Typically, discussions of public choice theory, particularly those that take place in the legal literature, simply assume implicitly the presence of slack,

159. See MUELLER, *supra* note 9, at 384; Levine & Forrence, *supra* note 8, at 191–94.

160. See, e.g., MUELLER, *supra* note 9, at 384 (“In the public sector, the bureaucrat typically exercises his discretion by creating and taking advantage of organizational slack.”); Levine, *supra* note 8, at 273. See generally Levine & Forrence, *supra* note 8 (referring to “slack” in the context of political theory).

161. See Levine, *supra* note 8, at 273 (observing that “[t]he operation of the economic theory of regulation implicitly relies on the existence of slack”).

162. See, e.g., WALTER NICHOLSON & CHRISTOPHER SNYDER, *MICROECONOMIC THEORY: BASIC PRINCIPLES AND EXTENSIONS* 127–28 (10th ed. 2010) (displaying a function that shows how a firm's profits are limited by expenditures).

and then proceed with examples of policies that reflect regulators pursuing their own interests.¹⁶³ Typically, this implicit assumption is perfectly acceptable for this examination for the simple reason that most lawmaking takes place in the presence of slack.¹⁶⁴ However, slack is central to understanding the puzzle of an expanding private securities market, and therefore it is useful to consider it in some detail.

In saying that public officials will be insulated from influence of the general electorate *most of the time*, the Article allows for the fact that the level of political slack present at any given time varies depending on both exogenous and endogenous factors. In other words, slack can be affected by events that fall both outside and inside the regulators' control. The determining factor behind this varying degree of slack is information costs. The less it costs the general public to be informed on a given issue, the less slack there will be at any given time. Issues that become so salient that they appear on every cable news channel will have less slack associated with them than issues that news outlets either don't pick up at all or that are marginalized—out of the reach for all but the most diligent follower of current events. Thus, one would expect periods of significant issue salience, where the cost of acquiring information and therefore political slack is low, to coincide with unusual legislative events.¹⁶⁵ And in fact, this is what the data shows. Stuart Banner, for example, has demonstrated that most new securities regulation in the United States has followed stock market crashes, an exogenous event that, like few others, focuses public scrutiny on an industry and its regulators.¹⁶⁶

The Sarbanes-Oxley Act, which was enacted following the accounting scandals of the early 2000s, and the Dodd-Frank Act,

163. See generally William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69 (2011) (assuming the existence of political slack in the analyzing the political economy of the fraud-on-the-market theory); John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019 (2012) (assuming the existence of political slack in discussing the influence of the financial services industry on legislative reform); Macey, *supra* note 10 (assuming the existence of slack in examining the political economy of potentially obsolete administrative agencies); Romano, *supra* note 135 (assuming the existence of political slack in discussing the politics behind the enactment of SOX).

164. For a discussion of the conditions that might lead to a reduction of political slack, see *infra* notes 190–210 and accompanying text.

165. This prediction is analogous to the one generated by a model developed by David Baron. See David P. Baron, *Persistent Media Bias*, 90 J. PUB. ECON. 1, 2 (2006).

166. See Banner, *supra* note 18, at 850.

which was enacted in response to the financial crisis of 2008, are additional data points consistent with Banner's thesis. These two examples are of particular interest because of the in-depth research that has been conducted (by Roberta Romano, in the case of SOX,¹⁶⁷ and Stephen Bainbridge, in the case of Dodd-Frank¹⁶⁸) on the origins of these two pieces of legislation. Although both studies take strong positions with respect to the value of the resulting legislation (concluding in each case that both SOX and Dodd-Frank are inefficient to the extreme), this Article is less interested in these value judgments and more interested in the public choice principles that are illustrated by these analyses. Both SOX and Dodd-Frank were passed during periods when political slack was at a low ebb. SOX was enacted during not only an election year, but one that followed a rash of corporate scandals that led to, what was at the time, the largest bankruptcies in U.S. history. The Dodd-Frank Act was also enacted in the wake of a serious economic event, this time the most significant credit contraction and recession since the Great Depression.¹⁶⁹ At least three principles, which are reflected in the public choice literature, arise from these two studies of real-world lawmaking in the presence of minimal political slack.

First, when political slack is minimal, public officials may take positions that are very different from what one would expect, given their interests. For example, as Professor Romano explains, what ended up being one of the most controversial (and in the view of the business community, burdensome) provisions in SOX—the requirement that the CEO and CFO certify the accuracy of their company's financial statements¹⁷⁰—was actually proposed by the Bush Administration itself.¹⁷¹ After the Administration included this certification provision in its ten-point plan for improving corporate responsibility in the summer of 2002, the Senate included it in the bill with a slightly different formulation that nevertheless preserved the substance of Bush's proposal.¹⁷² Moreover, the Republicans in the Senate ended up supporting the Democratic majority's bill, which

167. See Romano, *supra* note 135, at 1521.

168. See Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1780–84 (2011).

169. See, e.g., ANDREW ROSS SORKIN, TOO BIG TO FAIL 59 (2009).

170. 15 U.S.C. § 7241 (2006); 18 U.S.C. § 1350 (2006). In particular, the CEO and CFO must certify that their company's periodic reports do not contain material misstatements or omissions and "fairly present" the firm's financial condition and the results of operations. 15 U.S.C. § 7241(a)(3).

171. See Romano, *supra* note 135, at 1579.

172. See *id.* at 1579.

closely resembled the final legislation.¹⁷³ This support came despite the fact that the Senate bill had been influenced by Democratic policy advisers, including former SEC Chairman Arthur Leavitt, and was opposed by the Chamber of Commerce, an important Republican constituent.¹⁷⁴

When public officials take positions that are very different from what one would expect, as we saw to be the case in SOX, policies that have little chance of being adopted in the presence of slack all of a sudden become law when that slack disappears. This is the second principle that arises from these studies and is reflected in both the SOX and Dodd-Frank narratives. The SOX example has to do with the provision of that legislation that prohibits accounting firms from providing certain nonaudit services (for example, financial information system design and brokerage services) to the firms that they audit.¹⁷⁵ The rationale underlying the ban was that the fees accounting firms received in exchange for their nonaudit services compromised their auditor independence by encouraging them to cut corners or otherwise engage in inappropriate practices in the audit in order to maintain the nonaudit portion of their clients' business.¹⁷⁶ Then-SEC Chairman Arthur Levitt had tried for years to garner the necessary political support for this sort of ban.¹⁷⁷ Not surprisingly, however, the accounting profession had been united in its opposition to a ban on nonaudit services and managed to garner bipartisan congressional support for their opposition.¹⁷⁸ But in 2002, matters were entirely different. The accounting profession had suffered a serious blow with Arthur Andersen's complicity in Enron's financial fraud. With accounting professionals deemed *persona non grata* in Washington, the fact that the accounting industry opposed the ban when Levitt had worked for passage a few years earlier only served to strengthen the case in its favor.¹⁷⁹ Consequently, in a dramatic turn of events, the same members of Congress who had supported the accounting industry in its opposition against the ban not two years earlier switched their allegiances and voted in favor of including the ban in SOX.

173. *Id.* at 1567.

174. *See id.* at 1564–65.

175. *See* 15 U.S.C. § 78j-1(g) (2006).

176. *See* Romano, *supra* note 135, at 1553–54.

177. *See id.* at 1582.

178. *See id.* at 1566.

179. *See id.* at 1582.

Professor Bainbridge's discussion of the process behind enactment of the Dodd-Frank Act lends further support to this principle. As Professor Bainbridge explains, none of the corporate governance provisions that were included in the Dodd-Frank Act were novel;¹⁸⁰ rather, they had all been proposed in one form or another over the years.¹⁸¹ Yet, with only one exception, none of these rules had ever come close to becoming law. And the one exception—the shareholder proxy access rule¹⁸²—had stalled under the weight of a contentious (and voluminous) notice and comment period at the SEC.¹⁸³ As with all events that eliminate political slack, however, the financial crisis changed the political dynamic dramatically. As was the case with SOX, the interest groups that in normal times would have prevented these corporate governance reforms from gaining traction—for example, corporate interests like the Chamber of Commerce and the Business Roundtable—all of a sudden lost clout and ceded political ground to other interest groups such as unions, consumers, and institutional investors.¹⁸⁴ Institutional investors had for many years advocated and lobbied in favor of these corporate governance reforms, in particular the “say on pay” rule and the proxy access rule, with mixed success.¹⁸⁵ It was only when the animal spirits

180. These provisions fall into three main categories: (i) executive compensation, including a requirement that corporations hold periodic shareholder advisory votes on executive compensation and rules pertaining to pay clawbacks, 15 U.S.C. §§ 78n-1, 78j-4 (Supp. V. 2011); (ii) shareholder proxy access, including a provision authorizing the SEC to promulgate rules permitting shareholders to include on the company's proxy statement their own nominees for the board of directors, *id.* § 78n(a)(1); and (iii) executive responsibilities, including a requirement that companies disclose whether the same person holds both the CEO and Chairman of the Board positions, *id.* § 78n-2.

