

Berkeley Center for Law, Business and the Economy

Scaling Mandatory Disclosure in Both “Public” and “Private” Securities Markets

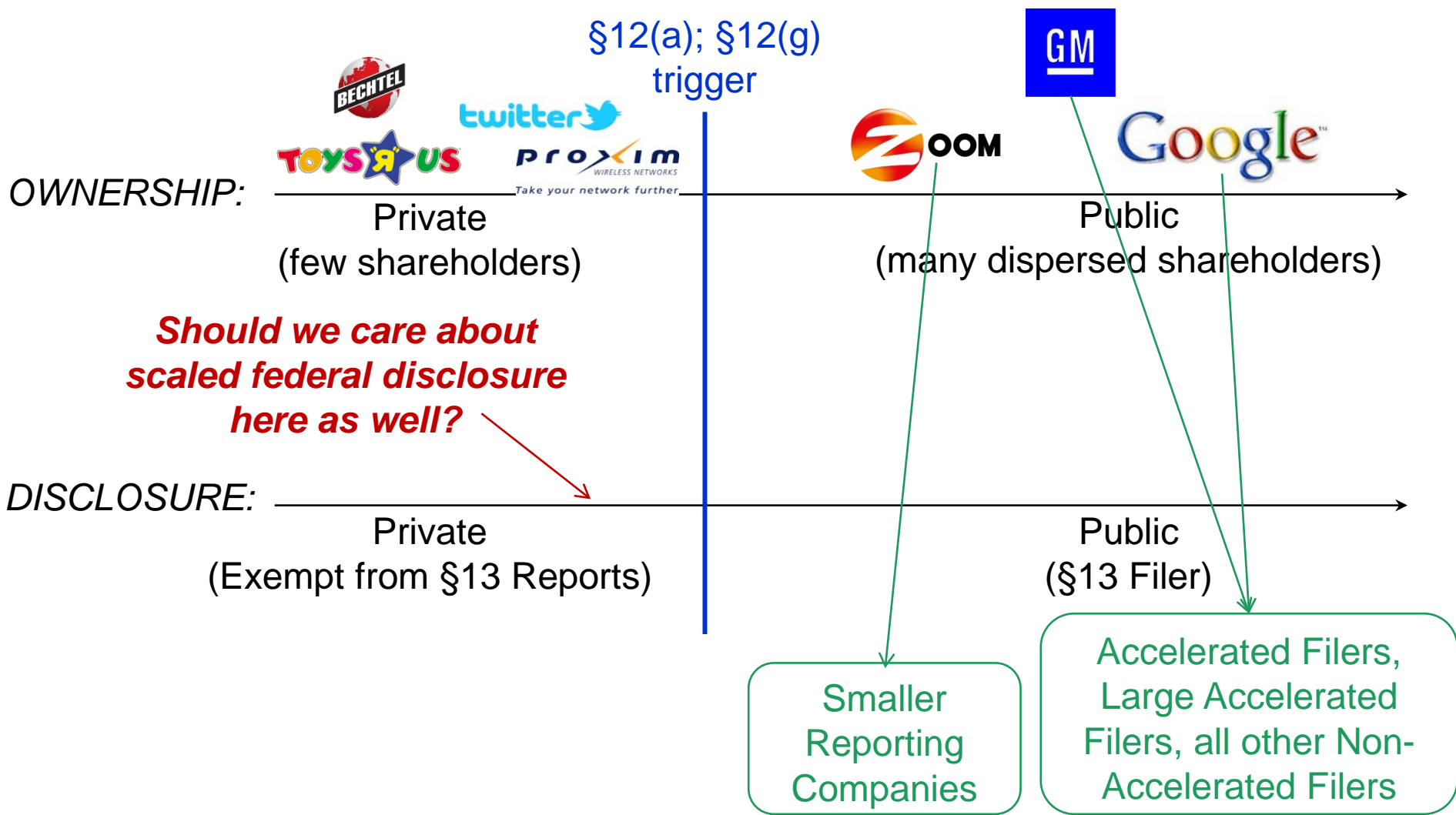
Robert Bartlett
UC Berkeley School of Law

