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Improving the Legal Environment for Start-Up Financing by Rationalizing Rule 144

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# Improving the Legal Environment for Start-up Financing by Rationalizing Rule 144

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## Abstract

Private equity is a crucial form of financing for start-ups and, therefore, important for economic innovation and growth. The securities laws have an enormous impact on the ability of start-ups to obtain private equity investment. One of the most important of these laws is the SEC's Rule 144. Surprisingly, there has been little academic analysis on the efficacy of this rule. This paper shows that Rule 144 is likely to impair and distort the financing of start-ups. The paper also explains how Rule 144 can be modified to reduce these costs without interfering with any of the functions for which it was designed.

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## I. INTRODUCTION

Raising funds is a pivotal and difficult task for start-up companies. Private equity is crucial for start-up companies, especially in the stages before they reach profitability. In these stages of the corporation, other forms of financing, such as debt financing, are rarely accessible.<sup>1</sup>

As entrepreneurial small-scale companies have become more central to the economic development in the US, private equity has been gaining increased recognition. In fact, studies have shown that during the last two decades small firms accounted for the majority of newly created jobs.<sup>2</sup> At the same time, the majority of the innovations were also created by those small firms.<sup>3</sup> With this vast contribution to the economy, the importance of private equity has increased.<sup>4</sup>

In addition to providing essential funds to start-up ventures, private equity is often accompanied by added value. Venture-capitalists (“VCs”) are active investors that both mentor and monitor the companies they invest in. They offer assistance and support in developing the business of their portfolio companies. Furthermore, VCs have both the access and expertise needed to conduct effective monitoring. Indeed, there is evidence that the VCs assume the role of monitoring and governance of such companies.<sup>5</sup>

The distribution of equity is affected by the requirements and restrictions imposed by the law on issuance and transfer of securities. The securities laws and regulations have a huge impact on private equity. As a general rule, absent an exemption, the law requires to register securities that are distributed. Complying with the registration requirement is not only

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<sup>1</sup> With neither profits nor tangible assets that could serve as collateral, start-up companies are unable to attract creditors, *See* David Denis, *Entrepreneurial Finance: an Overview of the Issues and Evidence*, *Journal of Corporate Finance* 10 (2004) 301-326, at p 304.

<sup>2</sup> *See* Denis *Id.*; *see also* US Small Business Administration, Office of Advocacy, *Small Business Resources for Faculty, Students, and Researchers: Answers to Frequently Asked Questions*, (March 2004) <http://www.sba.gov/advo/stats/arsbfaq.pdf>; and *see* Bristow, Benjamin and Petillon, *Venture Capital Formation and Access: Lingering Impediments of the Investment Company Act of 1940*, 2004 *Colum. Bus. L. Rev.* 77.

<sup>3</sup> *See Id.*

<sup>4</sup> *See* Denis, *supra* note 1.

<sup>5</sup> *See Id.* at p 305.

exceptionally time-consuming and costly but also involves public disclosure of potentially sensitive information. In addition, the preparation of a registration statement exposes the key participants to substantial liability.<sup>6</sup>

The SEC's Rule 144 (the "Rule" or "Rule 144") plays a key role in facilitating the transfer of securities once the company has become public. The Rule provides a safe harbor for sales of unregistered shares to the public. It enables investors who purchased shares in a private placement to sell those shares without requiring the company to file a registration statement. Filing a registration statement is extremely expensive and time-consuming for the company. Even if the company is contractually obligated to register the investors' shares when asked, large investors are likely not to exercise this contractual-right because of the onerous effect on the company. In practice, it is impossible to sell to the public unregistered shares of public companies without invoking the Rule.<sup>7</sup>

While the Rule allows investors to avoid the costly requirements of the law, it imposes other requirements in order to do so. There are two key limits to the safe harbor of the Rule: a holding-period restriction, and a selling-volume restriction. The Rule imposes a holding-period of one year for shares acquired in a private placement. The period begins when the shares have been purchased and fully paid for.<sup>8</sup> The selling-volume restriction limits the amount of shares that can be sold following the expiration of the one year holding. In accordance with the selling-volume restriction, the amount of shares each shareholder can sell is capped. Under the Rule, each shareholder can sell shares only up to an amount that added together with such shareholder's sales in the previous three months, will not exceed a certain maximal amount. This maximal amount is set as the greater of one percent of the outstanding shares, or the average reported weekly volume of trading of the company's securities during the preceding four weeks.

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<sup>6</sup> See Thomas Lee Hazen, *Treatise on the Law of Securities Regulation*, (3<sup>rd</sup> ed. 1996) at § 1.6.

<sup>7</sup> See Harold S. Bloomenthal and Holmes Roberts & Owen L.L.P., *Securities Law Series, Going Public Handbook, Going Public, the Integrated Disclosure System and Exempt Financing*, Vol. 1, 2002, (West Group), at 100.

<sup>8</sup> The date an option is exercised, rather than the date of grant, marks the beginning of the holding-period for the share issued pursuant to the option.

The rationale of the Securities and Exchange Commission (the "SEC") for the requirements of the Rule is threefold: (i) to protect investors by providing them "adequate current information"; (ii) to limit the impact of the Rule's safe harbor to "routine trading transactions" without disrupting the trading market; and (iii) to make sure that "persons who buy under a claim of a Section 4(2) exemption... have assumed the economic risks of investment."<sup>9</sup>

Despite the widespread use and importance of the Rule in the business world, there has been almost no academic analysis of the Rule. The academic literature often refers to the Rule's restrictions, but mostly as an example for diverse regulatory practices and not as the main focus of attention.<sup>10</sup>

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<sup>9</sup> See the SEC's Preliminary Note to Rule 144, SEC 2039 (9-03).

<sup>10</sup> For instance, the Rule is used as an example for the employment of a holding-period as a preventative measure in order to deter investments, with exploitive intent, by increasing the cost of the investment; See Ronald Gilson, *Drafting an Effective Greenmail Prohibition*, 88 Colum. L. Rev. 329, 335, (March, 1988): "Here, as in other regulatory regimes where a holding-period is imposed, the need to hold an investment subject to market risk for a significant period of time reduces the likelihood that the investor has an exploitive motive in making the investment by increasing the costs of such a strategy."

It is also used as an example for a regulation that can deter insider trading with duplicative and similar effects as those of Section 16(b) of the Securities and Exchange Act of 1934; See Ellen Taylor, *Teaching an Old Law New Tricks: Rethinking Section 16*, 39 Ariz. L. Rev. 1315, 1336 (1997): "Although the adoptive release for Rule 144 does not specify the restriction of insider trading as one of the rule's purposes, it does include the prevention of fraud, and the rule's effect is in some ways similar to that of section 16(b). ... These holding-period and 'trickle-out' provisions, even if not enacted for the same reasons, are likely to mirror some of the consequences of section 16's six-month profit prohibition. They should also create some of the same incentive effects as section 16(b). Insiders who must hold their securities for a significant period and who, thus, cannot sell them into the market quickly have an increased incentive to work for the long term profitability of their company."

In other works, the Rule is also used as an example for the failure of the securities regulations as a whole to protect the unsophisticated public investors. It is criticized for failing to provide a permanent protection, since after the holding-period expires it allows sales to the public by sophisticated investors; See Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 Calif. L. Rev. 279, (March 2000): "The private placement rules also fail to fully protect the truly unsophisticated. After a one-year holding-period, initial investors in a private placement may use Rule 144 to sell securities to the general public without regard to their sophistication."

In 1988, Steinberg and Kempler<sup>11</sup> offered a thorough detail of the requirements of the Rule and expressed concern about the magnitude of the Rule's safe harbor. They argued that the Rule is too permissive since it allows non-affiliates<sup>12</sup> to sell restricted shares without being subject to the selling-volume restriction, after the lapse of a holding-period<sup>13</sup>; "the detrimental effect on the capital trading markets and the investing public are identical, irrespective of whether one has affiliate status when reselling large quantities of stock."<sup>14</sup>

This paper, in contrast, argues that the selling-volume and holding-period restrictions should be abolished altogether, rather than extended. This paper shows that the selling-volume and holding-period restrictions of the Rule are not efficient and do not achieve their anticipated goal. Furthermore, it shows that the Rule has distorting inefficient effects. Thus, this paper presents the opposite conviction - the selling-volume restriction should not restrict any shareholder, regardless of whether such shareholder is an affiliate or non-affiliate. Market forces, rather than statutory restrictions, are likely to achieve a more efficient outcome that will eliminate the distorting effects of the Rule that are described below.

In more recent empirical work, Wan (2001) and Anderson, Dyl and Krigman (2004) find that the selling-volume restriction of the Rule has an inefficient effect on the company's choice of stock exchange on which to trade, as will be further discussed below.<sup>15</sup>

As I explain below, both the holding-period restriction and the selling-volume restriction impair investor liquidity. Shareholders are forced to wait 1 year before they are allowed to sell their shares, even though a market for

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<sup>11</sup> See Steinberg and Kempler, *The Application and Effectiveness of SEC Rule 144*, 49 Ohio St. L.J. 473.

