

WILL MORE SUNLIGHT FADE THE PINK SHEETS? INCREASING PUBLIC INFORMATION ABOUT NON-REPORTING ISSUERS WITH QUOTED SECURITIES

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*Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.*¹

INTRODUCTION

The Sarbanes-Oxley Act of 2002 (“SOX”)² contains a wealth of provisions designed to prevent a repetition of the many real and perceived corporate abuses of the late 1990s such as the Enron scandal. Many companies, particularly publicly traded companies subject to the Securities Exchange Act of 1934 (“Exchange Act”),³ were required after SOX to implement what seemed like an endless array of new compliance programs and to follow an extremely complex set of new rules.⁴ Around the same time, the country’s securities markets, including the New York Stock Exchange (“NYSE”) and The NASDAQ® Stock Market (“NASDAQ”), significantly toughened their corporate governance rules.⁵ Few would disagree that the stated purpose of these developments was to restore investor confidence in the nation’s securities markets.⁶ Investors, Congress hoped, would now feel that they could better trust the available information concerning public companies or that there would at least be serious criminal and civil penalties for companies and insiders who engaged in fraud or otherwise disseminated false or misleading information.

It seems, however, that SOX and related Securities and Exchange Commission (“Commission”) rulemaking led to unintended effects for many

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1. LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY* 92 (Frederick A. Stokes Co. 1913).

2. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

3. 15 U.S.C. §§ 78a-78nn (2000).

4. See *infra* notes 54-91 and accompanying text.

5. See *infra* notes 138-43 and accompanying text.

6. As the Securities and Exchange Commission stated: “The strength of the U.S. financial markets depends on investor confidence. Recent events involving allegations of misdeeds by corporate executives, independent auditors and other market participants have undermined that confidence.” Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 33-8177, Exchange Act Release No. 34-47235, 68 Fed. Reg. 5,110 (Jan. 31, 2003) (to be codified at 17 C.F.R. pts. 228, 229, and 249) (footnotes omitted). Of course, commentators were quick to point out many flaws in SOX. See generally Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes-Oxley Enough?*, 2003 COLUM. BUS. L. REV. 801.

companies. Instead of increasing the quantity and quality of the information that these companies provide to their investors, it drove them out of the public markets. During the two years following SOX, at least 158 companies that were reporting companies under the Exchange Act voluntarily went private.⁷ The owners of these companies now find themselves in the position of having far less information about their investments available to them than before SOX.⁸

7. Andrew Ross Sorkin, *Kissing the Public Goodbye*, N.Y. TIMES, Aug. 8, 2004, § 3, at 34 (“According to Thomson First Call, in the first year after [SOX] was approved, 99 companies were taken private. In the second year, the number was only 59.”). Another study, using the filing of a Schedule 13E-3, as the criterion for going private, found that 142 companies went private during the eighteen months following SOX, compared to ninety-three in the nineteen months before SOX was enacted. ELLEN ENGEL ET AL., *THE SARBANES-OXLEY ACT AND FIRMS’ GOING-PRIVATE DECISIONS* 12 (2004), <http://ssrn.com/abstract=546626>; see 17 C.F.R. § 240.13e-100 (2004). The study found data that was “consistent with the notion that SOX is associated with an increase in the number of firms electing to go private” despite prevailing “market conditions [that] would appear to provide an attractive reason for firms to stay public in the post-SOX period.” ENGEL ET AL., *supra*, at 12. Although the following figures are not precisely on point, according to the Commission:

In 2002, there were a total of 862 delistings [from securities exchanges], with the Commission receiving 474 Forms 25, 266 delisting applications from exchanges, and 62 *voluntary* delisting applications from issuers. In 2003, the Commission received a total of 799 delistings, which included 547 Forms 25, 190 delisting applications from exchanges, and 57 *voluntary* delisting applications from issuers.

Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-49858, 69 Fed. Reg. 34,860, 34,861 (June 22, 2004) (to be codified at 17 C.F.R. pts. 232, 240, 249) (emphasis added). See generally MARC MORGENSTERN & PETER NEALIS, *GOING PRIVATE: A REASONED RESPONSE TO SARBANES-OXLEY?* 1 n.3 (2004), <http://www.sec.gov/info/smallbus/pnealis.pdf> (“Some empirical data suggests that the frequency of going-private transactions has increased following the passage of Sarbanes-Oxley.” (citations omitted)).

8. Companies routinely went private for many reasons before SOX was enacted and many will do so in the future for reasons unrelated to SOX. However, the many requirements of SOX, particularly the internal controls report contemplated by Section 404, have substantially increased the costs of being public. Because these costs continue to be incurred year after year, some companies may opt out of being public.

For example, a survey conducted by the law firm Foley & Lardner asked: “As a result of the new corporate governance and public disclosure reforms implemented since the enactment of the Sarbanes-Oxley Act in 2002, is your company considering [going private]?” In 2003, thirteen percent of the companies that responded to the survey answered yes. In 2004, the number was twenty-one percent. In 2005, the number was twenty percent. THOMAS E. HARTMAN, *THE COST OF BEING PUBLIC IN THE ERA OF SARBANES-OXLEY* 10 (2005), http://www.foley.com/files/tbl_s31Publications/FileUpload137/2777/2005%20cost%20of%20Being%20Public%20Final.pdf.

Professor William J. Carney of the Emory Law School recently completed a study of the costs of securities regulation for smaller public companies. According to a summary of his study, which was included in written comments, dated June 17, 2005, that Professor Carney provided to the

SOX came shortly after the 1999 National Association of Securities Dealers, Inc. (“NASD”) “eligibility rule,” which required most issuers with securities quoted on the OTC Bulletin Board (“OTCBB”) to be Exchange Act reporting companies and attempted to reduce fraud and manipulation in that market.⁹ However, this requirement swept potential fraud and manipulation under the rug because most of the over 3000 companies that were delisted from the OTCBB—along with many of the companies that have gone private after SOX—now have their securities quoted on the Pink Sheets, which is a largely unregulated market. The Pink Sheets, which does not require that companies be Exchange Act reporters or meet any quantitative or qualitative requirements to have their securities quoted, has recently seen a massive increase in its market “population.”¹⁰

Information about issuers quoted on the Pink Sheets is often difficult to find because only a bare minimum of information about non-Exchange Act reporting companies must be available to investors. Further, the information that is provided is difficult to retrieve. Thus, the information rarely reaches the investor before the investment is made.¹¹ Still, the Pink Sheets recently took a significant step toward addressing this problem by adopting a new disclosure policy and threatening to discontinue displaying quotations for the securities of issuers that do not comply with it. The Pink Sheets should be commended for this very important step, particularly since the Pink Sheets market has long been filled with issuers about which no significant information is publicly available and previous attempts by the Commission to strengthen disclosure requirements have

Commission’s Advisory Committee on Smaller Public Companies, of the 114 companies that filed a Schedule 13E-3 during 2004, forty-four (39%) “not only listed high compliance costs as a reason for terminating registration” under the Exchange Act, but also included estimates of those costs. William J. Carney, Remarks to SEC Advisory Committee on Smaller Public Companies 2 (June 17, 2005), available at <http://www.sec.gov/rules/other/265-23/wjcarney061705.pdf>. Some of the other Schedule 13E-3 filers also mentioned increased compliance costs. An interesting aspect of this study is that these firms tended to be small public companies, with median gross revenues of \$25 million. Professor Carney observed: “Are investors and would-be investors in these companies better off as a result of SOX? I find it impossible to conclude that they are.” *Id.* at 5.

9. See *infra* notes 144-48 and accompanying text.

10. See *infra* notes 146-47 and accompanying text.

11. Although not all Pink Sheets securities are “microcap” stocks, the Commission has observed:

The biggest difference between a microcap stock and other stocks is the amount of reliable, publicly available information about the company. Larger public companies file reports with the SEC that any investor can get for free from the SEC’s website. Professional stock analysts regularly research and write about larger public companies In contrast, information about microcap companies can be extremely difficult to find, making them more vulnerable to investment fraud schemes.

U.S. Securities and Exchange Commission, Microcap Stock: A Guide for Investors (Aug. 2004), <http://www.sec.gov/investor/pubs/microcapstock.htm> [hereinafter Microcap Stock].

stalled.¹² However, this Article argues that the Pink Sheets' disclosure policy contains serious flaws, both in terms of which issuers it covers and what information it requires.

The big question, discussed in Part III of this Article, is how best to improve the quantity and quality of information available about non-reporting Pink Sheets issuers that voluntarily have entered the market. The goal should be to provide sufficient information without imposing unreasonable requirements on these issuers or unduly hindering the operation of markets like the Pink Sheets,¹³ as such, this Article does not argue that full Exchange Act reporting status should be required of such issuers. However, because one of the primary goals of the securities laws is to ensure that investors have access to important information about their investments and because increasing the amount and quality of information available to investors may help reduce fraud and benefit investors (not to mention the issuers themselves), Part III offers several suggestions toward a workable solution, including required periodic disclosures for Pink Sheets issuers. Part III also discusses ways to implement the Commission's long-stated desire to establish a repository of Exchange Act Rule 15c2-11 information and make it easily accessible to investors without overburdening issuers or broker-dealers. It also examines the regulatory basis upon which such requirements could be established and suggests a standardized warning that should be given to all investors in non-reporting Pink Sheets issuers to alert them to the many differences between such issuers and those that are fully subject to the requirements of the Exchange Act.

Before turning to these issues, this Article discusses important background material. Part I provides an overview of the extensive regulation to which public companies are subject and describes the requirements for an issuer's securities to be traded on a securities market. Part II briefly discusses how painless it can be for a public company to "go dark" and terminate its reporting obligations under the Exchange Act. These discussions provide a starting point to consider whether, and to what extent, current regulations should be changed.

I. OVERVIEW OF DISCLOSURE REQUIREMENTS AND THE PUBLIC SECURITIES MARKETS

The relationship between a corporation¹⁴ and its shareholders is primarily a matter of state law. As such, state law ordinarily will determine what

12. See *infra* notes 318-47 and accompanying text.

13. Although this Article focuses on the Pink Sheets, the reader should understand that other markets may arise in the future that function similarly; the concerns expressed in this Article about the scarcity of available information would also apply to such markets.

14. To avoid unneeded complexity, this Article is written as if all public companies are corporations. Obviously, this is not the case; many different types of business entities can have publicly traded securities. The reader should also be aware that this Article focuses on domestic issuers. The requirements for foreign issuers whose securities are traded in the United States are different in many significant respects.

information a corporation must provide to its shareholders.¹⁵ However, if the corporation is subject to the reporting requirements of the Exchange Act, the amount of information that it must provide to its shareholders and the Commission dramatically increases. Before examining those requirements, however, we will examine when registration under the Exchange Act is required. Interestingly, not all companies whose securities are traded by the public must be Exchange Act registrants.

A. *Exchange Act Registration Requirements*

There are three ways in which a company (the issuer) can be required to be “public” (i.e., subject to the reporting requirements of the Exchange Act): (1) registration under Section 12(b) of the Exchange Act,¹⁶ which is required when

15. The laws of most states require that corporations provide certain information to their shareholders. For example, the Model Business Corporation Act provides that shareholders are entitled to inspect and copy records such as the corporation’s articles of incorporation, bylaws, board resolutions relating to shares, and minutes of shareholder meetings. MODEL BUS. CORP. ACT § 16.02(b) (1984). In addition, shareholders may inspect and copy other information, such as board and committee meeting minutes and accounting records, if the shareholder makes a demand for inspection in “good faith and for a proper purpose” and the records are “directly connected with his purpose.” *Id.* § 16.02(c). Further, the corporation must mail its annual financial statements to shareholders within 120 days after the end of its fiscal year and file a brief annual report with the secretary of state, which shareholders are entitled to inspect under section 16.01(e), with or without a “proper purpose.” *Id.* §§ 16.20-.21. Finally, corporations must notify shareholders of the date, time and place of shareholders’ meetings or if action is to be taken by written consent without a meeting. *Id.* §§ 7.04-.05. Although these information requirements will vary, perhaps quite widely, from state to state, they are not particularly expansive. The shareholder who takes no steps to request information from the corporation will receive only annual financial statements and notices of shareholder meetings, if any are held (and oftentimes they are not). A minority shareholder who has no relationship to management that would allow greater access or more frequent information thus will not have much current information about his investment, unless the corporation voluntarily adopts a more liberal disclosure policy.

16. 15 U.S.C. § 78l(b) (2000). Together with Section 12(a), Section 12(b) requires registration when an issuer lists a class of its securities on a national securities exchange. NASDAQ, being completely electronic and lacking a trading floor or auction environment, currently is not an exchange, although its application to become an exchange was approved in January 2006. The Nasdaq Stock Market, Inc., Notice of Filing of Application for Registration as a National Securities Exchange Under Section 6 of the Securities Exchange Act of 1934, Exchange Act Release No. 34-44396, 66 Fed. Reg. 31,952 (June 13, 2001); In the Matter of the Application of The Nasdaq Stock Market, Inc. for Registration as a National Securities Exchange, Exchange Act Release No. 34-53128, 71 Fed. Reg. 3550 (Jan. 23, 2006). The Commission’s order approving the application of The Nasdaq Stock Market LLC to register as an exchange was conditioned on the satisfaction of certain conditions.

To list its securities, the issuer must comply with the exchange’s requirements, which typically concern the issuer’s size, financial condition, compliance with corporate governance requirements,

an issuer lists a class of its securities on a national securities exchange such as NYSE; (2) registration under Section 12(g),¹⁷ which is usually required when the issuer has 500 or more record holders of a class of its equity securities; or (3) by falling under Section 15(d),¹⁸ which subjects an issuer to Exchange Act reporting requirements for some time following the effectiveness of a registration statement for a securities offering under the Securities Act of 1933.¹⁹ Although Sections 12(b) and 15(d) are relatively self-explanatory, Section 12(g) is much trickier.

Section 12(g), along with Exchange Act Rule 12g-1,²⁰ requires that any issuer engaged in interstate commerce, in a business affecting interstate commerce (obviously easy tests to meet), or whose securities are traded through the mails or instrumentalities of interstate commerce and that has more than \$10 million in assets and 500 or more holders of record of a class²¹ of equity securities must register that class.²² Whether an issuer must register a class of equity securities

and other matters. *See infra* notes 130-43 and accompanying text. Section 12(b) does not require that an issuer have any specific number of security holders. As a practical matter, however, the exchanges require a minimum level of public ownership to ensure an active trading market. For example, NYSE generally requires that a domestic issuer have at least 2000 shareholders that each own at least 100 shares. *See* NYSE, Inc., Listed Company Manual § 102.01(A) (2005), available at <http://www.nyse.com/audience/listedcompanies.html> (follow "Listed Company Manual" hyperlink) (last visited Jan. 4, 2006) [hereinafter NYSE Listed Company Manual]; *see also infra* note 130 and accompanying text.

17. 15 U.S.C. § 78l(g).

18. 15 U.S.C. § 78o(d) (2000). Under Section 15(d), an issuer that has filed a registration statement under the Securities Act of 1933 that became effective is subject to the periodic reporting requirements of the Exchange Act regardless of the number of its security holders (subject to a few exceptions). *Id.* Unless the issuer is independently required to register its securities under Section 12(b) or Section 12(g), however, it will not be a "full" public company. For example, it will not be subject to the proxy rules under Section 14 and its shareholders will not be subject to Section 16 of the Exchange Act, both of which apply only to securities that are registered pursuant to Section 12. *See* 15 U.S.C. §§ 78n, 78p (2000). Section 15(d) reporting requirements are automatically suspended as to any fiscal year (other than the fiscal year in which the Securities Act registration statement became effective) if, at the beginning of that fiscal year, there are fewer than 300 security holders of record of each class of securities as to which the Securities Act registration statement related. 15 U.S.C. § 78o(d).

19. 15 U.S.C. §§ 77a-77aa (2000). A class of securities will only be considered registered under one of these sections at any given point in time. For example, even if a class of securities is required to be registered under Section 12(g), its registration under that section is automatically suspended while it is registered under Section 12(b).

20. 17 C.F.R. § 240.12g-1 (2005).

21. Section 12(g)(5) broadly defines a "class" of stock as including all securities with "substantially similar character" and whose holders have "substantially similar rights and privileges." 15 U.S.C. § 78l(g)(5). Thus, an issuer cannot artificially divide a class of stock into two or more classes and validly claim that each is a separate "class."

22. Section 12(g)(2) excludes some types of securities from this requirement, including

under Section 12(g) is determined at the end of its fiscal year. If the issuer then meets the requirements of Section 12(g), it must register the class within 120 days.

The 500-record holder threshold for registration may raise several issues. Rule 12g5-1(a) provides that securities are “‘held of record’ by each person who is identified as the owner of such securities on records of security holders maintained by or on behalf of the issuer.”²³ In an attempt to address common problems with company records, subsection (a)(1) of the rule further provides that if shareholder records have not been maintained in accordance with accepted practice, any additional person who would be identified as a holder of record if the records were properly maintained will be counted.²⁴ Also, Instruction 3 to the rule provides that if the issuer “‘knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of section 12(g) or 15(d) of the [Exchange] Act, the beneficial owners of such securities shall be deemed to be the record owners thereof.’”²⁵

For a corporation that is first becoming subject to Section 12(g), determining the number of record shareholders is usually relatively easy. For a corporation that is already public, however, determining the number of record shareholders is more difficult because it will likely have many “street name” or “beneficial” shareholders. These shareholders do not have physical stock certificates; instead, they own stock through a bank or broker-dealer, which in turn holds a position in a stock certificate for a large number of shares, which certificate is issued in the name of a large clearing house like Cede & Co.²⁶ (“the Depository”).²⁷ As far as the issuer can tell from its stock records, the Depository owns a large number of shares and should simply be counted as a single shareholder of record. Without taking some steps to find out, the issuer does not know who actually owns this stock.²⁸

securities issued by certain regulated lending institutions and insurance companies. *Id.* § 78l(g)(2). An issuer that does not meet the requirements of Section 12(g) could still register voluntarily.

23. 17 C.F.R. § 240.12g5-1(a).

24. *Id.*

25. *Id.* § 240.12g5-1(b)(3).

26. Cede & Co. is the nominee name for the Depository Trust Company (DTC). DTC is the primary depository where security certificates are deposited or transferred by participants such as brokerage firms. DTC clears and settles stock trades, allowing buyers and sellers to exchange securities electronically. DTC is owned by the Depository Trust and Clearing Corporation, which in turn is owned by several banks, brokerage houses, and trading exchanges. In practice, the terms “DTC” and “Cede & Co.” are used interchangeably.

27. According to the Commission: “Under street name registration, your firm will keep records showing you as the real or ‘beneficial’ owner, but you will not be listed directly on the issuer’s books. Instead, your brokerage firm (or some other nominee) will appear as the owner on the issuer’s books.” U.S. Securities and Exchange Commission, Holding Your Securities—Get the Facts, <http://www.sec.gov/investor/pubs/holdsec.htm> (last visited Jan. 4, 2006).

28. One observer has remarked:

The use of securities depositories has not entirely eliminated the use of paper

Although it is the named shareholder, the Depository does not own the certificate for itself. Rather, the Depository maintains constantly updated records of the banks and broker-dealers that hold a position in the stock and how many shares they hold. Further down the line, the banks and broker-dealers are, of course, not the actual owners of the stock—their customers are. Institutional custodians such as the Depository are *not* counted as single holders of record. Instead, each of the Depository's accounts is counted as a record holder. In other words, securities held in street name are held of record only by the bank or broker—not the ultimate beneficial owners.²⁹ Thus, under current rules if the Depository held an issuer's stock for the account of two brokerage firms which, in turn, held the stock in street name for several thousand of their customers, only the two brokerage firms would be counted toward the 500-record shareholder threshold of Section 12(g), not the thousands of beneficial owners.³⁰

As discussed below,³¹ an issuer that has registered a class of securities under Section 12(g) but later discovers it has fewer than 300 record holders may deregister that class.³² If the issuer is not otherwise subject to Sections 12(b) or

certificates. Instead, a paper certificate representing equity ownership on the corporate books remains in place as a “global certificate” with DTC's nominee, CEDE & Co., as the “holder of record”, representing all of the shares held in accounts of the brokerage firm members of DTC. These global certificates gather dust in a vault in the Wall Street area. In turn, the accounts of the brokerage firm members of DTC represent ownership by the many beneficial owners of those securities who are clients of the brokerage firms. Stock certificates are immobilized because the “global certificate” never moves from the vault.

Stephen Nelson, Petition for Commission Action to Require Exchange Act Registration of Over-the-Counter Equity Securities, Commission File No. 4-483 (July 3, 2003), <http://www.sec.gov/rules/petitions/petrn4-483.htm> [hereinafter Nelson Petition].

29. As the Commission has stated: “Institutional custodians, such as Cede & Co. and other commercial depositories, are not single holders of record Instead, each of the depository's accounts for which the securities are held is a single record holder. In contrast, securities held in street name by a broker-dealer are held of record under the rule only by the broker-dealer.” U.S. SECURITIES AND EXCHANGE COMMISSION, DIVISION OF CORPORATION FINANCE, MANUAL OF PUBLICLY AVAILABLE TELEPHONE INTERPRETATIONS EXCHANGE ACT RULES, Question (30) (1997), available at http://www.sec.gov/interps/telephone/cftelinterps_exchangeactrules.pdf.

30. The original version of Rule 12g5-1 that was proposed in 1964 would have required the inclusion of the ultimate beneficial holders (or at least an estimate of them) in the count. Notice of Proposed Rules 12g5-1 and 12g5-2 Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-7426, 1964 WL 66562. Although this requirement was dropped from the final version of the rule, it is required for foreign issuers. See 17 C.F.R. § 240.12g3-2.

31. See *infra* notes 221-23 and accompanying text for a discussion of the procedure for deregistering securities under Section 12(g).

32. Under Exchange Act Rule 12g-4(a)(1)(ii), the class may also be deregistered under Section 12(g) if it is held by fewer than 500 record holders and the issuer's total assets did not exceed \$10 million on the last day of any of its last three fiscal years. 17 C.F.R. § 240.12g-4. For sake of simplicity, however, this Article will usually refer only to the 300-record holder test, on the

15(d), it will thereafter cease to be subject to the Exchange Act's reporting requirements, even if the issuer has several thousand beneficial—but not record—security holders.³³ This explains why many issuers may have active trading markets for their stock yet escape the requirements of the Exchange Act.

B. Exchange Act Reporting Requirements

Although a full discussion of the requirements imposed on issuers by the Exchange Act is beyond the scope of this Article, the following summary is useful to compare these requirements to those imposed on non-Exchange Act issuers. As evident from the discussion below, vast amounts of information about public issuers are available to the public. This information is easily retrievable because virtually all documents that Exchange Act issuers are required to file with the Commission are available on the Commission's EDGAR database online, as well as many third-party websites.³⁴ In contrast, Pink Sheets issuers need disclose very little information.³⁵

Section 13(a) of the Exchange Act³⁶ allows the Commission to specify periodic reports that issuers must file. The Commission requires many different reports, the most important being Annual Reports on Form 10-K, Quarterly

assumption that most affected issuers will have more than \$10 million of total assets.

33. The danger in this scenario is that many beneficial holders may thereafter wish to obtain stock certificates, thereby becoming record holders. If the number of record holders were to increase to 500 or more, the issuer would again have to register the class of securities under Section 12(g). For this reason, an issuer contemplating deregistering a class under Section 12(g) should determine how many beneficial owners it has. There are a few ways to do so. First, when the issuer prints its proxy statement for a meeting of shareholders pursuant to the Commission's proxy rules under Section 14 of the Exchange Act, 15 U.S.C. § 78n (2000), each brokerage firm with a position in the stock as of the record date for that meeting must inform the issuer of the number of its customers who are beneficial owners of the stock. *See* Exchange Act Rule 14b-1(b)(1), 17 C.F.R. § 240.14b-1.