181. See Bainbridge, *supra* note 168, at 1796–97.

182. Pursuant to this provision, the SEC adopted a proxy access rule, which would have required any public corporation to include in its proxy statement the director nominees of certain significant shareholders that meet the rule's eligibility requirements. See Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,668 (Sept. 16, 2010) (codified at 17 C.F.R. pts 200, 232, 240, 294). This rule was subsequently invalidated by the D.C. Circuit on the ground that the SEC failed to adequately consider the rule's likely costs. See *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1155 (D.C. Cir. 2011).

183. See Stephen Choi et al., *The Power of Proxy Advisers: Myth or Reality*, 59 EMORY L.J. 869, 876 n.48 (2010).

184. Bainbridge, *supra* note 168, at 1816.

185. *Id.* at 1807–08. The battle over say on pay had mostly been fought on an ad hoc basis at corporations themselves. See Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1218–22 (2012) (discussing say-on-pay proposals sponsored by shareholders). On the proxy access issue, the institutional shareholders really did not have much success until they persuaded the Second Circuit that the SEC had violated administrative law principles in deciding that corporations could exclude from the company proxy statement shareholder proposals asking that the company amend its bylaws to include a proxy access

of the market pushed these issues onto the public agenda that these interests were able to prevail. Thus, like the principle in physics where the mere observation of sub-atomic particles seems to change their behavior, the public scrutiny of lawmakers changes the way in which lawmakers behave.¹⁸⁶

These two public choice principles that emerge from these studies of real-world lawmaking lead naturally to the third: everything else equal, lawmakers will gravitate toward slack. Perhaps the most vivid illustration of this principle comes from the story behind the enactment of SOX. Recall that the Republicans in the Senate supported the Democratic majority's bill, despite the fact that it had been heavily influenced by Democratic policy advisors and was vehemently opposed by the Chamber of Commerce.¹⁸⁷ Not only did the Republicans support the Senate bill, they actually voted to expedite its passage.¹⁸⁸ Professor Romano interprets this Republican support for expedited passage as nothing more than an effort to remove corporate issues from the public agenda.¹⁸⁹ In other words, they wanted to return to a world with slack and do so as quickly as possible.

The common theme in this discussion of SOX and Dodd-Frank is that political slack is the norm, not the exception. And the reason lawmakers prefer the norm is because the disappearance of political slack leads to conditions in which lawmakers are under increased scrutiny and have a difficult time pursuing their own interests.

2. Eliminating Political Slack: Exogenous v. Endogenous Triggering Events

In the case of both SOX and Dodd-Frank, the triggering event that eliminated political slack was exogenous: it had nothing to do with any action taken by lawmakers.¹⁹⁰ Rather, the issues surrounding

provision. See *Am. Fed'n of State, Cnty. & Mun. Emps. v. Am. Int'l Grp.*, 462 F.3d 121, 129 (2d Cir. 2006) [hereinafter *AFSCME v. AIG* or *AFSCME*]. That case led the SEC, under the leadership of Chairman Cox, to eventually propose a proxy access rule and a rule permitting companies to exclude shareholder nomination bylaw proposals. See Jill E. Fisch, *The Destructive Ambiguity of Federal Proxy Access*, 61 EMORY L.J. 435, 445 (2012). The SEC ultimately adopted the latter rule. See *id.*

186. This principle is referred to as "particle-wave duality." For an accessible and entertaining discussion of particle-wave duality, see JOHN GRIBBIN, *IN SEARCH OF SCHRÖDINGER'S CAT* 86–88 (1984).

187. See Romano, *supra* note 135, at 1564–65.

188. See *id.* at 1566–67.

189. See *id.*

190. Of course, this is not to say that the regulators bear no responsibility for the crisis. To the contrary, there is plenty of blame to go around. The point is simply that the SOX

each crisis (accounting and corporate governance failures in the case of SOX and risk-assessment failures in the case Dodd-Frank) came to light subsequent to very public economic events that could hardly be missed by even the least informed of the electorate. However, the theoretical literature, combined with recent events, suggests that slack can disappear not only because of such highly public events that fall outside of the lawmaker's control. Rather, slack can also disappear as a result of regulatory or legislative action itself, what one might call an "endogenous" triggering event.

Depending on how a particular legislative issue gets elevated from congressional offices and regulatory backrooms and on to the public agenda, an endogenous triggering event might be thought to follow one of two patterns, which this Article refers to as the "disgruntled negotiator" pattern and the "outraged public" pattern. The disgruntled negotiator pattern occurs when an interest group who feels dealt a bad hand in the negotiation of a particular rule or piece of legislation decides to change negotiating venues. In the complex negotiation that characterizes the lawmaking process, the lawmaker must uncover information regarding the goals and preferences of the various interests¹⁹¹ and, given those goals and preferences, make a decision about what type of regulatory or legislative package will maximize its own interests. As is commonly the case, some party will inevitably leave this negotiation feeling treated unfairly or entitled to a large piece of the pie. By surfacing the relevant issue with the public (or threatening to do so), this disgruntled interest group might hope to gain additional support or bargaining leverage for its position.

In the public choice literature, Professor Mark Roe's description of the interaction between Delaware and Washington, D.C. in the creation of corporate law is a useful illustration of how the disgruntled negotiator type of triggering event might play out.¹⁹²

and Dodd-Frank situations were not ones where regulators took some action that caused a public outcry. Rather, a confluence of events—a perfect economic storm—led to severe market dislocations and subsequently heightened public scrutiny.

191. In the negotiation literature, this information is referred to as a party's reservation value, which is the value placed on the party's best alternative to a negotiated agreement (or "BATNA"). *See, e.g.*, ROBERT MNOOKIN ET AL., *BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES* 19–20 (2000).

192. *See, e.g.*, Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2496 (2005) (explaining that in the context of the federal-state relationship between Washington and Delaware, Delaware's failure to appease management and shareholders with Delaware corporate law may cause a triggering event that places both focus and motivation on Congress).

Professor Roe is interested in explaining the features of U.S. corporate law, which is created largely by the legislature of the state of Delaware, the state in which the lion's share of U.S. corporations are incorporated.¹⁹³ The traditional theory is that the states compete among themselves to attract incorporations, which generate franchise tax revenue for the states, and the debate has largely focused on whether this interstate competition creates corporate law that favors management or shareholders.¹⁹⁴ Professor Roe, by contrast, argues that the principal competition is not among Delaware and other states but rather between Delaware and the U.S. Congress.¹⁹⁵ He contends that Delaware corporate law is not more pro-management (assuming that that is its natural political tilt) because if the Delaware legislature were to reach such a one-sided outcome, disgruntled shareholders would elevate the issue to the public agenda in Washington, thereby changing the stakes for the managerial interests.¹⁹⁶ It is this disgruntled negotiator type of triggering event combined with the federal alternative that, for Roe, explains at least in part the content of corporate law.¹⁹⁷

Of course, there are many ways in which a disgruntled negotiating party might elevate an issue to the public agenda. In Delaware, it might be by making noise in Washington. Another alternative would be to bring the issue to a federal court. This is essentially the strategy that labor interests adopted in the controversial case of *AFSCME v. AIG*,¹⁹⁸ which was decided by the United States Court of Appeals for the Second Circuit in 2006.¹⁹⁹ In that case, the labor union, *AFSCME*, had unsuccessfully tried to have AIG, a company of which it was a shareholder, to include in its proxy statement a shareholder proposal that called for the adoption of a "proxy access bylaw amendment."²⁰⁰ This bylaw amendment would have required AIG to include in its proxy statement the nominees for the AIG board of directors submitted by certain shareholders.²⁰¹

193. *Id.* at 2493.

194. See, e.g., Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 554–55 (2002); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 681 (2002); Roberta Romano, *State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 709 (1987).

195. See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 591–93 (2003).

196. See *id.*

197. See *id.*

198. 462 F.3d 121, 124 (2d Cir. 2006).

199. *Id.* at 121.

200. *Id.* at 123–24.

201. *Id.*

Essentially, this was an attempt at a private work-around for the failed attempts to persuade the SEC to adopt a rule giving certain shareholders of public companies access to the corporate ballot.²⁰² AIG excluded AFSCME's shareholder proposal from its 2005 proxy statement after receiving a no-action letter from the SEC's Division of Corporation Finance, and AFSCME filed suit.²⁰³ The Second Circuit took the position that the SEC's no-action letter authorizing the exclusion of the proposal represented a change from the SEC's initial position and that the SEC had never given any reasons for that change of policy.²⁰⁴ Consequently, the court deferred to the SEC's original policy of allowing such proposals, and the decision handed AFSCME an unexpected win, which paved the way for the SEC's ultimate adoption of a proxy access rule.²⁰⁵

Thus, a lawmaker's actions themselves might be the triggering event that eliminates political slack insofar as those actions cause a disgruntled party to the legislative or regulatory bargain to leave the negotiation table and elevate the issue to the public agenda. Alternatively, if the lawmaker's actions are particularly egregious, they may attract public scrutiny on their own, without the goading of a disgruntled interest group. An example of the "public outrage" type of triggering event is the recent scandal involving Bernard Madoff, which was mentioned previously.²⁰⁶ The SEC came under severe scrutiny following Madoff's arrest when it was revealed that the Commission had investigated Madoff at least six times since 1992 and received numerous tips regarding Madoff's questionable activities and yet failed to uncover any wrongdoing.²⁰⁷ Some commentators speculated that it was this public criticism of the Commission that led the SEC to undertake its subsequent enforcement action against

202. See Brett McDonnell, *Setting Optimal Rules for Shareholders Proxy Access*, 43 ARIZ. ST. L.J. 67, 73–79 (2011) (providing a helpful overview of the proxy access debate).