<sup>12</sup> An affiliate of an issuer is defined in 17 C.F.R. § 230.144(a)(1) as "a person that directly, or indirectly through one or more intermediaries controls, or is controlled by, or is under common control with, such issuer".

<sup>13</sup> The holding-period after which the volume requirement would not apply to non-affiliates was originally 3 years starting from the date of purchase of the stock. In 1997, the SEC shortened the duration of this holding-period to 2 years. See the Securities and Exchange Commission, *Revision of Holding Period Requirements in Rules 144 and 145*, (Release No. 33-7390; File No. S7-17-95) <http://www.sec.gov/rules/final/33-7390.txt>

<sup>14</sup> See *supra* note 11, at p 500.

<sup>15</sup> See *infra* note 19 and accompanying text.

their shares already exists, and once they are permitted to sell shares they may do so only to the extent allowed by the selling-volume restriction.

In this paper, I show that these Rule liquidity-reducing effects distort the financing of start-ups. The effects provide inefficient incentives and increase the cost of raising capital.

In particular, the Rule is likely to restrict the amount an investor is willing to invest in a single company. The selling-volume restriction allows each restricted shareholder to sell the same amount regardless of the size of its holdings. Thus, the last share purchased by an investor bears a much higher liquidity risk than the first. After investing a significant amount in a company, the shareholder knows that it is likely not to be able to use the Rule's safe harbor for the sale of new shares that it purchases. Therefore, the Rule provides a negative incentive to invest substantial amounts in one company.

This undesirable effect of the Rule can provide at least some explanation to a puzzling empirical finding. Researches reported that they were surprised to learn that while VCs' size more than doubled during the 1980's, the average size of their investments increased by only 40%. The Rule's distorting incentives that this paper identifies, however, may have played a major role in the VCs' decision to refrain from further increasing their investment in a single company, despite of efficient aspects that could have resulted from such increase.<sup>16</sup>

As a result of the selling-volume restriction, the number of investors a company needs for financing increases. The number of companies, in which an investor invests, increases as well. Generally, it is preferable and more cost-efficient, however, to have subsequent investment by the same investor. Subsequent investments lower searching-costs and monitoring-costs.

The decrease in the amount a company can raise from a single investor raises transaction-costs and searching-costs for both the company and the investors. The investors are likely to look for multiple potential investments and closely inspect a number of companies. Reinvesting in the same company, in contrast, would have required much less inspection, if any. At the same time, the company has to look for additional potential investors, cooperate in

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<sup>16</sup> See *infra* note 62 and accompanying text.



several due-diligence processes and coordinate multi-party negotiation processes, all of which are time-consuming and costly.

The increase in the number of investors that invest in the same company also negatively affects the monitoring of the company. Studies have shown that VCs are uniquely positioned to play an important role in the governance of their portfolio companies, and that in fact, they are participating in monitoring activities.<sup>17</sup> Monitoring a company, however, is a costly activity. The lower the stake an investor has in a company the lower its personal benefits from its own monitoring activities. Thus, since the Rule decreases the amount an investor is willing to invest in a single company, it is also likely to lead to suboptimal levels of monitoring.

In addition, the Rule can negatively affect the financing decisions of the company. By causing investors to hesitate to refinance and by increasing the cost of raising private equity, the Rule can force the company to go public too soon. Even though the company might still be in a stage where the benefits of staying private surpass those of going public, the choice of delaying public registration might not be available to it because the Rule's restrictions have rendered this choice much too cumbersome, and simply too expensive.

The company might be forced by its investors to decide not to go public at a time when going public is the most efficient strategic choice. Investors are likely to prefer a different means of exit, such as M&A, which offers them better liquidity prospects than being subject to the Rule's restrictions on sales, even at the cost of a lower valuation.

Finally, the Rule can distort the choice of the exchange on which the company going public will trade. While the Rule links the amount that may be sold under the safe harbor to the trading-volume, trading-volumes of similar transactions may be reported differently on different exchanges due to different trading methods.<sup>18</sup> This provides a bias towards the exchange where higher volume of trading will be reported. There is empirical evidence that the Rule inefficiently influences the choice of the stock exchange to be traded

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<sup>17</sup> See *supra* note 1 at p. 305.

<sup>18</sup> See *infra* note 67.

on.<sup>19</sup> According to these findings, companies often choose the NASDAQ as the venue for their initial listing, and companies traded on the NASDAQ often do not transfer their shares to the NYSE because of the Rule, despite the potential increase in share value associated with listing on the more prestigious NYSE, and lower trading-costs associated with such transfer.

I suggest eliminating both the selling-volume restriction and the holding-period restriction. This will remove the illiquidity costs incurred by the investors and lower the cost of capital for start-ups, it will also solve the distortions caused by the Rule.

Moreover, as I will show, both the holding-period restriction and the selling-volume restriction of the Rule undermine the main purpose of the law to secure full and fair disclosure and to provide current information to the public. Thus eliminating these restrictions will further the purposes for which the Rule was created.

Artificially limiting the sale of restricted shares, held by sophisticated investors, actually reduces availability of information about the firm by depriving the market of information about the value placed on the company by these shareholders. If they were permitted to sell, their decision not to sell could be used as a sign that they value the company at least as much as it is traded for. Their decision to sell, absent liquidity constraints, would mean that they believe that the market over-values the company. In addition, since the IPO registration statement includes a detailed account of the restricted shares purchased until that time, a sale to the public of such shares following the completion of the IPO process does not seem to harm the public.

In fact, the holding-period restriction is likely to affect the buyers in a negative way, since the detailed disclosures of the registration statement and the prospectus become less accurate with the lapse of time. Thus, allowing a sale of restricted shares to take place as early as possible may result in a more informed purchase transaction than a sale conducted after a year has elapsed.

Due to the aforementioned burdens on investors' liquidity created by the restrictions of the Rule, and especially due to the incentive to invest less in

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<sup>19</sup> See Kam-Ming Wan, *The Effect of Insider Restricted Equity on the Choice of Exchange* (SSRN Elec. Paper Coll. no. 268010, 2001), and Anderson, Dyl and Krigman, *Rule 144 and the IPO Exchange Listing Decision* (Feb. 2004).

a single company because of the selling-volume restriction, both the holding-period restriction and the selling-volume restriction should be eliminated. If efficiency requires that resale to the public of shares purchased prior to the IPO be restricted; the market itself will implement such restrictions. The company is best suited to distribute selling-rights among its restricted shareholders. It should, therefore, be allowed to determine whether or not such share resale should be permitted and, if so, under what restrictions. This will promote an efficient allocation and pricing of those selling-rights. Eliminating the restrictions will provide a more efficient investment incentive structure, reduce the disincentive to invest large amounts in a single company, and thus lessen the associated costs.

The remainder of this paper proceeds as follows. Part II provides a brief description of the current legal arena which is the setting for the discussion offered by this paper. The official rationale for the Rule, along with a discussion on the failure of the Rule to fulfill its intended goals is also presented there. In particular, Part II elaborates on the two requirements of Rule 144 that should be eliminated. Part III discusses the distorting effects of those requirements. Part IV questions the justification and reasoning for the imposition of any sale-restrictions following the IPO. Part IV presents the argument for a market-forces regime in place of the rigid and inefficient selling-volume and holding-period restrictions of the Rule. Part V concludes.

## II. THE LEGAL ENVIRONMENT OF PRIVATE EQUITY FINANCING

With the growing importance of small firms, private equity's fundamental contribution to the economic development is becoming increasingly evident. Thus, in Section A of this Part, I describe the important role of private equity financing in the development of small firms and new businesses. This Section further describes the value-added nature of VCs investments, which are far from being limited to the supply of much needed capital.

In the remainder of this Part, I describe certain aspects of the legal environment that controls private financing. Section B provides a general overview of the securities rules that affect every equity transaction. It

describes the historical background for the development of these rules. Section C focuses upon the safe harbor of Rule 144. The Section provides a description of the salient features of the selling-volume and holding-period restrictions of Rule 144, which are especially relevant to private equity financing.

Section D further details the main concerns that the Rule was designed to address. In addition, it describes how the Rule chose to deal with these concerns. Finally, Section E discusses the failure of the Rule to achieve its goal. It shows that, in addition to being incompetent in achieving its goals, the Rule is likely to aggravate some of the problems it was meant to solve and create additional problems.

#### *A. Private Equity Financing*

Entrepreneurial ventures are faced with the challenging task of securing funds for their operations. At the early stages, before they reach profitability or obtain assets that can be used as valuable collateral, those companies almost exclusively rely on private equity.