Another indicator of the number of beneficial owners is a non-objecting beneficial owner ("NOBO") list, which does not require that there be a shareholder meeting on the horizon. Exchange Act Rule 14b-1(b)(3), 17 C.F.R. § 240.14b-1. This requires brokers, dealers, and banks to provide Exchange Act issuers, upon request, with the names, addresses, and securities positions of their customers who are beneficial owners of the issuer's securities, so long as the customers have not objected to that disclosure. *Id.* However, because not all beneficial owners will consent to this disclosure, a NOBO list will not provide an exact count of the number of beneficial owners.

34. EDGAR is the Commission's "electronic data gathering and retrieval" system, which is governed by Regulation S-T. Rule 101 of Regulation S-T specifies which documents must be filed electronically on EDGAR, which documents are permitted but not required to be filed on EDGAR, and which documents may be filed only in paper. 17 C.F.R. § 232.101 (2005). The end result of this rule is that virtually all important documents that an issuer is required to file with the Commission must be filed via EDGAR.

35. *See infra* notes 151-97 and accompanying text.

36. 15 U.S.C. § 78m (2000).

Reports on Form 10-Q, and Current Reports on Form 8-K.³⁷

Form 10-K³⁸ requires extensive annual information about the company. Some of the most important sections of Form 10-K are Items 8 and 7. Item 8 requires annual financial statements prepared in accordance with generally accepted accounting principles (“GAAP”)³⁹ and additional Commission requirements⁴⁰ and audited by an accounting firm that meets stringent independence requirements.⁴¹ Item 7, which is “Management’s Discussion and Analysis of Financial Condition and Results of Operations” (“MD&A”), is a companion piece to the financial statements that should—at least if done well—explain the issuer’s financial statements and results in sufficient detail to allow investors to make informed investment decisions about the issuer’s securities.⁴² Form 10-Q,⁴³ which an Exchange Act issuer must file after its first three fiscal quarters each year, principally requires quarterly (non-audited) financial statements and MD&A. Form 8-K specifies a long list of events or conditions that must be disclosed on a rapid basis, such as the entry into or termination of certain “material” contracts, acquisitions or dispositions of significant amounts of assets, certain off-balance sheet arrangements, changes in control of the issuer or changes in its accountants, and “guidance” if the issuer determines that prior financial statements “should no longer be relied upon.”⁴⁴

37. Section 12 and Section 15(d) companies are also subject to Regulation FD (or, fair disclosure), the basic purpose of which is to require such companies to report to the public any previously nonpublic material information that is disclosed to certain third parties. 17 C.F.R. §§ 243.100-.103 (2005).

38. 17 C.F.R. § 249.310 (2005).

39. *See* SEC Regulation S-X, Rule 4-01(a)(1), 17 C.F.R. § 210.4-01 (2005) (providing that financial statements which are not prepared in accordance with GAAP “will be presumed to be misleading or inaccurate, despite footnote or other disclosures”).

40. *See generally* SEC Regulation S-X, *id.* pt. 210.

41. *See* SEC Regulation S-X, Rule 2-01(b), (c), *id.* § 210.2-01.

42. The precise requirements for the MD&A section are set forth in Item 303 of Regulation S-K, 17 C.F.R. § 229.303 (2005). As the Commission has observed:

The MD&A requirements are intended to satisfy three principal objectives: [t]o provide a narrative explanation of a company’s financial statements that enables investors to see the company through the eyes of management; [t]o enhance the overall financial disclosure and provide the context within which financial information should be analyzed; and [t]o provide information about the quality of, and potential variability of, a company’s earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 33-8350, Exchange Act Release No. 34-48960, 68 Fed. Reg. 75,056, 75,056 (Dec. 29, 2003) (to be codified at 17 C.F.R. pts. 211, 231, 241) (footnotes and bullet points omitted).

43. 17 C.F.R. § 249.308a.

44. *See* Form 8-K, Item 4.02, *id.* § 249.308. Form 8-K was amended in March 2004 to require disclosure of several additional events or conditions affecting the issuer. *See* Additional

C. Some Other Exchange Act Requirements

The Exchange Act imposes many additional requirements on Section 12 registrants. For example, Section 13(d)⁴⁵ requires a security holder (or a group acting in concert) to file a report with the Commission once it beneficially owns more than five percent of the outstanding units of a class of Section 12 equity securities. This report, Schedule 13D,⁴⁶ requires not only information about the holder (or group) but also information about the holder's (or group's) plans for the issuer.⁴⁷

Section 16(a) requires reports concerning transactions in an issuer's securities by its officers and directors, as well as persons who own more than ten percent of the outstanding shares of a class of the issuer's equity securities.⁴⁸ Section 16(b), which is a presumed insider trading prohibition, requires these persons to remit to the issuer any actual or hypothetical profit resulting from a matched purchase and sale (or sale and purchase) of the issuer's securities that occur within six months of one another.⁴⁹ Section 14 of the Exchange Act⁵⁰ and related Commission rules create a complex scheme of proxy regulation. One of the most important proxy rules is Rule 14a-3,⁵¹ which provides that proxy solicitations may not occur unless each person solicited is furnished a proxy statement that contains the information specified in Schedule 14A⁵² and, if the meeting is an annual meeting, with an annual report (often called the "glossy" annual report) that contains much of the information that is included in Form 10-K. As one might expect, Schedule 14A requires extremely detailed information

Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 33-8400, Exchange Act Release No. 34-49424, 69 Fed. Reg. 15,594 (Mar. 25, 2004) (to be codified at 17 C.F.R. pts. 228, 229, 230, 239, 240, and 249); *see also* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction, Securities Act Release No. 33-8400A, Exchange Act Release No. 34-49424A, 69 Fed. Reg. 48,370 (Aug. 10, 2004) (to be codified at 17 C.F.R. pts. 239 and 249).

45. 15 U.S.C. § 78m (2000).

46. Schedule 13G, which is less detailed than Schedule 13D, may be used in some limited circumstances. *See* Exchange Act Rule 13d-1(b), 17 C.F.R. § 240.13d-1 (2005).

47. Specifically, Schedule 13D requires disclosure of the reporting persons' plans or proposals that would result in, among other things, the acquisition or disposition of securities of the issuer; an "extraordinary corporate transaction, such as a merger, reorganization or liquidation, involving the issuer or any of its subsidiaries"; a "sale or transfer of a material amount of assets of the issuer or any of its subsidiaries"; any "change in the present board of directors or management"; any material change in the issuer's capitalization or dividend policy; and any "other material change in the issuer's business or corporate structure." *Id.* § 240.13d-101.

48. 15 U.S.C. § 78p (2000).

49. *Id.*

50. 15 U.S.C. § 78n (2000).

51. 17 C.F.R. § 240.14a-3(a).

52. *Id.* § 240.14a-101.

in an issuer's proxy statement for even routine annual shareholder meetings. For example, for meetings at which directors will be elected Schedule 14A requires information about nearly every conceivable form of compensation that the issuer pays its Chief Executive Officer and up to four other highly paid executive officers.⁵³

D. Increased Requirements Under SOX

Even though the Exchange Act already required extensive disclosures, SOX substantially increased the burden on public companies. Although the following discussion is not a comprehensive description of SOX, a review of some of the important provisions of the statute and related rulemaking shows that the recent trend has been toward much greater regulation of public companies and may explain why many companies are fleeing the Exchange Act.⁵⁴

1. *Audit Committee Requirements.*—Section 301 of SOX⁵⁵ directed the Commission to adopt a rule preventing each national securities exchange (e.g., NYSE) and national securities association (e.g., NASDAQ)⁵⁶ from listing the securities of issuers that are not in compliance with certain audit committee requirements.⁵⁷ The centerpiece of these new rules is Exchange Act Rule 10A-3.⁵⁸ Under this rule, the exchange/association rules must require all audit committee members to be “independent” of the issuer, subject to some limited exceptions.⁵⁹ Further, the exchange/association rules must require the audit

53. See SEC Regulation S-K, Item 402, 17 C.F.R. § 229.402 (2005).

54. As discussed below, the Commission recently established an advisory committee to study the impact of SOX and other federal securities laws on small public companies and recommend changes in the laws that would serve to lessen this burden while still maintaining adequate investor protection. See *infra* note 357. The committee plans to issue a final report with its recommendations in April 2006. As such, it is likely that the Commission will act on many of these recommendations and thereby reduce the regulatory burden imposed by the securities laws on small public companies.

Meanwhile, however, two other sources of rules have worked to increase the regulatory burden on public companies. First, the securities exchanges and NASDAQ have significantly increased their corporate governance requirements. See *infra* notes 138-43 and accompanying text. Second, many proxy voting advisory service firms such as Institutional Shareholders Services award “points” for compliance with certain standards, whether or not the standards are required by law or exchange/association rules. For example, under some of the proxy voting advisory service firms’ rating systems, a company’s rating is better if it has a nominating committee that is composed only of independent directors, despite the availability of some exceptions to this requirement under Commission and exchange/association rules.

55. Codified at Section 10A(M) of the Exchange Act, 15 U.S.C.A. § 78j-1 (West 2005).

56. The Commission recently approved the application of the Nasdaq Stock Market, Inc. to register as a national securities exchange. See *supra* note 16.

57. 17 C.F.R. § 240.10A-3(a).

58. *Id.* § 240.10A-3.

59. *Id.* § 240.10A-3(b)(1)(i).

committee to establish procedures for investigating complaints “regarding accounting, internal accounting controls, or auditing matters” and the “confidential, anonymous submission by employees . . . of concerns regarding questionable accounting or auditing matters.”⁶⁰ Also, pursuant to SOX Section 407 and related Commission rules, a public issuer must periodically disclose whether its audit committee has at least one member who is an “audit committee financial expert.”⁶¹

2. *Financial Statement Certification Requirements.*—SOX imposed two new certification requirements for periodic⁶² Exchange Act reports. First, Section 906⁶³ provides that each periodic Exchange Act report that contains financial statements must be accompanied by a certification by the issuer’s chief executive officer (“CEO”) and its chief financial officer (“CFO”) that the report “fully complies” with the requirements of Section 13(a) or Section 15(d) of the Exchange Act and that the information in the report “fairly presents, in all material respects, the financial condition and results of operations of the issuer.”⁶⁴ Second, Section 302, along with new Commission rules,⁶⁵ requires the CEO and CFO to certify in each annual and quarterly Exchange Act report that they have reviewed the report. This certification is an acknowledgment that, based on their knowledge, the report does not contain any untrue statements or omit material facts and that the financial statements and other information fairly present, in all material respects, the issuer’s financial condition and results of operations.

3. *Enhanced Financial Disclosures.*—As required by Sections 401(a) and

60. *Id.* § 240.10A-3(b)(3).

61. 17 C.F.R. § 229.401 (2005). Item 401(h) of Regulation S-K defines an “an audit committee financial expert” as a person who has certain attributes, including

[e]xperience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the [issuer’s] financial statements, or experience actively supervising one or more persons engaged in such activities” and an “understanding of internal control over financial reporting.

Id. Item 401(h) further specifies that such a person must have attained these attributes through education and specified types of experience or “[o]ther relevant experience.” *Id.* § 229.401(h)(3).

62. “Periodic” reports include annual reports on Form 10-K and quarterly reports on Form 10-Q. See SEC Regulation S-K, Item 601(a), (b)(31), (b)(32), *id.* § 229.601.

63. Codified at 18 U.S.C.A. § 1350 (West 2005).

64. *Id.* § 1350(b). Section 906 specifies that whoever certifies a Section 906 report “knowing” that the periodic report does not comport with the requirements of Section 906 shall be fined up to \$1 million or imprisoned up to ten years. *Id.* § 1350(c). Persons who “willfully” certify a Section 906 report “knowing” that the periodic report does not comport with the requirements of Section 906 shall be fined up to \$5 million or imprisoned up to twenty years. *Id.*

65. See Exchange Act Rule 13a-14(a), 17 C.F.R. § 240.13a-14; SEC Regulation S-K, Item 601(b)(31), 17 C.F.R. § 229.601.

(b) of SOX, the Commission amended the MD&A portions of Form 10-K⁶⁶ to require issuers to explain any “off-balance sheet” arrangements. It also adopted Regulation G,⁶⁷ which requires issuers that release any non-GAAP financial measure also to present the most directly comparable GAAP financial measure and a reconciliation of the non-GAAP measure to the GAAP measure.

4. *Internal Controls Report.*—From an issuer’s perspective, probably the most onerous provision of SOX is Section 404, which directed the Commission to adopt rules that would require each annual report (e.g., Form 10-K) to contain an internal controls report (1) stating management’s responsibility for establishing and maintaining an “adequate internal control structure and procedures for financial reporting” and (2) containing an assessment of the effectiveness of structure and procedures.⁶⁸ In June 2003, the Commission issued final rules on this topic,⁶⁹ which were effective as of August 14, 2003, although the rules contained phased-in compliance dates.⁷⁰ The centerpiece of the new

66. See Regulation S-K, Item 303(a)(4), 17 C.F.R. § 229.303. These amendments were implemented pursuant to Disclosure in Management’s Discussion and Analysis of Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Securities Act Release No. 33-8182, Exchange Act Release No. 34-47264, 68 Fed. Reg. 5982 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 228, 229, and 249).

67. 17 C.F.R. 244.100 (2005). This part was adopted in Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 33-8176, Exchange Act Release No. 34-47226, 68 Fed. Reg. 4820 (Jan. 30, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 244, and 249).

68. Codified at 15 U.S.C.A. § 7362 (West 2005).

69. Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8238, Exchange Act Release No. 34-47986, Investment Company Act Release No. 26068, 68 Fed. Reg. 36,636 (June 18, 2003) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, and 274).

70. *Id.* Specifically, the release specified that, for non-investment companies, companies that were “accelerated filers” as defined in Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2, as of the end of their first fiscal year ending on or after June 15, 2004, must begin to comply in annual reports for that fiscal year. Other companies were given until their first fiscal year ending on or after April 15, 2005. These compliance dates were later extended in Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8392, Exchange Act Release No. 34-49313, Investment Company Act Release No. 26,357, 69 Fed. Reg. 9722 (Mar. 1, 2004) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, and 274). As a result of this release, accelerated filers have been subject to the Section 404 reporting requirements since fiscal years that ended on or after November 15, 2004. In September 2005, however, the Commission issued a final rule that extended the deadline for internal controls reports by non-accelerated filers for an additional year, i.e., to fiscal years ending on or after July 15, 2007. Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies That Are Not Accelerated Filers, Securities Act Release No. 33-8618, Exchange Act Release No. 34-52492, 70 Fed. Reg. 56,825 (Sept. 29, 2005) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, and 249). The internal controls report is a major focus of the Commission’s Advisory Committee on Smaller Public Companies. See *infra* note 357.

rules is Exchange Act Rule 13a-15,⁷¹ which requires a public issuer to (1) maintain disclosure controls and procedures (as defined in the rule) and internal control over financial reporting (as defined in the rule); (2) evaluate the effectiveness of its disclosure controls and procedures as of the end of each fiscal quarter; (3) evaluate the effectiveness of its internal control over financial reporting as of the end of each fiscal year; and (4) evaluate any change in its internal control over financial reporting that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.⁷² Moreover, the evaluation of the issuer's internal control over financial reporting must be done in a "suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment."⁷³ Disclosure about these items must be included in an issuer's Form 10-K pursuant to new Items 307 and 308 of Regulation S-K.⁷⁴ Furthermore, Section 404(b) of SOX requires the issuer's independent auditors to attest to and report on the issuer's assessments made under Section 404(a).⁷⁵ Complying with these new requirements will entail enormous amounts of management effort, as well as a great deal of additional fees payable to the issuer's independent auditors.

5. *Auditor Requirements.*—Public accounting firms may no longer provide non-audit services to public companies contemporaneously with audit services, with some exceptions.⁷⁶ SOX also created the Public Company Accounting Oversight Board⁷⁷ ("PCAOB") and required public accounting firms to register with the PCAOB. The PCAOB has authority to establish "auditing, quality control, ethics, independence, and other standards relating to the preparation of

71. 17 C.F.R. § 240.13a-15. For Section 15(d) issuers, see Exchange Act Rule 15d-15, *id.* § 240.15d-15.

72. *Id.* § 240.13a-15.

73. Exchange Act Rule 13a-15(c), *id.*

74. 17 C.F.R. § 229.307, .308 (2005); *see also* Form 10-K, Item 9A, 17 C.F.R. § 249.310 (2005); Form 10-Q, Item 4, *id.* § 249.308a.

75. To this end, the Commission amended Rules 1-02 and 2-02 of Regulation S-X to require such reports, which now must appear in Forms 10-K. 17 C.F.R. §§ 210.1-02(a), .2-02(f) (2005). *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8238, Exchange Act Release No. 34-47986, Investment Company Act Release No. 26068, 68 Fed. Reg. 36,636 (June 18, 2003) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, and 274).

76. Exchange Act § 10A(g), (h) and (i), 15 U.S.C.A. § 78j-1 (West 2005), as added by Sections 201 and 202 of SOX. Some non-audit activities are completely prohibited, such as bookkeeping or other services related to accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services; fairness opinions; broker or dealer, investment advisor, or investment banking services; and legal services and expert services unrelated to the audit. *Id.* §§ 78j-1(g), (h).

77. *See* Sarbanes-Oxley Act of 2002 §§ 101-09, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

audit reports for [public] issuers,"⁷⁸ among other powers.

6. *Code of Ethics for Senior Financial Officers.*—Section 406 of SOX directed the Commission to adopt rules requiring public companies to disclose whether they have a code of ethics for certain senior officers and, if not, why not. The new rule, which is found in Item 406 of Regulation S-K,⁷⁹ requires the code to be "reasonably designed to deter wrongdoing and to promote," among other things; "[h]onest and ethical conduct"; "[f]ull, fair, accurate, timely, and understandable disclosure in [Exchange Act] reports"; and compliance with laws.⁸⁰

7. *Acceleration of Periodic Reporting Deadlines.*—Pursuant to Section 409 of SOX,⁸¹ the Commission designated some large public companies as "accelerated filer[s]."⁸² These companies will eventually⁸³ be required to file their Forms 10-K within sixty days after the end of their fiscal years (as opposed to the ninety days allowed in pre-SOX days) and their Forms 10-Q within forty days after the end of their fiscal quarters (as opposed to forty-five days, before SOX).⁸⁴

78. *See id.* § 101(c)(2).

79. 17 C.F.R. § 229.406.

80. *Id.* This disclosure is required under Item 10 of Form 10-K. 17 C.F.R. § 249.310 (2005). In addition, Item 406 specifies that the actual text of the code must appear as an exhibit to the annual report or on the company's website (in which case the company must disclose in its annual report that it has posted the code on its website). *Id.* Alternatively, the company may undertake in its annual report to provide to any person a copy of the code. *Id.*

81. Codified at Section 13(l) of the Exchange Act, 15 U.S.C.A. § 78m (West 2005).

82. *See* Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (2005).

83. In Temporary Postponement of the Final Phase-In Period for Acceleration of Periodic Report Filing Dates, Securities Act Release No. 33-8507, Exchange Act Release No. 34-50684, 69 Fed. Reg. 68,232 (Nov. 23, 2004) (to be codified at 17 C.F.R. pts. 210, 240, and 249) (postponing the final phase-in of these requirements). Under that amended schedule, an accelerated filer was to file its annual report within sixty days after its fiscal year ending on or after December 15, 2005, and its next three quarterly reports within thirty-five days after the end of the quarter. *Id.* However, in December 2005, the Commission adopted rule changes to segregate "large accelerated filers," which are those with a public float (the market value of common equity held by persons who are not affiliates of the issuer) of \$700 million or more, from mere "accelerated filers," which are those with a public float between \$75 million and \$700 million. Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, Securities Act Release No. 33-8644, Exchange Act Release No. 34-52989, 70 Fed. Reg. 76,626 (Dec. 27, 2005) (to be codified at 17 C.F.R. pts. 210, 229, 240, and 249). Under the new schedule, only large accelerated filers will be subject to the final phase-in of the sixty-day annual report filing deadline. This sixty-day deadline will apply to annual reports for fiscal years ending on or after December 15, 2006. Until then, the deadline is seventy-five days. "Regular" accelerated filers will continue to have seventy-five days to file annual reports, and *both* large accelerated filers and "regular" accelerated filers will continue to have forty days to file quarterly reports.

84. *See* Form 10-K, Instruction A(2), 17 C.F.R. § 249.310; Form 10-Q, Instruction A(1), *id.* § 249.308a.

8. *Attorney Conduct Rules*.—Section 307 of SOX required the Commission to promulgate new rules applicable to attorneys representing public issuers. The purpose of the new rules⁸⁵ is to require attorneys who become aware of evidence of a past, pending, or imminent “material violation” involving an Exchange Act issuer or certain subsidiaries to report it to the issuer.⁸⁶ “Material violations” include material violations of applicable federal or state securities laws, breaches of fiduciary duties under federal or state law, and “similar” violations of any federal or state law.⁸⁷ In addition to reporting this evidence, the attorney must also determine whether the issuer adopts an “appropriate response.”⁸⁸

9. *Nominating Committee Functions and Shareholder Communications with Directors*.—Although not required by SOX, the Commission adopted new rules imposing on public companies additional disclosure requirements with respect to the functions of the nominating committees of their boards of directors.⁸⁹ The Commission also amended Schedule 14A to require that an issuer state whether its board “provides a process for security holders to send communications to the board of directors and, if the registrant does not have such a process . . . state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a process.”⁹⁰

Again, this summary is not a comprehensive description of the obligations that the Exchange Act imposes on public issuers or how those requirements have increased under SOX. Rather, it is intended to remind the reader of the extensive regulation to which public companies are subject and the vast amount of information about them that is consequently available to the public easily and free of charge. As the Commission has observed, the information contained in Exchange Act reports “is a treasure trove for investors.”⁹¹ It is easy to see why.

E. A Brief Overview of the U.S. Securities Markets

1. *National Securities Exchanges*.—The “hallmark of a stock exchange

85. 17 C.F.R. pt. 205 (2005).

86. *Id.* § 205.3.

87. *Id.* § 205.2.

88. *Id.* § 205.3(b)(3).

89. Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors; Republication, Securities Act Release No. 33-8340, Exchange Act Release No. 34-48825, Investment Company Act Release No. 26,262, 68 Fed. Reg. 69,204 (Dec. 11, 2003) (to be codified at 17 C.F.R. pts. 228, 229, 240, 249, 270, and 274). A public company whose board of directors has a nominating committee must disclose certain information about the committee’s charter (if it has one), and provide shareholders with access to a copy of the charter, either in the proxy statement itself or on the company’s website. *See* Schedule 14A, Items 7(d)(2)(ii)(A), (B), 17 C.F.R. § 240.14a-101 (2005). Item 7(d)(2), as recently amended, also requires detailed information about the nominating committee and the process for identifying and evaluating nominees for director. *Id.*

90. Schedule 14A, Item 7(h)(1), 17 C.F.R. § 240.14a-101.

91. Microcap Stock, *supra* note 11.

historically has been the centralization of trading on an exchange floor.”⁹² Before automation, this meant that each order for a stock would be communicated to a “specialist” in that stock at his or her post on the exchange floor, usually by a floor broker physically carrying the order to the specialist.⁹³ There are several securities exchanges registered with the Commission, the most prominent being NYSE and the American Stock Exchange (“AMEX”).⁹⁴ Nearly 2800 companies have securities listed on NYSE⁹⁵ and approximately 800 have securities listed on AMEX.⁹⁶ NYSE is the largest stock exchange,⁹⁷ and its listed companies had a combined market capitalization (number of shares outstanding multiplied by the value of the shares) of more than \$12.1 trillion at the end of 2003.⁹⁸ The volume of trading activity on NYSE is staggering: average daily share volume in 2003 was nearly 1.4 billion shares, and the total value of trades on NYSE during 2003 was nearly \$9.7 trillion.⁹⁹ The second largest national stock exchange has historically been AMEX, although it is much smaller than NYSE. AMEX’s listed companies had a combined market capitalization of more than \$176 billion at the end of 2003.¹⁰⁰ AMEX’s average daily share volume in 2003 was more than 67 million shares, and the total value of trades on AMEX during 2003 was more than \$563 billion.¹⁰¹ The smaller exchanges represent

92. 5 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 2525 (3d ed., rev. vol. 2001). Section 3(a)(1) of the Exchange Act, 15 U.S.C. § 78c (2000), defines an “exchange.” Sections 5 and 6 of the Exchange Act, 15 U.S.C. §§ 78e, 78f (2000), in effect require all exchanges to be registered as national securities exchanges.