203. *AFSCME*, 462 F.3d at 124.

204. See *id.* at 128–29.

205. The SEC adopted the proxy access rule in the Fall of 2010. See *Facilitating Shareholder Director Nominations*, 75 Fed. Reg. 56,668, 56,668 (Sept. 16, 2010) (codified at 17 C.F.R. pts 200, 232, 240, 294). However, the rule was subsequently vacated by the D.C. Circuit because the SEC had, in the court's view, given insufficient consideration to the economic consequences of the proxy access rule and had ignored certain empirical data demonstrating that the rule would have negative economic effects. See *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1155 (D.C. Cir. 2011).

206. See, e.g., Amir Efrati & Robert Frank, *Madoff Set to Plead Guilty to 11 Felonies*, WALL ST. J., Mar. 11, 2009, at A1; see also *supra* note 155 and accompanying text.

207. Kara Scannell, *SEC Botched Inquiries into Madoff Scheme: Inspector General Cites Inexperienced Staff and Delays; 'A Failure That We Continue to Regret,'* WALL ST. J., Sept. 3, 2009, at C3.

Goldman Sachs for an unrelated transaction²⁰⁸ in an attempt to revive its tarnished reputation.²⁰⁹

Thus, to summarize, political slack plays an essential role in public choice theory. Indeed, a lawmaker's objective function could be characterized as a constrained maximization problem with political slack as the constraint. As illustrated through the foregoing examples, lawmakers will seek out political slack in order to maximize their own self-interest. While lawmakers will not always have control over the triggering events that elevate issues to the public agenda and thereby eliminate political slack, sometimes they will exercise such control. When they do, they will avoid triggering those events (as in the case of Delaware's moderate take on corporate law) or will scramble to reduce the negative fallout from those events (as in the SEC's attempt to silence its critics in the wake of the Madoff scandal by coming down hard on Goldman Sachs's allegedly improper role in the Abacus transaction). These concepts are essential for understanding the political economy of the expanding private securities market.

3. The SEC's Choice: Reform the Public or Private Securities Market?

a. Why the Choice at All? The Case of the Declining IPO Market and the Forces Pushing for Reform

The SEC, when faced with the choice of liberalizing the public markets or the private markets, may find it advantageous to focus reform efforts on the private markets. But first, we need to explain why the SEC faces this choice at all. After all, the traditional public choice account of SEC action posits that, everything else being equal, the SEC will continue to cater to its interest groups and grow its

208. The SEC brought the suit against Goldman, alleging that it violated the securities laws by failing to inform the purchasers of a complex security that Goldman had created (at the request of the hedge fund manager John Paulson) that Paulson had handpicked the underlying assets and had taken a short position with respect to the securities. Litigation Release No. 21489, SEC, The SEC Charges Goldman Sachs with Fraud in Connection with the Structuring and Marketing of a Synthetic CDO (Apr. 16, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21489.htm>; Complaint at 2–3, SEC v. Goldman, Sachs & Co. and Fabrice Tourre, 10-CV-3229 (S.D.N.Y. Apr. 16, 2010). Goldman ended up settling the case for \$550 million. Susanne Craig & Kara Scannell, *Goldman Settles Its Battle with SEC*, WALL ST. J., July 16, 2010, at A1.

209. David Lieberman & Matt Krantz, *Goldman Sachs Concedes Mistake, Settles SEC Suit; Investment Bank Agrees to \$550M Fine in Mortgage-Securities Case*, USA TODAY, July 16, 2010, at 1B (“Some legal scholars say that it was a much-needed victory for the SEC, which was on the hot seat after years of appearing to be overwhelmed by the breadth and complexity of white-collar crimes it had to fight.”); Gregory Zuckerman et al., *U.S. Charges Goldman Sachs with Fraud*, WALL ST. J., Apr. 17, 2010, at A1.

bureaucratic reach. The theory does not exactly spell out where and when, if at all, the SEC will undertake a reform agenda. But it is also a mainstay of the public choice literature that shocks to a particular industry can alter an existing political equilibrium, thereby disrupting the “everything else being equal” assumption, and potentially causing an agency to change tack, including, for example, by taking up reforms.²¹⁰

The shock that has disrupted the political equilibrium in the world of securities regulation is the dramatic decline over the past decade in the market for IPOs, resulting in what some have referred to as a “crisis” for capital formation.²¹¹ The numbers certainly are enough to give one pause. From 1991 to 2000, the United States averaged approximately 530 IPOs per year.²¹² Yet, since 2001, that average has dwindled to only 126, with only thirty-eight IPOs in 2008 and sixty-one in 2009.²¹³ Furthermore, there is little consensus on the cause of this IPO decline. Many believe that the decline is the result of increased regulatory costs as a result of the Sarbanes-Oxley Act.²¹⁴ According to these commentators, the increased costs of being public under SOX deter prospective IPO candidates from pulling the trigger.²¹⁵ Others, by contrast, claim that the IPO decline predates the enactment of SOX and is instead attributable to market changes that have made it uneconomical for market makers, traders, and analysts to follow and trade small-cap stocks, which would include recent IPOs.²¹⁶ Still others point to culprits like the elimination of the investment research industry, which resulted from Eliot Spitzer’s efforts to prevent brokers from generating investment research on companies with which they had banking relationships.²¹⁷

210. See Macey, *Federal Deference*, *supra* note 128, at 265–66.

211. WEILD & KIM, *supra* note 21, at 3; see also Felix Salmon, Op-Ed., *Wall Street's Dead End*, N.Y. TIMES, Feb. 14, 2011, at A27; *Whatever Happened to IPOs?*, WALL. ST. J., Mar. 22, 2011, at A14 (tying fewer IPOs to the costs imposed by the Sarbanes-Oxley Act); Alan Patricof, *It's Official: The IPO Market Is Crippled—And It's Hurting Our Country*, BUS. INSIDER (Jan. 12, 2011, 12:07 PM), <http://www.businessinsider.com/alan-patricof-greycroft-ipo-market-2011-1> (attributing the decrease in IPOs to a decrease in underwriting firms, prohibitive research costs, smaller permitted spreads on trades, and increasing costs to go public).

212. See WEILD & KIM, *supra* note 21, at 5.

213. See *id.* at 3.

214. See, e.g., L. Gordon Crovitz, *How Washington Defriended Investors*, WALL. ST. J., Jan. 10, 2011, at A15; Francesco Bova et al., *The Sarbanes-Oxley Act and Exit Strategies of Private Firms* 1 (May 5, 2011) (SSRN, Working Paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1730242.

215. *Whatever Happened to IPOs?*, *supra* note 211.

216. See WEILD & KIM, *supra* note 21, at 3–4.

217. *Whatever Happened to IPOs?*, *supra* note 211.

The IPO market decline and the uncertainty as to the causes of this decline are troubling because of the role this market plays in the economy. The IPO market is central to economic growth because it has historically provided companies with an important way to raise large amounts of capital necessary for investment in research and development. In addition, as Ron Gilson and Bernard Black first identified, IPOs provide venture capitalists with a way to exit their investment in private companies.²¹⁸ As that exit option closes, it threatens to discourage the type of financing at the heart of technological innovation in the United States.

Consider how the declining IPO market disrupts the prevailing political equilibrium at the SEC. As discussed before, that equilibrium is dependent upon interests within the securities industry that benefit from increased disclosure regulation, including securities analysts and lawyers. But it is also dependent upon larger, more established companies that welcome higher regulatory costs. These higher regulatory costs protect the large companies' market position by erecting real barriers to entry for new, upstart firms with little or no effect on the large companies' bottom lines.

A dramatically declining IPO market, however, disrupts this equilibrium by giving the smaller, upstart firms greater bargaining leverage with the SEC.²¹⁹ As the dwindling IPO market causes upstart firms to become more vocal about the lack of financing and exit and its effect on American innovation, these firms gain additional leverage as their complaints threaten to galvanize public support for their position, thereby eliminating political slack. The upstart firms become comparatively more powerful than before, and the SEC feels pressed to help these firms in order to preserve political slack.

Thus, a declining IPO market is likely to lead the SEC to adopt a deregulatory position. Others have pointed to dwindling political slack as the cause of other deregulatory episodes, including airline deregulation in the 1980s.²²⁰ But, importantly, when faced with these deregulatory pressures, the SEC is not limited only to reform of the IPO market. As discussed previously, the private market is a substitute for its public counterpart. Like the public securities market, the private securities market provides a company with capital,

218. Black & Gilson, *supra* note 62, at 245.

219. One example of this shifting political clout is the SEC's creation of the "Advisory Committee on Small and Emerging Companies" in 2011. See Letter from Mary Schapiro, *supra* note 101.