Studies have found a dramatic increase in the amount of capital allocated to the private equity market.<sup>20</sup> This increase corresponds to the rise in the importance of entrepreneurial ventures to economic development. For the last two decades, small firms have been responsible for the creation of the majority of both new jobs and innovations.<sup>21</sup>

Venture capitalists are a key source of capital for emerging ventures. They provide the entrepreneurial ventures with crucial capital needed for the daily operations and growth. Though not the exclusive source for private equity, VCs are a dominant source of capital for emerging companies that passed the seed stage (the initial early stage of development).<sup>22</sup>

In addition to providing valuable capital, VCs are providing their portfolio companies with added value; VCs are active investors. The literature

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<sup>20</sup> See Denis, *supra* note 1, at p 301-2.

<sup>21</sup> See *Id.*

<sup>22</sup> See *Id.* at p 304.

has identified three main types of roles that VCs assume in order to help their portfolio companies.<sup>23</sup>

Under the first role, VCs offer their portfolio companies a range of support services that assist in building the internal organization of the companies and in marketing their products. They are particularly influential in the development of the companies' business plans. They are also well known for being instrumental in forming strategic alliances.

The second important role that VCs assume is that of monitoring. As part of their governance activities, the VCs frequently visit their portfolio companies, often serve on the boards of such companies, and are involved in shaping the top management team.

Lastly, the VCs' reputation often helps the companies raise additional funds. It has been empirically found that VCs sometimes play the role of certifying the quality of the start-up in which they have invested.<sup>24</sup>

#### *B. The Securities Rules*

The stock market collapse of 1929 and the Great Depression that followed were partially blamed on securities frauds.<sup>25</sup> Such frauds included

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<sup>23</sup> See *Id.* at p 305-7.

<sup>24</sup> See *Id.* at p 306-7.

<sup>25</sup> See Thomas Lee Hazen, *Treatise on the Law of Securities Regulation*, (3<sup>rd</sup> ed. 1996) § 1.2. See, also, Gary M. Brown, *Investigating Enron, Life After Enron and Sarbanes-Oxley (Sometimes History is Our Best Teacher)*, Owen, Vanderbilt University, summer 2003, 29 at 33: "Congressional investigations have exposed cases of double-dealing in the securities business. Self-dealing and outright fraud (not the least of which involved a gigantic, rapidly growing energy operation) have become associated with erosion of the stock market.

Senate hearings have revealed financial irregularities of large New York banks, their executives, affiliated securities companies, and Wall Street investment bankers. Leading Wall Street investment banks are under fire for their lending and investing practices, including transactions designed to allow companies to misstate their financial results. Private side deals and tax avoidance have evoked much criticism of executives and their corporate activities in banking and commerce.

The problem—all of the above that appear to be headlines of 2002 actually are the findings of a 1932 Senate committee that investigated the 1929 stock market crash. The energy company was not Enron; it was Insull. The bankers were not J.P. Morgan Chase or Citigroup, but their direct corporate predecessors. Obviously, the adage—those who forget history are doomed to repeat it—still applies."

abuses of holding companies, insider trading and accounting scandals (such as the infamous case of Kreuger & Toll<sup>26</sup>). This has led to the realization that a federal legislation is needed. Congress enacted the Securities Act of 1933 which is also known as the “Truth in Securities” Act. The Act intended to provide adequate protection to investors by disclosing, fully and fairly, all the aspects of the marketed securities. The Act is directed primarily at the distribution of securities (the process by which securities are first offered to the public) and generally requires the registration of all securities being distributed (either directly by the issuer or by an investor in a secondary distribution, i.e. a distribution of shares previously issued by the company to the selling shareholders). In the year that followed, Congress enacted the Securities and Exchange Act of 1934, which was intended to regulate all aspects of public trading of securities.<sup>27</sup>

In order to comply with the registration requirement, the company has to file a registration statement, which is a disclosure document, with the SEC. The filing of the registration statement potentially discloses sensitive confidential information of the company to the public. In addition, the process of preparing a registration statement is not only expensive and time-consuming but also exposes the key participants in the registration to substantial liability for failing to comply with the disclosure requirements strictly.<sup>28</sup> Thus, the company, most likely, will prefer to avoid registering the investors’ shares. Furthermore, the company’s own plans for raising capital might be negatively affected by a registration of the investor’s previously issued share.

Absent a contractual-right, an investor might not be able to convince the company to register its shares with the SEC. In the customary investment agreements the company grants the investors a right to force the company to register the investors’ shares. This right, which is called a demand-right, is customarily limited both in how often it can be exercised and in the ability to exercise. Usually no more than three demand-rights are granted and only

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<sup>26</sup> See Paul M. Clikeman, *The Greatest Frauds of the (Last) Century*, New Accountant, August 2003.

<sup>27</sup> See Thomas Lee Hazen, *Treatise on the Law of Securities Regulation*, (3<sup>rd</sup> ed. 1996) §§ 1.1-1.2.

<sup>28</sup> See *Id.* at § 1.6.

investors that hold a majority of the class-shares are allowed to initiate such exercise.<sup>29</sup>

In practice, however, demand-rights are rarely exercised.<sup>30</sup> The choice not to exercise these rights is likely to result from both the high costs that the company would incur from such exercise and the lack of managerial support of the registration. The investor, though wishing to sell its shares, is interested in the cost of such sale to the company. This is because such cost affects the price it can receive for the shares and the value of any shares it might decide not to sell. In addition, managerial support is important to the success of a registration.<sup>31</sup> Also, in an underwritten registration in which numerous shares are sold, as opposed to a gradual sale of shares to the market, under-pricing of the stock is likely to occur. Thus, even the receipt of a contractual-right to register one's shares by the company does not render the registration option a viable option for an investor who wishes to sell its shares. Despite the fact that the registration rights are typically not going to be exercised, investors insist on being granted these rights for a different reason - to obtain future leverage against the company, and not in order to be able to register the shares in the future.<sup>32</sup>

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<sup>29</sup> See, for example, Mann, O'Sullivan, Robbins, Roberts, *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 Ark. L. Rev. 773 (2004), in the sample term sheet in the appendix: "Demand Rights: The holders of the Series A Stock shall be entitled to two demand registrations to be paid for at Company expense commencing at the earlier of four years from the closing date of this financing or the date six months after the effective date of the Company's initial public offering for its Common Stock, provided that the holders of at least a majority of the Series A Stock (or Common Stock issued upon conversion of the Series A Stock) request that such demand rights be exercised."

<sup>30</sup> See D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. Small & Emerging Bus. L. 133: "Demand registration rights, which allow the venture capitalists to determine the nature and timing of registration, are rarely used..."

<sup>31</sup> See Joseph W. Bartlett, *Equity Finance, Venture Capital, Buyouts, Restructurings, and Reorganizations* 1.1, at 1 (2d ed. 1995), 9.4, at 195: "The actual use of the demand rights . . . could prove very awkward . . . because the CEO of the portfolio company may not be enthusiastic about marketing the securities."

<sup>32</sup> See Gordon Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?*, 65 Tenn. L. Rev. 79, (1997) at 130: "Although there may be practical constraints on the exercise of demand registration rights, they still may be utilized as leverage over management of the portfolio company." See also Hewitt & Armstrong, *Liquidity*, in *Venture Capital 1991*, at 170: "Although it is difficult to force an

The 1933 Act provides certain exemptions from its registration requirement.<sup>33</sup> The Section 4(1) exemption, also known as the exemption for non-professionals, was designed to facilitate day-to-day trading transactions between individual investors with respect to securities already issued rather than distribution of securities. Section 4(1) exemption allows most of the day-to-day trading between investors on the exchanges and the over the counter markets to take place. It provides a registration exemption for transactions by any person other than an issuer, underwriter, or dealer. Generally, the Act provides that an underwriter is anyone who purchases a security from the issuer with a view towards distribution of the security (including anyone who indirectly participates therein).<sup>34</sup> One of the key criteria in determining whether or not a security was purchased with a view towards distribution is whether the would-be underwriter had sufficient investment intent at the time of purchase.<sup>35</sup>

The case-law, the SEC interpretation of the Act's underwriter's status, and the scope of the exemption under Section 4(1) have not provided much firm practical guidance for the sale of restricted securities, since each decision as to whether or not the registration requirement was triggered, was extremely factual and required analysis of all the particular circumstances.<sup>36</sup> The decisions regarding those issues were frequently confusing and often appeared inconsistent.<sup>37</sup>

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issuer to register, regardless of what the agreement says, a failure to comply with the registration covenant can give rise to liability for damages and, as noted, can be a strong bargaining tool in the hands of the investors."

<sup>33</sup> One of the important registration exemptions is the Section 4(2) exemption for non-public offerings by issuers, which was designed to apply to offerings to purchasers that are sufficiently sophisticated and have sufficiently strong bargaining positions or are able to bear the investment's risk, so that the public interest is not involved, and there is no need for the protections of federal registration (*See Hazen supra* note 6 at § 4.1 & § 4.21).