September 7, 2012
Meeting of the SEC Advisory
Committee on Small and
Emerging Companies



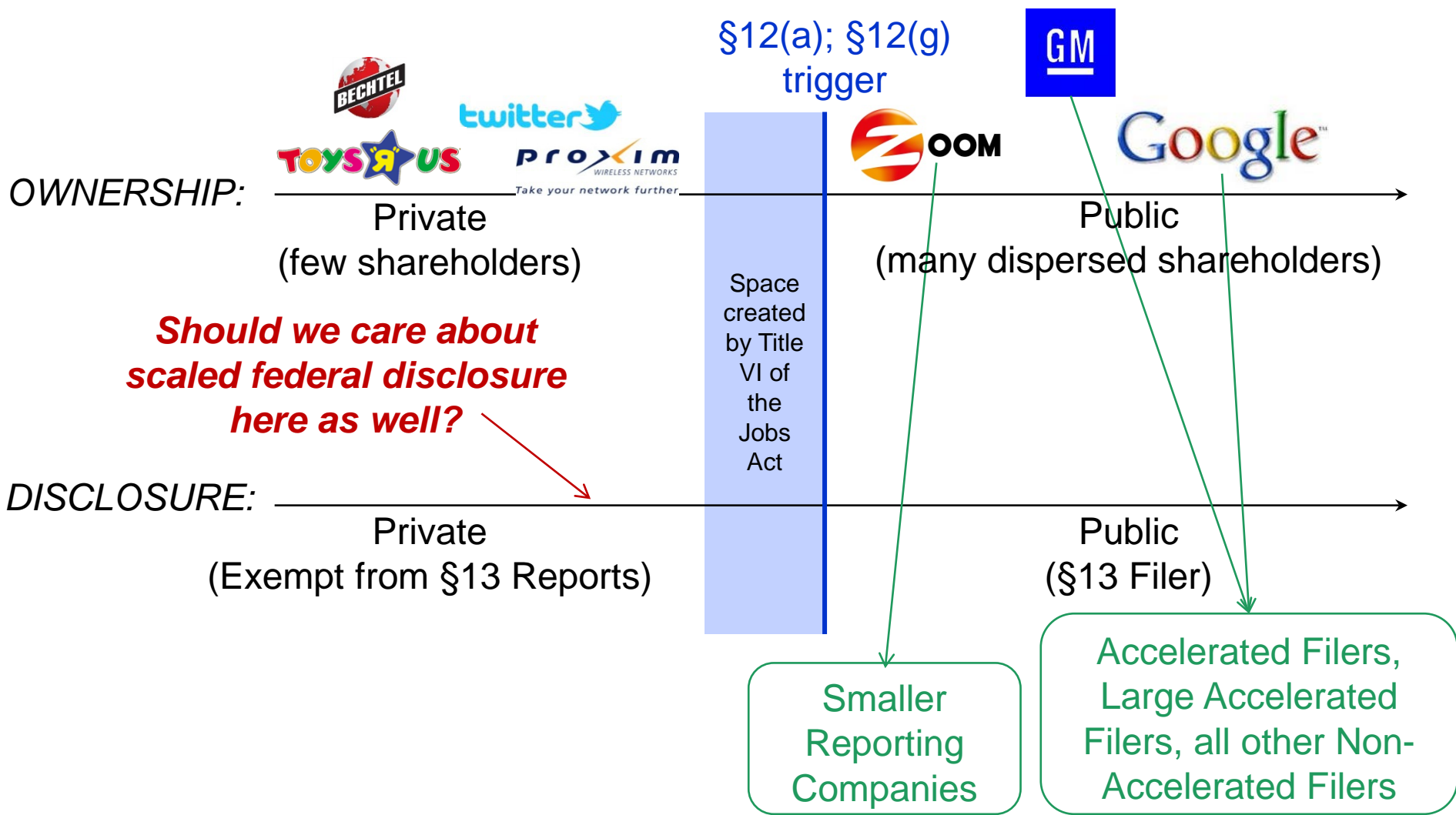
Introduction

- The conventional view of mandatory disclosure:



Introduction

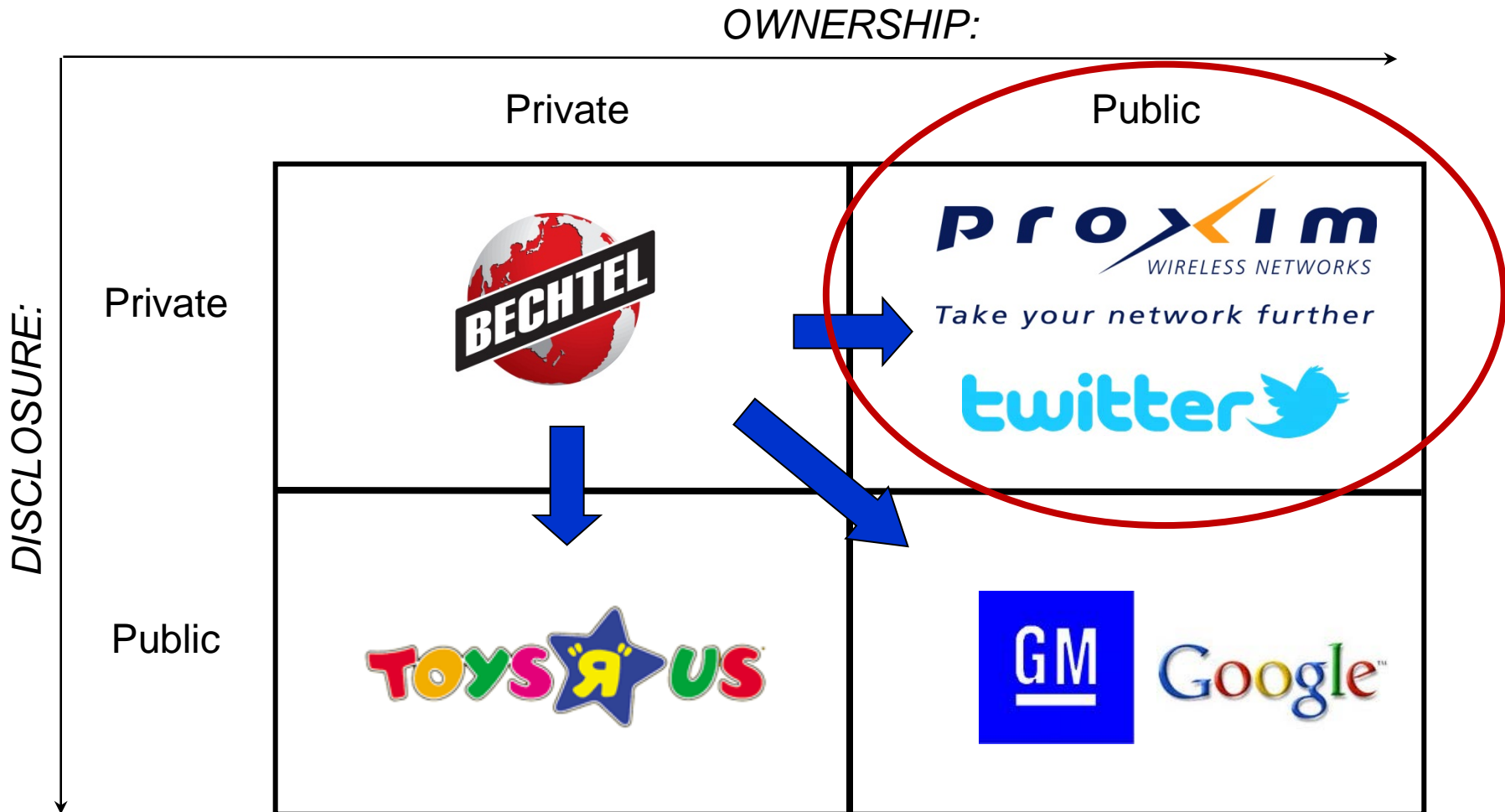
- The conventional view of mandatory disclosure:



Outline

- Existing mandatory disclosure obligations of “private” firms (ie, non-Exchange Act firms)
- Some problems with this state of affairs
- What the Commission can do about it

Existing mandatory disclosure obligations of “private” firms (ie, non-Exchange Act firms)





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

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Tue, Jun 5, 2012 01:10:16 PM

Most Active		Advancers		Decliners		Market Makers	
Symbol	Price	Pct Chg	\$ Volume	Share Volume	# Trades		
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1.55 0.00 (0.00%)	Previous Close 1.55	Daily Range N/A - N/A	Volume 0	Average Vol (3m) 444
Real-Time Best Bid & Ask 1.60 / 1.70 (1 x 1) <small>Why is size 1?</small>	Open N/A	52wk Range 6.01 - 1.30	Dividend N/A	Yield N/A

Trade Time May 30, 2012/ Last Best Bid & Ask Update Jun 1, 2012

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NITE	4.05	4000	10.01
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PRXM **Proxim Wireless Corp.**  OTC Pink No Information

Common Stock

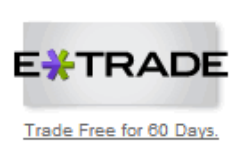
1.55 0.00 (0.00%) at May 30, 2012 Real-Time Best Bid & Ask **1.60 / 1.70** (1 x 1) [Why is size 1?](#)



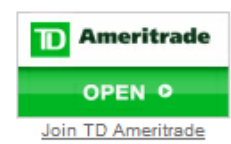
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View:	All	Active	Inactive
Publish Date	Report Title	Period End Date	Status
Nov 12, 2010	Quarterly Report - Proxim Wireless Corporation Quarterly Report for the Fiscal Quarter ended September 30, 2010	Sept 30, 2010	Active
Nov 11, 2010	Interim Financial Report - Proxim Wireless Reports Third Quarter 2010 Financial Results	Sept 30, 2010	Active
Aug 13, 2010	Quarterly Report - Proxim Wireless Corporation Quarterly Report for the Fiscal Quarter Ended June 30, 2010	Jun 30, 2010	Active
Aug 13, 2010	Interim Financial Report - Proxim Wireless Reports Second Quarter 2010 Financial Results	Jun 30, 2010	Active
May 14, 2010	Quarterly Report - Proxim Wireless Corporation Quarterly Report for Fiscal Quarter Ended March 31, 2010	Mar 31, 2010	Active
May 14, 2010	Interim Financial Report - Proxim Wireless Reports First Quarter 2010 Financial Results	Mar 31, 2010	Active
Apr 12, 2010	Proxy Materials - 2010 Annual Meeting Stockholder Information Statement	May 17, 2010	Active



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Common Stock

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How and why can these “private” (non-Exchange Act) firms be subject to disclosure obligations?

- As publicly-traded firms, OTC firms raise the same issues of information asymmetry posed by other “public” firms, yet they avoid mandatory federal disclosure.
 - Reasons for federal exemption:
 - Firms go (or stay) beneath the Section 12 shareholder trigger to avoid Section 13 reporting obligations;
 - Firms avoid selling securities in a public primary offering; and
 - Selling shareholders/dealers can rely on Section 4(1), 4(3) and 4(4) exemptions to avoid registration of resale transactions.
- But in so doing, firms lose the benefits of federal preemption of state blue sky laws.
 - Section 18 preemption of state registration/disclosure laws is limited to “covered securities.” These include:
 - Securities listed on a major stock exchange
 - Securities sold in 4(1) and 4(3) transactions if the issuer is subject to Section 13 or 15(d) of the Exchange Act.
 - Upshot→most OTC transactions will be subject to state registration/disclosure obligations absent an exemption.
 - EG: CA Corp. Code § 25130 (requiring registration of nonissuer transactions).