220. See generally Levine, *supra* note 8 (applying concept of political slack to airline deregulation).

liquidity, and a market price. To be sure, the private securities market is not a perfect substitute for its public counterpart, but it is a fairly close one. And the private securities market involves fewer costs, including those associated with compliance and litigation risk, than the public market.²²¹ Because these two markets are substitutes, even if imperfect ones, the SEC could respond to a declining IPO market by either reforming the IPO market or reforming the private securities market. Thus, the SEC can ease these deregulatory pressures not only by liberalizing the public market (the IPO market), but the private one as well. And it appears that the SEC has taken the latter route.²²² To be sure, the SEC has taken some steps to curb the effects of Sarbanes-Oxley.²²³ But it could clearly do more to curb the costs of that legislation, as scholars²²⁴ and research groups²²⁵ have

221. See *supra* Part I.A.

222. As mentioned above, the SEC has not stopped the growth of the private securities market, even when specifically asked by investors, and has undertaken at least one major action to grow it: shortening the Rule 144 holding limitations. See *supra* Part I.B. There is also evidence that the SEC was considering increasing the threshold test for determining section 12(g) Exchange Act reporting applicability before being preempted by the 2012 JOBS Act. See *supra* notes 118–120 and accompanying text.

223. See Steven M. Davidoff, *With Facebook, Debate Renews over I.P.O. Regulation*, N.Y. TIMES DEALBOOK (Jan. 11, 2011, 7:09 PM), <http://dealbook.nytimes.com/2011/01/11/with-facebook-debate-renews-over-i-p-o-regulation/> (pointing out that the SEC has, among other things, reduced the regulatory burden on foreign issuers by permitting them to use international standards in complying with accounting rules). One might also point out that, in 2005, the SEC undertook a major overhaul of the rules governing public offerings. See generally Securities Offering Reform, 70 Fed. Reg. 44,722 (Aug. 3, 2005) (codified as amended in scattered parts of 17 C.F.R.) (modifying “registration, communications, and offering processes under the Securities Act of 1933”). However, this reform effort had little, if anything, to do with decreasing the regulatory costs of being a public company in an effort to jumpstart the IPO market. See *id.* at 44,724–25 (explaining that the reforms are an extension of a longstanding goal to harmonize the Securities Act and the Exchange Act and to modernize the securities laws more generally). Rather, its main purpose was to liberalize the rules that limit communications during the public offering process. See *id.* at 44,725. Moreover, the primary beneficiaries of the 2005 public offering reforms were not small growth firms but rather large, established firms that are able to fall under the SEC’s new category of the “well-known seasoned issuer” and the more lax rules pertaining to these firms. See *id.* at 44,726–27 (explaining that the most flexible communication rules under the reforms would be reserved for this new category of large issuers).

224. See, e.g., Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. ON REG. 229, 239–51 (2009) (citing, approvingly, commissioned reports suggesting the need for the SEC to revisit its implementation of Rule 404 of SOX, including by permitting certain firms to opt out of the rule entirely).

225. See, e.g., COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 1–5 (2006), http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf; MCKINSEY & CO., SUSTAINING NEW YORK’S AND THE US’ GLOBAL FINANCIAL SERVICES LEADERSHIP, 17–21, 97–100 (2007), http://www.nyc.gov/html/om/pdf/ny_report_final.pdf;

pointed out. The reason the SEC has decided to focus its efforts on the private market makes sense in light of the discussion about political slack above. In short, “reform” of the private securities market carries with it less risk of a loss of political slack than reform of the public IPO market does.

b. Why Private Securities Market Reform Might Be More Politically Appealing than Public Securities Market Reform

When the SEC is presented with the possibility of reforming the public or the private securities market, private securities market reform is probably more appealing from a public choice perspective. This is because reform of the private securities market involves less of a risk of a loss in political slack due to endogenous triggering events. As discussed above, there are basically two different types of endogenous triggering events, the “disgruntled negotiator” and the “outraged public.” Both types of triggering events will be less likely with private securities market reform than with the public alternative.

i. *Private Securities Market Reform and the “Disgruntled Negotiator”*

Private securities market reform involves less risk of creating a triggering event through a disgruntled negotiator who elevates an issue to the public agenda for the simple reason that the private securities market involves fewer interest groups than the public securities market. After all, the private securities market is limited to “sophisticated investors” and “qualified institutional buyers” and excludes the average retail investor.²²⁶ Furthermore, rules that the SEC imposes on the valuation of illiquid securities tend to deter mutual funds and pension funds from investing in the private securities market and in fact their participation in this market has been historically quite low.²²⁷ For this reason, groups representing these interests are not present at the bargaining table when it comes to private securities market reform. With fewer interest groups at the

U.S. CHAMBER OF COMMERCE, COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY: REPORT AND RECOMMENDATIONS 24–28 (2007), http://www.uschamber.com/sites/default/files/reports/0703capmarkets_full.pdf; Hal S. Scott, Op-Ed, *Capital Market Regulation Needs an Overhaul*, WALL. ST. J., Apr. 20, 2011, at A13 (noting the need for reform in his capacity as Director of the Committee of Capital Markets Regulation).

226. See *supra* notes 35–55 and accompanying text.

227. See Dr. Janet Kiholm Smith et al., *The SEC’s “Fair Value” Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities*, 6 FORDHAM J. CORP. & FIN. L. 421, 423–24 (2001).

table, there are fewer voices left to channel potential dismay over policy decisions into efforts to elevate the relevant issues to the public agenda.

That interest group formation depends greatly on the venue in question and may determine political choices is an important theme in the public choice literature. For example, Professor Roe has made this observation in the context of the competition between Delaware and the U.S. Congress over the creation of corporate law.²²⁸ Roe argues that there are fewer interest groups involved in the corporate lawmaking process in Delaware than in Washington.²²⁹ Whereas Washington is influenced by everyone from labor to populists, Delaware's political economy is much simpler and appears to be dominated largely by managerial and shareholder interests.²³⁰ Given Delaware's streamlined interest group landscape, managerial and shareholder groups will typically prefer to keep the corporate lawmaking process in Delaware.²³¹ Moreover, because of the difference in interest group formation, public choice theory would predict that the legislative outcome in Delaware will look very different from federal legislation on the same issue,²³² and indeed it does.²³³

Not only are there differences in interest group formation between Congress and states but also between Congress and administrative agencies, like the SEC. This may be because certain groups have greater influence with administrative agencies. For example, there is evidence that business interests are particularly successful at lobbying administrative agencies.²³⁴ Alternatively, interest group formation may differ between Congress and administrative agencies simply because of the time lag between the creation of legislation and the administrative implementation of that legislation. The political climate can change dramatically during this time lag. For example, one possible public choice criticism of the Dodd-Frank Act is that the many rules that must be promulgated in order to implement the legislation itself will be implemented so long after the public's interest in financial reform will have waned that

228. See Roe, *supra* note 192, at 2500–04.

229. See *id.*

230. See *id.*

231. See *id.* at 2504.

232. See *id.* at 2504–18.

233. See *id.* at 2518–28.

234. Jason Webb Yackee & Susan Webb Yackee, *A Bias Towards Business? Assessing Interest Group Influence on the U.S. Bureaucracy*, 68 J. POL. 128, 133–35 (2006).

certain interests, like those representing the financial industry, will have an outside influence on the rulemaking process.²³⁵

Thus, what emerges from a synthesis of this literature is that interest group formation is part of a continuum. There may be fewer interest groups at the SEC than in Congress, but probably not as few as in states like Delaware. Not only does interest group formation depend upon a given lawmaking venue, however, it also depends upon the policy issue in question. Thus, even within a given venue, like the SEC, different issues will involve a different array of interest groups. That lawmakers will gravitate toward areas of greater political slack also means that they will gravitate toward areas with fewer interest groups, as is the case with private securities market reform.

*ii. Private Securities Market Reform and the
"Outraged Public"*

Not only does private securities market reform exhibit less of a risk of setting off a disgruntled negotiator triggering event than reform of its public counterpart, it also carries with it less risk of igniting the other type of triggering event discussed above: agency action that in and of itself creates public outrage.

The public is more or less of two minds on financial market policy. It is either focused on ensuring the competitiveness of the U.S. markets with those of other countries (possibly at the cost of an occasional crisis) or it is focused on preventing financial crises (even if such crisis-prevention might come at the cost of U.S. competitiveness). These goals are reflected in nearly all finance-related legislation. This is because the political realities are such that every piece of securities-related legislation is adopted in the wake of a crisis and therefore has as one of its goals the prevention of future crises.²³⁶ Crisis prevention itself, however, will always entail rules that are applicable only to U.S. companies.²³⁷ Therefore, legislation that is intended to prevent future crises lends itself to the concern that U.S. companies, burdened by the weight of the new rules, will no longer

235. See, e.g., Annie Lowrey, *Facing Down the Bankers*, N.Y. TIMES, May 31, 2012, at B1 (reporting on the intense fight among financial interests to influence implementation of the Dodd-Frank Act and the relative lack of influence wielded by public interest advocates).