<sup>34</sup> Section 2(11) of the Act (15 U.S.C.A. § 77b(11)).

<sup>35</sup> *See supra* note 6 at §§ 4.23-4.24.

<sup>36</sup> *See Hazen supra* note 6 § 4.24, at p 256: "The one clear lesson of the cases and SEC decisions is that section 2(11)'s definition of underwriter is a trap for the careless and unwary."

<sup>37</sup> *See Id.* at § 4.26.



### C. Rule 144

In 1972, in order to clear some of the uncertainty, the SEC promulgated Rule 144<sup>38</sup> which provides some guidance for answering the question of who is an underwriter and thereby defining the scope of the statutory exemption under Sections 4(1). Rule 144 is not the exclusive method by which restricted securities may be sold in reliance upon an exemption. However, reliance on non-rule 144 precedent imposes a substantial burden of proof in establishing that an exemption is available.<sup>39</sup> In fact “the liability of the rule and the attitude of the Commission, issuers and their counsel generally have made sales of restricted securities of public reporting companies outside of Rule 144 imprudent or impossible (unless the sale is a private negotiated transaction...).”<sup>40</sup>

Rule 144 provides a safe harbor that allows investors who purchased their shares in a transaction not involving a public offering, such as transactions that occurred prior to the IPO, in an unregistered private placement, to sell their shares to the public without registering those shares with the SEC, as required by Section 5 of the Act, subject to certain limitations.<sup>41</sup> The two main limitations are: (I) time restrictions - sales are allowed only following the lapse of a holding-period (one year in length beginning from the date of purchase); and (II) volume restrictions - the amount allowed to be sold, after the expiration of the holding-period, is calculated based on the volume of trading in the stock. In accordance with Section (e) of the Rule, each restricted shareholder is allowed to sell up to such amount of restricted shares that added together with the amount of restricted shares it sold during the preceding three months, shall not exceed

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<sup>38</sup> 17 C.F.R. § 230.144.

<sup>39</sup> See *supra* note 6 at § 4.26.

<sup>40</sup> See Harold S. Bloomenthal and Holmes Roberts & Owen L.L.P., *Securities Law Series, Going Public Handbook, Going Public, the Integrated Disclosure System and Exempt Financing*, Vol. 1, 2002, (West Group), at 100.

<sup>41</sup> Rule 144 provides shareholders, of a publicly traded company, with a safe harbor from being required to have a registration in order to sell their restricted or control securities. If the shareholders fulfill the requirements of the Rule, they are deemed not to be engaged in a distribution and therefore, are perceived not to be underwriters, all within the meaning of the law. Thus, such shareholders may use the exemptions of Section 4(1) of the 1933 Act to sell their shares.

the greater of (i) one percent of the outstanding shares, or (ii) the average reported<sup>42</sup> weekly volume of trading in such securities during the preceding four calendar weeks.<sup>43</sup>

#### *D. The Official Rationale*

The Preliminary Note to the Rule<sup>44</sup> describes the concerns that the Rule was intended to address. There are three main concerns that the restrictions to the safe harbor of Rule 144 attempt to resolve.

First, the Rule was designed to implement the purpose of the Act under which it was promulgated; to provide full and fair disclosure to the public and prevent fraud in the sale of securities. Thus, the Rule was designed to protect investors by preventing the creation of public markets in securities, absent adequate current information concerning the issuer thereof. In order to achieve this purpose, the Rule requires that there be current public information about the company as a condition for the use of the safe harbor. Rule 144(c) states that the safe harbor is available subject to the company complying with the periodic reporting requirements of the 1934 Act.<sup>45</sup> In addition, Rule 144(h) requires a shareholder that uses Rule 144 safe harbor to

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<sup>42</sup> Provided the class of shares sold is listed on a stock exchange or quoted on NASDAQ, and not merely traded over the counter.

<sup>43</sup> It should be noted that shareholders who are not affiliates of the company may freely sell their restricted shares after the lapse of another year following the expiration of the one year holding-period.

Affiliates are also subject to the one year holding-period. However, affiliates are always restricted by the volume limitation, even after the lapse of two years and even if they wish to sell shares acquired in the public market after the IPO.

<sup>44</sup> See Hazen, *supra* note 6.

<sup>45</sup> Thus, customary investment agreements include a provision that requires the company to comply with the necessary requirements for the investors to use the Rule's safe harbor. See Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?*, 65 Tenn. L. Rev. 79, (1997) at 131: "Because venture capitalists are often able to obtain securities in portfolio companies privately without registering them under the 1933 Act, they must ensure that they are able to sell them to the public in order to provide themselves with liquidity. Registration rights provisions often state that the portfolio company will make all filings or take other actions necessary to allow venture capital investors to sell their shares that are not included in a registration in the public market pursuant to Rule 144 of the Securities Act of 1933."

file a notice with the SEC if its sales exceed a certain threshold.<sup>46</sup> However, such filing is allowed to be submitted concurrently with the sale.<sup>47</sup>

Second, the holding-period restriction of the Rule was designed to ensure that the restricted shareholders have personally assumed the economic risks of their investment at the time they have purchased the shares, and are not acting on behalf of the company as its underwriters. This is because the safe harbor under the Rule is intended to exempt transactions between individual investors from registration, rather than sales by the company to the public or by persons acting as conduits for such sales on behalf of the company. Sales by the company to the public, on the other hand, require full compliance with the registration provisions of the Act in order to protect the public.<sup>48</sup>

Third, the selling-volume restriction of the Rule was designed to allow only routine trading transactions, as permitted under Section 4(1) of the Act, rather than distributions. A distribution is a public offering and is “generally interpreted to involve a large amount of securities.”<sup>49</sup> This restriction is concerned with the impact of the transaction on the market, and limits the quantities allowed to be sold, in any given time, so as not to disrupt the market. Thus, the ceiling set by the selling-volume restriction is linked to the volume of trading of the stock. The volume of trading of a stock plays an important role in trading. This is because the ratio of the size of a transaction and the trading-volume is an indicator of the impact the transaction will have

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<sup>46</sup> The threshold for the current filing requirement is a sale of more than 500 shares or proceeds of an aggregate dollar amount greater than \$10,000 in any three-month period.

<sup>47</sup> To be sure, an advance notice requirement, along the lines of the proposal by Professor Fried, to require insiders to disclose their intended trading shortly beforehand in order to reduce profits from insider trading, would help achieve a more transparent and efficient securities market. See Jesse Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, Southern California Law Review, vol. 71, Jan 98, no. 2.

<sup>48</sup> See *supra* notes 33-35 and accompanying text.

<sup>49</sup> See *Hazen, supra* note 6, at § 4.24, and *Ackerberg v. Johnson*, 892 F.2d 1328, 1335 n. 6(8<sup>th</sup> Cir. 1989) “the definition of an underwriter found in § 2(11), depends on the existence of a distribution, which in turn is the equivalent of a public offering.”

on the price of the stock. The higher the ratio the greater the price pressure caused by the transaction.<sup>50</sup>

#### *E. The Failure of the Rule in Achieving its Goals*

However, the Rule does not entirely succeed in fulfilling its intended goals. In fact, the restrictions of the Rule are likely to result in less informed sales, the Rule ignores the general assumption of economic risks by private investors, and it does not efficiently contribute to the stabilization of the market.

##### *1. Delayed Sales and Public Information*

First, after the restrictions expire the public is likely to be less informed than it was at the time of the IPO (or secondary offering), as it is farther from the registration statement. The detailed disclosures of the registration statement and the prospectus become less accurate with the lapse of time.

Following the IPO, the press, analysts, and certain sophisticated investors usually manage to acquire access to some new information about the company, but such information is limited in scope and accuracy in comparison to the disclosures that the company is required to make as part of the registration process. The company is under no obligation to cooperate with and assist the exposure of such new information. The company's cooperation, however, is likely to be offered to the underwriters who engage in a due diligence process as part of the preparation of the registration, since

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<sup>50</sup> Because of low volumes of trading, "microcap companies" provide an extreme example to the connection between trading-volume and the effect of trade on the price of the stock. Microcap companies are companies with low capitalization. In an SEC guide for investors, the SEC warns investors from the risks of investing in microcap companies. One of these risks is the extreme sensitivity of the stock price to trading due to low volume of trading. See U.S. Securities and Exchange Commission, *Microcap Stock: A Guide for Investors*, <http://www.sec.gov/investor/pubs/microcapstock.htm> (02/05/2003): "Because microcap stocks trade in low volumes, any size of trade can have a large percentage impact on the price of the stock."

all of the participants in the preparation of the registration statement, and especially the company, are liable for misstatement or omissions therein.<sup>51</sup>

Even though Section (c) of the Rule requires that updated information about the company be available, the registration statement is broader in its extent and has gone under the scrutiny of the underwriters' counsels and auditors who performed a due diligence review of the company. Rule 144(c) only requires that the company comply with the reporting requirements of the 1934 Act, which are, basically, periodic disclosure requirements, with some exceptions such as Form 8-K report requirements of extraordinary corporate events.<sup>52</sup>

The periodic reporting is less detailed and undergoes less scrutiny than the registration statement. The periodic reporting is literally periodic, triggered by the passage of time rather than the occurrence of material events.<sup>53</sup> Generally, there is no extensive duty to disclose new information in-between the reports. In addition, the scope of most of the periodic reports is limited, and the quarter reports might not even be audited.