How and why can these “private” (non-Exchange Act) firms be subject to disclosure obligations?

- In practice, few OTC transactions are subject to state registration/disclosure requirements in light of exemptions.
 - Primary resale exemptions:
 - Rely on an unsolicited broker transaction (almost all states)
 - Rely on an isolated non-issuer transaction exemption or private resale transaction exemption (most states)
 - Rely on a manual exemption for resale (37 states; not CA)
 - Common manuals: Standard & Poor’s and Mergent.
 - States commonly differ in requirements
- Additionally, disclosure is imposed through regulation of broker-dealers who actively make markets in OTC securities.
 - Exchange Act Rule 15c2-11:
 - Unless an exception is available, Rule 15c2-11 requires that, prior to entering a quotation for an OTC security in a quotation medium, a broker/dealer have in its files specified information about the security and its issuer.
 - 16 items of information including: basic corporate details; officers and directors; capital structure; most recent balance sheet and income statement.

Some problems with this state of affairs

- From a disclosure perspective, there are good reasons to believe this is not optimal for either investors or issuers.
 - Regarding state disclosure obligations:
 - Complexity of complying with exemptions from registration across multiple states.
 - What is an “isolated” transaction? Has a firm complied with states’ differing manual requirements? Has a firm complied with idiosyncratic non-manual state laws (e.g., CA)?
 - Do these exemptions still make sense with robust OTC markets? If not, might certain states choose to limit their availability?
 - Example: Decision by many states to abandon or modify the manual exemption (originally articulated in §402(b)(2)(A) of the Uniform Securities Act of 1956).

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

Some problems with this state of affairs

- From a disclosure perspective, there are good reasons to believe this is not optimal for either investors or issuers.
 - Regarding 15c2-11 information:
 - Governs only the initiation or resumption of quotations
 - Information can quickly become outdated.
 - Doesn't apply to “new” secondary markets (e.g., SharesPost)
 - No public repository of the 15c-11 information
 - Efficacy is limited by exceptions:
 - Rule 15c2-11 does not apply to an unsolicited quotation
 - Rule 15c2-11(f)(3)—or the “piggyback” exception—exempts a BD from the rule if, during the 30 calendar days preceding that BD's submission of quotations, the security was the subject of bid and ask quotations on at least 12 days, and there were no gaps of more than four business days during which no quotations were published.
 - Result→Rule15c-11 has been repeatedly criticized:

“[T]he quoting broker-dealer is commanded by regulation to stuff the information into its files where, in all likelihood, it will never again see the light of day. Rule 15c2-11 is a rule of darkness.”

- R. Cromwell Coulson, CEO Pink Sheets, LLC (June 10, 2005)

Some problems with this state of affairs

- From a disclosure perspective, there are good reasons to believe this is not optimal for either investors or issuers.
 - All of these problems become potentially aggravated by expansion of these markets.
 - “OTC No information” firms
 - 3,007 as of September 6, 2012
 - 2,417 based in U.S.
 - JOBS Act Title VI expands pool of potential “private” firms with secondary trading.
 - How will states respond?

“[W]e do have concerns about drastic changes in the thresholds for reporting companies or the information they must disclose.... The primary reason for requiring a company to be ‘public’ is to facilitate secondary trading of the company’s securities by providing easily-accessible information to potential purchasers. The principal concern for states is the facilitation of this secondary trading market with adequate and accurate information.”

- NASAA President Jack Herstein, Dec. 1, 2011 Testimony to the Senate Committee on Banking, Housing, and Urban Affairs.

What can the Commission can do about it?

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