93. 5 LOSS & SELIGMAN, *supra* note 92, at 2527. For a more detailed description of the process for placing securities orders, see *id.* at 2527-28.

94. The other stock exchanges are the Pacific Exchange, the Chicago Stock Exchange, the National Stock Exchange (formerly the Cincinnati Stock Exchange), the Boston Stock Exchange, the Philadelphia Stock Exchange, and the Chicago Board Options Exchange (“CBOE”), “although the CBOE does not appear currently to have any volume in stock trades.” *Id.* at 2525 n.76. The International Securities Exchange is also registered as a national securities exchange.

95. See New York Stock Exchange, Listed Companies, <http://www.nyse.com/about/listed/1089312755443.html> (last visited Jan. 4, 2006).

96. See American Stock Exchange, <http://www.amex.com> (last visited Jan. 4, 2006). Some companies may have securities listed on more than one exchange.

97. 5 LOSS & SELIGMAN, *supra* note 92, at 2529 (“As of 1998, the NYSE was responsible for 88 percent of the dollar value of the stocks traded on exchanges and 87 percent of the shares traded.” (citations omitted)).

98. SECURITIES INDUSTRY ASSOCIATION, *SECURITIES INDUSTRY FACT BOOK* 43 (2004).

99. *Id.* at 46. Based on an average stock price of \$27.50, the average value of the NYSE average daily share volume in 2003 was nearly \$38.5 billion. In 2004, average daily share volume was more than 1.4 billion shares, with an average daily dollar value of trading of more than \$46.1 billion. See New York Stock Exchange, NYSE Market Statistics, <http://www.nyse.com/marketinfo/1022221393893.html> (last visited Jan. 5, 2006).

100. SECURITIES INDUSTRY ASSOCIATION, *supra* note 98, at 43.

101. *Id.* at 48. Based on an average stock price of \$33.30, the average value of the AMEX average daily share volume in 2003 was more than \$2.2 billion.

only about one percent of the market capitalization of listed companies.¹⁰²

2. *NASDAQ*.—Unlike securities exchanges, the over-the-counter (“OTC”) markets do not exist in any physical trading location, instead existing among dealers who communicate electronically and by telephone. Of the OTC markets, NASDAQ is the best known. Its two main markets are the National Market System and the Capital Market (formerly known as the SmallCap Market).¹⁰³ The National Market System is primarily for large, well-established companies; whereas, the Capital Market is designed for smaller companies. This difference is reflected in the listing criteria for the two markets; it is more difficult for a company to qualify for the National Market System than the Capital Market.¹⁰⁴

Before 1971, quotations in OTC stocks were reported only in the Pink Sheets, which was then a daily publication of the National Quotations Bureau.¹⁰⁵ Brokers and dealers thus had to call one of the dealers in a particular OTC security to get current quotations for it, resulting in an inefficient market.¹⁰⁶ This situation improved when NASDAQ debuted in 1971 as the world’s first electronic stock market. As commentators observed: “In the early 1970s, over-the-counter trading was revolutionized by the replacement of the daily ‘pink sheets’ with the NASDAQ electronic system, which permitted brokers to read up-to-the-minute . . . quotations from desk top terminals.”¹⁰⁷ On February 8, 1971, its first day of trading, NASDAQ displayed quotations for more than 2500 OTC stocks.

At the end of 2003, NASDAQ’s listed companies had a combined market capitalization of nearly \$3 trillion.¹⁰⁸ NASDAQ’s average daily share volume in 2003 was nearly 1.7 billion shares, and the total value of trades on NASDAQ during 2003 was more than \$7 trillion.¹⁰⁹ Today, NASDAQ says that “[w]ith approximately 3,300 companies, it lists more companies and, on average, trades more shares per day than any other U.S. market.”¹¹⁰

3. *The OTC Bulletin Board*.—The OTCBB is a “regulated quotation service

102. 5 LOSS & SELIGMAN, *supra* note 92, at 2531. Only a small number of stocks are exclusively listed on one of these “regional” exchanges; most are dually listed on another exchange. *Id.*

103. NASDAQ also has a PORTAL market for transactions in securities governed by Rule 144A under the Securities Act of 1933, 17 C.F.R. § 230.144A (2005). The Commission recently approved the application of the Nasdaq Stock Market, Inc. to register as a national securities exchange. *See supra* note 16.

104. *See infra* notes 133-35 and accompanying text.

105. 5 LOSS & SELIGMAN, *supra* note 92, at 2605.

106. *Id.* (“[T]he time and difficulty involved in telephoning over-the-counter dealers frequently discouraged brokers or dealers placing orders from engaging in rigorous comparative shopping.”).

107. *Id.* at 2487.

108. SECURITIES INDUSTRY ASSOCIATION, *supra* note 98, at 43.

109. *Id.* at 47. Based on an average stock price of \$16.62, the average value of the NASDAQ average daily share volume in 2003 was more than \$28 billion.

110. NASDAQ.com, Overview, <http://www.nasdaq.com/about/overview.stm> (last visited Jan. 5, 2006).

that displays real-time quotes, last-sale prices, and volume information in over-the-counter (OTC) equity securities.”¹¹¹ Although the OTCBB is operated by the NASD, companies do not apply to list their securities on the OTCBB, as is the case with NASDAQ; instead, market makers initiate quotations for securities on the OTCBB. In fact, a company could not prevent its securities from being traded on the OTCBB. Also, quoted companies need not meet or maintain any qualitative or quantitative listing standards, as they must with NASDAQ and the securities exchanges.¹¹²

Section 17B(b)(1) of the Exchange Act,¹¹³ which was added by the Penny Stock Reform Act of 1990,¹¹⁴ directed the Commission to facilitate the dissemination of last sale and quotation information for penny stocks, with a goal of establishing “one or more automated quotation systems that will collect and disseminate information regarding all penny stocks.” As a result, the OTCBB

111. OTC Bulletin Board, Overview and History of the OTCBB, <http://www.otcbb.com/aboutOTCBB/overview.stm> (last visited Jan. 5, 2006).

112. NASDAQ previously contemplated replacing the OTCBB with a new market to be called the Bulletin Board Market, or BBX. It was envisioned that this market, unlike the OTCBB, would impose qualitative and quantitative listing requirements, in an effort seemingly designed to “clean up” the less-than-stellar reputation of the OTC market. This proposal was dropped in 2003. JAMES J. ANGEL ET AL., FROM PINK SLIPS TO PINK SHEETS: LIQUIDITY AND SHAREHOLDER WEALTH CONSEQUENCES OF NASDAQ DELISTINGS 10-11 (2004), http://www.bus.wisc.edu/finance/pdfs/Seminar/Spring2005/Angel_Harris_Panchapagesan_Werner_2004_Nov_02.pdf. See generally Karen Talley, *Small-Stock Focus: An Overhaul for the OTC Bulletin Board Is Set*, WALL ST. J., Jan. 21, 2003, at C7 (noting that the prior “lenient approach has led to a slew of questionable companies garnering listings on the [OTC] Bulletin Board”).

113. 15 U.S.C. § 78q-2 (2000).

114. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. 101-429, 104 Stat. 931 (1990) (codified as amended in scattered sections of 15 U.S.C. (2000)). The primary effect of the Penny Stock Reform Act of 1990 was to require that a broker-dealer give a customer certain information before effecting a transaction in a “penny stock” for that customer. Exchange Act Section 3(a)(51), 15 U.S.C. § 78c (2000), and Exchange Act Rule 3a51-1, 17 C.F.R. § 240.3a51-1 (2005), define a penny stock to include an equity security, *other than* one (among other things): (1) that is traded on a national securities exchange or NASDAQ, subject to some detailed qualifications, (2) that has a price of \$5.00 or more, or (3) whose issuer meets certain tests regarding net tangible assets and revenues. 15 U.S.C. § 78c. The Commission recently amended the definition of penny stock. See Amendments to the Penny Stock Rules, Exchange Act Release No. 34-51983, 70 Fed. Reg. 40,614 (July 13, 2005) (to be codified at 17 C.F.R. pt. 240). Exchange Act Rules 15g-2 and 15g-9 essentially require that the broker-dealer in most cases provide the customer with a disclosure form on Schedule 15G, which gives certain warnings about penny stocks, and receive from the customer a signed acknowledgment that the customer has received the document and consents to the transaction. 17 C.F.R. §§ 240.15g-2, .15g-9. Further, the broker-dealer usually must determine that a transaction in a penny stock is “suitable” for that customer. Rules 15g-2 and 15g-9 were also recently amended by the Commission pursuant to Exchange Act Release No. 34-51983, *supra*.

began operation in June 1990, on a pilot basis.¹¹⁵ In April 1997, the Commission approved the operation of the OTCBB on a permanent basis.¹¹⁶ Currently, approximately 3300 securities are quoted on the OTCBB, fewer than 300 of which are quoted exclusively on the OTCBB. The remaining securities are also quoted on the Pink Sheets.¹¹⁷ According to the OTCBB's website, in 2003 average daily share volume was more than one billion shares, and the dollar value of that average daily share volume was nearly \$160 million.¹¹⁸

4. *The Pink Sheets*.—The Pink Sheets describes itself as:

the leading provider of pricing and financial information for the over-the-counter (OTC) securities markets. We provide products and services that increase the transparency of information available in the OTC markets so as to make them more efficient for all participants. Our centralized information network includes services designed to benefit market makers, issuers, brokers and OTC investors. Pink Sheets information enhances the efficiency of OTC trading, provides better executions for OTC investors and improves the capital formation process for OTC issuers.

The origins of the Pink Sheets go back to 1904, when the National Quotation Bureau began as a paper-based, inter-dealer quotation service linking competing market makers in OTC securities across the country. Since that time, the Pink Sheets . . . have been the central resource for trading information in OTC stocks and bonds.¹¹⁹

Although it may seem to many laypeople to be simply another stock market, the Pink Sheets is not registered with the Commission because it does not fall within the definition of an "exchange," a "broker-dealer," or an exclusive "securities information processor" under the Exchange Act.¹²⁰ Further, the Pink

115. See OTC Bulletin Board, *supra* note 111.

116. Although the OTCBB was created after the Penny Stock Reform Act of 1990, this does not mean that all stocks quoted on it are "penny stocks"—although approximately 94% of them are. ANGELET AL., *supra* note 112, at 11.

117. According to the Pink Sheets website, 4809 securities were exclusively quoted on the Pink Sheets, 271 securities were exclusively quoted on the OTCBB, and 3015 securities were dually quoted on the OTCBB and the Pink Sheets on February 2, 2006. See Pink Sheets, <http://www.pinksheets.com/index.jsp> (last visited Feb. 2, 2006); see also ANGELET AL., *supra* note 112, at 10 ("[D]espite the fact that approximately 3,200 stocks trade concurrently on both [the OTCBB and the Pink Sheets] and another 4,300 stocks trade exclusively in the Pink Sheets, very little is actually known about them in the academic community.").

118. OTC Bulletin Board, Historical Annual Statistics, <http://www.otcbb.com/TradingData/HistAnnualStats.stm> (last visited Jan. 5, 2006).

119. Pink Sheets, About the Pink Sheets: Revolutionizing OTC Markets, <http://www.pinksheets.com/about/index.jsp> (last visited Jan. 5, 2006). On February 14, 2003, the Pink Sheets began allowing issuers to sponsor real-time quotations for their stock on the Pink Sheets' website, for a fee of \$174.95 per month. ANGELET AL., *supra* note 112, at 11.

120. See generally Exchange Act §§ 5, 6, 11A, 15; 15 U.S.C. §§ 78e, 78f, 78k-1, 78o (2000).

Sheets is not registered with the Commission as a self-regulatory organization (“SRO”) or national securities association.¹²¹ Thus, although brokers that use the Pink Sheets to trade securities are regulated by the NASD and the Commission, the Pink Sheets itself is simply a private entity. As discussed below, issuers with securities quoted on the Pink Sheets need not meet any qualitative or quantitative listing standards, as they must with NASDAQ and the national securities exchanges (but not the OTCBB), or be Exchange Act reporting companies, as they must with all of those other markets.¹²²

Although share volume on the Pink Sheets may often exceed that of the other markets, the dollar value of those trades is significantly lower than the other markets¹²³ due to a much lower average price for Pink Sheets securities, often less than one dollar per share.¹²⁴ For example, in a letter to the Commission, the Pink Sheets noted that trading volume for April 2004 was over 20.6 billion shares of stock, with a market value of more than \$2 billion.¹²⁵ Because there were

The Pink Sheets website, in response to the question “Who Regulates the Pink Sheets?,” puts it this way:

Pink Sheets is neither a Securities and Exchange Commission (SEC) Registered Stock Exchange nor a NASD broker/dealer. Pink Sheets is considered a Non-exclusive Securities Information Processor and an Interdealer Quotation System, for which registration is not required under current securities laws. However, [the] Pink Sheets quotation and trading system is only open to registered broker/dealers and those broker/dealers are subject to NASD Rules and regulations regarding their conduct and use of the Pink Sheets. Issuers are subject to Federal and State securities laws.

Pink Sheets, Frequently Asked Questions, <http://www.pinksheets.com/faq.jsp#9> (last visited Jan. 5, 2006).

121. See generally Exchange Act §§ 15A, 19, 15 U.S.C. §§ 78o-3, 78s (2000).

122. See *infra* notes 151-72 and accompanying text. The CEO of the Pink Sheets is reported as having said that “We are the tier of stuff that can’t, won’t, or doesn’t want to be listed on the exchange.” ANGEL ET AL., *supra* note 112, at 2 n.1.

123. “An estimated \$75 million a day trades in Pink Sheet issues. That is still tiny compared with the \$41 billion in trades averaged by the New York Stock Exchange in December” Jeff D. Opdyke, *More Blue Chips Hit the Pink Sheets*, WALL ST. J., Jan. 21, 2003, at D1; see also Ianthe Jeanne Dugan, *Pink Sheets Aims For Respectability Under Ex-Trader*, WALL ST. J., Dec. 17, 2005, at B1 (“Since 2003, the amount of stock traded on the Pink Sheets has more than doubled to \$50 billion annually. But honest businesses are mingled with murky enterprises, which have proliferated as the Internet allows bogus information to spread quickly and small investors to trade for themselves.”). Opdyke also notes that although the Pink Sheets “has long been notorious for distressed companies and dubious penny stock,” it “is also home to hundreds of financially solid companies.” Opdyke, *supra*; see also Russ Wiles, *Gazing at Penny Stocks*, ARIZ. REPUBLIC, June 30, 2003, at D1 (“[P]enny stocks make up the dark matter of the investment universe: a murky and treacherous realm of low visibility. . . . This corner of the stock market now trades more shares than Nasdaq, though the dollar value is much less.”).

124. As with the OTCBB, although many Pink Sheets stocks fall within the definition of “penny stock,” not all of them do. ANGEL ET AL., *supra* note 112, at 11.

125. Letter from R. Cromwell Coulson, CEO, Pink Sheets, LLC, to Jonathan G. Katz,

twenty-two trading days in April 2004, this would mean that the Pink Sheets' average daily volume was slightly less than one billion shares and approximately \$91.7 million during that month.

It is very easy for stock to be traded through the Pink Sheets. Essentially, all that needs to be done is to find an NASD-member broker-dealer to quote the issuer's securities on the Pink Sheets. In most cases, this "market maker" must file a Form 211¹²⁶ with the NASD OTC Compliance Unit, along with the information required by Exchange Act Rule 15c2-11.¹²⁷ After a review by the NASD OTC Compliance Unit, quotations of the security may be entered on the Pink Sheets.¹²⁸ The form must be filed at least three business days before the quotation is entered.¹²⁹

The former exchange-listed company that wants to move to the Pink Sheets may find this hard to believe. Unlike applying to list securities on an exchange or NASDAQ, there are no quantitative or qualitative standards for the company

Secretary, Securities and Exchange Commission (June 24, 2004), *available at* <http://www.sec.gov/rules/sro/nasd/nasd2004056/pinksheets062404.pdf>. This letter stated that in April 2004, "registered broker-dealers used the services of Pink Sheets to electronically negotiate 359,515 trades in OTC equity securities consisting of 20,612,015,510 shares of stock with a market value of \$2,017,438,749."

126. Form 211 is not a difficult or time-consuming form to complete. Part 1 of the form requires basic information about the issuer and the security; part 2 requires the broker-dealer to specify which portion of Rule 15c2-11 it is relying on to satisfy its informational requirements under that rule; part 3 requires some limited supplemental information; and part 4 consists of a certification for the submitting brokerage firm to sign stating, among other things, that the firm has a reasonable basis for believing that the Rule 15c2-11 information is accurate. Form 211, *available at* <http://www.otcbb.com/aboutOTCBB/forms/form211.pdf> (last viewed Feb. 2, 2006).

127. 17 C.F.R. § 240.15c2-11 (2005). Exceptions exist, including exceptions for unsolicited quotes and where the market maker already quotes the security in another market. *See generally id.* § 240.15c2-11(f). Under the rule, an unsolicited quote must be made (1) "solely on behalf of a customer (other than a person acting as or for a dealer)"; (2) "represent[] the customer's indication of interest"; and (3) "not involve the solicitation of the customer's interest." *Id.* The "Pink Sheets has become increasingly concerned that the unsolicited quote exception in Exchange Act Rule 15c2-11 is being abused by unscrupulous individuals to engage in questionable and possibly fraudulent activities in violation of the federal securities laws." Pink Sheets, How Does a Company Become Quoted on the Pink Sheets: Unsolicited Quotes, http://www.pinksheets.com/otcguide/issuers_getquoted.jsp (last visited Jan. 5, 2006). As such, this portion of the website notes that the Pink Sheets will only publish unsolicited quotations if (1) the issuer is subject to Exchange Act reporting requirements and is current in its reports to the Commission; (2) the securities were delisted from NYSE, the American Stock Exchange, NASDAQ or the OTCBB; (3) the issuer is a bank, savings and loan, or insurance company; (4) the securities were issued as part of a bankruptcy reorganization; (5) the security "is a foreign ordinary, which is listed on a foreign exchange, or an ADR representing such ordinaries"; or (6) the issuer has complied with the Pink Sheets Disclosure Policy discussed below. *Id.*; *see infra* notes 173-97 and accompanying text.

128. *See* Form 211, *supra* note 126.

129. *Id.*

to meet and very little for the company to do. Of course, after the issuer finds a sponsoring market maker, the market maker may ask the issuer to supply it with the information that it needs for its files under Rule 15c2-11; however, this likely presents only a minor inconvenience for the issuer. Further, many companies whose securities are quoted on the Pink Sheets will be neither subject to the Exchange Act reporting requirements nor subject to the Pink Sheets disclosure policy discussed in Part I.G.3.

F. Requirements of NYSE and NASDAQ

Not every issuer may list its securities on NYSE or NASDAQ; both require issuers to meet certain quantitative tests. For example, for domestic issuers, NYSE requires that the security must have at least 2000 shareholders that each own at least 100 shares (round lot holders).¹³⁰ NYSE also has detailed requirements relating to the level of the issuer's earnings or cash flows.¹³¹ After it is listed, the issuer must continue to meet somewhat lesser standards for its securities to remain listed.¹³² Of course, since NYSE is a national securities exchange, any class of securities that is listed on NYSE must be registered under Section 12(b) of the Exchange Act, thus subjecting the issuer to the full panoply of Exchange Act (and SOX) requirements. To have its securities listed on the Nasdaq National Market System, not only must a domestic or Canadian issuer be a public company (or about to become one),¹³³ but it must also meet at least one of three different standards which contain criteria relating to the value of the

130. See NYSE, Inc., Listed Company Manual, *supra* note 16, § 102.01(A). There are, however, alternative standards for this requirement. See *id.* § 102.01(B).

131. *Id.* § 102.01(C).

132. See *id.* § 802.01.

133. Under the *Nasdaq Marketplace Rules*, the security to be listed (if not distributed in an IPO) must be "(1) registered pursuant to Section 12(g)(1) of the [Exchange] Act; (2) registered on a national securities exchange pursuant to Section 12(b) of the Act; or (3) issued by an insurance company pursuant to Section 12(g)(2)(G) of the Act"; or (4) issued by a registered investment company, subject to certain conditions. *Nasdaq Marketplace Rules* § 4310(a) (2005), available at <http://nasd.complnet.com/nasd/display/index.html> (follow "Marketplace Rules" hyperlink). Because NASDAQ currently is not a national securities exchange, securities listed on it do not have to be registered under Section 12(b) of the Exchange Act. *Id.* As noted above, the Commission recently approved the application of The Nasdaq Stock Market LLC to register as a national securities exchange. See *supra* note 16. However, in the release approving this application, the Commission noted that NASDAQ's "initial and continuing listing standards [will] be largely the same as current NASD listing rules." In the Matter of the Application of The Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 34-53128, 71 Fed. Reg. 3550, 3564 (Jan. 23, 2006) (footnote omitted). Similarly, the "corporate governance listing standards proposed for the Nasdaq Exchange are the same as those previously approved by the Commission . . ." *Id.* The *Nasdaq Marketplace Rules* are Rules 4000 to 7000 of the NASD Manual (2005), available at www.nasd.complnet.com/nasd/display/index.html (follow "Marketplace Rules" hyperlink).

issuer's stockholders' equity, the value of its total assets or its annual revenues, the number of its publicly held shares and the market value and minimum bid price of those shares, the number of round lot shareholders, and its operating history.¹³⁴ As with NYSE, NASDAQ's continuing listing requirements are less stringent than its initial requirements.¹³⁵

Even if an issuer meets the numerical quantitative tests, it must also meet qualitative standards concerning corporate governance issues.¹³⁶ For example, Section 3 of the *NYSE Listed Company Manual* contains detailed requirements relating to, among other things, annual shareholder meetings, shareholder voting rights, corporate governance standards, and classified boards of directors. NASDAQ's qualitative requirements relate to annual shareholder meetings, shareholder voting rights, shareholder meeting quorum requirements, the independence of directors and certain board committees, and the approval of related party transactions.¹³⁷ Moreover, both NYSE and NASDAQ recently implemented extensive changes to their corporate governance requirements to require that, among other things, a majority of directors be independent;¹³⁸ require executive sessions of independent directors;¹³⁹ impose new obligations on audit committees,¹⁴⁰ nominating committees,¹⁴¹ and compensation committees;¹⁴² and require codes of ethics that are applicable to all of an issuer's directors and employees.¹⁴³ In general, these new requirements complement SOX, but in many cases they go much further than SOX.