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<sup>51</sup> See Hazen, *supra* note 6, at § 7.3.

<sup>52</sup> In 2002 the SEC proposed to expand the scope of the 8-K filing of material events of corporate changes and to shorten the filing deadline in a move away from a periodic disclosure regime towards a materiality regime (*See* the SEC Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8106). *See* also Bochner & Bukhari, *The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives*, *Stanford Journal of Law, Business & Finance*, Vol. 7:2 (2001), 225.

<sup>53</sup> *See Id.*

Thus, allowing a sale of restricted shares as early as possible, and in particular prior to the expiration of the holding-period, may result in a more informed purchase transaction than a sale taking place after a year has expired.

Second, before the restrictions expire, while they are still in effect, the original investors' sentiments about the value of the stock relative to the market price is camouflaged. By artificially delaying sales, the Rule causes the market price not to reflect the valuations attributed to the stock by the entire market. By forcing the original shareholders to retain their holdings in the company, the Rule is likely to cause unsophisticated investors to misinterpret this as a sign for the original investors' sentiments about the company.

Both the holding-period condition as well as the selling-volume condition, undermine the main purpose of the law to secure full and fair disclosure and current information to the public. Artificially limiting the sale of the restricted shares (by delaying it, as the holding-period restriction does, or - and this is practically also a partial delay - by rationing the amount that may be sold at each given time, as the selling-volume restriction does) is hindering the availability of information about the real sentiments of the restricted shareholders about the company's valuation. The restrictions obstruct the picture of the market valuation of the company's shares, and the real decisions of the initial investors whether to maintain their holdings or dismiss them are not revealed to the public as well.

## 2. *Economic Stake and Length of Investment*

It seems that the Rule ignores the general assumption of economic risks by private placement investors. Thus, it over restricts investors, much more than is necessary to ensure that the registration requirements are not circumvented by the issuer.

No investor can assume, with absolute certainty, that the company it invests in will succeed in going public, let alone shortly after the closing of the investment. A shareholder who purchases shares before the company goes public assumes the full risk of the company's failure to finalize a registration and become public. Even mezzanine investments, which are venture capital investments in relatively advanced companies that have passed the start-up

stage though just barely and are on the verge of going public, are risky economic private investments.

Investors who purchased shares in a mezzanine round of investment, at a point where it seemed that the company was about to go public and its management was actively planning such a move, did not always see the company go through with the process of going public. Those investors were often left with shares of a private company without the ability to realize profits, or just sell the shares for any price, for years thereafter. (This was especially the case of investment transactions that closed shortly before the burst of the technology bubble.) Thus, the risk associated with participation in private placement transactions is such that it does not seem necessary to add another deterrent (in the form of a holding-period restriction) merely because of the concern that the investor might be a “conduit for sale to the public of unregistered securities, directly or indirectly, on behalf of an issuer”<sup>54</sup> who did not assume the economic risks of its investment.

### 3. *Market Stabilizing and Limiting Sales*

The restrictions of the Rule do not effectively contribute to the prevention of market disruption and the stabilization of the market for the stock, by preventing extreme price fluctuations.<sup>55</sup> The restrictive effect of the Rule on the volume of trading of the company varies with the number of restricted shareholders that the company has, as will be shown below. The selling-volume restriction is not sensitive to the effect of the aggregate sales, by all the restricted shareholders, on the trading-volume of the company and fails to control the effect of such sales of restricted shares on the volume of trading. Thus, the Rule does not effectively control the aggregate increase in the volume of trading since it only limits the quantities of individual sales.<sup>56</sup>

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<sup>54</sup> See *supra* note 9.

<sup>55</sup> Stabilizing the market is especially important in the immediate period that follows the IPO, See Hazen, *supra* note 6, at § 6.1: “Both during and immediately after a public offering, the market is trying to digest the new issue. At this time, price fluctuations are common and there is the potential of price manipulation. ... under limited circumstances the issuer may artificially stabilize the price of the security. All other stabilizing activities fall within the category of illegal manipulation.”

<sup>56</sup> For a numerical example for the selling-volume restriction’s ineptitude see the text accompanying *infra* note 61.

It must be noted that underwriters find it necessary to administer lock-ups contractually for the purpose of stabilizing the market despite of the presence of the Rule's requirements. The underwriters' lock-ups are different from the Rule's requirements both in the length of time and in the amount restricted. This suggests that stabilization is desired by the parties, but they can achieve it without external intervention. This also suggests that Rule 144 is over restrictive by imposing a holding period that lasts longer than the customary lock-up period (i.e. more than 6 months) in some cases.

Generally, the entire concern of the Act with restricted shares that were acquired prior to the IPO becomes mute after the filing of the IPO registration statement. The registration statement has to include a detailed account of the restricted shares and the rights attached thereto. Thus, the filing requirements associated with going public are intended to inform the public and, in a sense, rectify and redeem those previously acquired shares for the purpose of the Act. A resale transaction by a private investor that acquired its shares prior to the IPO is not similar to a transaction in which securities are issued by the company itself following the IPO. The latter involves a change in the capital structure of the company and a decision to raise more funds by the company, while the former does not.

Following the IPO, a sale of shares purchased prior to the IPO should not be viewed as a distribution within the meaning of the Securities Act of 1933 (the "Act"). This should be the case even if the shares were purchased at a mezzanine investment, and even with the intent to sell such shares in the future, as long as it is done in the manner specified under the Rule.<sup>57</sup> Indeed,

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<sup>57</sup> Chronologically, there are two types of transactions: (i) private placements occurring prior to the actual IPO; and (ii) issuances not involving any public offerings that take place following the IPO. One might want to distinguish between securities purchased in a private placement before the IPO and those purchased after the IPO.

With regard to issuances occurring prior to the IPO, the fact that the registration statement has to include a detailed description of such issuances should be enough.

When it comes to issuances that follow the IPO, there seems to be a more justified concern about the issuer trying to avoid an additional registration by using exempt private placements with the intent that public resale will soon follow. In such event, if the new shareholders are able to resell their shares in the market easily, the company might be able to circumvent the requirements associated with another public offering.



Rule 144(f) imposes a manner of sale condition that prohibits solicitation of orders to buy the shares and requires the use of a broker or a market maker for the sale. The payment to such broker can not exceed the usual and customary broker's commission. In addition, Rule 144(c) adds a current public information requirement; sales are permitted, subject to the other requirements of the Rule, only if the company has complied with the periodically reporting requirements of the 1934 Act.

Not only does the Rule fail to achieve its intended purpose, as I have shown above, additional negative effects result from the Rule's restrictions. Such effects, which will be described in the next part, include increase in the cost of raising capital and inefficient investment incentives.

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However, the "manner of sale" condition of the Rule and the current information requirement along with the Form 8-K reporting requirements seem to ease the concern especially when it concerns the former type of transactions.

### III. THE DISTORTIONS CAUSED BY THE RULE

Rule 144, in its current form, induces inefficient behavior and provides wrong incentives. Not only is it harmful to investors, who hold restricted shares and are directly restricted by it, and to the company, which thus has more difficulty raising capital, but also, as will be shown below, the Rule adversely affects the public that buys the company's shares. The discussion below will focus on the two main restrictions of the Rule - the holding-period requirement of the time restriction and the selling-volume restriction. The rest of this Part is divided into four Sections. Each Section discusses a different problem caused by the Rule's restrictions.

Section A describes the increase in the cost of capital incurred by emerging companies. Such increase is a direct result of the investors' inability to liquidate their investment in an economic fashion.

Section B discusses the effect of the reduced liquidity on the ability of the VCs to finance investments in inefficient capital markets. The reduction in available funds hurts the ability of emerging ventures to receive financing from VCs.

Section C presents the problem of suboptimal investment that the Rule creates. The Section describes the pressure not to invest significant amounts in a single start-up. The Section further describes the costs that are generated because of the inefficiently low levels of investments that each VC is willing to invest in one start-up. Such costs include higher investigation costs, higher search costs, reduced monitoring, and increased risk of conflict of interests.

Section D describes the negative effects of the Rule on the financing decision of the company. The Section shows how the Rule is likely to play a pivotal role in the company's decision when and where to go public.