236. See, e.g., Banner, *supra* note 18, at 850–51.

237. This differential treatment between U.S. and foreign regulators opens up the possibility of regulatory arbitrage. See Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 230 (2010) (explaining the concept of arbitrage in the context of a deal).

operate as efficiently as their counterparts in other markets where those rules do not apply. Thus, the Sarbanes-Oxley Act, which was undoubtedly crisis-prevention legislation, has given rise to a cottage industry of studies examining its effect on U.S. competitiveness.²³⁸ The same has been true of much of the Dodd-Frank Act.²³⁹ And academic discourse typically must address how a financial or securities reform proposal affects both goals.²⁴⁰

Since any public securities market reform will require the SEC to revisit a statute (or more specifically, rules promulgated under a statute) that created the part of the public market in question, the SEC will have to navigate, as with Scylla and Charybdis, between the competitiveness and crisis-prevention positions created by the statute. This is precisely what IPO market reform requires. For example, if the SEC concluded that the cause of the IPO market downturn is the regulatory costs created by certain rules promulgated under the Sarbanes-Oxley Act, then the Commission would need to revisit those rules in an effort to reduce the regulatory burden that they impose on companies. However, doing so risks drawing the ire of that portion of the public that is concerned mainly with crisis prevention. Of course, the SEC might be able to weather the resulting political storm, provided that the deregulatory action satisfies the public cohort that is concerned more with competitiveness issues. For that to occur, however, the SEC's deregulatory action would actually have to

238. John Thain, *Sarbanes-Oxley: Is the Price Too High?*, WALL. ST. J., May 27, 2004, at A21; see also Engel et al., *supra* note 87, at 142–43 (finding that firms went private in increasing numbers following passage of SOX); Litvak, *supra* note 87, at 226–27 (finding that foreign firms that cross list in the United States and are subject to SOX experienced a significant decrease in stock price following passage of the legislation as compared to foreign cross-listed firms that are not subject to SOX); Zhang, *supra* note 87, at 77 (finding that the U.S. stock market reacted overwhelmingly negatively to passage of SOX).

239. See, e.g., *Financial Regulatory Reform: The International Context: Hearing Before the H. Comm. on Fin. Servs.*, 112th Cong. 16–17 (2011) (discussing the various impacts of Dodd-Frank on America's international business community); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-529, PROPRIETARY TRADING: REGULATORS WILL NEED MORE COMPREHENSIVE INFORMATION TO FULLY MONITOR COMPLIANCE WITH NEW RESTRICTIONS WHEN IMPLEMENTED 28 (2011) (“[N]o other industrialized countries in Europe or around the world plan to enact provisions that parallel the U.S. restrictions [on proprietary trading]. The foreign regulators we spoke with indicated that if the U.S. restrictions were implemented in a way that restricts the ability of U.S. banking entities to serve their clients through market-making, underwriting, or in other ways, that U.S. banking entities could lose business to their competitors in Europe and elsewhere.”).

240. See, e.g., Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1195–97 (2010) (observing that their proposal to make investment bankers personally liable for their banks' debt would decrease risk and competitiveness, but that maybe that is not a drawback).

be successful. In other words, it would have to result in a reinvigorated IPO market. If, instead, the SEC were to scale back SOX-related rules without having any perceptibly positive effect on the IPO market, then the SEC would fail to satisfy any of the public, and political slack would deteriorate.

Contrast this scenario with the prospect of reform of the private securities market. A private market reform agenda involves less risk of outraging the public for the simple reason that the public has little interest in the private securities market. After all, the public cannot directly participate in it. And private securities market reform is unlikely to raise the hackles of either the crisis-prevention-minded or the competitiveness-minded public. The SEC can expand the scope of the private securities market without being accused in the court of public opinion of scaling back crisis-prevention legislation along the lines of SOX.²⁴¹ And there is little risk that such reforms would raise competitiveness issues because, unlike reforming SOX in the hope of jumpstarting the IPO market, an effort to expand the scope of the private securities markets is by definition going to achieve its goal of making privately held capital more accessible to small business.

Thus, the decision to focus reform efforts on the public IPO market involves a gamble that is simply not present in the case of private securities market reform: the SEC must be relatively certain that such efforts will be successful, which means that it must be relatively certain that the cause of the IPO market decline is SOX. Otherwise, it risks public outrage. But, as discussed previously, there is no clear consensus on the causes of the IPO contraction.²⁴² Thus, any uncertainty as to the outcome of efforts to reform the public markets increases the likelihood that the SEC will turn its sights on the private markets instead.

* * *

To summarize, this Article has argued, relying on the example of the SEC, that contrary to the traditional public choice account, agencies will sometimes have the incentive to expand the scope of the unregulated portion of their industry. They will do so, however, only if such action will avert a situation of diminishing political slack. This will occur under two conditions: (1) where there has been an exogenous shock to the industry, like the IPO market decline, that

241. To be sure, it would involve modifying the rules promulgated under the Securities Act of 1933, but the Securities Act does not exactly have the same salience as crisis legislation that SOX has.

242. See *supra* notes 214–17 and accompanying text.

changes the political dynamic and creates a deregulatory environment; and (2) where there is considerable uncertainty about how to reverse the effects of that exogenous shock by reforming the public markets. Expanding the scope of the private securities market allows the SEC to maximize political slack by dealing with a relatively small number of interest groups and avoiding the risk of causing public outrage in the event that IPO market reform were to end in failure.

Before transitioning to a discussion of the implications of this public choice account, it might be useful to briefly consider how this account might explain the politics surrounding Congress's recent adoption of the 2012 JOBS Act.²⁴³ One of the central features of this legislation was the increase from 500 to 2,000 of the threshold number of shareholders of record that a company can have before being obligated to register as a reporting company under section 12(g) of the Exchange Act.²⁴⁴ This legislation represents the first time in nearly fifty years that Congress (as opposed to the SEC) has expanded the private securities market.²⁴⁵ And commentators have questioned the politics surrounding the legislation's adoption, since the received wisdom that applies to the politics of the SEC is similar to that of Congress—Congress has an incentive to grow the regulatory state, particularly in the wake of a crisis.²⁴⁶ Perhaps most puzzling of all, however, is not just that the JOBS Act was deregulatory, but that its deregulatory agenda was rooted in the expansion of the private securities market rather than the reformation of the public market through, for example, the scaling back of SOX.²⁴⁷

243. Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.A. (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)).

244. See *id.* § 501, 126 Stat. at 325 (codified at 15 U.S.C.A. § 78l(g)(1)(A) (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)). As a technical matter, the JOBS Act increased the shareholder of record threshold only with respect to "accredited investors." See *id.* For a definition of "accredited investor," see *supra* note 50.

245. Robert B. Thompson, *The JOBS Act: Raising the Threshold for '34 Act Obligations*, CONGLOMERATE (Apr. 24, 2012), <http://www.theconglomerate.org/2012/04/the-jobs-act-raising-the-threshold-for-34-act-obligations.html>.

246. See Brett McDonnell, *Special Forum: JOBS Act—A Political Puzzle*, CONGLOMERATE (Apr. 24, 2012), <http://www.theconglomerate.org/2012/04/special-forum-jobs-act-a-political-puzzle.html>. Professor McDonnell offers a number of possible explanations for the politics underlying the JOBS Act, including that the JOBS Act represented a response to a sea change in the public's appetite for regulation; that Congress was simply uninformed; and that the legislation was a type of regulatory stimulus for the weak U.S. economy. *Id.*

247. To be sure, the JOBS Act offered some relief from SOX for certain small growth companies. See JOBS Act, Pub. L. No. 112-106, §§ 101-08, 126 Stat. 306, 306-13 (codified

However, what the foregoing public choice account suggests is that the JOBS Act represented Congress's response to the same forces that the SEC has been responding to since the turn of the twenty-first century and is therefore the culmination of this decade-long expansion of the private securities market. The logic of this account should be familiar by now. The dysfunctional IPO market creates pressure to either reform the public market or expand the private one. Just as the SEC has done for the past decade, Congress decided to expand the private securities market with the JOBS Act because this alternative offers greater political slack and avoids the uncertainty that accompanies any attempt at diagnosing and solving the underlying problem with the public market.

III. IMPLICATIONS

A. *Implications for the SEC and Securities Law*

It was argued in Part II that the expansion of the private securities market can be viewed as a political strategy on the part of the SEC to maximize its bureaucratic career support in the face of uncertainty over how to reform the dysfunctionality of the public market. This updated public choice account suggests that, as long as the IPO market remains in the doldrums, there will be strong political forces pushing for an ever-expanding private securities market. And because those political forces exclude the public interest, they are likely to lead the SEC to expand the private securities market beyond its optimal scope.²⁴⁸ Three negative implications follow from a private securities market that is inefficiently large: there will be too little disclosure, too little liquidity, and too few investment opportunities as retail investors are crowded out from a market that is reserved principally for "sophisticated" investors.