G. Requirements of the OTC Bulletin Board and the Pink Sheets

Unlike NYSE and NASDAQ, there simply are no quantitative or qualitative

134. Nasdaq Marketplace Rules, *supra* note 133, § 4310.

135. Also, it is somewhat easier to satisfy the quantitative listing requirements for the Nasdaq Capital Market. *See id.*

136. In addition, both NYSE and NASDAQ retain discretion to refuse to list the securities of an issuer that meets the quantitative requirements, or to impose greater requirements. *See* NYSE, Inc., Listed Company Manual, *supra* note 16, § 101.00; *see also* Nasdaq Marketplace Rules, *supra* note 133, at IM-4300.

137. *See* Nasdaq Marketplace Rules, *supra* note 133, §§ 4350, 4351.

138. *See* NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).01; Nasdaq Marketplace Rules, *supra* note 133, §§ 4350(c)(1), 4200(a)(15).

139. NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).03; Nasdaq Marketplace Rules, *supra* note 133, § 4350(c)(2).

140. NYSE, Inc., Listed Company Manual, *supra* note 16, §§ 303(A).06, .07; Nasdaq Marketplace Rules, *supra* note 133, § 4350(n).

141. NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).04; Nasdaq Marketplace Rules, *supra* note 133, § 4350(c)(4).

142. NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).05; Nasdaq Marketplace Rules, *supra* note 133, § 4350(c)(3).

143. NYSE, Inc., Listed Company Manual, *supra* note 16, § 303(A).10; Nasdaq Marketplace Rules, *supra* note 133, § 4350(d).

requirements for issuers whose securities are quoted on the OTCBB or the Pink Sheets. However, these issuers must make certain information available to investors, as discussed below.

1. *NASD Eligibility Rule*.—On January 4, 1999, the Commission approved the NASD's eligibility rule for the OTCBB.¹⁴⁴ Issuers whose securities were not already quoted on the OTCBB at that time were required, before quotation on the OTCBB, to report their current financial information to the Commission or, alternatively, banking or insurance regulators. Non-reporting companies whose securities were already quoted on the OTCBB were given until June 2000 to comply with the new requirements. Before the eligibility rule, the OTCBB quoted the securities of more than 3600 non-Exchange Act reporters.¹⁴⁵ After the eligibility rule was approved, the NASD began delisting noncompliant issuers from the OTCBB. More than 3000 companies were delisted.¹⁴⁶ What did the delisted companies do? Many of them now have their securities quoted on the Pink Sheets.¹⁴⁷

In its release approving the eligibility rule, the Commission observed that one reason for the rule was that the "lack of reliable and current financial information about the issuers, and the perception by the public that the OTCBB is similar to

144. Nasdaq Marketplace Rules, *supra* note 133, § 6530. This rule defines the securities that are eligible to be quoted on the OTCBB. For the typical domestic equity security, the rule requires (1) that the security not be listed on NASDAQ or a U.S. national securities exchange (with some exceptions) and (2) one of the following: (a) the issuer of the security is required to file reports under Section 13(a) or Section 15(d) of the Exchange Act and is current in its reports (with a thirty-day grace period), (b) the security is described in Section 12(g)(2)(B) of the Exchange Act (which deals with investment company securities registered under the Investment Company Act) and is current in its reporting obligations (subject to a thirty-day grace period), (c) "the security is described in Section 12(g)(2)(G) of the Exchange Act" (which deals with securities of certain insurance companies) and is current in its reporting obligations (subject to a sixty-day grace period), or (d) the "issuer of the security is a bank or savings association that is not required to file reports with the Commission pursuant to Section 13 or 15(d) of the Exchange Act" and is current with all required filings with its appropriate federal banking agency or state bank supervisor (subject to a sixty-day grace period).

145. Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACCT. & ECON. 233, 235 (2005).

146. The eligibility rule "phase-in" started on July 1, 1999, and was completed as of June 22, 2000. The NASD staff reviewed all 5601 companies whose securities were quoted on the OTCBB. This review led to 3187 companies being deemed ineligible for continued quotation and their removal from the OTCBB. However, 205 of the ineligible issuers later met the requirements. OTC Bulletin Board, Eligibility Rule, <http://www.otcbb.com/news/EligibilityRule/ercomplete.stm> (last visited Jan. 5, 2006).

147. "Between 1999 and 2000, OTCBB de-listed about 3,000 of its then 6,500-name roster." Peter Chapman, *The Rise of the Pink Sheets*, TRADERS, June 2003, at 42, 44. "At that time, the mass de-listing caused the number of securities quoted on the Pink Sheets . . . to surge from about 1,000 to 4,000." *Id.*

a highly regulated market, such as the registered exchanges or Nasdaq.”¹⁴⁸ Further, the Commission stated that the NASD was concerned that “where there is no public information available regarding a security, the broad-based automated display of quotations in that security creates an unjustified perception of reliability.”¹⁴⁹ The Commission approved the eligibility rule because it ensured that there would be current publicly available information about OTCBB issuers, which “may help to reduce fraud and manipulation.”¹⁵⁰ One wonders why these concerns do not also apply to the Pink Sheets—did the NASD and the Commission simply change the venue for fraud and manipulation from the OTCBB to the Pink Sheets?

2. *Exchange Act Rule 15c2-11*.—Companies whose securities are quoted on the Pink Sheets do not have to be Exchange Act reporters or banking or insurance reporters. Moreover, in the case of a non-reporting company, the information available to investors may be quite limited because Rule 15c2-11¹⁵¹ only requires a broker-dealer to have a small amount of information (despite recent Commission attempts to expand Rule 15c2-11¹⁵²). As such, the Commission has observed:

With the exception of a few foreign issuers, the companies quoted in the Pink Sheets tend to be closely held, extremely small and/or thinly traded. Most do not meet the minimum listing requirements for trading on a national securities exchange Many of these companies do not file periodic reports or audited financial statements with the SEC, making it very difficult for investors to find reliable, unbiased information about those companies. For all of these reasons, companies quoted in the Pink Sheets can be among the most risky investments. That’s why you should take extra care to thoroughly research any company quoted exclusively in the Pink Sheets. Be aware that some broker-dealers are required by [SEC] Rule 15c2-11 . . . to have some information about the issuer. Ask your broker-dealer whether it has any Rule 15c2-11 information before you invest.¹⁵³

Rule 15c2-11 requires a broker-dealer to have in its records the “paragraph (a) information” specified in the rule before it publishes any quotation for the issuer’s security in any quotation medium other than a national securities

148. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1 To Be Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Microcap Initiatives—Amendments to NASD Rules 6530 and 6540, Exchange Act Release No. 34-40878, 64 Fed. Reg. 1255, 1256 (Jan. 8, 1999).

149. *Id.*

150. *Id.* at 1257.

151. 17 C.F.R. § 240.15c2-11 (2005).

152. See *infra* notes 318-47 and accompanying text.

153. Securities and Exchange Commission, Pink Sheets, <http://www.sec.gov/answers/pink.htm> (last visited Jan. 5, 2006).

exchange or NASDAQ.¹⁵⁴ Further, the broker-dealer must, based upon a review of that information along with any other documents and information required by subsection (b) of Rule 15c2-11, have a “reasonable basis under the circumstances” for believing that the information is “accurate in all material respects” and that the sources of the information are reliable.¹⁵⁵ For a private issuer that has not filed a Securities Act registration statement within the past ninety days or a Regulation A offering statement¹⁵⁶ within the last forty days,¹⁵⁷ the paragraph (a) information includes: (1) “the nature of the issuer’s business”; (2) “the nature of products or services offered”; (3) “the nature and extent of the issuer’s facilities”; (4) the names of the CEO and directors; and (5) “the issuer’s most recent balance sheet and profit and loss and retained earnings statements” and “similar financial information for such part of the [two] preceding fiscal years as the issuer or its predecessor has been in existence.”¹⁵⁸

This information obviously pales in comparison to the extensive disclosures required by the Exchange Act. For example, although some financial statements are required, they need not be audited, reviewed, or even compiled by an accounting firm, let alone an accounting firm that meets the Exchange Act’s independence requirements.¹⁵⁹ Similarly, the requirements of information concerning “the nature of the issuer’s business” and “the nature of products or services offered” are quite vague when compared to extensive, specific disclosures required by Item 101 of Regulation S-K to be included in Forms 10-

154. 17 C.F.R. § 240.15c2-11. Although Pink Sheets is a “quotation medium” within the meaning of Exchange Act Rule 15c2-11(e)(1), the rule does not apply to securities that are listed on an exchange or quoted on NASDAQ. *See* Publication or Submission of Quotations Without Specified Information, Exchange Act Release No. 34-39670, 63 Fed. Reg. 9661, 9661 (Feb. 25, 1998) (to be codified at 17 C.F.R. pt. 240), 1998 WL 74890 [hereinafter 1998 Release].

155. 17 C.F.R. § 240.15c2-11(b).

156. *See generally* 17 C.F.R. §§ 230.251-.263 (2005).

157. *See* Exchange Act Rule 15c2-11(a)(1), (2)-(3), 17 C.F.R. § 240.15c2-11(a)(2).

158. Exchange Act Rule 15c2-11(a)(5), *id.* § 240.15c2-11(a)(5). More mundane information is also required, such as the issuer’s name, address and state of incorporation, the exact title and class of the security and its par value, and

whether the quotation is being submitted or published directly or indirectly on behalf of the issuer, or any director, officer or any person, directly or indirectly the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

Id. Subsection (b) requires that the broker-dealer possess (1) a record of the circumstances involved submitting the quotation, (2) certain information relating to any trading suspension order issued by the Commission with respect to any securities of the issuer or a predecessor during the past twelve months, and (3) “any other material information (including adverse information) regarding the issuer which comes to the broker’s or dealer’s knowledge or possession before the publication or submission of the quotation.” Exchange Act Rule 15c2-11(b), *id.* § 240.15c2-11(b).

159. *See generally supra* notes 39-41 and accompanying text.

K.¹⁶⁰ Further, Rule 15c2-11 does not apply to an unsolicited quotation (i.e., a quotation “solely on behalf of a customer . . . that represents the customer’s indication of interest and does not involve the solicitation of the customer’s interest”), subject to some qualifications.¹⁶¹

The “paragraph (a)” information must be made “reasonably available upon request to any person expressing an interest in a proposed transaction in the security” with the broker-dealer.¹⁶² Due to the rule’s “piggyback” provision,¹⁶³ however, it may be difficult for an investor actually to get the information. As the Commission observed in 1998: “This requirement may have little practical effect because only the first broker-dealer to publish quotations must have the information, and an investor might find it difficult to identify that broker-dealer. In fact, that broker-dealer may no longer be publishing quotations.”¹⁶⁴ Although the piggyback exception is based on the premise that “regular and frequent quotations for a security generally reflect market supply and demand and are based on independent, informed pricing decisions,” the effect of the exception is that the rule “is essentially limited to just the first broker-dealer publishing quotes.”¹⁶⁵ The result is that Rule 15c2-11 is badly flawed because neither the investor nor the registered representative of the broker-dealer will possess the required information in most instances.¹⁶⁶ Moreover, even if the piggyback exception does not apply, the investor will receive the information only if he or she asks for it.

Just as the content of paragraph (a) information is paltry compared to the information required of Exchange Act reporters, its timeliness could lag far behind that required of Exchange Act reporters. As discussed above, Forms 10-K (which contain annual financial statements) must be filed within ninety days after an issuer’s fiscal year and even sooner for accelerated filers.¹⁶⁷ Similarly, Forms 10-Q are due within forty-five days after the quarter, and sooner for accelerated filers.¹⁶⁸ By contrast, paragraph (a) information is only required to

160. 17 C.F.R. §§ 229.101, 249.310 (2005).

161. Exchange Act Rule 15c2-11(f)(2), 17 C.F.R. § 240.15c2-11(f)(2).

162. Exchange Act Rule 15c2-11(a)(5), *id.* § 240.15c2-11(a)(4).

163. See *infra* note 322 and accompanying text.

164. 1998 Release, *supra* note 154, at 9669.

165. Publication or Submission of Quotations Without Specified Information, Exchange Act Release No. 34-41110, 64 Fed. Reg. 11,124, 11,126 (Mar. 8, 1999) (to be codified at 17 C.F.R. pt. 240) [hereinafter 1999 Release].

166. As R. Cromwell Coulson of Pink Sheets, LLC, stated in a June 10, 2005, letter to the Commission, “the quoting broker-dealer is commanded by regulation to stuff the information into its files where, in all likelihood, it will never again see the light of day. Rule 15c2-11 is a rule of darkness.” Letter from R. Cromwell Coulson, CEO, Pink Sheets, LLC, to Jonathan Katz, Secretary, Securities and Exchange Commission (June 10, 2005), available at <http://www.sec.gov/rules/other/265-23/pinksheets061005.pdf> [hereinafter Coulson 2005 Letter].

167. See *supra* notes 81-84 and accompanying text.

168. See *supra* notes 81-84 and accompanying text.

be “reasonably current.”¹⁶⁹

Paragraph (a) financial statements are generally presumed reasonably current if the balance sheet is less than sixteen months old at the time of the quotation and the statements of profit and loss and retained earnings are for the twelve months preceding the balance sheet date.¹⁷⁰ If the balance sheet is six months or more old, the broker-dealer must also have statements of profit and loss and retained earnings for the period from the date of the balance sheet to a date within six months.¹⁷¹ With respect to other “paragraph (a)” information, it is generally presumed reasonably current if it is less than twelve months old.¹⁷² The end result is that Rule 15c2-11 information, although considered “reasonably current,” could be much, much older than Exchange Act information. For example, balance sheets could be up to sixteen months old and income statements (i.e., profit and loss statements) could be up to six months old.

3. *Pink Sheets Disclosure Policy*.—In an apparent effort to make more information about its issuers publicly available, the Pink Sheets recently adopted a disclosure policy (“Disclosure Policy”).¹⁷³ Although the actual text of the Disclosure Policy does not so indicate, it is only applicable to companies that have securities quoted on the Pink Sheets on an unsolicited basis¹⁷⁴ and that have not previously had securities listed on an exchange or quoted on the OTCBB.¹⁷⁵ Nevertheless, the “Pink Sheets encourages all issuers to make this information available to the public.”¹⁷⁶

169. Exchange Act Rule 15c2-11(a)(5), 17 C.F.R. § 240.15c2-11(a)(s) (2005).

170. *Id.* § 240.15c2-11(g)(1).

171. *Id.*

172. *Id.* § 240.15c2-11(g)(2).

173. Pink Sheets, Guidelines for Providing Adequate Current Information Pursuant to Rule 15c2-11 (Version 5.5, Dec. 29, 2005), http://www.pinksheets.com/otcguide/15c2-11_guidelines.pdf [hereinafter Disclosure Policy]. When it was first adopted in October 2004, it was only effective for companies whose securities would thereafter be quoted on the Pink Sheets. In February 2005, however, the Pink Sheets extended the Disclosure Policy to companies whose securities were quoted before October 2004. E-mail from Liz Heese, Issuer Services, Pink Sheets, LLC, to Michael K. Molitor, Assistant Professor of Law, Thomas M. Cooley Law School (Feb. 25, 2005, 08:01 EST) (on file with author).

174. This would mean that the informational requirements of Exchange Act Rule 15c2-11 are not applicable. See *supra* note 161 and accompanying text.

175. Press Release, Pink Sheets, LLC, New Disclosure Policy Effective February 15th for Issuers of Securities Quoted on an Unsolicited Basis (Feb. 15, 2005), available at http://www.pinksheets.com/about/pr_021405.jsp. It is unclear whether this would include securities that had been listed on NASDAQ. Perhaps the Pink Sheets meant to include NASDAQ within the meaning of an exchange in this context, particularly since NASDAQ requires issuers to meet listing requirements but the OTCBB does not.

176. *Id.* This press release continues:

If an issuer is quoted on an unsolicited basis, this means that the NASD has not cleared a market maker to enter a quote in the security pursuant to SEC Rule 15c2-11. Instead, a broker is relying on an exemption to the rule This exception has been used to

In addition, the Disclosure Policy indicates that the specified information must be available in four situations: (1) at the “time of initial quotation in the public markets,” (2) when the issuer’s insiders or affiliates are offering, buying or selling its securities, (3) when the issuer or affiliates are engaged in “promotional activities having the effect of encouraging trading of the issuer’s securities,” and (4) when securities initially sold in a private placement (i.e., restricted securities) become freely tradable.¹⁷⁷ As such, not all Pink Sheets issuers would be subject to the Disclosure Policy. For example, an issuer whose securities were once traded on NYSE but which determined to delist would not be subject to this policy because its securities were once listed on a securities exchange—no matter how long ago.¹⁷⁸ Moreover, other issuers would be subject to it only in the four situations described above.

The Disclosure Policy begins with a series of “general considerations,” one of which is that investors “should be provided with all ‘material’ information—the information . . . necessary to make a sound investment decision. The disclosure should enable an investor of ordinary intelligence and investment skills to understand the issuer’s business and prospects.”¹⁷⁹ To this end, the required disclosure should “generally” be less than ninety days old¹⁸⁰ and include “the issuer’s business plan—a full and clear picture of the issuer’s assets, facilities, properties, investments, management and other resources as well as a complete description of how they will be used to make profits.”¹⁸¹

The required contents of the Disclosure Policy are divided into two parts. The first essentially parallels, and elaborates to some extent, the requirements of Rule 15c2-11.¹⁸² The second part essentially mimics the required disclosures on Form 8-K by requiring the issuer to issue a press release within ten business days

trade securities of new issuers without any disclosure to the investing public. To address this situation, in October 2004, Pink Sheets revised our policy for brokers entering unsolicited quotes in a new security that has never been listed on an exchange or quoted on the OTCBB. We now require that prior to publication of an unsolicited quote in the Pink Sheets for such securities; the broker must ascertain that the issuer has made adequate current information publicly available on www.pinksheets.com. The information disclosure policy has been very successful at creating transparency of the basic information that investors trading in public markets deserve.

Pink Sheets is now extending the information disclosure policy to the issuers of securities in which unsolicited quotes were entered into the Pink Sheets prior to October 2004.

Id.

177. Disclosure Policy, *supra* note 173, at 1.

178. Exchange Act Rule 15c2-11 would apply, however.

179. Disclosure Policy, *supra* note 173, at 1.

180. *Id.*

181. *Id.*

182. *Id.* at 2-11; *see* 17 C.F.R. § 240.15c2-11 (2005). The Pink Sheets Disclosure Policy does not require information with respect to subsections (a)(5)(xiv) and (xv) of Rule 15c2-11.

after various events, as discussed below.¹⁸³

In its counterpart to Rule 15c2-11's requirement of information about the "nature of the issuer's business," the Disclosure Policy requires that the issuer discuss material events during the past three years.¹⁸⁴ Enumerated material events include bankruptcy or similar proceedings; material business combination transactions or any "purchase or sale of a significant amount of assets"; financing defaults; changes in control; recapitalizations, stock splits, and similar events; delisting of the company's securities from an exchange, NASDAQ, or the OTCBB; and any proceedings that could have a material effect on the issuer.¹⁸⁵ The Disclosure Policy requires the issuer to describe its business "so a potential investor can clearly understand it" and, "to the extent material to an understanding of the issuer," disclose matters such as affiliated companies, the "effect of existing or probable governmental regulations on the business," costs of environmental law compliance, and research and development expenditures.¹⁸⁶ The issuer must also disclose information about its investment policies, particularly with respect to real estate.¹⁸⁷

The portion of the Disclosure Policy that parallels Rule 15c2-11's requirement of information about the "nature of products or services offered," requires disclosure of the following items "so that a potential investor can clearly understand the products and services of the issuer": the issuer's products or services and their markets; its distribution methods; "competitive business conditions, the issuer's competitive position in the industry, and methods of competition"; the availability of raw materials; the issuer's dependence on major customers; intellectual property matters; and whether any government approvals are required.¹⁸⁸

Rule 15c2-11 simply requires the names of the issuer's CEO and directors.¹⁸⁹ However, the Pink Sheets Disclosure Policy greatly expands on this by requiring such information as employment histories for the past ten years, board memberships and "other affiliations" of not just the CEO and board members, but also many other related persons.¹⁹⁰ Furthermore, the issuer must disclose

183. Disclosure Policy, *supra* note 173, at 12-21; see 17 C.F.R. § 249.308 (2005). See generally *infra* notes 267-71 and accompanying text.

184. Disclosure Policy, *supra* note 173, at 3; see 17 C.F.R. § 240.15c2-11(a)(5)(viii).

185. Disclosure Policy, *supra* note 173, at 3-4.

186. *Id.* at 4-5.

187. *Id.* at 5.

188. *Id.* at 5-6; see 17 C.F.R. § 240.15c2-11(a)(5)(ix).

189. 17 C.F.R. § 240.15c2-11(a)(5)(ix).

190. Disclosure Policy, *supra* note 173, at 7. The Disclosure Policy notes that the "goal of this section is to provide an investor with a clear understanding of the identity of all the persons or entities that are involved in managing, controlling or advising the operations, business development and disclosure of the issuer, as well as the identity of any significant shareholders." *Id.* These persons could include executive officers, directors, general partners, investment bankers, promoters, control persons, legal counsel, accountants or auditors, public relations consultants, and "[any] other advisor(s) that assisted, advised, prepared or provided information with respect to this

whether any of these persons were involved in certain “bad boy” legal proceedings within the last five years.¹⁹¹ For the issuer’s accountant or auditor, the disclosure should “describe the responsibilities of the accountant and the responsibilities of management (i.e. who audits, prepares or reviews the issuer’s financial statements, etc.).”¹⁹²

Rule 15c2-11 requires the issuer’s most recent balance sheet and profit and loss and retained earnings statements and “similar financial information for such part of the two preceding fiscal years as the issuer or its predecessor has been in existence.”¹⁹³ The Pink Sheets Disclosure Policy adds to this in a number of respects. First, it requires that the financial statements be prepared in accordance with GAAP.¹⁹⁴ Second, it requires not just a balance sheet and income statement, but also statements of cash flows and changes in stockholders’ equity and notes to the financial statements.¹⁹⁵ Third, these financial statements “should” be provided for the most recent fiscal year and any interim quarters.¹⁹⁶ Annual financial statements won’t be considered “current” more than ninety days after the end of the following fiscal year; quarterly financial statements will not be considered “current” more than forty-five days after the end of the following quarter. Most importantly, however, the Disclosure Policy also notes that

financial statements should either be audited or contain a certification by the chief financial officer of the issuer, or any other person responsible for the preparation of such statements, that such statements, and the notes thereto, present fairly, in all material respects, the financial position of the issuer and the results of its operations and cash flows for the periods presented, [in accordance with GAAP].¹⁹⁷

Again, the Pink Sheets should be commended for taking this important step, particularly since it was under no obligation to do so. However, the Disclosure Policy contains serious flaws, both in terms of which issuers are subject to it and in terms of the information that it requires. These concerns are discussed in Part III below, which also presents several suggestions for an alternative approach.

II. HOW TO GO (OR STAY) PRIVATE

A. *In General*

Obviously, the Exchange Act imposes extensive disclosure obligations.

disclosure documentation.” *Id.* at 8.

191. *Id.* at 8-9. These provisions appear loosely based on Item 401(f) of Regulation S-K, 17 C.F.R. § 229.401 (2005).

192. Disclosure Policy, *supra* note 173, at 8.

193. 17 C.F.R. §§ 240.15c2-11(a)(5)(xii), (xiii).

194. Disclosure Policy, *supra* note 173, at 10.

195. *Id.* at 9.

196. *Id.*

197. *Id.* at 10.