#### *A. Increase in the Cost of Capital*

The restrictions of the Rule impede the liquidity of the holders of restricted securities. Such holders are artificially forced to wait before they are allowed to sell their shares, even though a market for their shares already exists.

The holding-period restriction renders the restricted shares completely illiquid for the duration of the holding-period. The extent of the liquidity that is permitted by the selling-volume restriction is basically determined by two factors. The first factor is the volume of trading of the company's shares - a variable over which the shareholder has no direct control and which often cannot be accurately predicted. The other factor is the number of shares such shareholder holds. The liquidity of the shareholder is positively correlated with the first factor, the volume of trading, and negatively correlated with the latter factor, the number of shares the shareholder owns.

As long as the volume of trading is not exceptionally high and the holdings of the shareholder are not extremely small, the selling-volume restriction is responsible for partial illiquidity of the shareholder.

The ability of a shareholder to sell its shares freely is valuable. The market views illiquidity as a cost.<sup>58</sup> The investor faces the risk that should it be in need of funds, while its investments are illiquid, it will be forced to bear borrowing costs or lose a promising new investment. In addition, illiquidity exposes the shareholder to the risk of losing the value of its investment. Reducing the VC's liquidity increases its risk bearing costs. It is faced with the risk that the value of its shares will fall, yet it is restricted from divesting its investment upon the first signs of a downward trend and diversifying the risk by lowering the amount of such shares in its portfolio, forcing it to choose different venues to manage and mitigate the risk. VCs are particularly sensitive to liquidity. Their structure is such that after a relatively short time

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<sup>58</sup> See Goldreich, Hanke and Nath, *The Price of Future Liquidity: Time-Varying Liquidity in the U.S. Treasury Market*, (SSRN Elec. Paper Coll. no. 301967, 2002): "Liquidity, the ability to quickly and cheaply trade an asset at a fair price, is thought to be an important element that affects the value of securities. Ever since Amihud and Mendelson's (1986) seminal work, there have been a number of studies showing that an asset's liquidity is valued in the market place." See, also, Acharya and Pederson, *Asset Pricing with Liquidity Risk*, (SSRN Elec. Paper Coll. no. 366300, 2003), "... investors require a return premium for a security that is illiquid when the market as a whole is illiquid. ...investors would require a return premium for assets with positive covariance between individual and market illiquidity. ...When the market declines, the ability to sell easily is especially valuable."

they are expected to convert their investments into cash or marketable securities.<sup>59</sup>

In addition to liquidity constraints, the investors incur more costs as a result of the Rule, as described below. All of the investing costs that the investors incur are taken into calculations when they negotiate with the startup. In order to compensate themselves, the investors shift to the company at least part of the excessive cost, and increase the return they demand from the company. This raises the cost of capital with which startups are faced. Thus, a venture that wishes to raise capital is faced with more obstacles. It is forced by the investors to bear the higher costs that the restrictions of the Rule generate. The increased cost of capital makes it more expensive and difficult for startups to receive financing.

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<sup>59</sup> See Fenn, Liang & Prowse, *The Economics of the Private Equity Market*, Board of Governors of the Federal Reserve System, December 1995, at 29: "Because partnerships have finite lives and investors expect repayment in cash or marketable securities, an exit strategy is an integral part of the investment process". See also D. Gordon Smith, *Control over Exit in VC Relationships* (SSRN Elec. Paper Coll. no. 272231, 2001), "Exit is not optional for VCs. Most VC funds have a fixed life, usually ten years... the VC must ensure that exit is available."

### *B. Reduction in Resources Available to Emerging Ventures*

As capital markets are not perfect, reducing the liquidity of investors locks their resources and hinders their ability to support an alternative new investment. It may be more efficient, though, if such investors, that are less risk averse and/or more capable of assessing the risk, support the new investment while the public invests in the matured one.

This is especially relevant to resources of investors like VCs that support emerging ventures in their initial steps, when it is too risky for the unsophisticated public, which lacks the needed expertise, to invest. Due to market inefficiency, VCs might not be able to raise enough funds from institutions to allow them to invest in an optimal level. Restricting the ability to liquidate VCs' investments once the companies are public is likely to reduce the availability of funds for new investments even further. Thus, one of the outcomes of the Rule is that fewer resources are available for emerging ventures.

### *C. Suboptimal Investment*

The Rule discourages from investing large amounts in a single company. Investors are likely to prefer to put-in small amounts in more companies, rather than larger amounts in fewer companies. This is because the liquidation rights granted under the Rule's safe harbor are disproportionate to the amount of restricted shares a shareholder has.

The formula that the Rule provides for the calculation of the maximum amount of restricted shares a shareholder may sell, in any given three months, is based on the average weekly trading-volume of the stock in the preceding four weeks of a sale. The Rule does not distinguish among shareholders; it states the allowed amount per shareholder without taking into account the size of its holdings, the number of other holders of restricted shares or the aggregate amount of restricted shares.

This leads to the surprising outcome that one shareholder may liquidate 100% of its holdings while a bigger shareholder may only liquidate a small fraction of its holdings.

In contrast, note that customary contractual arrangements, in effect prior to the IPO, do link rights of shareholders to their percentage holdings [e.g. participation in first refusal rights (the right to participate in future issuances of the company) and co-sale rights (the right to participate in a sale transaction by certain shareholders)].<sup>60</sup> Market behavior in similar circumstances may be an indicator of an efficient contracted arrangement.

In fact, the Rule links the right to sell with the shareholder rather than with the share. Each restricted shareholder is allowed to sell the same amount regardless of the size of its holdings. Thus, the last share purchased is accompanied by a much higher risk of no liquidity than the first. After a certain amount of investment, the shareholder knows that it will not be able to use the safe harbor of the Rule for selling any of the new shares that it purchases.

For example, to illustrate the effect of the Rule, let us look at two hypothetical companies A and B. Company A has one restricted shareholder who has 100 restricted shares. Company B has 10 restricted shareholders owning 10 restricted shares each. Other than that, the two companies are similar in all respects. Let us assume that the average weekly trading-volume for the last four weeks was 10 shares for both companies. Let us further assume that all of the restricted shareholders of both companies are eager to liquidate their respective holdings.

Then, the restricted shareholder of Company A will sell 10 shares in the market, increasing the volume of traded shares by 10 shares. While, at the same time, the 10 restricted shareholders of Company B will each sell 10 shares, accumulating to a total aggregate of 100 shares.

One can see that Company B will experience an increase in volume of trading associated with Rule 144 safe harbor of 100 shares, as opposed to only 10 shares increase by Company A. This result shows the weakness of the Rule in stabilizing the market for the shares; it does not effectively control the increase in the trading-volume. It does not effectively prevent excessive price-pressure and market disruption, as discussed above.<sup>61</sup>

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<sup>60</sup> It might be interesting to note that other contractual arrangements that are not strictly financial, such as veto rights and rights to nominate directors, often are not proportionate to the shareholders' percentage holdings.

<sup>61</sup> See *supra* note 56 and accompanying text.

Furthermore, Company B restricted shareholders have been able to liquidate all of their restricted holdings, while Company A restricted shareholder was only able to liquidate a fraction of its restricted holdings (in this example, only 10%). If it had diversified its investment and partially invested in Company B, instead of continuing its support of Company A, it would have increased its liquidity. Had it invested, for example, in ten similar companies, buying ten shares in each, instead of just focusing on Company A, in this example, it would have enjoyed full liquidity.

Therefore, the Rule has the effect of restricting the amount an investor is willing to invest in one company, though it might be preferable and more cost-efficient to have subsequent investments by this same investor. This effect of the Rule can provide at least a partial explanation of the empirical findings that have puzzled researchers. According to these findings, while VCs' size more than doubled during the 80's, the average size of investments increased by only 40% during the same period, despite of market-wide acknowledgement that efficiency requires increase in the size of investments, rather than the number of investments.<sup>62</sup>

As I will now explain, there are four reasons why it might be more efficient to have a follow-on investment by the same investor, and therefore why it might be inefficient to limit the amount of shares an investor can sell under the safe harbor in the manner that the Rule does.

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<sup>62</sup> See Fenn, Liang & Prowse, *supra* note 59, at p14: "Venture capital partnerships increased steadily in size over the 1980s, and by the early 1990s the average partnership was two and one-half times larger than the average partnership of a decade earlier. ...

Many market participants suggest that as the size of partnerships increases, increasing the average size of investments is more efficient than increasing the number of investments. They also emphasize that later-stage investments require less work for the general partners than investments in start-up firms and early-stage new ventures. These observations underlie the widespread perception that the increase in average fund size has been accompanied by a shift toward larger and laterstage investments.