1. Disappearing Disclosure

The SEC's favoring of the private market will result in fewer companies entering the public market (and complying with that

in scattered sections of 15 U.S.C.A. (West 2009 & Supp. 2012 & Pamphlet 1A Sept. 2012)). And interestingly, it commissioned the SEC to test whether one popular theory—the decision to set at one penny the minimum increment at which securities prices are quoted (also called the “tick size”)—might explain the IPO market decline. *See id.* § 106(b), 126 Stat. at 312. But it does not permanently exempt anyone from SOX, and it does not make any attempt to reform the public market. For this reason, it is more accurate to view the JOBS Act as primarily intended to deregulate by expanding the private securities market rather than reforming the public market.

248. *See, e.g.,* Levine, *supra* note 8, at 273.

market's mandatory disclosure requirements). In other words, the political economy of the private securities market may lead to disappearing disclosure in corporate America. To be sure, whether a shift from public to private securities markets results in a sub-optimal amount of disclosure depends on where one comes out in the debates over the necessity of a mandatory securities disclosure regime and the ability of private ordering to achieve an efficient level of disclosure. The theoretical literature that explores this question is notoriously inconclusive.²⁴⁹ On one side are those who argue that market forces will compel securities issuers to disclose the optimal amount of information.²⁵⁰ On the other side, there are those scholars who point out a number of market failures as evidence of the need for a mandatory disclosure rule.²⁵¹ While the theoretical literature is difficult to sort out on its own, the few empirical studies that have been conducted tend to favor supporters of mandatory disclosure.²⁵² Thus, it would appear that the current state of the literature implies that as capital-raising activity shifts from the public to the private securities market, thereby avoiding the mandatory disclosure regime

249. See MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 395 (1995) (observing that "the cases for and against mandatory disclosure [are] more or less in equipoise"); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 314 (1991) ("We are left . . . with arguments rather than proof. And the arguments are themselves inconclusive.").

250. See, e.g., HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* 169 (1966); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 916 (1998); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 687 (1984); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361 (1998); Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 389 (2001).

251. See, e.g., John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 733–34 (1984) (arguing that mandatory disclosure "reduces wasteful duplication by establishing a central information repository"); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 738–40 (2006).

252. See generally Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACCT. & ECON. 233 (2005) (finding that rule changes on the over-the-counter bulletin board were correlated with a drop in the volatility and an increase in the returns of the stocks traded on that market); Allen Ferrell, *Mandatory Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, 36 J. LEGAL STUD. 213 (2007) (finding similar results with respect to the imposition of mandatory disclosure on the over-the-counter market in 1964); Michael Greenstone et al., *Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments*, 121 Q. J. ECON. 399 (2006) (also finding that the imposition of mandatory disclosure was correlated with an increase in the returns of the stocks traded on that market).

of the public markets, there will be too little corporate disclosure from an efficiency perspective.

In the event that an expanding securities market does lead to such sub-optimal disclosure, the social costs could be significant. Securities disclosure is thought to be an essential component of efficient capital allocation, since publicly available information will affect stock prices, which in turn affects the number of shares a company must sell to raise a given amount of capital.²⁵³ Therefore, less efficient disclosure leads to less efficient stock prices, which in turn leads to less efficient capital allocation. The bottom line is that disappearing disclosure may result in less valuable companies and a less valuable economy.

2. Disappearing Liquidity

Too little disclosure would inevitably lead to too little liquidity as well. The liquidity of a securities market refers to "the ease (and cost) of converting one's stock into cash."²⁵⁴ There are at least two main social costs associated with less liquid securities markets. The first is simply the increased cost entailed in liquidating one's investment.²⁵⁵ If a firm decides that it no longer wants to hold a particular security, it is considerably less costly to sell, for example, the highly liquid share of Apple, Inc. than it is to sell the comparatively less liquid share of any of the dozens of private companies just down the road from Apple in Silicon Valley. This increased transaction cost associated with disappearing liquidity contributes to the second social cost, which is a sub-optimal investment portfolio. If it costs investors more to sell certain securities, then this increased transaction cost may cause investors to hold investment portfolios that are materially different from the optimal portfolio that they would hold in a highly liquid

253. See, e.g., Christine A. Botosan & Marlene A. Plumlee, *A Re-Examination of Disclosure Level and the Expected Cost of Equity Capital*, 40 J. ACCT. RES. 21, 21 (2002) (finding a negative relationship between cost of capital and analyst rankings of annual report disclosures); Christine A. Botosan, *Disclosure Level and the Cost of Equity Capital*, 72 ACCT. REV. 323, 323 (1997) (finding a negative relationship between cost of equity capital and the extent of disclosure); Jere R. Francis et al., *Disclosure Incentives and Effects on Cost of Capital Around the World*, 80 ACCT. REV. 1125, 1125 (2005) (finding that increased disclosure is negatively correlated with the cost of capital in firms outside of the United States); Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 988, 1005 (1992). But see Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 617-18 (1988).

254. See Kahan, *supra* note 253, at 1017 n.181.

255. See *id.* at 1020.

market.²⁵⁶ For years, commentators have drawn a distinction between the U.S. securities market, which is highly liquid and deep, and its European counterparts, which are less so.²⁵⁷ An expanding private securities market blurs this distinction.

3. Disappearing Investment Choice: The Crowding-Out of the Retail Investor

An expanding private securities market would make the U.S. securities market more like its European counterparts in other ways as well. Until relatively recently, one of the defining characteristics of the U.S. corporation has been its dispersed shareholder base.²⁵⁸ Unlike European corporations, which are owned largely by banks and wealthy families, U.S. corporations have historically been owned by the people themselves.²⁵⁹ As Professor Roe has argued, this sort of American-style democracy mixed with capitalism emerged out of a distinctively American psyche and its aversion to centralized power, be it financial or otherwise.²⁶⁰ To be sure, share ownership in public corporations in the United States has undergone a significant consolidation in recent years as managed funds, like Fidelity and Vanguard, have grown to become the largest shareholders in corporate America.²⁶¹ But underlying these funds are still retail investors: plumbers, teachers, doctors—people of all stripes who, either through their retirement plans or their non-retirement savings, invest in these companies.

256. *See id.*

257. This difference in depth and liquidity of financial markets is primarily what the “law and finance” literature is trying to explain. *See, e.g.,* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1146–51 (1998) (examining the legal rules in forty-nine countries and finding that securities ownership is more distributed in the United States and U.S.-influenced nations than in many European nations). As Professor Mark Roe explains, these studies measure the “depth” of a country’s financial markets with reference to the degree of ownership separation exhibited by that country’s firms. Mark J. Roe, *Legal Origins, Politics and Modern Stock Markets*, 120 HARV. L. REV. 460, 495 & n.104 (2006). However, Roe cautions, “[s]eparation is only one rough indicator” of depth, and he identifies stock market capitalization, size of the IPO market, and the number of firms as other important factors to be weighed. *Id.* at 495 n.104.

258. *See* Mark J. Roe, *Political Preconditions for Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539, 542, 562 (2000) (drawing a distinction between firms with dispersed ownership in the United States and the United Kingdom and firms with concentrated ownership in European countries with social democracies); Roe, *supra* note 257, at 496 (presenting evidence that the United States has the highest degree of ownership separation among publicly-traded firms of the twenty-seven countries included in the sample).

259. *See* Roe, *supra* note 257, at 544.

260. *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 28–33 (1994).

261. *See* Davis, *supra* note 98, at 1130–31.

This is not so in the case of the private securities market, for these same investment intermediaries, including mutual funds, face considerable legal limitations on their ability to invest in private securities.²⁶² Thus, as the private securities market expands, the retail investor is crowded out, and the model of democratic capitalism that has defined the American corporate landscape for nearly a century is upended. This is a concern for several reasons. The first is a personal finance concern. Financial economics tells us that, with perhaps the exception of certain investing savants like Warren Buffett, investors are better off when they can diversify their investments. Through diversification, investors are able to maximize returns and minimize risk. However, the private securities market represents an entire class of investments that are out of reach for the retail investor. And many of these companies, particularly the innovative growth companies like an early-stage Groupon or Facebook, simply do not have close substitutes in the public markets. So, the crowding-out problem that is exacerbated by the political economy leaves retail investors with less ability to optimize their personal investment profile.

This personal finance effect of the expanding private securities market itself leads to increasing financial inequality in the United States. This effect has a direct and indirect component. The direct component is simply that retail investors will be excluded from an increasing number of investments, many of which will be highly profitable, while wealthy, sophisticated investors retain a piece of the action. Thus, the crowding-out problem increases wealth inequality and highlights class differences.

Perhaps even more important, however, is the indirect effect of the crowding-out problem, which is that it may lead to undesirable political correctives. The American aversion to financial inequality and the concentration of financial power in the hands of a relative few has a powerful influence on the political landscape—so powerful in fact that, as Professor Roe has argued, it is a significant determinant of the dispersed shareholder corporation in the first place.²⁶³ But it can also lead to other, less desirable political outcomes. For example, Professor Rajan has argued that it was these same political dynamics that caused American politicians to react to an increasingly unequal wealth distribution in the United States by maintaining low interest

262. See *supra* note 227 and accompanying text.

263. See ROE, *supra* note 260, at 26 (introducing the argument that the public's "mistrust [of] private large accumulations of power" contributed to the model of dispersed share ownership in the United States).

rates, subsidizing mortgages, and encouraging home ownership.²⁶⁴ In other words, the crowding-out problem simply revitalizes the climate that some believe played a role in causing the recent financial crisis.