Moreover, from the standpoint of the issuer's compliance team, the demands for disclosure and substantive conduct controls have increased substantially in recent years and show few signs of lessening in the future. It is thus not surprising that many public companies decided to go private after SOX.¹⁹⁸ Moreover, it is possible that the number of companies going private could substantially increase in the future as the magnitude of costs relating to SOX, particularly the Section 404 internal controls report, become more widely appreciated.¹⁹⁹

In this Article, "going private" or "going dark" refers to the situation where an Exchange Act reporting issuer terminates its reporting obligations by deregistering its securities under Sections 12(b) or (g) of the Exchange Act. This usually also involves the issuer's securities being delisted from an exchange or NASDAQ. But this does not necessarily mean that the issuer's securities will stop trading in all securities markets; indeed, many former Exchange Act companies have moved to the Pink Sheets to maintain a trading market for their securities.²⁰⁰

As such, laypeople may think that such a "dark" issuer is still a "true" public company because investors may purchase its securities in much the same manner they may purchase securities of Exchange Act reporters. However, the information that such an issuer is required to make public is dramatically less than what is required of Exchange Act reporters; thus, shareholders of issuers that have gone dark are at an extreme disadvantage in terms of their ability to access information about their investments. Although Part III of this Article examines some approaches for remedying this situation, it is helpful first to review how easily a public company can go private.

198. There are many good reasons to go private. It eliminates the expenses (e.g., accounting and legal fees) and management time involved in preparing Exchange Act reports. It also results in more privacy, as the issuer no longer must disclose the information required by the Exchange Act, much of which could be sensitive from a competitive standpoint. Going private also permits management to focus more attention on running the company, rather than on short-term concerns like stock prices. But going private can create disadvantages. The most obvious disadvantage is that, even if the issuer's securities are quoted on the Pink Sheets, they will probably be less "liquid" than when traded on an exchange or NASDAQ. Academic literature indicates that this loss of liquidity results in a decline in the value of the securities. *See generally infra* notes 232-41 and accompanying text. For a discussion of the economic consequences to issuers that are involuntarily delisted from an exchange or NASDAQ and whose securities are subsequently traded in an OTC market, see JONATHAN MACEY ET AL., *DOWN AND OUT IN THE STOCK MARKET: THE LAW AND FINANCE OF THE DELISTING PROCESS* (Nov. 2003, revised Mar. 2004), <http://www.haas.berkeley.edu/finance/delistings%20-%20Mar04%20draft.pdf>. Also, no longer being public will likely make it more difficult for the issuer to raise additional capital in securities offerings; borrow on favorable terms; or attract and retain personnel by using publicly traded stock, or options to acquire such stock, as a compensation device.

199. *See supra* notes 7-8 and accompanying text.

200. *See supra* notes 145-47 and accompanying text.

B. How to Terminate Exchange Act Reporting Obligations

If an issuer decides to go private, the exact process will depend on the nature of its shareholder base. A Section 12(g) registrant can deregister once there are fewer than 300 record shareholders of the registered class of securities.²⁰¹ As such, if an issuer that wishes to go private has more than 300 record shareholders, it must reduce this number below 300,²⁰² often by taking steps to “cash out” some shareholders.²⁰³

201. See *supra* notes 32-33 and accompanying text. Some practitioners refer to this rule as “500 going up, 300 coming down.” In some cases, “500 coming down” may be applicable. See *supra* note 32 for a discussion of Exchange Act Rule 12g-4, 17 C.F.R. § 240.12g-4 (2005).

202. From a practical standpoint, such an issuer should reduce the number of record shareholders far below 300, so as to guard against later becoming subject to the Exchange Act’s reporting requirements by having more than 500 shareholders of record. As discussed above, many shares are held in “street name,” which means that the number of record holders may be far below the number of beneficial holders. See *supra* notes 26-30 and accompanying text. After going private, those beneficial holders may request stock certificates for their shares, thereby becoming record shareholders. In sufficient numbers, this could cause the issuer to again cross the 500 record-shareholder threshold of Section 12(g).

203. Many devices may be used to eliminate a sufficient number of shareholders. See generally FRANKLIN A. GEVURTZ, CORPORATION LAW 729-32 (West Group 2000). For example, the issuer could engage in a reverse stock split, issuing one share in exchange for a number of shares calculated to eliminate enough shareholders to get below 300 record shareholders. If the split ratio chosen were say, 1-for-100, then each shareholder that owns 100 shares would receive one new share in exchange for his currently outstanding 100 shares. Shareholders with fewer than 100 shares would not receive new shares; instead, their shares would be redeemed for cash at a predetermined price, leaving them with no equity interest in the company and thus reducing the number of shareholders. Similarly, the issuer could engage in a merger with a newly formed entity, the terms of which provide that the issuer’s shareholders would receive cash for their shares while the owners of the new company—typically insiders of the issuer—would continue to own shares in the surviving entity. Another method is an issuer tender offer, whereby the issuer would offer to redeem its outstanding shares for cash. Tender offers could also be made by newly formed entities owned by insiders. Under Exchange Act Rule 13e-3, 17 C.F.R. § 240.13e-3, some of these transactions will require the issuer to file a Schedule 13E-3 if they have a reasonable likelihood or a purpose of causing any class of equity securities that is subject to Sections 12(g) or 15(d) of the Exchange Act to be held of record by fewer than 300 persons or causing any class of equity securities that is listed on a securities exchange or NASDAQ to no longer be listed. In addition, Exchange Act Rule 13e-4 requires that issuers that make tender offers for their own securities must make disclosures to their security holders that are substantially similar to the information that is required under Exchange Act Section 14(d) when a third party makes a tender offer for the securities. This information is normally contained in a Schedule TO that must be filed with the Commission. See General Instruction J to Schedule TO, 17 C.F.R. § 240.14d-100.

If a transaction is needed to reduce the number of record shareholders below 300 and the transaction will involve insiders remaining as equity holders, there are at least three more issues to be considered. Although these issues are beyond the scope of this Article, a few words about them

For issuers who are already below the 300-record-shareholder threshold, no such transaction is necessary. Going private in this situation involves two considerations. First, if the issuer's securities are listed on a securities exchange or NASDAQ, the issuer will need to abide by that organization's requirements to delist those securities. Second, it must follow the Commission's requirements in this area. These requirements are neither difficult nor time-consuming.²⁰⁴

1. *Voluntarily Delisting From NYSE.*²⁰⁵—The NYSE Listed Company Manual simply provides that an issuer may delist a security from NYSE after its board approves the action and the issuer furnishes NYSE with a certified copy of the board resolution.²⁰⁶ Thereafter, the issuer may file an application with the Commission to withdraw the security from listing on NYSE and from registration under the Exchange Act.

2. *Commission Requirements for Voluntarily Delisting from an Exchange and Deregistering Under Section 12(b).*—Until recently, Exchange Act Rule 12d2-2(d) provided that the issuer of a security listed on a national securities exchange could file an application with the Commission to withdraw the security

are in order. First, the applicable "appraisal rights" statute must be consulted because it may allow minority shareholders to demand the "fair value" of their shares if they must vote on the transaction. *See, e.g.,* MODEL BUS. CORP. ACT § 13.02 (1984). Second, there is a considerable body of case law concerning the rights of minority shareholders in "freeze-out" mergers and similar transactions. *See* GEVURTZ, *supra*, at 733-43. This means that the insiders may need to demonstrate that the issuer had a "business purpose" for the transaction and that it engaged in "fair dealing" and offered a "fair price" for the minority's shares. Finally, some states have anti-takeover legislation that may, among other things, limit the ability of an "interested" shareholder to engage in a transaction with the issuer within a specified period of time. *See, e.g.,* DEL. CODE ANN. tit. 8, § 203 (2005).

204. *See* David Alan Miller & Marci J. Frankenthaler, *Delisting/Deregistration of Securities Under the Securities Exchange Act of 1934*, INSIGHTS, Oct. 2003, at 7 ("An Exchange Act registered company with less than 300 record holders that wants to 'go private' need not engage in a complex, time consuming and expensive 'going private' transaction to avoid the costs of periodic reporting and compliance with Sarbanes-Oxley.").

205. Although there are several securities exchanges, this section considers only NYSE's delisting requirements. As a technical matter, because NASDAQ currently is not an "exchange," securities listed on it are registered under Section 12(g) rather than Section 12(b). *But see supra* note 16. NASDAQ allows an issuer to terminate its listing by written notice. NASDAQ Marketplace Rules, *supra* note 133, § 4480(b). The OTCBB does not have any formal procedures for delisting. *See* Miller & Frankenthaler, *supra* note 204, at 10.

206. NYSE, Inc., Listed Company Manual, *supra* note 16, § 806.02. This rule was amended in October 2003. At the same time, former NYSE Rule 500 was repealed. Previously, Rule 500 had required approval of a delisting decision by both the board and the audit committee, as well as the issuance of a press release and notice to the issuer's thirty-five largest institutional shareholders. The delisting would not be effective until at least twenty or up to sixty days after the date of the press release or the shareholder notice, whichever was later. Before 1999, Rule 500 had also required shareholder approval of a delisting decision. Board approval will always be required for such a major change in the company's status. Under the new rule, shareholder approval is not required, except where the issuer's charter documents provide otherwise.

from listing.²⁰⁷ The Commission would then publish notice of the filing in the *Federal Register*, and the notice would allow any interested party to submit to the Commission “all facts bearing upon . . . what terms should be imposed by the Commission for the protection of investors.”²⁰⁸ However, the Commission “rarely receive[d] comments on issuer withdrawal applications.”²⁰⁹ Also, although the Commission could have imposed terms on a delisting for the protection of investors, it rarely did so.²¹⁰ If the Commission approved the application after the comment period, typically twenty-one days,²¹¹ it issued an order delisting the securities.

In July 2005, the Commission adopted changes to Rule 12d2-2 designed to “streamline” the process of delisting securities from an exchange and removing them from Section 12(b) registration.²¹² For voluntary delisting applications, the issuer now must file a Form 25²¹³ with the Commission via EDGAR²¹⁴ to notify the Commission that a class of its securities has been delisted from an exchange and that it intends to deregister that class under Section 12(b). However, at least ten days before filing the Form 25 with the Commission, the issuer must notify the exchange of its intent to withdraw the security from listing and

207. 17 C.F.R. § 240.12d2-2 (2004) (as amended in 2005). Rule 12d2-2 also specifies the methods by which an exchange may delist a security where, for example, the security no longer meets the exchange’s listing criteria. However, this section focuses on a situation where the issuer is applying to voluntarily delist its securities from the exchange.

208. *Id.* § 240.12d2-2(d).

209. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-49858, 69 Fed. Reg. 34,860, 34,861 (proposed June 22, 2004) (to be codified at 17 C.F.R. pts. 232, 240, and 249). The Commission noted that it received one comment on a delisting application in 2003, three in 2002, and none in 2001. *Id.* at 34,865 n.66. In a later Release, the Commission noted that it had received two comments on delisting applications in 2004 and two comments to date in 2005. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-5202, 70 Fed. Reg. 42,456, 42,457 n.12 (July 22, 2005) (to be codified at 17 C.F.R. pts. 232, 240, and 249).

210. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, 69 Fed. Reg. at 34,865 n.66 (“[T]he Commission has not in recent years, imposed any conditions on the delisting applications it approved.”).

211. Miller & Frankenthaler, *supra* note 204, at 10.

212. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, 70 Fed. Reg. at 42,456. The changes will become operative on April 24, 2006.

213. Before these amendments, Form 25 was only required to be filed by exchanges, not issuers, in certain delisting situations. *See* Exchange Act Rule 12d2-2(a), 17 C.F.R. § 240.12d2-2.

214. Before these changes, Exchange Act Rule 12d-2 did not require EDGAR filings of delisting applications, although it appears to have been a common practice for issuers that proposed to voluntarily delist their securities to issue press releases to that effect. Also, Item 3.01(d) of Form 8-K (added in March 2004) requires disclosure of board actions that may cause securities to be listed from an exchange or NASDAQ. 17 C.F.R. § 249.308 (2005).

contemporaneously publish notice of its intentions via a press release and by a posting on its website (if it has one).²¹⁵ Also, if the issuer has not arranged for listing and/or registration on another exchange or for quotation of its securities in a quotation medium such as the Pink Sheets, the press release and website posting must so indicate.²¹⁶

Under the amended rule, the delisting would become effective ten days after the Form 25 is filed with the Commission, whereas the removal of the securities from registration under Section 12(b) of the Exchange Act would not become effective until ninety days after the filing (although the Commission could impose a shorter time period).²¹⁷ However, the amended rule would allow the Commission to delay these dates if necessary to protect investors.²¹⁸ As the Commission stated in 2004 when it proposed revisions to Rule 12d2-2, these amendments will “reduce uncertainty to issuers, exchanges, and the public as to the timing and status of a security because delisting and deregistration would be accomplished by the electronic filing of revised Form 25, instead of by Commission order.”²¹⁹

The Commission is correct that the revised process will provide more notice to investors, particularly by requiring an electronic filing and press release. Moreover, investors will know more precisely when the delisting will occur. However, it appears the Commission does not view delisting as terribly problematic for most contemporary investors. The Commission observed in its 2004 proposal that Rule 12d2-2 was adopted at a time

when delisting from an exchange had broad ramifications for shareholders, because of the lack of alternative markets. . . . While delisting can still have a major impact on an issuer and its shareholders, under the current market structure, delisting on one market does not necessarily mean that shareholders would be unable to trade an issuer’s securities in another market environment.²²⁰

Nonetheless, a former Exchange Act reporting company shareholder whose securities are now traded in a market “environment” that does not require

215. 17 C.F.R. §§ 240.12d2-2(c)2(ii), (iii). This posting must remain available until the delisting becomes effective. Subsection (c)(3) of the amended rule would require the exchange to post notice of receiving this information from the issuer on its website by the next business day.

216. *Id.*

217. *See* Exchange Act Rule 12d2-2(d)(1)-(2), *id.* § 240.12d2-2(d)(1)-(2). Subsection (d)(5) of the amended rule provides that the issuer’s duty to file reports under Section 13(a) of the Exchange Act would typically be suspended upon the effectiveness of the delisting, even though the deregistration would not take effect until later. *Id.* § 240.12d2-2(d)(5).

218. *See* Exchange Act Rule 12d2-2(d)(3), *id.* § 240.12d2-2(d)(3).

219. Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-49858, 69 Fed. Reg. 34,859, 34,862 (proposed June 22, 2004) (to be codified at 17 C.F.R. pts. 232, 240, and 249) (footnote omitted).

220. *Id.* at 34,861.

Exchange Act reporting would likely argue that this change has had “broad ramifications.”

3. *Voluntary Deregistration Under Section 12(g)*.—For an issuer with fewer than 300 record shareholders, deregistering under Section 12(g) is very easy: simply file a Form 15²²¹ with the Commission. This one-page form requires the issuer to specify the rule under which it is deregistering. This will often be Exchange Act Rule 12g-4(a)(1)(i), which allows for terminating the registration of a class of securities if the class is held by fewer than 300 record holders.²²² Although the deregistration typically is not effective for ninety days, Rule 12g-4(b) provides that the issuer’s duty to file periodic Exchange Act reports is usually suspended immediately.²²³

III. WHAT SHOULD BE REQUIRED OF NON-REPORTING PINK SHEETS ISSUERS?

A. *Why Require Information?*

It goes without saying that the federal securities laws are largely²²⁴ designed to ensure the flow of information about issuers to investors in the capital markets, whether in the context of a public offering of securities, as under the Securities Act, or on an ongoing basis, as under the Exchange Act. Many provisions can be seen as attempts to bolster public confidence in the capital markets and to level the playing field among investors.²²⁵ As commentators have observed,

221. 17 C.F.R. § 249.323 (2005).

222. 17 C.F.R. § 240.12g-4. For the corresponding rule to suspend the duty to file reports required by Section 15(d) of the Exchange Act, see Exchange Act Rule 12h-3(b)(1)(i), *id.* § 240.12h-3.

223. See *supra* note 205 for a discussion of how an issuer delists its securities from NASDAQ.

224. Commentators note that with SOX “Congress departed radically from its historical preoccupation of addressing investor protection via disclosure.” JAMES D. COX ET AL., *SECURITIES REGULATION* 9 (4th ed. 2004).

225. One former Commissioner asked us to imagine:

if each investor needed to decide for himself what disclosure was desirable and separately contracted for liability protection. The result would be . . . expensive chaos. Ultimately, investors would seek a system similar to what now exists with standard agreements, customary arrangements, and general terms and conditions. Anything else would be unworkable. Moreover, there are some investors who would not be able to contract very well, and because our society to a fair degree does care about others, legislation or rules would be enacted to protect the less sophisticated from those who would take advantage of them. Under our current regulatory structure, the result is that the SEC seeks, and imposes through regulation, what would be the collective contract of many disaggregated investors if there were an efficient mechanism for each to contract separately and well. In this manner, the SEC can be viewed as the collective bargaining agent for investors

Steven M. H. Wallman, *Competition, Innovation, and Regulation in the Securities Markets*, 53 *BUS. LAW.* 341, 351-52 (1998).

Congress settled on disclosure instead of substantive regulation in an attempt to prevent a repetition of the disastrous stock market abuses of the early twentieth century.²²⁶ Although this disclosure approach is firmly embedded in securities law despite ongoing academic criticism,²²⁷ a few words about some of its primary justifications are warranted.

One argument for mandatory disclosure is that information about issuers is useful to all market participants. Without mandatory disclosure, there would be wasteful duplication of efforts, as many market participants worked to uncover the same information about the same issuers. Requiring disclosure eliminates this problem to a large degree.

Another justification is that management of the issuer has an interest in disclosing (and emphasizing) good news about the issuer and suppressing bad news, and thus only would disclose favorable information without specific reporting obligations.²²⁸ Although some have argued that market forces would lead some, if not most, issuers to voluntarily adopt an evenhanded disclosure policy to gain the market's confidence,²²⁹ the prevailing view is that this carrot would not work without a stick (the threat of Commission enforcement and civil liability). The recent deluge of Commission enforcement cases concerning fraudulent disclosures or omissions supports this view. A related justification is that required disclosures allow shareholders to better monitor management's performance, thereby promoting the efficient allocation of capital to companies that perform well and away from companies that do not.²³⁰

226. See, e.g., COX ET AL., *supra* note 224, at 3.

227. See generally 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 179-223 (3d ed., rev. vol. 1998) (discussing and summarizing arguments for and against mandatory disclosure under federal securities laws); Sharon Hannes, *Comparisons Among Firms: (When) Do They Justify Mandatory Disclosure?*, 29 J. CORP. L. 699, 704-08 (2004) (same). Two well known law review articles addressing this topic are Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) and John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

228. Conversely, management could selectively release bad news for the purpose of driving down the price of the issuer's securities and then buying them at a discount.

229. 1 LOSS & SELIGMAN, *supra* note 227, at 187-89 ("In theory, it can be argued that a mandatory corporate disclosure system is unnecessary because corporate managers possess sufficient incentives to disclose voluntarily all or virtually all information material to investors. . . . [M]anagement in theory will seek to establish a reputation for honest and full disclosure in order to preserve its ability to sell securities in the new issues market." (footnotes omitted)).

230. See, e.g., Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 763-64 (1985) ("A primary objective of securities regulation is to promote informed investment decisions. When a person is confident that the information he possesses about the value of a security is complete and materially accurate, he either will be more willing to place capital at risk or will demand less compensation for assuming the risk. Because increased access to information facilitates capital formation and thus furthers economic growth, there is a prima facie justification for government intervention to promote that end." (footnotes

Fraud prevention is another reason to require disclosure.²³¹ With much less information available about non-reporting Pink Sheets issuers compared to Exchange Act issuers, one might expect a higher incidence of fraud involving Pink Sheets securities. Indeed, the lower rungs of the OTC market have long been regarded as dangerous for investors. As the report of the Twentieth-first Annual SEC Government-Business Forum on Small Business Capital Formation stated regarding NASDAQ's then-current plan to replace the OTCBB with the Bulletin Board Exchange ("BBX"):

The stock of many companies that currently trade on the OTCBB may become forced to trade in the Pink Sheets due to the inability of the

omitted)).

231. 1 LOSS & SELIGMAN, *supra* note 227, at 193 ("The mandatory corporate disclosure system was adopted because of widely held beliefs that securities fraud was prevalent and that state laws often could do little to prevent or punish it." (footnote omitted)). One common form of fraud involves the use of "shell companies," or companies with little or no operations and assets. As the Commission recently explained in a release proposing to prevent shell companies from using Securities Act Form S-8, the classic "pump and dump" scheme involving a shell company typically includes the following factors:

the shell company promoters issue large amounts of securities to themselves or designated nominees, sometimes using Form S-8; [t]he shell company acquires or is merged with a private business that the promoters claim has high growth potential; [i]nadequate information is available to investors regarding the post-transaction company; [t]he promoters "pump" up the price of the stock to investors through unduly positive press releases on the company and its prospects, exaggerated tout sheets, or fraudulent messages on the Internet; [t]he promoters use high-pressure tactics to get people to invest, and also engage in market manipulation to create artificial demand and artificially high prices for the stock of the company; and [t]he promoters "dump" their stock in the company by selling it at the artificially high prices their promotional activities have created, halt those activities and move on, allowing the price of the stock to sink in value in the hands of the investors who have been misled into purchasing it.

Use of Form S-8 and Form 8-K by Shell Companies, Securities Act Release No. 33-8407, Exchange Act Release No. 34-49566, 69 Fed. Reg. 21,650, 21,651 (proposed Apr. 21, 2004) (to be codified at 17 C.F.R. pts. 230, 239, 240, and 249) (footnotes and bullet points omitted); *see also* Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act Release No. 33-8587, Exchange Act Release No. 34-52038 (July 21, 2005), 70 Fed. Reg. 42,234 (July 21, 2005) (to be codified at 17 C.F.R. pts. 230, 239, 240, and 249).

Of course, a "pump and dump" scheme need not involve a shell company; many issuers with legitimate operations could use such a scheme, particularly if the issuer has a limited trading market and is not well known, as is typical of many non-reporting Pink Sheets issuers. *See generally* Securities and Exchange Commission, Pump&Dump.com: Tips for Avoiding Stock Scams on the Internet (Jan. 11, 2005), <http://www.sec.gov/investor/pubs/pump.htm>. Because issuers often rely on rumors about information that is not yet public, subjecting issuers to disclosure requirements will not prevent "pump and dump" schemes. However, subjecting issuers to periodic disclosure requirements could hamper the prevalence of these schemes.

issuing companies to meet the BBX listing standards. Once in the Pink Sheets, the issuing companies may no longer be required to be reporting companies under the 1934 Act. The more this group of companies . . . decides to drop out of the 1934 Act reporting system, the greater is the likelihood and potential for micro-cap fraud in their securities.²³²

Similarly, in a 1998 proposal to amend Exchange Act Rule 15c2-11, the Commission observed: "Without information, it is difficult for investors . . . to evaluate the risks presented by microcap securities. Investors consequently can fall prey to persons who make false representations and unrealistic predictions about these securities."²³³ These concerns become even more important as the Pink Sheets continues to grow, as it has in recent years.

Perhaps the most compelling reason to make disclosures mandatory is that it may benefit the issuer, and thereby the shareholders.²³⁴ Studies of the costs and benefits of mandatory disclosure requirements have been largely inconclusive, with some (hotly disputed) studies concluding that the securities laws have not resulted in any significant value to investors.²³⁵ However, the implementation of the NASD eligibility rule presented an opportunity to study the effects on a substantial number of issuers becoming subject to Exchange Act reporting requirements *en masse* (or choosing to move to the Pink Sheets instead).