Somewhat surprisingly, data on investments suggest only moderate shifts toward larger investments and investments in later-stage new ventures (table 3). Average investment size increased 40 percent from the early 1980s to the early 1990s, significantly less than the increase in average fund size. Over the same period, the ratio of early-stage investments to total investments declined only slightly and remained near 30 percent even during 1987-88, peak years of LBO financing by venture capital partnerships. More recently, early-stage investments accounted for a record high 37 percent of total investments in 1994."

1. *The Costs of Smaller-than-Desirable Investments in Startups*

a. *Higher Investigation Costs*

As opposed to new investors, existing investors do not need to conduct a costly extensive due diligence on the company. They have already conducted such expensive research at the time they first considered investing in it. They are usually well informed of any material changes that took place since, and they have acquired familiarity with the company. Thus, the review of the company that they will require before reinvesting, if any, will be more focused and less expensive. The fact that the Rule has the effect of increasing the number of new investors, rather than reinvestments, is associated with costs that could have been prevented by having existing investors reinvest.

b. *Higher Search Costs*

Since the Rule has the effect of reducing the amount an investor is willing to invest in one company, it is not enough to find one promising venture in which to invest and reinvest. The investors incur the costs associated with further looking for additional investments. (Similarly, part of the increase in the cost of capital is caused by additional searching-costs of the company that has to look for more investors.)



*c. Reduced Monitoring*

The pre-investment screening process, along with the structure of the financial contracts, provides VCs with unique access to information that facilitates monitoring. The monitoring activities themselves, however, are not without cost.<sup>63</sup>

The alignment of interests of the company with those of its shareholders declines with the decrease in percentage holdings of the latter. The lower the stake of the investor in the company, the lower its incentive to monitor the operation of the company's management. An investor that invests less in a company internalizes less of the benefits of its own monitoring.

Hence, the Rule might lead to less monitoring than is optimally desired.

*d. Increased Risk of Conflict of Interests*

The risk (probability) of conflict of interests between an investment fund and its portfolio companies, caused by potential conflict between two portfolio companies, increases with the increase of the number of portfolio companies. The investor might inefficiently favor one company in place of the other because it is invested more in the former.

This misalignment of interests between the company and the investor, aggravated by the increase in the number of ventures backed by the same investor, might provide the investor with incentives to stir the company towards an inefficient result. To be sure, such behavior will be done in a subtle way, without raising the suspicion of the management of the company that is unaware of any specific conflicting interests. The special role that the VCs play in the emerging venture's business, as described above,<sup>64</sup> allows the VCs to influence the company opportunistically without raising doubts as to their hidden intentions.

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<sup>63</sup> See *supra* note 1 at p 305.

<sup>64</sup> See *supra* notes 5 and 23 and accompanying text.

#### *D. Distortion of the Company's Financing Decisions*

A private company, looking to finance its operations, can try to do so in several ways. It is likely to raise money in private financing transactions; in a public offer; or in an M&A deal. The decision how to finance the operations is likely to be influenced by the Rule and this influence might lead to a less efficient choice. I show below how, because of the Rule, a company might inefficiently decide to refrain from or delay going public, it might under certain circumstances go public prematurely, and when it decides to go public it might choose to be traded on a specific stock exchange not because of its merits but rather because of the Rule's restrictions.

##### *1. Delay in Going Public*

Even though it might be more efficient, the company might postpone or decide against going public because of investors' pressure to find a different means for financing, such as M&A and credit facilities, that provides easier liquidity prospects for the investors. The value that venture capitalists associate to liquidity is particularly significant. Accordingly, it was recently reported that venture capitalists preferred a sale of their portfolio company to an IPO despite a 25% higher valuation in the latter deal.<sup>65</sup>

##### *2. Going Public Too Soon*

The company might be forced to go public too soon, because the alternative private placement has become too expensive. In general, the increase in the cost of private equity, due to the liquidity constraints imposed on investors by the Rule, makes it harder for the company to find investors. In

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<sup>65</sup> See Sophie Shulman, *PowerDsine Keeps Silent on Talk of Sale*, Haaretz Newspaper, (March 12, 2004): "PowerDsine is engaged in talks concerning the sale of the company to an East Asian electronics firm. At this stage, the negotiations are centering on a company value of \$170-200 million. ...While the company talks of a sale, it is also in the process of an IPO on the NASDAQ according to a value of \$250 million before the money. The company aims to raise \$70-80 million... In the event that PowerDsine reaches an agreement with the potential East Asian buyer, company shareholders are expected to opt for the sale rather than the stock issue. While the sale would allow the shareholders to immediately realize their holdings, the public issue comes with a risk of a drop in the value of their investment."

addition, the old investors of the company might be reluctant to reinvest after having reached a certain level of investment, because of the selling-volume restriction of the Rule, as explained above. After failing to secure private financing at an affordable price, the company is likely to turn to the public option.

Despite the benefits of becoming a public company, the process involves notable costs and risks. The preparation of the registration statement itself is a demanding task. Once the company is registered, it is further exposed to additional risks and costs such as those required to comply with the mandatory periodic reporting. The preparation of such reports is expensive, consumes management time, exposes those involved to liability, and divulges information that a private company may keep confidential. In addition, generally a public company is more likely to be pressured to show quick returns, rather than to focus on the long run.

### 3. *Inefficient Choice of Stock Exchange*

Empirical studies have found that the selling-volume restriction of Rule 144 is an important factor that influences the choice on which stock exchange to trade, and often results in an inefficient choice for the traded company.<sup>66</sup> Companies often choose the NASDAQ as the venue for their initial listing, and Companies traded on the NASDAQ often do not transfer their shares to the NYSE, due to the difference in measuring trading-volumes,<sup>67</sup> despite the potential increase in share value associated with listing on the more prestigious NYSE,<sup>68</sup> and lower trading-costs associated with such transfer.<sup>69</sup>

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<sup>66</sup> See *supra* note 19.

<sup>67</sup> See *Id.*, the trading-volumes attributed to a similar transaction may be reported differently on the NYSE and the NASDAQ because of the different trading methods of the two exchanges. On the NASDAQ, dealers often take position (buy/sell) as opposed to merely acting as an agent who matches and completes the transaction. The result is a doubling of the reported volume for a similar transaction.

<sup>68</sup> See Wan at p 41 and Anderson, Dyl and Krigman at p 2: "Numerous studies suggest that firms benefit from being listed on the New York Stock Exchange (NYSE). ...enhanced visibility and liquidity of firms listing on the NYSE results in an increase in the value of the firm."

<sup>69</sup> See Wan at p 2: "...recent studies ... indicate that the bid-ask spread for Nasdaq-listed stocks is larger than comparable NYSE-listed stocks. This implies that stocks of companies that are eligible for NYSE listing but that list on the Nasdaq bear larger

According to the empirical findings: "The IPO listing decision is strongly related to subsequent Rule 144 selling activity. ... the presence of venture capital backing of the IPO firm significantly increases both the number of sellers of restricted shares and the amount of such selling after the IPO. ...the listing decision and the decision about how many restricted shares to sell in the post-IPO window are not independent events. ...It appears that the choice of exchange listing is highly related to Rule 144 trading activity ex post. ...Many firms that are eligible for listing on the NYSE choose, instead, to have their shares traded on NASDAQ. These firms shareholders are more active in selling restricted shares during following the IPO, compared to IPO firms that list on the NYSE."<sup>70</sup>

As a rough estimate for some of the costs born by shareholders and indirectly caused by Rule 144, one can look at the excessive costs incurred as a result of trading on NASDAQ rather than trading on the NYSE. This quantification of some of the measures that shareholders will undertake to avoid the restrictions of the Rule can indicate that the aggregated costs of the Rule's restrictions to the shareholders are at least as high as the costs of those measures. Let us use the 10.8 cents per share difference in the effective spreads calculated by Huang and Stoll,<sup>71</sup> as a conservative measure for the calculation of the higher costs that investors chose to incur in order to circumvent some of the restrictions of the Rule.<sup>72</sup> The corresponding average

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transaction costs than they need to when they are traded. Despite the added costs, hundreds of firms eligible for the NYSE remain on the Nasdaq, including many well-known companies such as Microsoft, Intel, Apple Computer, and MCI."

<sup>70</sup> See Anderson, Dyl and Krigman, *Rule 144 and the IPO Exchange Listing Decision* (Feb. 2004), p 9-13.

<sup>71</sup> See R.D. Huang, H.R. Stoll, *Dealer versus Auction Markets: A Paired Comparison of Execution Costs on NASDAQ and the NYSE*, *Journal of Financial Economics* 41 (1996) 313-357: "The cost of executing transactions is higher on NASDAQ than on the NYSE by every measure we calculate. Our empirical findings are based on all transactions during 1991 for a paired sample of 175 stocks." and "The contrast between the two markets is quite striking. In each trade size category, the quoted spread on NASDAQ is nearly twice the quoted spread on the NYSE. The difference in all cases is statistically significant based on the sample of 2,100 stock-month pairs."