B. Potential Solutions to the Crowding-Out of the Retail Investor?

The forgoing discussion suggests that, should the trend of an expanding private securities market continue, we are likely to witness a potentially fundamental transformation in U.S. capital markets as we grapple with the disappearance of disclosure and liquidity and the crowding out of the retail investor. Responding to these issues will require solutions that are adequate to address the magnitude of the problem. While a full-blown reform proposal falls outside of the scope of this paper, it is useful to briefly sketch one potential approach to one potential problem: the crowding-out of the retail investor. Although one of the other problems (disappearing disclosure or liquidity) could just as easily have been chosen, this Article focuses on the crowding-out problem because it seems potentially the most troublesome. This Article takes a two-prong approach: a first-order solution (which would likely act as a first-order solution for the disappearing disclosure and liquidity problems as well) and a second-order solution, which is more specific to the crowding-out problem itself.

First-Order Solution. A first-order solution to the crowding out problem would address the root cause of the problem, which, as argued here, is a political one. By expanding the private securities market, the SEC can appease those interests (small firms, in particular) that demand a solution to the IPO market decline but without the risk, associated with reform of the IPO market itself, of elevating the issue to the public agenda and eliminating political slack. Thus, the first-order solution would aim to alter this calculus so that the SEC is indifferent as to which market it focuses on for reform purposes.

One way of creating this indifference is suggested by the political science literature. Professors Matthew McCubbins and Thomas Schwartz have argued that Congress typically controls executive agencies, like the SEC, through what they term “fire-alarm oversight”—a decentralized system of oversight that relies on individual citizens and interest groups to smoke out potential areas of

264. See RAJAN, *supra* note 144, at 38, 41–43.

agency complacency or neglect of legislative goals.²⁶⁵ Through this fire-alarm structure, individual citizens and interest groups can examine administrative decision-making—perhaps by attending administrative hearings—and can then alert Congress, spurring Congress to action in the event of a problem.²⁶⁶ This theory of fire-alarm oversight is consistent with public choice theory's view of political slack. The fire-alarm approach to congressional oversight provides agencies with substantial political slack, creating space for an agency to focus on regulatory rent creation until an issue is elevated (for one of the reasons discussed above) to the public agenda and political slack is eliminated.

But fire-alarm oversight is not the only possible means of keeping agencies in check. There is also what McCubbins and Schwartz refer to as “police-patrol oversight”—a more centralized system of oversight in which Congress itself, or some group answerable to the full Congress, keeps active watch over agencies in an attempt to detect and remedy any objectionable conduct.²⁶⁷

One attempt at a first-order solution to the crowding-out of retail investors in the private securities market is to adopt a model of SEC oversight that retains the fire-alarm model but incorporates certain features of police patrols as well. This hybrid system would attempt to improve the monitoring of SEC action, not by changing the identity of the monitors, but by improving the quality of the monitoring.²⁶⁸ So, unlike a pure police-patrol model of congressional oversight, this hybrid system would not vest oversight responsibility primarily with Congress. Rather, the general electorate would retain control of this oversight responsibility, as in the current fire-alarm model. Instead, the primary goal of the proposed hybrid system would be to lower the transaction and information costs the public faces in monitoring SEC activity. As explained above, it is these transaction and information costs that create the political slack that allows agencies like the SEC

265. See Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms*, 28 AM. J. POL. SCI. 165, 165–66 (1984). Others have argued that Congress also uses this fire-alarm structure of oversight with respect to federalism issues. See, e.g., Roe, *supra* note 192, at 2530.

266. See McCubbins & Schwartz, *supra* note 265, at 166.

267. See *id.*

268. This proposal is conceptually similar to the idea of a “regulatory contrarian,” as introduced by Brett McDonnell and Daniel Schwarcz, which they define as “an entity that is affiliated with, but independent of, a financial regulator with the task of monitoring that regulator and the regulated marketplace and publicly suggesting new initiatives or potential structural or personnel changes.” Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629, 1632–33 (2011).

to pursue an agenda of regulatory rent creation. And, as this Article has argued, it is this agenda that actually leads, somewhat counter-intuitively, to an expanding private securities market and the crowding-out of the retail investor. Thus, if we could lower these monitoring costs, we would remove the principal barrier to effective monitoring that creates political slack and the preconditions for regulatory rent creation.

The proposed hybrid system would require the creation of a public interest watchdog group, a bi-partisan entity independent from the executive and accountable directly to Congress whose sole goal would be to lower the transaction and information costs that the public faces in monitoring SEC activity. This public interest watchdog group would be a populist enterprise, independent of the SEC, with the goal of explaining, in the simplest terms possible, how SEC action, or inaction, affects the public. It might highlight, for example, the implications of an expanding private securities market, explaining that it leaves retail investors with fewer investment options, effectively crowding them out. Or it might explain how certain disclosure rules benefit lawyers and securities analysts. The group's work product might be analogized to a research analyst's report of SEC action: a short, accessible analysis of how the SEC is impacting the public to be published, perhaps online, for public consumption.²⁶⁹

To be sure, this proposal raises as many questions as it answers: Who would be the members of this police patrol? How would they be chosen? Do we have any indication that this group would not themselves become captured by interest groups, effectively using their service on the panel to take their career in new, exciting directions? The goal here is more exploratory than anything else, and so these details must be left for another day. But the author does think it is possible to structure this sort of panel in such a way so as to

269. Recently, Professor Saule Omarova has made a similar proposal to create an entity, independent from the executive and legislative branches and answerable only to Congress, whose purpose would be to "introduce the public interest directly into the regulatory process." Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621, 659–60 (2012). Professor Omarova envisions a group charged with monitoring, more or less, the entire financial regulatory system in order to ensure the representation of the public interest. *See generally id.* (proposing this reform). This Article's proposed public interest watchdog group is, by contrast, much less ambitious, and for good reason. While the author thinks that the SEC's political economy may lead to undesirable results, he is less willing than Professor Omarova to assert a need to correct for public choice distortions in all aspects of our financial regulatory system, and even if he were so inclined, he is not particularly optimistic that a small group of people could sufficiently represent the public interest to achieve that goal.

minimize interest group capture. For example, the membership on the panel might not be a full-time job but instead might be a service rendered on a part-time basis by academics and professionals with a public-minded interest in the securities markets. To be sure, this type of panel would be far from a silver bullet for solving the crowding-out problem, but, if structured correctly, it would at the very least improve understanding among the electorate about how SEC action, and inaction, affects their interests.

Second-Order Solution. A second-order solution to the crowding-out problem addresses not the root cause of the problem—the political economy—but rather its effects. In this case, the political economy results in an expanding private securities market that is off limits to the retail investor.

One potential second-order solution to the crowding-out problem would be to simply give retail investors greater direct access to the private securities markets.²⁷⁰ The problem of course is that the constraints on investor participation in the private securities market, including the rules regarding sophistication, are there for a reason: we do not want less sophisticated investors getting in over their heads and losing their life savings in ill-advised investments. Indeed, until or unless we adequately address the problem of disappearing information and liquidity posed by the expanding private securities market, it would seem odd to solve the crowding-out problem by giving retail investors greater access to this market characterized by a relative paucity of information and liquidity.²⁷¹

Thus, the only reasonable second-order solution to the crowding-out problem is one that attempts to give retail investors access to this market while addressing the information and liquidity issues presented by the private securities market. To this end, we might want to think about increasing retail investors' indirect access to the private securities markets, as opposed to direct access. Most Americans' stock ownership is indirect anyway, as sixty-two percent of the U.S. stock market is held indirectly, including through mutual funds and other intermediaries, with direct ownership accounting for

270. Cf. Stephen Choi, *Regulating Investors, Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 280 (2000) (proposing a regulatory structure that would focus on investors rather than issuers and that would include relaxed restrictions with respect to certain types of investors).

271. Note that even under the regulatory structure proposed by Professor Choi, *see supra* note 270, at 300–02, unsophisticated retail investors would still face restricted access to the private securities markets.

a mere thirty-eight percent.²⁷² Moreover, investing in private securities through mutual funds would allow the retail investor to have a more diversified portfolio of these securities, thereby reducing the risks that would result from opening up direct access to the private securities market.

The principal barrier to realizing this second-order solution to the crowding-out problem is legal in nature. As mentioned previously, there are legal constraints that deter mutual funds from investing in the type of illiquid securities that trade in the private securities markets.²⁷³ This deterrence effect stems largely from the manner in which the SEC has advised mutual funds to value these securities. Because restricted securities are not traded widely, they are less liquid than a share of a blue-chip public company like IBM, for example, that trades on the NYSE. Therefore, the market price of restricted securities is not always reliable, leading to questions of valuation. With respect to mutual funds, the SEC has taken the position that these funds should value all securities, including illiquid ones, at the price that they would command upon a “current sale”—or, in other words, an immediate liquidation of these securities.²⁷⁴ Furthermore, the SEC requires mutual fund boards to certify the accuracy of these valuations,²⁷⁵ which exposes these boards and the funds that insure them to litigation risk in the event that the valuations turn out to be incorrect.