A recently completed study found that more than seventy-six percent of the non-Exchange Act reporters that had been traded on the OTCBB before the eligibility rule chose *not* to become Exchange Act reporters and thus were removed from the OTCBB.²³⁶ This suggests that many firms find that the costs of Exchange Act disclosure outweigh the benefits. The study also found that these issuers (noncompliant firms) tended to be smaller than issuers that chose to become reporting companies (newly compliant firms) suggesting that a "consequence of mandatory SEC disclosures is to push smaller firms with lower

232. FINAL REPORT OF THE 21ST ANNUAL SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION (Feb. 2003), <http://www.sec.gov/info/smallbus/gbfor21.htm> [hereinafter FINAL REPORT]. This report also noted that replacing the OTCBB with the BBX would result in many "companies simply opting to continue trading in the Pink Sheets and to forgo any incentive to become reporting companies under the 1934 Act" and that "[h]istorically, companies have lost significant market value when forced to withdraw from the OTCBB and subsequently trade in the Pink Sheets." *Id.*

233. 1998 Release, *supra* note 154, at 9662.

234. See ENGEL ET AL., *supra* note 7, at 5 ("A large theoretical literature in accounting argues that firms can benefit by committing [in advance] to certain types of disclosure . . .").

235. See Bushee & Leuz, *supra* note 145, at 237-38 ("Early studies . . . conclude that the 1933 and 1934 Acts were of no apparent value to investors, but these findings have been repeatedly challenged . . .").

236. *Id.* at 235 ("We document that over 2,600 (or 76%) of the firms not previously filing with the SEC did *not* comply with the required disclosures and hence were removed from the OTCBB. Thus, for the vast majority of OTCBB firms, the costs of mandatory SEC disclosures appear to outweigh the benefits.").

outside financing needs into a less regulated market, rather than to compel them to disclosure.”²³⁷ However, the authors also found that the eligibility rule resulted in “positive abnormal returns” (measured around key dates as the eligibility rule was announced and phased in) for OTCBB firms that were already SEC reporting issuers (already compliant firms), which may be the result of external factors such as the reputation of the OTCBB as a whole being improved by the eligibility rule.²³⁸ The study found significantly lower returns for newly compliant firms than for already compliant firms;²³⁹ however, newly compliant firms experienced increases in liquidity that were “significantly larger than for the other groups.”²⁴⁰ Not surprisingly, noncompliant firms experienced “significantly negative abnormal returns” when they were removed from the OTCBB.²⁴¹

These results suggest that mandatory disclosure is a mixed bag for issuers—although it obviously entails costs, it can also result in significant benefits in terms of stock price and liquidity.²⁴² Clearly, many issuers that are not Exchange Act reporters would find that full Exchange Act reporting is too high a burden, regardless of possible benefits. On the other hand, requiring mandatory disclosures seems to produce positive results for issuers and investors, whether from a general belief that the market’s reputation has improved or otherwise. The trick, then, is to arrive at a disclosure regime that will produce these positive results without scaring too many issuers away. In other words, the goal is to increase benefits more than costs.

B. General Considerations

In determining what disclosures should be required of Pink Sheets issuers, several considerations should be kept in mind. First, any Pink Sheets issuer that is already an Exchange Act reporter should not be required to do anything

237. *Id.* at 261.

238. *Id.* at 235 (“We find positive abnormal returns for Already Compliant firms around key announcements and phase-in dates, suggesting positive externalities from the imposition of mandatory disclosures on other firms.”).

239. *Id.*

240. *Id.* at 236.

241. *Id.* at 235. Noncompliant issuers also experienced “significant and sustained decreases in all liquidity measures” after they were removed from the OTCBB. *Id.* at 236.

242. See also MACEY ET AL., *supra* note 198, at 5-6 (finding that delisting an issuer’s securities from a stock exchange due to its failure to maintain listing requirements is detrimental to both the issuer and its security holders, even when the issuer’s securities subsequently trade on the Pink Sheets, and arguing that “investors in delisted firms be provided with a ‘soft-landing’ in the form of an efficient alternative trading venue when these firms fail traditional listing requirements”). See generally Steven Huddart et al., *Disclosure Requirements and Stock Exchange Listing Choice in an International Context*, 26 J. ACCT. & ECON. 237, 260 (1999) (finding that “trading concentrates on high disclosure exchanges prompting exchanges to engage in a ‘race to the top’ in setting their disclosure requirements to maximize trading volume”).

more.²⁴³ Second, and most importantly, the amount of information about issuers should be sufficient to provide investors with a good basis for making investment decisions, without becoming an excessive burden on the issuer. If the burden is too high, it is likely that issuers will not comply, as demonstrated by the aftermath of the eligibility rule discussed above. As such, full Exchange Act reporting status is too high a burden, as evidenced by the many issuers that fled the Exchange Act after SOX.

Another concern involves the fact that whether an issuer's stock is quoted on the Pink Sheets is beyond its control. Thus, imposing disclosure requirements on all Pink Sheets issuers could in some cases be unfair, particularly because it would result in disclosure of sensitive financial and business information that issuers would prefer to keep out of the hands of their competitors. For example, consider the situation where Company A, a competitor of Company B, manages to acquire some Company B stock and then attempts to have it quoted on the Pink Sheets so that Company B would be required to divulge information to the public. Instead, any disclosure requirements that are imposed on Pink Sheets issuers should only apply if the issuer—or any affiliate of the issuer—has taken some steps to facilitate a market for the issuer's securities or otherwise availed itself of the capital markets. For issuers that have not done so, perhaps the current approach of Rule 15c2-11 is sufficient.

Another basic consideration is that if less informational and other requirements are imposed on Pink Sheets issuers than Exchange Act reporters, steps should be taken to make investors aware of this fact because some may think that the Pink Sheets is simply another securities market like NYSE or NASDAQ.²⁴⁴ Warnings delivered in a manner similar to penny stock disclosures may be helpful in this regard, as discussed below.²⁴⁵ In this vein, if an issuer refuses to comply with any disclosure requirements, as may occur where its securities are traded on the Pink Sheets without its involvement or blessing, or perhaps even over its objections, investor warnings are all that could likely be accomplished, short of refusing to allow that company to be traded at all. On the

243. Similarly, foreign issuers that are subject to disclosure requirements under the laws of their home country and domestic issuers that are banking or insurance reporters exempt from registration under Section 12(g) of the Exchange Act should not be required to do anything further, assuming that the information disclosed is reasonably available to the public.

244. As Professor Leuz observed, markets may want to consider establishing different "tiers" of disclosure levels, with the lower tiers featuring prominent "buyer beware" warnings. Knowledge Wharton, *Do High Regulatory Costs Force Public Firms to Go Private?*, Sept. 10, 2003, <http://knowledge.wharton.upenn.edu/index.cfm?fa=viewarticle&id=847> (website requires free registration). "This might strike a balance between the SEC's job of protecting investors and the desire not to overburden companies with regulations." *Id.* Apparently the Pink Sheets is contemplating a similar approach. See Dugan, *supra* note 123 (discussing the Pink Sheets' plans to create three different tiers of issuers, but noting that "it remains to be seen whether other issuers [will] jump to join" because "many are on the Pink Sheets because they don't want to disclose information").

245. See *infra* note 379 and accompanying text.

other hand, if an issuer is trading on the Pink Sheets as a result of its own (or its insiders') efforts, then it would seem reasonable to require the issuer to provide the information. Finally, in the past the Commission has suggested that Rule 15c2-11 information be available in an information "repository" to make it more accessible to investors and alleviate the burden on broker-dealers to provide the information to customers and others.²⁴⁶ Some suggestions toward this goal are discussed below.²⁴⁷

C. Information That Should be Required

The Exchange Act requires public issuers to disclose an enormous amount of information to the public. The history of the Exchange Act can be seen as the story of an ever-increasing list of required disclosures, each added for reasons that the Commission found compelling (even if some others would disagree). Indeed, a strong case can be made why each required item of information is important to investors. Nonetheless, this Article does not advocate imposing full Exchange Act reporting status on Pink Sheets issuers. Doing so would create too great a burden for these companies, many of which have taken steps to avoid the Exchange Act altogether.

Instead, a compromise should be reached to address the active and growing trading market for the securities of thousands of issuers for which little information is available. In this sense, requiring some additional information, and making it easier for investors to access this information, would be a step in the right direction. For these reasons, this Article advocates that the following information should be disclosed, as it is fundamental to an investment decision, yet does not go too far toward making Pink Sheets companies "minor league" Exchange Act reporters. A case can be made that additional information should be required; however, the following is intended to highlight major areas for consideration.

1. *Financial Statements and MD&A.*—Recent financial statements prepared in accordance with GAAP are probably the most important information for an investment decision. An investor obviously wants to know whether a company is profitable or not. However, Exchange Act Rule 15c2-11 permits financial statements that could be quite stale and that may not conform to GAAP.²⁴⁸ As such, annual and quarterly GAAP financial statements should be required within reasonable deadlines so that investors know the issuer's current results. Although audited financial statements are preferable, reviewed financial statements would also be acceptable, particularly if the issuer or the trading activity in its stock is sufficiently small. In addition, some management discussion of the financial statements and future trends and contingencies is warranted, but it need not be as detailed as the required MD&A portions of

246. See *infra* notes 340-45 and accompanying text.

247. See *infra* notes 359-73 and accompanying text.

248. 17 C.F.R. § 240.15c2-11 (2005); see *supra* notes 170-71 and accompanying text.

periodic Exchange Act reports.²⁴⁹ In addition to knowing whether the company is making money or losing money, an investor also should be entitled to an explanation why.

2. *Business Information.*—Information about the issuer's business activities; products or services; properties; and threatened, pending, and recently completed litigation is also vitally important. Unlike financial statements, however, it would not be helpful to require this information more than once annually, unless there is a material change. The disclosures required by the Small Corporate Office Registration ("SCOR") form, Form 1-A under Regulation A, or those required by the first part of the Pink Sheets Disclosure Policy (all of which are discussed below) would be appropriate mechanisms for disclosure of these topics, supplemented by current disclosures of significant interim events, along the lines of what Form 8-K requires.

3. *Management Information.*—Although information about an issuer's business and financial condition is important to an investor, information about its management and promoters is also vital; an investor should know who is running the issuer. To this end, information concerning the backgrounds (including any adverse information such as criminal convictions or regulatory proceedings) and experience, stock and option ownership levels, and compensation of the issuer's management and promoters should be available, along with information about transactions and other relationships between the issuer and its insiders.

4. *Material Current Events.*—Finally, an issuer should not wait until the due date of its next periodic report to disclose important events that could have a material, immediate impact on the issuer and the valuation of its securities. As such, current information about significant non-recurring events, such as some of the events that trigger the obligation to file a Form 8-K, should be required to some degree.

Again, all of this information could be much less extensive than what the Exchange Act requires, particularly with regard to management compensation issues, yet still provide an enormous benefit to investors. It is possible to arrive at a solution that balances the interests of investors with the interests of issuers.

C. Possible Disclosure Models²⁵⁰

1. *The Pink Sheets Disclosure Policy.*—The first candidate for a disclosure model is the Pink Sheets' Disclosure Policy itself. However, the Disclosure Policy has many defects. First, it only applies to issuers that have *not* previously had securities traded on an exchange, NASDAQ, or the OTCBB. This would

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

250. Another approach to be considered is found in Regulation D under the Securities Act, 17 C.F.R. §§ 230.501-.508 (2005), which requires that certain information be provided to persons who are not "accredited investors" in a Rule 505 or a Rule 506 offering. *Id.* § 230.502(b)(2)(i). These requirements are similar to Regulation A. 17 C.F.R. § 239.90 (2005). As such, Regulation D disclosures are not discussed further in this Article.

mean that quotations for the securities of a listed issuer that decided to “go dark” would never be subject to the Disclosure Policy and would instead only be subject to Rule 15c2-11 or nothing at all if they qualified for the “piggyback” exception or the unsolicited-quotation exception.²⁵¹

Second, the Disclosure Policy only applies to securities that are quoted on an unsolicited basis.²⁵² This seems puzzling at first because Rule 15c2-11 itself does not impose any informational requirements when the quote is unsolicited, seeming to reflect the idea that there is less risk of fraud and manipulation when an investor, not a broker, is the source of the interest in the security (although this does not protect the counter-party to the investor). On the other hand, an exception for unsolicited quotes could be abused and the issuers of securities that are quoted exclusively on an unsolicited basis may never have made *any* information public.²⁵³ Nonetheless, it is strange to require *more* information for unsolicited quotes. In any event, if the goal of reform is to create a more transparent market in Pink Sheets securities, it matters little whether a quote is solicited or unsolicited; an investor should be entitled to some information in all cases. Third, the Disclosure Policy applies only in certain situations, such as when the security is first quoted in the public markets or when the issuer’s insiders are offering, buying, or selling its securities.²⁵⁴ The Disclosure Policy is thus not *always* applicable, unlike Exchange Act reporting obligations.

Turning from coverage issues to substantive issues, the first part of the Disclosure Policy elaborates on the requirements of Rule 15c2-11²⁵⁵ and the second part functions much like Form 8-K.²⁵⁶ Generally speaking, the Disclosure Policy does well specifying the information required with respect to the issuer’s business, properties, and pending litigation, and in many instances looks much like a reworked version of portions of Regulation S-K. It also requires a great deal of information concerning the employment histories of executive officers, directors, and other insiders, as well as information about their stock ownership levels,²⁵⁷ and whether they have been involved in specified criminal or

251. See *supra* notes 174-78 and accompanying text.

252. See *supra* note 174 and accompanying text.

253. As the Commission noted: “The unsolicited status of the underlying customer orders would be called into question if a broker-dealer repeatedly publishes quotations on the basis of [the unsolicited order] exception.” 1998 Release, *supra* note 154, at 9669. The Pink Sheets website also observes: “Pink Sheets has become increasingly concerned that the unsolicited quote exception in Exchange Act Rule 15c2-11 is being abused by unscrupulous individuals to engage in questionable and possibly fraudulent activities” Pink Sheets, Quoting Pink Sheets Securities: Unsolicited Quotes, http://www.pinksheets.com/otcguide/brokers_index.jsp (last visited Jan. 16, 2005).

254. See *supra* note 177 and accompanying text.

255. See *supra* notes 184-97 and accompanying text.

256. See *supra* note 183 and accompanying text.

257. It is unclear whether any disclosure of options information would be required. However, page three of the Disclosure Policy does require information about options that have been granted within the past two years. Disclosure Policy, *supra* note 173, at 3.

disciplinary proceedings similar to those specified in Item 401(f) of Regulation S-K²⁵⁸ and Rule 262 of Regulation A.²⁵⁹

The Disclosure Policy also requires sufficient information with respect to financial statements. First, it requires that they be prepared in accordance with GAAP. Second, in addition to annual financial statements, it requires quarterly financial information, e.g., a balance sheet as of the end of the most recent quarter, as well as income, cash flows, and shareholders' equity statements for that quarter and the corresponding period in the prior year.²⁶⁰ Annual financial information will not be considered "current" more than ninety days after the end of the following fiscal year and quarterly financial information will not be considered current more than forty-five days after the end of the following quarter.²⁶¹ Third, the Disclosure Policy requires that the financial statements either be audited or the CFO or another person responsible for preparing the statements must certify that the statements present the issuer's financial position and results fairly, in all material respects.²⁶² This is a reasonable alternative to requiring audited financial statements, which involve much more expense and loss of management time than do reviewed financial statements.

The first part of the Disclosure Policy runs into problems, however, because it does not require anything resembling an MD&A section or any management compensation information (other than information about stock and options that were "issued for services" within the past two years).²⁶³ It is also vague in several instances. For example, it requires the issuer to "[d]escribe any relationships existing among and between the issuer's officers, directors and shareholders," without explaining what types of "relationships" are covered.²⁶⁴ Perhaps a better way to approach this requirement would be to borrow from Item 404 of Regulation S-K, which requires disclosures about a well-defined universe of related-party transactions and other relationships between the issuer and certain insiders.²⁶⁵ The Disclosure Policy also seems to require too much information in some places; for example, one wonders whether the ten-year employment history of the issuer's public relations consultants would really be useful information to many investors.²⁶⁶

The second part of the Disclosure Policy seems largely to be a "cut and paste job" that fails to take into account important differences between Exchange Act

258. 17 C.F.R. § 229.401 (2005).

259. 17 C.F.R. § 230.262 (2005).

260. Disclosure Policy, *supra* note 173, at 9.

261. *Id.* at 10.

262. *Id.* In addition, the Disclosure Policy provides that issuers "should," with respect to the entire contents of the policy, include a certification by appropriate officer(s) that "they have prepared or reviewed such information and the notes thereto, and the information is complete and presented fairly, in all material respects." *Id.* at 2.

263. *Id.* at 2-3.

264. *Id.* at 9.

265. 17 C.F.R. § 229.404 (2005).

266. *See* Disclosure Policy, *supra* note 173, at 7-8.

reporters and other issuers. For example, Item 15 of the second part of the Disclosure Policy requires information whenever the issuer's code of ethics that applies to its principal executive and financial officers and similar officers has been amended.²⁶⁷ However, a non-Exchange Act company that is not listed on an exchange or quoted on NASDAQ is not even required to have such a code of ethics in the first place. Similarly, Item 10 of the Disclosure Policy requires certain information when the issuer's principal independent accountant resigns or similar events occur.²⁶⁸ As with the code of ethics, however, a non-reporting Pink Sheets issuer is not required to have audited financial statements, or even an outside accounting firm (although it may voluntarily).²⁶⁹

This is not to say that the second part of the Disclosure Policy does not require disclosure of important information. However, it does seem overbroad in terms of what information it requires; it clearly would benefit from careful tailoring to take into account the peculiarities of non-reporting issuers.²⁷⁰ Perhaps a better approach would be to require the disclosures that Form 8-K required *before* SOX, which largely concerned changes in control, acquisitions, or dispositions of significant amounts of assets; bankruptcy and similar proceedings; changes in accountants (assuming the company has outside accountants); and resignations of directors.²⁷¹ Such events are tremendously important to investors. The same cannot be said of all of the disclosures required by the current version of Form 8-K, at least insofar as smaller issuers are concerned. This approach would also have the benefit from the issuer's perspective of keeping required disclosures to a more manageable level.

2. *Regulation A Disclosures.*—Disclosure for non-reporting Pink Sheets issuers could alternatively be modeled on Regulation A requirements. Regulation A²⁷² establishes an exemption from registration under the Securities Act for certain public offerings of securities by eligible non-public issuers.²⁷³ Regulation A specifies many conditions the issuer must meet, including filing a Form 1-A offering statement with the Commission, the “qualification” of which is required before sales may be made.²⁷⁴ In this way, Regulation A establishes a “mini-registration” process—the information it requires is much less onerous

267. *Id.* at 20-21.

268. *Id.* at 16-17.

269. *See id.* at 10. Similarly, Items 4 and 5 of the second part of the Disclosure Policy concern certain off-balance sheet arrangements, disclosure of which was required for public companies by Section 401 of SOX but perhaps are less likely to apply to many small companies. *Id.* at 13-15.

270. Another problem is that the Pink Sheets Disclosure Policy omits important guidance. For example, Item 3 of the second part requires information when the issuer has completed the acquisition or disposition of a “significant” amount of assets, without defining that term, unlike the specific guidance given in Item 2.01 of Form 8-K. *See id.* at 13.

271. *See* 17 C.F.R. § 249.308 (2003).

272. 17 C.F.R. §§ 230.251-.263 (2005).

273. *Id.* § 230.251(a). The usual dollar limit on a Regulation A offering is \$5 million. *Id.* § 230.251(b).

274. *Id.* § 230.251(d)(2).

from the issuer's perspective than a Securities Act registration form.

Form 1-A allows an issuer to choose between disclosure alternatives, including Model A and Model B.²⁷⁵ With respect to non-financial information, Model A requires the issuer to answer a series of questions about various aspects of its business and the proposed offering.²⁷⁶ Model B requires similar information but allows the issuer to present it in a more "traditional" prospectus format.²⁷⁷ Form 1-A seems well designed to require much of the information that is crucial to an investment decision, as identified above.²⁷⁸ Specifically, a sufficient—but not onerous—amount of information is required about the issuer's business activities, properties, pending litigation, management and promoter backgrounds, stock and stock option ownership levels, compensation, and related-party transactions.²⁷⁹

Form 1-A also requires GAAP financial statements.²⁸⁰ For most issuers this will be a balance sheet ninety or fewer days old,²⁸¹ and statements of income, cash flows, and stockholders equity for each of the two fiscal years before the recent balance sheet, as well as any interim period between the most recent fiscal year end and the most recent balance sheet date.²⁸² The financial statements need not be audited, but if the issuer has audited financial statements it must provide them.²⁸³ Model A of Form 1-A also requires a brief "Management's Discussion

275. See Form 1-A, 17 C.F.R. § 239.90 (2005), available at <http://www.sec.gov/about/forms/form1-a.pdf>.

276. *Id.* at 4-21.

277. *Id.* at 22-30.

278. In addition, much like Securities Act Rule 408, 17 C.F.R. § 230.408, with respect to registered offerings, Rule 252(a) provides that Regulation A offering statements must include "any other material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." *Id.* § 230.252(a).

279. Form 1-A, *supra* note 275.

280. *Id.* at 30.

281. *Id.* The Commission may permit older balance sheets (up to six months old) upon a showing of "good cause." *Id.* In addition, if the filing is made more than ninety days after the issuer's most recent fiscal year, a balance sheet as of the end of the most recent fiscal year must be included. *Id.*

282. *Id.* Part F/S further requires that:

Income statements shall be accompanied by a statement that in the opinion of management all adjustments necessary for a fair statement of results for the interim period have been included. If all such adjustments are of a normal recurring nature, a statement to that effect shall be made. If otherwise, there shall be furnished as supplemental information . . . a letter describing in detail the nature and amount of any adjustments other than normal recurring adjustments entering into the determination of results shown.

Id.

283. However, if audited financial statements are filed, the qualifications and reports of an independent auditor must comply with the requirements of Article 2 of Regulation S-X, 17 C.F.R. § 210.2-01-07 (2005). Form 1-A, *supra* note 275, at 30.

and Analysis of Certain Relevant Factors,” in which the issuer answers a series of questions.²⁸⁴ Although not nearly as extensive as an MD&A section in an Exchange Act report, this information would nonetheless be very useful to an investor when evaluating an issuer’s financial statements. For example, it requires the issuer to describe any trends in its financial results and, if the issuer has experienced losses from operations, to explain why and describe the steps that it is taking to address these problems.²⁸⁵

3. *SCOR Disclosures*.—Another potential model for disclosure for non-reporting Pink Sheets issuers is the Small Corporate Offering Registration (SCOR) form, Form U-7, the most recent version of which was approved by the North American Securities Administrators Association in 1998.²⁸⁶ This form, which a substantial majority of states have adopted,²⁸⁷ is typically used to register a federal Rule 504 offering under state “blue sky” laws, meaning that the offering is limited to \$1 million in any twelve-month period.²⁸⁸ As commentators put it: “SCOR has fashioned a balanced approach between ‘full’ disclosure, as defined by SEC registration forms and rules relating to disclosure, and sufficient information to protect investors under most circumstances by providing a uniform form to reduce the costs of compliance without sacrificing investor protection.”²⁸⁹ As with Form 1-A, the SCOR form requires a reasonable amount of information about the issuer, its business activities, its management, and similar matters.

As for financial statements, the SCOR form usually requires a balance sheet as of the end of the most recent fiscal year,²⁹⁰ statements of income, cash flows and stockholders’ equity for the most recent fiscal year (or such shorter period as the issuer has been in existence), and statements of income and cash flows for any interim period at least as current as the end of the issuer’s most recent third fiscal

284. Form 1-A, *supra* note 275, at 21.

285. *Id.*

286. See North American Securities Administrators Association, Form U-7 (Sept. 28, 1999), available at www.iid.state.ia.us/docs/scor_form.pdf [hereinafter SCOR Form].