<sup>72</sup> See *Id.* at pp 324-5 "The average quoted half-spread on NASDAQ is 24.6 cents, nearly double the average quoted half-spread of 12.9 cents on the NYSE. The statistically significant difference is not due to differences in stock characteristics since we have matched the stocks. ...If trades can occur inside the spread, a better measure of execution

monthly means of trading-volume on NASDAQ in round lots, calculated by Huang and Stoll, is 36,815.<sup>73</sup> Multiplying the difference in the effective spreads by an estimate of the yearly volume of trading of a hypothetical company traded on the NASDAQ<sup>74</sup> results in a yearly estimated total loss of about \$5 million. Capitalizing<sup>75</sup> the excessive yearly costs over the entire life of the firm (assuming no future switch to the competing exchange and no change in the difference between the exchanges) provides the estimated lifetime loss by the shareholders of the average company traded on the NASDAQ of about \$60 million.<sup>76</sup>

#### IV. REPLACING THE RESTRICTIONS WITH MARKET-FORCES

A market-forces driven regime, in which each company decides whether or not to restrict the resale of pre-IPO acquired shares, and if so to what extent, would lead to more efficient results if implemented.

Currently, underwriters contractually prevent sales by shareholders who purchased their shares prior to the IPO for a period of usually 180 days

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costs is the effective spread, which is based on trade price. The effective half-spread compares the trade price to the quote midpoint ...The average effective half-spread for all trade sizes is 7.9 cents on the NYSE, reflecting price improvement relative to the average NYSE quoted half-spread of 12.9 cents, In NASDAQ the effective half-spread for all trade sizes is 18.7 cents, reflecting price improvement relative to the quoted half-spread of 24.6 cents. Over all trades, the difference in effective spreads across the two markets is 10.8 cents per share, which is statistically and economically significant. The effective spread on NASDAQ is again more than twice the NYSE's effective spread."

<sup>73</sup> See Id. Table 1 at p 321.

<sup>74</sup>  $(10.8 \div 100) \times 36,815 \times 100 \times 12 = 4,771,224$

<sup>75</sup>  $(4,771,224 \div 0.0814) = 58,614,545$  The 8.14 discount rate used for the capitalization is the long term interest rate in effect at the date of the data used for the empirical findings of Huang & Stoll. The rate used is the 1991 thirty year treasury constant maturity rate as reported by the Federal Reserve, See <http://www.federalreserve.gov/releases/h15/data/a/tcm30y.txt>

<sup>76</sup> While this shows another important inefficient behavior that is a direct result of the Rule, it must be noted that this result can be fixed relatively easily by regulating the exact way volume should be measured for the calculation required by the Rule, without abolishing the restriction altogether. However, this shows the extent that shareholders will go to avoid the Rule's restrictions.

following the IPO.<sup>77</sup> This contractual market stabilizing mechanism is called Underwriters Lock-up. At the time of their investment, investors undertake to be bound by such lock-ups, should the underwriters deem it advisable for the success of the initial public offering of the company. The 1 year holding-period of Rule 144 might be longer than the customary 180 day lock-up period administered by underwriters for the stabilization of the market following the IPO (the first holding-period starts running at the time the stock is purchased while the latter begins at the time of the IPO). This might be unnecessary or even inefficient for the purpose of stabilizing the market.<sup>78</sup> If a longer period would have been needed, an efficient market would have administered such longer restriction contractually, since clearly stabilizing the market is in the interest of the shareholders as a group.

If an economic justification to restrict the sale of shares further, following the initial public offering, existed, as the one stated in the SEC's note to the Rule,<sup>79</sup> such restrictions would have been contractually agreed upon and enforced, driven by market forces similar to those behind the administration of the underwriters lock-up.

Moreover, contractual restrictions have the advantage of being specifically tailored to fit the different needs of each company. Each company might require a somewhat different restriction in order to create and stabilize a public market for its shares, based, *inter alia*, on its capital structure, over-all size and other accounting, business as well as reputation related characteristics. For example, an extremely promising company might not need any sale-restrictions in order to stabilize the market for its shares, thus there should be no concern associated with allowing its shareholders the benefit of liquidity.

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<sup>77</sup> See the U.S. Securities and Exchange Commission, *Initial Public Offerings, Lockup Agreements*, <http://www.sec.gov/answers/lockup.htm> (09/27/2000): "The terms of lockup agreements may vary, but most prevent insiders from selling their shares for a period of 180 days."

<sup>78</sup> One may note that the time period of at least one year seems inconsistent and excessive in comparison with the only six month period of Section 16 of the Securities and Exchange Act of 1934 (the "1934 Act") that fends off abuse of inside information in short swing transactions; though both periods seem arbitrary. A six month period, however, seems to have a market validation as an efficient period for stabilizing the market, contractually enforced by underwriters as a lock-up period.

<sup>79</sup> See *supra* note 9.

A company-initiated lock-up, such as the underwriters' lock-ups, is likely to be more efficient than the Rule's restrictions, as explained above. However, it should be explored whether a market free of any such temporary artificial limitations on the supply of shares is not likely to be even more preferable to the market as a whole. Indeed, the administration of a lock-up period following an IPO is a deeply rooted custom in the going public practice. The fact that it is an underwriters' custom, by itself, however, cannot provide a justification. In fact, another underwriters' custom, the custom of under-pricing the offer price of hot IPO's for the benefit of selected friends who are granted privileged access to such lucrative public placements, is currently being challenged.<sup>80</sup> The interaction between those two customs might shade a different light on the use of the underwriters' lock-ups. It might be argued, that the lock-ups are instrumental in enabling those who were granted the privileged access to the under-priced IPO's to realize quick gains before more shares are entered into the market. Thus, it might well be that these underwriters' lock-ups are, in fact, driven by private dealing.

Shareholders have an inherent interest in avoiding price reduction triggered by a sudden large increase in supply of shares in the market that they themselves might cause. This leads to self restraint. Rational

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<sup>80</sup> This practice is known as "spinning" or as "the friends of Frank." See Andrew Ross Sorkin, *Banker's Trial Gives Glimpse Into Close Ties Of Tech Boom*, The New York Times, October 13, 2003: "...bankers often tried to attract new business by offering corporate executives access to hot initial public offerings, while executives held out the possibility of giving the bankers business in exchange for the shares. ...Under such an allocation arrangement, the recipient would be able to buy the shares at the initial offering price, while most other investors would have to wait until after actual trading began - often missing out on early gains. ...Last April... a \$1.4 billion industrywide settlement with the Securities and Exchange Commission over... conflicts of interest in securities research. ...The NASD has accused Mr. Quattrone of improperly pressuring his analysts and passing hot offerings to clients in return for banking business. ...At the time of the NASD complaint, which is still pending, a spokesman for Mr. Quattrone said in a statement, "The NASD charges are completely without merit and represent an unprecedented attempt to take punitive action against an individual for conduct that was legal at the time and widespread throughout the industry." Also see Matt Marshall, *Opening Up the IPO to Smaller Investors - Concept Catching the Interest of Bay Area Tech Companies*, Mercury News, Sep. 22, 2003: "...Ritter, the University of Florida professor ... says 5 percent to 10 percent underpricing might be justifiable. But there's no good explanation for underpricing 15 percent or more in a fair system, he says. (All local tech IPOs this year have enjoyed first-day jumps of 25 percent or more.)"

shareholders will therefore refrain from hastily dumping substantial amounts of shares into the market. Some increase in the supply of the stock caused by the old investors realizing profit by liquidating some of their original investment is a foreseeable natural event. Since this is known at the time of the IPO it should not cause a significant effect on stock price later on. In the event that the old investors wish to conduct extensive sales, in an amount not reasonably foreseen at the time of the IPO, the stock price should reflect such conduct to the full extent, in the same manner as it reflects any exogenous changes in the share supply. Artificially delaying such sales, either by the Rule and/or by using underwriters' lock-ups does not seem to benefit the public. Thus, if in fact the underwriters' lock-ups are driven by private dealing, and efficiency would require that there be no such contractual restriction, then the Rule is highly inefficient.

## V. CONCLUSION

Rule 144, at its current form, is inefficient and has distorting effects on the stock market and on the economy. The Rule's negative effects especially concern emerging ventures. Both the selling-volume restriction and the holding-period restriction of the Rule impose a significant burden on companies. An increase in the cost of raising capital and an incentive to invest in suboptimal levels are two of the main problems that are caused by the Rule's restrictions.

In addition, the selling-volume restriction and the holding-period restriction fail to address the concerns that are at the basis of the Rule's promulgation, properly. The restrictions might even cause the purchasing public to be less informed. Furthermore, the restrictions do not effectively govern the trading-volume increase and their contribution to market stabilization is limited at best.

I proposed abolishing the main restrictions of the Rule and allowing market forces to reach an efficient mechanism.

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