This regulatory structure might not be a problem if it were not the case, as some have argued, that a liquidation measure of value for illiquid securities leaves much to be desired. The main problem is that mutual funds do not purchase restricted securities with the goal of immediately trading them, but rather to hold on to them until the company goes public or sells itself to a larger firm. Instead, by basing valuation on a short-term horizon, the fund may end up undervaluing these securities, raising red flags in light of the litigation exposure created by the certification rules. For these reasons, it should come as little surprise that whereas mutual funds were active investors in restricted securities prior to the SEC’s guidance on valuation and

272. See Scott, *supra* note 225.

273. See *supra* note 227 and accompanying text.

274. Accounting for Investment Securities by Registered Investment Companies, Investment Company Act, 35 Fed. Reg. 19,986, 19,987 (Dec. 31, 1970); Restricted Securities, 35 Fed. Reg. 19,989, 19,989 (Dec. 31, 1970); Smith et al., *supra* note 227, at 423.

275. See 17 C.F.R. § 270.2a-4 (2012); Smith et al., *supra* note 227, at 423.

certification in the early 1970s,²⁷⁶ it is difficult in recent years to find mutual funds that devote any substantial investments to restricted securities.²⁷⁷

Thus, in order to realize the second-order solution of increased indirect access to private securities markets, it might be advisable for the SEC to consider allowing funds more latitude in determining and reporting the values of their illiquid securities. Additionally, the SEC might consider alternatives to the certification requirements that may just create too much litigation risk. By doing so, we might succeed in eliminating some of the legal barriers that seem to deter these funds from investing widely in the private securities market.

C. *Implications Beyond the SEC*

Taking one step back, the updated public choice account developed in this Article suggests that the SEC may have political reasons to expand the private securities markets, which, as demonstrated, carries with it potentially costly implications from a societal perspective. This analysis yields implications beyond the SEC and the private securities market. Specifically, the updated public choice account developed in this Article suggests the need for a greater appreciation of the political elements involved in the theory of regulatory arbitrage and optimal policy-making generally.

1. Policy Outcome Uncertainty

Much has been written about how policymakers should choose laws and regulations under conditions of uncertainty. Some argue that policymakers should choose the policy that maximizes expected payoff.²⁷⁸ Others prefer the policies that have the lowest uncertainty as to outcome.²⁷⁹ Still others have suggested that policymakers may actually embrace the uncertainty of a particular policy's potential outcome through policy experimentation. Under this view, policymakers should adopt the policy for a trial period to see what happens and then adjust accordingly depending on the results.²⁸⁰ When viewed through a public choice lens, policy outcome uncertainty may play an entirely different role than the literature

276. For example, prior to 1970, some mutual funds invested, on average, close to seventy percent of their portfolios in restricted stock. See Smith et al., *supra* note 227, at 455–56, app. A at 473.

277. See *id.* at 423, 454–56.

278. Yair Listokin, *Learning Through Policy Variation*, 118 YALE L.J. 480, 480 (2008).

279. See *id.*

280. See *id.*

suggests, causing policymakers to look for alternative ways to satisfy their constituents without having to wade into the uncertainty presented by a particular policy path. As this Article has argued, the uncertainty surrounding the causes of the IPO market decline pushes the SEC to look for alternative ways of satisfying those interests that demand increased capital availability. The SEC has found this alternative in the private securities market.

2. A Political Component to Regulatory Arbitrage?

Regulatory arbitrage has been defined as “the manipulation of the structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment.”²⁸¹ In other words, regulatory arbitrage occurs when parties choose to structure an economic transaction in a particular way to avoid certain regulatory costs that would attend an alternative structure. Examples of regulatory arbitrage abound. The so-called “shadow-banking” industry that attracted attention for its role in the financial crisis of 2008 is but one prominent example.²⁸² The decision to incorporate a company in Delaware instead of somewhere else, and the decision to raise capital in the private instead of the public securities market are others. The literature on regulatory arbitrage depicts this strategy for avoiding regulatory costs as almost exclusively the domain of private, profit-motivated parties with a private sector lawyer acting as a “transaction-cost” engineer.²⁸³ To the extent that the government is involved at all, they are seen as having to be persuaded, through “sound and reasonable arguments” that a given agency interpretation is the correct one.²⁸⁴ However, what has been suggested here is that this traditional analysis of regulatory arbitrage may be incomplete, and that under certain conditions, politicians and bureaucrats themselves may actually have an incentive to facilitate certain types of regulatory arbitrage in the pursuit of their own interests. In these cases, efforts to minimize regulatory arbitrage will fall short unless they take into account the political nature of the problem.

281. See Fleischer, *supra* note 237, at 236.

282. See Zachary J. Gubler, *Regulating in the Shadows: Systemic Moral Hazard and the Problem of the Twenty-First Century Bank Run*, 63 ALA. L. REV. 221, 235 (2012).

283. For an example, see Fleischer, *supra* note 237, at 236, 283–84 (depicting the lawyer as a “regulatory arbitrageur” and characterizing the standard model of regulatory arbitrage as a game in which the government “moves first” through statutes and regulations that lawyers and their clients then try to get around through clever planning).

284. See *id.* at 284.

CONCLUSION

In 1989, the economist Michael Jensen famously predicted the "eclipse" of the public corporation.²⁸⁵ His argument was that the agency costs arising from the public corporation's separation of ownership from control and diffuse shareholder base would make the private firm relatively more attractive.²⁸⁶ While compelling, there was reason to doubt Jensen's prediction at the time. In particular, public choice theory suggested that the SEC would not allow its regulatory reach to erode as a large swathe of companies either left the regulated market for its unregulated counterpart or simply avoided entering the public market altogether. Yet, history appears to have vindicated Jensen's prediction while we are left having to explain why public choice theory got it wrong.

This Article has argued that the traditional public choice account is simply incomplete. Under certain conditions, bureaucrats and legislators will in fact be willing to permit, or even facilitate, the expansion of the unregulated portion of their industry if, by doing so, they are able to avoid the risk of public scrutiny that accompanies their next best alternative regulatory strategy. Legislators and bureaucrats will adopt this strategy, in particular, (1) where there has been an exogenous shock to the industry that changes the political dynamic and creates a deregulatory environment, and (2) where there is considerable uncertainty about how to reverse the effects of that exogenous shock by reforming the public, regulated market. In the case of the SEC, the exogenous shock has been the dramatic, decade-long decline in the market for initial public offerings, what some have referred to as an "IPO crisis." Not only has the market for IPOs atrophied, but the cause of this abrupt slowdown is uncertain. In this environment, the SEC is better off allowing its constituents greater latitude in accessing capital in the private securities market than attempting to reform the public, regulated market and attracting public scrutiny, which would prevent the SEC from pursuing its own agenda.

Thus, contrary to the traditional public choice prediction, this Article has argued that the SEC will not always have the incentive to expand its regulatory turf and that it will continue to allow, if not facilitate, the expanding private securities market, at least as long as the IPO market remains in its current, dysfunctional state. This

285. Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 61-62.

286. *Id.*

prediction raises a concern, however, that as the private securities market expands relative to its public counterpart, an inefficient amount of capital-raising will take place in the private securities market (where disclosure and liquidity are relatively low, and to which retail investors are barred access). Consequently, there will be sub-optimal amounts of disclosure and liquidity in U.S. markets. Perhaps even more troubling, the average retail investor, who is prevented by both legal and pragmatic constraints from directly accessing the private securities market, will be “crowded-out” from investment options as that market expands.

A full-blown policy proposal for dealing with these negative implications of an expanding private securities market is beyond the scope of this Article. But as an example of how we might approach such policy reform, this Article has sketched the outlines of a first- and second-order solution to what may be the thorniest of the three problems identified here—the crowding-out of the retail investor from U.S. securities markets. The Article suggests two approaches to this problem. The first-order solution would focus on reducing the information and monitoring costs that create political slack in the first place and lead the SEC to shy away from IPO market reform. To this end, the Article suggests establishing a public interest watchdog group, independent from the executive and answerable to Congress, whose job would be to monitor the SEC and translate its actions and inactions into a simple, periodic report that would inform the public of the impact of SEC decision-making on the retail investor. The second-order solution would focus on how to provide the average retail investor with greater access to the private securities market, for example, by increasing mutual fund participation in that market by relaxing rules that limit such funds’ investment in illiquid securities.

The growth of the private securities market is a remarkable development in the history of American capitalism. In order to take stock of this development and evaluate its implications for our economy, we need a fine-grained understanding of the underlying causes. These causes may not lie entirely, or even most importantly, in Silicon Valley or Wall Street, but instead in the back rooms of the Securities and Exchange Commission.