287. See generally Hugh H. Makens & Willie R. Barnes, *Blue Sky Developments Part II: Small Corporate Offering Registration—Form U-7*, REGULATION D OFFERINGS AND PRIVATE PLACEMENTS (2004), available at SK066 ALI-ABA 371 (Westlaw). This Article was included in a book of materials for seminars sponsored by the American Law Institute and the American Bar Association in 2004, beginning on page 233; the electronic version has different pagination.

288. 17 C.F.R. § 230.504 (2005). It has also been accepted by the Commission for Regulation A offerings and offerings of up to \$5 million registered on Securities Act Form SB-1. Makens & Barnes, *supra* note 287, at 237, *375.

289. Makens & Barnes, *supra* note 287, at 237, *375.

290. North American Securities Administrators Association, NASAA Small Company Offering Registration (SCOR) Manual 95 (Sept. 28, 1999), available at http://www.iid.state.ia.us/docs/scor_man.pdf. If the effective date of the registration is within forty-five days after the issuer’s fiscal year end, then the balance sheet may be as of the end of the prior fiscal year; however, in that case the issuer must also include a balance sheet at least as current as the end of its most recent third fiscal quarter.

quarter.²⁹¹ Financial statements must be prepared in accordance with GAAP.²⁹² Interim financial statements may be unaudited.²⁹³ Annual financial statements must be audited; however, if certain conditions are met, they may instead be reviewed.²⁹⁴

The SCOR form, much like Model A of Form 1-A, features a fill-in-the-blank and question-and-answer format.²⁹⁵ Instead of a full MD&A section, the issuer answers a series of questions concerning its financial health.²⁹⁶ Although the form seems designed for relatively new and small companies, its format is likely more beneficial to prospective investors than a traditional prospectus because "just by including the question, [it] provides information to the reader, regardless of whether the corresponding answer is affirmative or negative."²⁹⁷

4. *Which Disclosure Model is the Best?*—Each of the Pink Sheets Disclosure Policy, Form 1-A, and SCOR generally requires reasonable amounts of information, subject to some deficiencies. However, because each of these possible disclosure models has advantages and disadvantages, one designing a disclosure regime for non-reporting Pink Sheets issuers would do well to borrow ideas from all of these forms.²⁹⁸ For example, the question-and-answer format of Model A of Form 1-A and the SCOR form is attractive because it would alert investors to the *absence* of certain information, and issuers would likely find it easier to complete a standardized form.²⁹⁹

As for financial statements, the Pink Sheets Disclosure Policy seems the best approach, largely because it contemplates ongoing financial disclosures, unlike Form 1-A and the SCOR form.³⁰⁰ First, it requires that the financial statements be prepared in accordance with GAAP and that annual financial statements either be audited or include a management certification.³⁰¹ Second, it requires all of the usual financial statements (balance sheet, income statement, cash flows statement and shareholders' equity statement) and specifies reasonable deadlines for them (ninety days after the

291. *Id.* at 95-96.

292. *Id.* at 96.

293. *Id.*

294. *Id.* These conditions include (1) the amount of the offering does not exceed \$1 million, (2) the aggregate amount of all previous sales of securities by the issuer (with exclusions for certain debt securities) did not exceed \$1 million, and (3) the issuer has not been previously required under federal or state securities laws to provide audited financial statements in connection with a sale of its securities. *Id.*

295. SCOR Form, *supra* note 286, at 1-36.

296. *Id.* at 17-19.

297. Makens & Barnes, *supra* note 287, at 237, *375.

298. Many portions of Form 1-A and the SCOR form that concern offering-specific information such as use of proceeds would obviously not be well-suited for a periodic disclosure document unrelated to a specific securities offering.

299. To be fair, the Pink Sheets Disclosure Policy also requires issuers to "provide a response to each Item and sub-item . . . and include in their response whether a particular Item is not applicable or the information is unavailable and the reason it is not applicable or unavailable." Disclosure Policy, *supra* note 173, at 2.

300. *Id.* at 9-10.

301. *Id.*

end of the year or forty-five days after the end of the quarter).³⁰² Two slight modifications borrowed from Form 1-A may be warranted, however. First, if an issuer has audited financial statements, it should be required to provide them. Second, interim financial statements should be accompanied by a statement of management regarding any necessary adjustments.³⁰³

The Pink Sheets Disclosure Policy, however, does not require any MD&A-style discussion. Comparing Form 1-A to the SCOR form, SCOR's requirements in this area seem preferable because they are slightly broader than Form 1-A.³⁰⁴ Although these requirements are much less detailed than Item 303 of Regulation S-K, both Form 1-A and the SCOR Form nonetheless ask important questions about trends in the issuer's historical operating results and, if applicable, steps the issuer is taking to address losses from operations.

Finally, the Pink Sheets Disclosure Policy is the only one of these three approaches that requires information about non-recurring events that affect the issuer, such as in a Form 8-K.³⁰⁵ This is obviously because the other two forms are directed at specific points in time (i.e., the time of a securities offering) rather than ongoing disclosure obligations. As discussed above, however, one would do well to model such disclosures after the pre-SOX Form 8-K rather than the second part of the Pink Sheets Disclosure Policy.

The above comparison of the strengths and weaknesses of the different approaches, although helpful in the abstract, obviously is not intended as a definitive guide to create a disclosure form for Pink Sheets issuers. Indeed, any attempt to do so would result in a level of detail far beyond what is useful in an article such as this. Instead, it identifies some major themes and concerns to facilitate the task of future regulators. Again, the overall goal is to ensure that a sufficient amount of important information is available to investors without overburdening issuers.

*E. Possible Approaches to Implementing Disclosure Requirements*³⁰⁶

In June 2005, R. Cromwell Coulson, the CEO of the Pink Sheets, wrote a letter

302. *Id.* Given that many Pink Sheets issuers are likely to be less well-staffed than larger companies, perhaps longer deadlines would be in order.

303. *See supra* note 282.

304. *Compare* SCOR Form, *supra* note 286, at 17-19, with Form 1-A, *supra* note 275, at 21.

305. Disclosure Policy, *supra* note 173, at 12-21.

306. Another possible approach would be to amend state laws to require greater informational requirements for issuers incorporated or organized in the state. However, the fact that there are fifty states would mean that the laws of each state would need to be amended to achieve uniformity. Political realities being what they are, it is unlikely that a uniform approach could be adopted in a significant number of states. Any state that did not adopt such laws, or that adopted less demanding laws, may receive an influx of corporations reincorporating there, given that a corporation may incorporate in any state even if it has no operations there. States eager to supplement governmental revenues through the collection of corporation franchise fees would likely engage in a "race to the bottom" to encourage corporations to reincorporate there to take advantage of favorable disclosure laws, or lack thereof.

to the Commission's Advisory Committee on Smaller Public Companies³⁰⁷ in which he stated that the "current regulation of non-reporting issuers is woefully deficient and fails to protect investors" and urged the committee to consider steps to remedy this problem.³⁰⁸ Mr. Coulson argued that non-Exchange Act companies should have reporting obligations (1) when insiders are trading securities in the public markets and (2) when "the issuer is conducting promotional activities intended to encourage public trading in its securities."³⁰⁹ He also argued that the Commission should establish a website where this information could be easily available.³¹⁰ Mr. Coulson further wrote that the Commission should abandon its efforts to achieve similar goals by amending Rule 15c2-11 (which in its current form places the information-gathering burden on broker-dealers) and instead place "the responsibility and burden of continuing disclosure where it belongs—on issuers."³¹¹

Although there is much to admire about Mr. Coulson's proposals,³¹² one should note that they would result in a non-reporting Pink Sheets issuer having disclosure obligations only sporadically, i.e., when its insiders are trading the issuer's shares or the issuer is engaged in "promotional activities" to encourage trading by others. With respect to the first of these circumstances, Mr. Coulson argues that it is based on a "fundamental principle of market fairness: The uninformed may trade with the uninformed, those who are informed may trade with each other, but the informed may not trade with the uninformed."³¹³ Obviously, allowing trading by well-informed insiders in the absence of publicly available information about the issuer would violate the last aspect of this principle.

But should the securities laws allow the uninformed to trade Pink Sheets securities with the uninformed? As an initial matter, this is not the approach that the Exchange Act takes with respect to reporting companies. The Exchange Act requires an enormous amount of information to be made public—and it requires this information on an ongoing basis regardless of whether the issuer's insiders are trading its securities or the issuer is encouraging others to do so. In other words, the Exchange Act gives every investor the tools always to be "informed." Second, Mr. Coulson argues that buyers and sellers who have equal access to information (or perhaps *no* information), will set a fair price although "[i]t may not be the correct

307. *See infra* note 357.

308. Coulson 2005 Letter, *supra* note 166, at 1.

309. *Id.* at 6-7.

310. *Id.* at 2. As to this point, Mr. Coulson bemoaned the fact that although Rule 144 under the Securities Act, 17 C.F.R. § 230.144 (2005), requires that there be publicly available information about an issuer before an insider or a holder of restricted securities may sell the issuer's securities pursuant to the rule, the Commission has not clarified how this requirement can be met in the case of a non-Exchange Act issuer. *Id.* at 8 n.11.

311. Coulson 2005 Letter, *supra* note 166, at 6.

312. Another excellent proposal that Mr. Coulson made is that NASD Rule 2460, which prohibits broker-dealers from receiving fees for assisting issuers in gathering the required Rule 15c2-11 information, should be rescinded. *See id.* at 5. As a result of this rule, unregulated entities such as public relations firms, step in to fill this void—and receive fees for doing so. *See id.*

313. *Id.* at 7 (emphasis omitted).

price.”³¹⁴ Although this may be true from a philosophical standpoint, it begs the question—why not require continuous information so that investors are able to set the “correct” price or some approximation of it?

Mr. Coulson argued that at times other than the two situations described above, “the benefits of . . . disclosure do not justify its costs” because “the cost of being a reporting issuer is now prohibitive” after SOX.³¹⁵ In other words, Mr. Coulson may believe that the only alternatives available to the Commission are (1) continuing with the status quo, which is not desirable or (2) the prohibitively costly alternative of requiring non-reporting Pink Sheets issuers to become full-blown Exchange Act registrants.³¹⁶ However, it is possible for the Commission to revise its rules to require non-reporting Pink Sheets issuers to make periodic disclosures if they have purposely availed themselves of the public markets and—most importantly—tailor the disclosure obligations of such issuers so that they are far less onerous than what is required by the Exchange Act.³¹⁷ This Article now turns to considering the means to do so.

1. *Pink Sheets Disclosure Policy.*—The first and most obvious approach to making more information about Pink Sheets issuers that are not Exchange Act reporters available to the public is the Pink Sheets Disclosure Policy. Assuming that its coverage were broadened to include all Pink Sheets issuers that are not Exchange Act reporters and to apply at all times, a few additional problems come to mind. First, as an unregulated entity, nothing requires the Pink Sheets to receive Commission approval of any rule changes or to submit proposed rule changes to a public comment process, as is required for Commission and SRO rules. For example, if the Pink Sheets finds that the Disclosure Policy is sufficiently objectionable to the users of its services (i.e., broker-dealers who will likely not want to comply with the detailed requirements of the Disclosure Policy when entering unsolicited quotes), it could terminate it. Second is the issue of whether the Pink Sheets is sufficiently staffed to ensure compliance with its rules. Further, the Pink Sheets has no authority to impose fines on those who do not follow its rules—its only recourse for a violation would be to discontinue the quotation of an issuer’s securities or to prevent a broker-dealer from using the Pink Sheets’ services. Finally, although perhaps unlikely, nothing would prevent a competitor of the Pink Sheets—one that did not share its commitment to investor protection and periodic disclosures by issuers—from setting up shop and enticing brokers and issuers to use its services.

2. *Amending Rule 15c2-11.*—One way to increase the level of information that is required of Pink Sheets companies would be to amend Rule 15c2-11. As discussed above, this rule specifies the information that a broker-dealer must have in its records before it publishes any quotation for a security in a quotation medium such as the Pink Sheets.³¹⁸ Desirable changes to Rule 15c2-11 would include increasing the amount of information required about issuers, making it easily available to investors,

314. *Id.*

315. *Id.* at 13.

316. *See id.*

317. *See infra* notes 357-58 and accompanying text.

318. *See supra* notes 151-72 and accompanying text.

eliminating the “piggyback” exception, and shifting the burden of gathering the information from broker-dealers to issuers. In fact, in 1998 and 1999, the Commission proposed similar changes to Rule 15c2-11.³¹⁹ But more than six years have now passed without any amendments to Rule 15c2-11 resulting from these proposals.³²⁰

The Commission made the 1998 proposal “in response to increasing incidents of fraud and manipulation in the over-the-counter securities market involving thinly traded securities of thinly-capitalized issuers.”³²¹ The 1998 proposal concerned several changes to Rule 15c2-11, including eliminating the “piggyback” provision,³²² expanding the information required about non-Exchange Act issuers,³²³ increasing investor access to the information required by the rule, and requiring broker-dealers

319. See 1998 Release, *supra* note 154; 1999 Release, *supra* note 165.

320. The comment period with respect to the 1999 proposal expired on May 8, 1999. See Extension of Comment Period: Reproposed Rule: Publication or Submission of Quotations Without Specified Information, Exchange Act Release No. 34-41261, 64 Fed. Reg. 18,393 (April 14, 1999). *But see* FINAL REPORT, *supra* note 232 (suggesting certain changes to Rule 15c2-11).

321. 1998 Release, *supra* note 154, at 9661.

322. Subsection (f)(3) of the rule, colloquially known as the “piggyback” provision, basically provides that the informational requirements of the rule do not apply when the security has already been the subject of quotations, even by other brokers, over specified periods of time, usually thirty days, before the current quotation. 17 C.F.R. § 240.15c2-11(f)(3) (2005). As the Commission explains, this provision “is grounded on the assumption that regular and frequent quotations for a security generally reflect market supply and demand forces based on independent, informed pricing decisions.” 1998 Release, *supra* note 154, at 9663. In 1991, the Commission attempted to remove the piggyback provision, but was met with resistance from the brokerage community, which argued that eliminating the provision would discourage market-making for non-NASDAQ OTC securities. See *id.* (discussing Initiation or Resumption of Quotations Without Specified Information, Securities Exchange Act Release No. 34-29094, 56 Fed. Reg. 19,148 (April 25, 1991), and Initiation or Resumption of Quotations Without Specified Information, Securities Exchange Act Release No. 34-29095, 56 Fed. Reg. 19,158 (April 25, 1991), and noting that the “vast majority” of commenters opposed the proposed change, arguing that it would “discourage, or even eliminate, market making for many non-Nasdaq OTC securities”). In the 1998 release, the Commission argued that eliminating the piggyback provision was an “essential step to preventing microcap fraud. . . . [R]esponsible broker-dealers would be deterred from publishing quotations if they were aware of basic information about the issuer that suggested a possible fraud.” *Id.* at 9663-64.

323. The Commission also proposed minor changes to the information required about other types of issuers, such as clarifying that Exchange Act reporting issuers must be current in their Exchange Act reporting. 1998 Release, *supra* note 154, at 9665. Although at least one commenter had suggested that this problem could be solved by marking quotations of delinquent reporters to indicate that current information about the issuer was unavailable, the Commission did “not view this alternative as responding adequately to the problem of active trading facilitated by priced quotations without current information. Moreover, that approach would remove an incentive that delinquent issuers may have to provide current information to their shareholders and the marketplace.” *Id.*

that publish priced (as opposed to unpriced³²⁴) quotations for a security to obtain and review updated information about the issuer annually.³²⁵

For U.S. non-reporting issuers, the Commission proposed revising Rule 15c2-11 to require expanded information about the issuer's outstanding securities and capital structure; its control persons (e.g., criminal and other disciplinary actions within the past five years that may raise "red flags"); its financial statements (including a requirement that the financial statements comply with GAAP); and "significant events" involving the issuer within the past two years, such as mergers, acquisitions or dispositions of assets, and changes in control.³²⁶ The Commission stated that these amendments would provide broker-dealers with a "greater understanding of the issuer's operations and a better indication of whether potential or actual fraud or manipulation may be present."³²⁷

Although Rule 15c2-11(a)(5) requires that paragraph (a) information be made available by the broker-dealer to any person expressing an interest in a transaction in that security with the broker-dealer,³²⁸ the piggyback provision essentially means that only the first broker-dealer to publish quotations for the security needs to have the information, making it difficult for most investors to obtain the information.³²⁹ As such, the Commission proposed to impose this requirement on *every* broker-dealer that published a quotation for the security.³³⁰ However, to ease the burden of eliminating the piggyback provision and expanding the information required of non-Exchange Act reporting companies, the Commission suggested establishing a repository of information about non-Exchange Act reporters, as discussed further below.³³¹ It seems that the Commission had in mind something similar to its EDGAR system,³³² but privately run.

The 1998 proposal met with resistance from the brokerage community, resulting in the Commission's release in 1999 of a scaled-back proposal which would have revised the rule to focus principally on priced quotations, but not unpriced quotations.³³³ The 1999 proposal would also have completely exempted certain

324. The Commission defined a priced quotation as a "bid or offer at a specified price" and an unpriced quotation as "any indication by a broker or dealer in receiving bids or offers from others or any indication by a broker or dealer that advertises its general interest in buying or selling a particular security." *Id.* at 9664 n.29.

325. The Commission defended this proposal by noting that a broker-dealer "should know if there is no current information about the issuer or if the current information reflects a significant change in the issuer's ownership, operations, or financial condition." *Id.* at 9664.

326. *Id.* at 9667.

327. *Id.* at 9671.

328. 17 C.F.R. § 240.15c2-11(a)(5) (2005).

329. *See id.* § 240.15c2-11(f)(3).

330. 1998 Release, *supra* note 154, at 9663.

331. *Id.* at 9670.

332. *See* 17 C.F.R. §§ 232.10-.501 (2005).

333. 1999 Release, *supra* note 165. The Commission noted that the 1998 proposal had generated 199 comment letters, the majority of which opposed many of the proposed changes. According to the Commission:

securities from Rule 15c2-11, including (1) securities of issuers with net tangible assets above \$10 million, (2) securities with a bid price of at least \$50 per share, and (3) securities with a worldwide average daily trading value of at least \$100,000 during each of the past six months.³³⁴ In the Commission's view, these securities are less "likely to be the subject of improper activities"³³⁵ and "applying the Rule to the securities of larger issuers [and] more liquid securities . . . is not directly related to microcap fraud concerns."³³⁶

It is obvious from the release that the Commission's focus was not improving the information available to investors but attempting to reduce microcap fraud; the Commission began the release by saying it "has made combating microcap fraud one of its top priorities"³³⁷ and seemed especially concerned that priced quotations lend an air of legitimacy to securities that could be the subject of a "pump and dump" scheme.³³⁸ In fact, the Commission noted that the overall purpose of Rule 15c2-11 was to "prevent broker-dealers from becoming involved in the fraudulent manipulation of OTC securities."³³⁹

Another aspect of these proposals is noteworthy. As noted above, Rule 15c2-11 currently requires a broker-dealer to make information available upon request to those who express an interest in a transaction in the security with the broker-dealer.³⁴⁰ Although the 1998 proposal would have required a broker-dealer to provide this information to anyone,³⁴¹ the 1999 proposal would have required the broker-dealer to provide it only to current or prospective customers, other broker-dealers, and information repositories.³⁴² However, if the information were on EDGAR or in such

Commenters also expressed views about the possibility of: reduced liquidity in covered OTC securities if broker-dealers stopped making markets; less transparent markets if broker-dealers did not publish priced quotes to avoid the annual review requirement; less competitive pricing for covered OTC securities; impaired access to capital by issuers; and increased compliance costs for broker-dealers. . . . Some commenters also remarked that the proposal would not stop microcap fraud, which, in their view, is really a sales abuse problem.

Id. at 11,126-27.

334. *Id.* at 11,127.

335. *Id.*

336. *Id.* at 11,128. The Commission estimated that these exceptions would apply to approximately ten percent of OTC securities. *Id.* at 11,128 n.25.

337. *Id.* at 11,125. Of course, these two goals are not inconsistent: more information means less possibility for fraud. However, excluding issuers with net tangible assets in excess of \$10 million from Rule 15c2-11 will not go a long way toward helping investors make better decisions with respect to such OTC securities. In addition, an issuer could engage in a reverse stock split to raise the price of its securities above \$50 and thus escape coverage.

338. *Id.*

339. *Id.* at 11,126.

340. 17 C.F.R. § 240.15c2-11(a)(5) (2005).

341. 1998 Release, *supra* note 154, at 9664-65.

342. 1999 Release, *supra* note 165, at 11,127.

a repository, the broker-dealer would not have an obligation to provide it.³⁴³ Furthermore, subsection (b)(3) of the revised version of Rule 15c2-11 proposed in 1999 would have provided that a broker-dealer would be deemed to have obtained the required issuer information if it obtained the information from an information repository.³⁴⁴ The Commission stated that acting as a repository “is not a function that we can assume at this time” and that the NASD had similarly declined such a responsibility; however, the Commission did note that it would encourage private-sector initiatives to create a repository that collects information about a substantial segment of issuers subject to Rule 15c2-11, maintains current and accurate information about such issuers, and charges reasonable fees for access to this information.³⁴⁵

Had they been adopted, the Commission’s proposals would have gone a long way toward making more information about non-reporting Pink Sheets issuers available to investors. First, the actual amount of information would have been expanded in many helpful ways. Second, the elimination of the piggyback provision and the creation of an information repository would have made it much easier for investors to actually obtain information. Furthermore, the proposals would have made it easier for broker-dealers to obtain the required issuer information, at least to the extent that such information was available on an information repository.

The exclusion of some issuers, such as those with net tangible assets in excess of \$10 million, would have been problematic, however, especially with respect to issuers that deregister under Section 12 of the Exchange Act and thereafter begin trading on the Pink Sheets, because these issuers would then be *completely* “dark.”³⁴⁶ Although the Commission’s proposals would have helped combat microcap fraud, these exclusions would have meant that many non-reporting Pink Sheets issuers would remain mysterious. Requiring more information about *all* non-reporting Pink Sheets issuers and making that information easily available to investors seems a better approach. Although these goals could be achieved through amendments to Rule 15c2-11, it is likely that the broader goal of making issuers responsible for providing the information—rather than making broker-dealers responsible for finding it—would require wholesale revisions to the structure of Rule 15c2-11. A simpler solution is proposed below.³⁴⁷

3. *Amending Rule 12g5-1 to Count Street Name Holders as Record Holders.*— Another possible solution to the current problem would be to amend Exchange Act

343. *Id.*

344. *Id.* at 11,142.

345. *Id.* at 11,134.

346. *See supra* notes 20-22 and accompanying text. An issuer must register its securities under Section 12(g) of the Exchange Act if, among other things, it has more than \$10 million in assets. Although an issuer could take steps to reduce the number of its record shareholders below 300 and then deregister under Section 12(g), it obviously would not also want to reduce its assets below \$10 million. Assuming that its assets remained at \$10 million or more, a former Section 12(g) registrant would escape Rule 15c2-11 completely under the Commission’s 1999 proposal. *See* 1999 Release, *supra* note 165, at 11,127.

347. *See infra* notes 357-58 and accompanying text.

Rule 12g5-1 to explicitly count “street name” holders as holders of record for purposes of Section 12(g). As discussed above, the current scheme only counts record shareholders (for the most part, those that hold actual stock certificates) and banks and brokerage firms as “record” holders, leading to substantial undercounting of the “true” number of beneficial shareholders in many companies.³⁴⁸ If all shareholders were counted, many companies would be prevented from deregistering under Section 12(g) because they would be deemed to have more than 300 shareholders.

In July 2003, several institutional investors filed a petition with the Commission requesting just such a change.³⁴⁹ In this petition, the applicants argued that Rule 12g5-1 is outdated:

The 38 years since Rule 12g5-1 was adopted have witnessed monumental changes in clearing and settlement procedures. The transformation of clearing and settlement procedures have [sic] caused, among many other things, a dramatic increase in the percentage of beneficial owners holding equity securities in street name. In contrast to conditions that prevailed in 1965, it is now unusual for a beneficial owner to appear on the corporate books as a holder of record or hold a stock certificate. As a result, Rule 12g5-1 fails to properly effectuate the Congressional intent expressed in Section 12 or the policy goals of the Exchange Act.³⁵⁰

Citing several examples of companies that had deregistered under Section 12(g) because they had fewer than 300 record shareholders (although some of them admitted having thousands of beneficial shareholders), and discussing in detail the rise of street name ownership since 1964, the petitioners argued that complete termination of Exchange Act reporting requirements for issuers that “go dark” would mean the loss of the “disinfecting benefits of public disclosure” that “enlighten these issuers’ footsteps.”³⁵¹ Instead, the petitioners argued, if relief from some aspects of SOX was necessary for small issuers, the Commission should continue “tailoring disclosure obligations to [the] special circumstances” of small companies.³⁵²

Despite this observation, if this proposal were adopted, companies that fled the Exchange Act after SOX would find themselves in exactly the same position that they were before: as an Exchange Act reporting company subject to the whole panoply of new SOX requirements.³⁵³ SOX did not create any middle ground for these

348. See *supra* notes 26-33 and accompanying text.

349. Nelson Petition, *supra* note 28.

350. *Id.*; see also MORGENSTERN & NEALIS, *supra* note 7, at 23 (noting that when Rule 12g5-1 was enacted “[t]he reasonable regulatory assumption was that 300 holders of record would be approximately equal to 300 beneficial owners” (footnote omitted)).

351. Nelson Petition, *supra* note 28.

352. *Id.*

353. Another objection to the petitioners’ arguments is that perhaps 500 should not be the “magic number” for Exchange Act registration if street name holders are included. As noted above, Section 12(g) was enacted in 1964. Given that the population of the United States and the percentage of households that own stock have both increased substantially since then, perhaps some

companies; they either agree to comply with the new rules or try to find a way to avoid them, such as by going private.³⁵⁴ Although the Commission has recognized that smaller companies should shoulder a somewhat reduced disclosure burden in light of their often limited resources, such as by adopting Regulation S-B and by establishing its Advisory Committee on Smaller Public Companies³⁵⁵ to study and recommend further changes for small public companies, there currently are few provisions in SOX or related Commission rules that make such a distinction. Doing so would likely require additional Congressional action, or at least very substantial revisions to the many Commission rules that have been adopted pursuant to SOX.

4. Requiring the Pink Sheets and Similar Markets to Register as Self-Regulatory Organizations.—The Pink Sheets is not registered with the Commission as an exchange, a broker-dealer, a securities information processor, an SRO, or a national securities association.³⁵⁶ Although the details of market regulation are beyond the scope of this Article and remain under constant reevaluation by the Commission, requiring the Pink Sheets (or any similar organization) to register as an SRO would

number higher than 500 should be the test for determining whether an issuer is “public.” A similar point was made by a subcommittee of the Commission’s Advisory Committee on Smaller Public Companies in December 2005 when it made a preliminary recommendation that beneficial holders should be counted for purposes of Section 12(g) of the Exchange Act, but that the number of holders required for registration should be increased from 500 to 1,000. Corporate Governance and Disclosure Subcommittee of the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, Preliminary Recommendations 2 (Dec. 7, 2005), available at <http://www.sec.gov/info/smallbus/acspc/pr-cgd.pdf> (last viewed Feb. 8, 2006). Although few are likely to argue that the Commission was not justified in increasing the measure of an issuer’s total assets requiring Section 12(g) registration from \$1 million in Section 12(g)(1) to \$10 million pursuant to Rule 12g-1, 17 C.F.R. § 240.12g-1 (2005), increasing the number of security holders on some sort of “human inflation” theory is more problematic. Are 500 investors less important today than they were in the past?

354. Indeed, the petitioners’ comments appear premised on the notion that Exchange Act reporting is the *only* way for investors to receive sufficient information. For example, in discussing an issuer that had deregistered under Section 12(g), the petitioners stated: “It is a cruel result, and contrary to the purposes of the Exchange Act, to deprive [shareholders] of their last remaining good opportunity to influence the management of their hard-earned investment dollars.” Nelson Petition, *supra* note 28, at 6. Other portions of the petition are equally alarmist with respect to the loss of full Exchange Act reporting status:

No longer confronting the scrutiny of informed investors, management may feel secure in its tenure, to the detriment of the thousands of public investors who can no longer rely on the federal securities laws to protect them from invidious or incompetent management behavior. Without the discipline imposed by public investors, scarce resources are unlikely to be applied by management to their most desirable uses, spreading negative consequences throughout the economy in derogation of the public interest.

Id.

355. See *infra* note 357.

356. See *supra* notes 120-21 and accompanying text.

bring at least a few benefits. First, it would subject it to Commission oversight and regulation. Second, it would require that all rules that the Pink Sheets proposes to adopt or amend be subject to public comment, a process that may result in better rules.

5. *Creating a New Category of Issuers.*—A new category of issuers should be created: issuers that are not Section 12 registrants, but whose securities are quoted with some specified level of regularity in markets like the Pink Sheets and that have taken some steps to facilitate a market for their securities. If this approach were adopted, it would have the benefit of flexibility. As discussed above, the Exchange Act and SOX are largely “one size fits all” and impose many requirements that are ill-suited to many Pink Sheets issuers, particularly small companies.³⁵⁷ Creating a separate set of disclosure requirements would allow the Commission to tailor requirements carefully to ensure a sufficient level of information, yet not require detailed disclosures that would overburden these issuers and result in negligible benefits to investors.

This result could be achieved by amending Exchange Act Rule 12g5-1. Instead of defining the number of an issuer’s holders “of record” for purposes of Section 12(g) of the Exchange Act solely in terms of record holders (as that term was understood in 1964) or solely in terms of beneficial holders (as proposed by the institutional investors discussed above), the Commission could amend the rule to provide for a novel two-tier approach. Specifically, if an issuer’s securities were listed on NASDAQ, the OTCBB, or another market that requires an issuer to register such securities under Section 12(g), then it would count only record holders. This would mean that all such issuers would be Section 12(g) registrants. However, the rule could further provide that an issuer that has fewer than 500 (or, for purposes of deregistration, 300) record holders and has taken affirmative steps, or whose insiders have taken such steps, to cause that class to be quoted on a market like the Pink Sheets that does not require Section 12(g) registration would be required to count the number of its beneficial holders—*unless* the issuer complies with the reduced reporting requirements described in this Article. Therefore, non-reporting Pink Sheets issuers would be required to comply with reporting requirements even though

357. The Commission recently established an advisory committee to study the impact of SOX and other federal securities laws on small public companies. One area that this committee, the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, will study is “corporate disclosure and reporting requirements and federally imposed corporate governance requirements for smaller public companies, including differing regulatory requirements based on market capitalization, other measurements of size or market characteristics.” Press Release, Sec. and Exch. Comm’n, SEC Establishes Advisory Comm. to Examine Impact of Sarbanes-Oxley Act on Smaller Public Co.’s (Dec. 16, 2004), *available at* <http://www.sec.gov/news/press/2004-174.htm>. The committee is to recommend changes in laws and regulations by April 2006. Securities and Exchange Commission Advisory Committee on Smaller Public Companies, Master Schedule 5 (Jan. 24, 2006), *available at* <http://www.sec.gov/info/smallbus/acspc/acspc-mastersched.pdf>. Because the committee is an advisory committee pursuant to the Federal Advisory Committee Act, 5 U.S.C. App. 1, it has no rulemaking authority. Instead, the decision whether to adopt any of the committee’s recommendations rests with the Commission.

they have fewer than the requisite number of “traditional” record holders under Section 12(g). At the same time, it would spare them from full blown Section 12(g) registration and give them an incentive to comply with these reporting requirements so that they do not have to register under Section 12(g). Exchange Act Section 12(g)(5) specifically provides that the “Commission may . . . define by rules and regulations the term[] . . . ‘held of record’ as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection.”³⁵⁸

F. Possible Disclosure Venues

Once it is decided exactly what information should be required of non-reporting Pink Sheets issuers and how to implement those requirements, the next question is *where* that information should be available. As an initial matter, it would be wise to require that this information be collected in a centralized location; requiring each issuer to post information on its own website would seem unworkable from a compliance monitoring standpoint and would relegate an investor to as many different websites as he has Pink Sheets investments, losing the “one-stop shopping” advantage of the other approaches discussed below.³⁵⁹

On the other hand, requiring issuers or broker-dealers to post the information on their own websites³⁶⁰ may be a good interim solution, as the exact requirements of many of the other approaches discussed below would likely take some time to develop and implement. This interim solution could be coupled with a requirement that each issuer periodically certify to the appropriate regulatory or other body, whether that would be the Pink Sheets, the NASD, or the Commission, that it has posted the required information.³⁶¹

358. 15 U.S.C.A. § 78l(g)(5) (West 2005).

359. Also, a company website will often contain “soft” information that could easily be confused with the “hard” information that is contained in periodic reports.

360. Specifically, if a broker-dealer recommends a transaction in an issuer’s securities and that issuer has not posted the required information on its own website, the broker-dealer should be required to post the information on the broker-dealer’s website. Although Rule 15c2-11 requires a broker-dealer in most cases to have certain information in its files, this information often does not reach the investor. *See supra* notes 154-55 and accompanying text. Whatever approach is undertaken to remedy this problem will also entail the broker-dealer having information about the issuer before recommending a transaction in the issuer’s securities. If the broker-dealer were required to post the information on its website when the issuer has not, the investor is much more likely to be able to access the information than it is under current practice.

361. A related provision should require broker-dealers to certify annually that they have sufficient procedures in place to ensure that the required issuer information has been made available for any Pink Sheets stocks that they recommend to customers. *Cf.* Order Approving NASD Proposed Rule Change Relating to Chief Executive Officer Certification and Designation of Chief Compliance Officer, Exchange Act Release No. 34-50347, 69 Fed. Reg. 56,107 (Sept. 17, 2004) (approving NASD rule that requires the CEO of each NASD member firm to certify annually that the firm has in place policies and procedures reasonably designed to achieve compliance with

1. *Pink Sheets Website*.—Following the adoption of its Disclosure Policy, the Pink Sheets has allowed issuers to post the information required by the policy directly on the Pink Sheets website. This approach has the advantage of putting all Pink Sheets issuers' information in the same place and also appears relatively easy for issuers.

2. *EDGAR*.—Another obvious possible venue is the Commission's EDGAR system, which is used for all documents that the Commission requires to be filed electronically, including nearly all Exchange Act reports.³⁶² There is much to admire about the EDGAR system, particularly since all documents filed via EDGAR are available on the Commission's website soon after they are filed and can be easily retrieved, free of charge. Moreover, all Exchange Act issuers' documents are available in one place.³⁶³ However, it is likely that many issuers, particularly small ones, will object to the expense involved in converting their reports, which are often done in standard word processing or spreadsheet programs, into the EDGAR format. Suffice it to say for purposes of this Article that one cannot simply press a button and have a document converted into EDGAR-ready format; rather, it requires specialized software and knowledge, which leads most filers to outsource the function to a third party such as a financial printer or a law firm. This outsourcing, of course, comes at a price.

3. *SEDAR*.—One intriguing approach comes to us from Canada: the System for Electronic Document Analysis and Retrieval ("SEDAR") system.³⁶⁴ SEDAR was established in 1997 "to make Canadian public securities filings easily accessible to all."³⁶⁵ It is essentially akin to the Commission's EDGAR system; all Canadian public companies electronically file required Canadian Securities Administrators documents and, in many cases, the documents that they file with Canadian stock exchanges, on SEDAR. These documents are usually available to the public on the SEDAR website within a day after they are filed.³⁶⁶ Unlike EDGAR, filing a document on SEDAR is relatively easy because all documents must be filed in Adobe PDF format, software which is widely available and does not require any special expertise for conversion.³⁶⁷ Moreover, it appears that the hardware requirements and

applicable rules and regulations, including federal securities laws).

362. Regulation S-T, 17 C.F.R. §§ 232.10-.501 (2005), contains the Commission's rules with respect to the EDGAR system. Rule 101 of Regulation S-T specifies which documents must be filed electronically, which may be, but are not required to be, filed electronically, and which can be filed only in paper format. *Id.*

363. *See generally* SEC, Search the EDGAR Database, <http://www.sec.gov/edgar/searchedgar/webusers.htm> (last visited Jan. 17, 2006).

364. *See generally* SEDAR Home Page, http://www.sedar.com/homepage_en.htm (last visited Jan. 17, 2006).

365. *Id.*

366. SEDAR Frequently Asked Questions, http://www.sedar.com/sedar/faq_en.htm (last visited Jan. 17, 2006).

367. *See id.* "In developing SEDAR, the Canadian Securities Administrators tried to balance the needs of filers seeking a way to efficiently file their documents on SEDAR against the desire to make the documents easily available to the public." *Id.*

initial software set-up to become a SEDAR filer are not unreasonably demanding. Although SEDAR does charge issuers fees for filing documents,³⁶⁸ whereas EDGAR does not,³⁶⁹ it is likely that the ease of SEDAR filing outweighs this cost.

SEDAR is also easy for investors to use because it requires only Internet access. The SEDAR website features profiles of each listed issuer, arranged in alphabetical order.³⁷⁰ These profiles contain general information about each issuer.³⁷¹ From that page, one can click a link to access all of the issuer's SEDAR filings, in reverse chronological order. These documents (at least those filed since September 1999) are in PDF format, meaning that they look the same as the original "hard copies" of the documents, and are searchable.³⁷²

In its releases concerning proposed amendments to Rule 15c2-11, the Commission suggested establishing a "repository" to collect and maintain current and accurate information about issuers subject to Rule 15c2-11.³⁷³ Today, it seems obvious that this repository would be Internet-based. Moreover, although this Article certainly does not comment on any technical requirements of such a website, SEDAR does present an attractive model, in that it is easy to use for both issuers and investors, it is free for investors and reasonably priced for issuers, and it retains EDGAR's centralized location advantage. Moreover, if something like SEDAR were used as an information repository for Pink Sheets issuers and were overseen by regulators (as opposed to the Pink Sheets or another private entity), it would have stability and regulatory advantages that may be lacking in a purely private-run enterprise. As such, in establishing the information repository that the Commission has long envisioned, one need look no further than SEDAR for a good template.

G. Disadvantages

In 1998 and 1999 when the Commission proposed increasing the amount of information required under Rule 15c2-11 and eliminating the piggyback exception, the result was a howl of protest from the brokerage community, which complained that such requirements would dry up the Pink Sheets market.³⁷⁴ If one accepts that

368. SEDAR filers are subject to two types of fees. The first is an annual "continuous disclosure fee" which ranges from \$495 (Canadian) for mutual funds to \$1595 for "multi jurisdiction issuers." The second is a per-document fee, which varies depending on the nature and length of the document. See generally SEDAR Filing Service Charges, http://www.sedar.com/pdf_files/CDSfees_E.pdf (last visited Jan. 17, 2006). In addition, the license fee for the SEDAR software is \$390, both initially and annually.

369. This should not be confused with the fact that some documents, such as Securities Act registration statements, require filing fees; these fees predate EDGAR and have nothing to do with the fact that the document is filed via EDGAR.

370. See SEDAR, Public Companies: A, http://www.sedar.com/issuers/company_issuers_a_en.htm (last visited Jan. 17, 2006).

371. *Id.*

372. *Id.*

373. See *supra* notes 340-45 and accompanying text.

374. See *supra* note 322.

claim, it would be naïve to believe that the approach advocated in this Article would not result in a similar protest. However, creating an information repository and the capability to monitor compliance by issuers could free broker-dealers from the obligation to independently determine that the required information is publicly available.

Another likely objection will be from issuers that would be subject to a new disclosure regime—particularly if they took steps to go private and avoid the Exchange Act and SOX. The response to this argument is that they should not be allowed to have their cake and eat it too. If they wish to remain “dark,” they may do so, especially since the Pink Sheets is not structured so that an issuer could prevent its securities from being quoted there. However, if an issuer or its insiders want to gain the benefit of a market for the issuer’s stock, then the issuer should be required to make the sacrifice of public disclosure of at least a modest amount of information.³⁷⁵

Another potential problem is that many issuers may simply refuse to comply.³⁷⁶ But this is also true for many Exchange Act companies that fail to file required reports. It is also true that broker-dealers may not utilize Rule 15c2-11 if the information required by that rule cannot be obtained. The response, then, would be to prohibit trading in a company’s securities if it is required to disclose information but fails to do so.

It should also be emphasized that the approach advocated by this Article would not by itself result in any regulatory review of the disclosures an issuer makes, unlike Exchange Act disclosures³⁷⁷ and Securities Act registration statements. Unless the Commission or some other regulatory body were to assume that task, one solution to this problem would be to ensure that investors understand that the information disclosed by an issuer has not been independently reviewed by regulators, as suggested in the following section. Another solution is to require standardized “fill-

375. One should also keep in mind that many issuers have bank financing, the terms of which ordinarily will require regular financial reports to the lender. As such, requiring that this information also be made public will likely not be unduly burdensome to many issuers. However, as discussed in *supra* note 302, perhaps the deadlines under the Exchange Act and the Pink Sheets Disclosure Policy for annual and quarterly financial statements (ninety days and forty-five days, respectively) should be extended.

376. Consider the attitude of one Pink Sheets company:

At the other end of that spectrum: Anderson-Tully, for which investors are currently bidding \$175,000 a share. Because it has fewer than 500 [record] shareholders, Anderson-Tully doesn’t file financial reports with the Securities and Exchange Commission. The company shares financial information only with shareholders. “We aren’t going to distribute the information publicly” to anyone who calls up and asks for it before they invest, explains Chip Dickinson, Anderson-Tully’s president.

Opdyke, *supra* note 123.

377. For example, 15 U.S.C.A. § 7266 (West 2005), added by Section 408 of SOX, requires the Commission to review, at least once every three years, disclosures made by Exchange Act issuers that are listed on a national securities exchange or NASDAQ “on a regular and systematic basis for the protection of investors.”

in-the-blanks” forms, which should be particularly helpful for small issuers that have not previously been subject to securities disclosure requirements and that may not engage counsel for assistance in completing the forms.³⁷⁸

H. A Final Note: Investor Warnings

The approach advocated by this Article would not require Pink Sheets companies to be full-fledged Section 12(b) or 12(g) registrants, nor would it require the Pink Sheets to adopt any quantitative or qualitative listing criteria. Although it would result in more information about Pink Sheets issuers that have voluntarily availed themselves of the capital markets being available to the public, it would not subject these companies to the many investor-oriented provisions of the Exchange Act, particularly as modified by SOX.

Will this confuse investors? Will investors be able to distinguish between “true” public companies and those that only seem to be? In a sense, these questions are unimportant because many investors in Pink Sheets companies may currently be unaware of this distinction. Nonetheless, it seems that if the approach advocated by this Article, or some similar approach, were adopted, the confusion would intensify. An issuer that now is required to publish documents that resemble Exchange Act reports in some superficial way may seem more like a public company than one that does not publish much information about itself at all. For this reason, another requirement that should be implemented is a “warning sign” to Pink Sheets investors.

What should be contained in this warning? It essentially should contain a statement that the issuer is not subject to the Exchange Act and the many investor protections that it contains. For example, the warning could state the following:

Attention Investors: Our company does not have securities that are registered under Section 12(b) or Section 12(g) of the Securities Exchange Act, nor does it have securities that are traded on a market that imposes listing criteria, investor-oriented protections or corporate governance requirements. As such, you should be aware that we are not subject to the following requirements that are imposed on such public companies (among others). Although we may *voluntarily* observe these requirements, we could discontinue doing so at any time:

- We are not required to file Forms 10-K, 10-Q, and 8-K and meet the detailed disclosure provisions of those forms. The forms that we file are much less detailed and less stringent.
- We are not required to file audited financial statements. Instead, we

378. Of course, this is no guarantee of compliance. A humorous example was given by Makens and Barnes: “The states have experienced a great deal of difficulty with officers of issuers attempting to fill out the forms without advice of counsel, with the result [of this] answer . . . List in order of importance the factors which the Company considers to be the most substantial risks to an investor in this offering Answer: NONE.” Makens & Barnes, *supra* note 287, at 241, *379.

may file "reviewed" financial statements.

- If we file audited financial statements, our CEO and CFO are not required to personally certify the accuracy of those financial statements.
- We are not required to have any "independent" members on our board of directors.
- We are not required to have an audit committee, a compensation committee, or a nominating committee whose members are "independent" of the company.
- We are not required to have a "financial expert" on our audit committee.
- Our accountants are not required to be "independent."
- We are not required to furnish an internal controls report.
- We are not required to have a code of ethics.
- Our shareholders, including insiders, are not subject to Section 13(d) or Section 16 of the Securities Exchange Act.
- We are not subject to the rules concerning the solicitation of proxies under Section 14 of the Securities Exchange Act.
- We are not required to maintain any level of liquidity for our shareholders.
- Neither the Securities and Exchange Commission nor any other regulatory body reviews the information that we disclose to determine that it is accurate or adequate.

This is not a complete list of the differences between our company and public companies. You should be aware that all investments entail risk. However, because our company is not subject to the requirements listed above, as well as others, an investment in our company may subject you to significantly more risk than other investments.³⁷⁹

These warnings should be included in whatever periodic reports may end up being required of Pink Sheets issuers. They could also be delivered to investors in much the same way that the penny stock rules require a Schedule 15G to be delivered

379. Obviously, such a warning would be tailored to the precise nature of the disclosure requirements imposed upon Pink Sheets issuers.

to investors;³⁸⁰ alternatively, broker-dealers could be required to refer investors to the warnings included in an issuer's reports whenever recommending a transaction in that issuer's securities. Furthermore, for issuers whose securities are involuntarily traded on the Pink Sheets and that choose not to comply with any disclosure requirements, the warning should also include information describing the dangers of investing in an issuer for which little public information is available.

CONCLUSION

A curious result of the Exchange Act's structure is that issuers with few record shareholders but whose securities are quoted on a market like the Pink Sheets are able to escape the detailed periodic disclosure requirements of the Exchange Act even if they have several thousand beneficial shareholders. Given the many developments since Section 12(g) was adopted more than forty years ago, current rules are not sufficient to ensure that adequate information about these issuers is available to investors. Current rules have also created a perverse incentive for many public companies to "go dark" in order to avoid the requirements of the Exchange Act and its ever-expanding requirements. The result is a trading market for many securities about which little is known outside Internet "chat rooms" and other unreliable sources.

This Article has pointed the way toward a solution to this problem that will provide more information to investors without unduly burdening issuers and their markets. Of course, many issuers, particularly those who have not voluntarily created a market for their securities, will object to any disclosure requirements whatsoever. It is true that we should not penalize such recalcitrant issuers, particularly if competitively sensitive business information must be disclosed. In that case, it would seem sufficient to adequately warn investors of the dangers that they face when they invest blindly. On the other hand, if an issuer or its insiders voluntarily takes steps to avail themselves of the benefits of having a market for their securities, it seems only fair that other shareholders and prospective investors be put on a more level informational playing field. Doing so will not only benefit investors, but it will also benefit issuers.

380. *See supra* note 114.

