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## Grown from the Shadows: How Technology and Taxes Can Bring Private Companies into the Public Light

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# Grown from the Shadows: How Technology and Taxes Can Bring Private Companies into the Public Light

## ABSTRACT

*The initial public offering (IPO) has started to make a comeback, but in forms that require less oversight and at a later point in a company's lifecycle. These new trends cut main street investors out of early-stage corporate growth and have imperiled the fortunes and retirement funds of a generation. One of the most significant precipitating factors in this new dynamic is electronic private markets that allow sophisticated investors to trade pre-IPO shares. These electronic private markets provide liquidity to institutional investors, which relieves institutional pressure on companies to go public. The current approaches to IPO reform are primarily deregulatory, and they do not address the role of electronic private markets.*

*This Note proposes a tax incentive that would allow investors to defer capital gains on shares that trade on an electronic private market and then go public within a limited window. Investors would receive tax deferral on these "Opportunity Securities" only if they reinvest their proceeds in another qualifying private company or IPO. These requirements would reignite the IPO pipeline. The incentive would apply to private market investors as well as main street investors who buy shares within one year of the IPO. Opportunity Securities would encourage companies to go public sooner because investors would be motivated to seek this tax deferral and pressure companies accordingly. Unlike other proposals, this solution would encourage IPOs and align the incentives of heterogenous investors without sacrificing disclosure or investor protections.*

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Imagine a scenario where entrepreneurial and tech-savvy law professors or recent law school graduates spotted an opportunity of a lifetime, the next Amazon.com, and they were able to buy shares in the company's Initial Public Offering (IPO). By spotting this growth opportunity, they were able to sell five to ten years later and help fund a new academic institute or launch the newest legal tech start-up. This is no longer a reality.<sup>1</sup> If these same people spotted the next big emerging company today, they would likely be shut out of the market.<sup>2</sup> They might not be accredited investors who can buy shares in a company that is not publicly traded,<sup>3</sup> or even if they are accredited, they

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1. See Scott Austin, Stephanie Stamm & Rolfe Winkler, *Uber Jackpot: Inside One of the Greatest Startup Investments of All Time*, WALL ST. J., <https://www.wsj.com/articles/uber-jackpot-inside-one-of-the-greatest-startup-investments-of-all-time-11557496421> [<https://perma.cc/X2Y3-FVLF>] (last updated May 10, 2019 12:14 PM); Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 456–57 (2017); Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 543–46 (2012).

2. See Austin, et al., *supra* note 1 (describing the Uber IPO and how many investors tied into the Silicon Valley investing and technology community were able to invest in the company early on, unlike public investors).

3. *Updated Investor Bulletin: Accredited Investors*, U.S. SEC. & EXCH. COMM'N (Jan. 31, 2019) [hereinafter *Investor Bulletin: Accredited Investors*], <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-accredited-investors> [<https://perma.cc/7HR7-UGZM>]. In order to participate in nearly all of the offerings at issue in this Note, an individual must be an accredited investor. *Id.* In order to qualify as an individual

might not have the requisite social or business connections to buy shares.<sup>4</sup> This is not a distant capitalist doomsday scenario but an ever-increasing reality and a constraint on investor access and economic growth. This Note explains how a creative yet rarely explored solution can help to resolve a deteriorating legal and economic problem.<sup>5</sup>

Since the dot-com boom of the late 1990s, the United States' securities markets have seen a marked decline in the number of companies selling their shares in IPOs.<sup>6</sup> One reason for this trend is that investors who hold these private securities are now able to liquidate them through Electronic Private Markets (EPMs).<sup>7</sup> EPMs provide a platform to buy and sell privately held securities.<sup>8</sup> Privately held securities are often called private securities or exempted securities.<sup>9</sup> These securities fall within certain exemptions for registration with the US Securities and Exchange Commission (SEC).<sup>10</sup> SEC registration is expensive, often burdensome, and has high costs and benefits.<sup>11</sup> Through a synthesis of technologies,<sup>12</sup> EPMs are able to

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accredited, the investor must have earned income above \$200,000 in the prior year or have a household net worth above \$1 million excluding a primary residence. *Id.* These financial thresholds underlie the problem with sustained private company status by limiting investor access on strong policy grounds. *Id.* By staying private longer, accredited investors receive greater growth opportunities in companies that often become household mainstays, leaving public shareholders with lower future prospects. *Cf.* Begum Erdogan, Rishi Kant, Allen Miller & Kara Sprague, *Grow Fast or Die Slow: Why Unicorns Are Staying Private*, MCKINSEY & CO. (May 11, 2016) [hereinafter *McKinsey Staying Private Report*], [mckinsey.com/industries/technology-media-and-telecommunications/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private](https://mckinsey.com/industries/technology-media-and-telecommunications/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private) [https://perma.cc/ZS42-UDJP].

4. *Cf.* Austin, et al., *supra* note 1 (implying that the typical early start-up investors that are able to capture real growth premiums are institutional venture capitalists with long-standing social and economic ties to Silicon Valley).

5. *See infra* Part III.

6. Schwartz, *supra* note 1, at 543–46.

7. *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 36–39 (2012).

8. *See id.*

9. *See* SCOTT BAUGUESS, RACHITA GULLAPALLI & VLADIMIR IVANOV, U.S. SEC. & EXCH. COMM'N, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009–2017 40 (Aug. 2018), [https://www.sec.gov/files/DERA%20white%20paper\\_Regulation%20D\\_082018.pdf](https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf) [https://perma.cc/GE26-P6U6]; Zachary J. Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. REV. 745, 747–48, 751 (2013).

10. *See* Ibrahim, *supra* note 7, at 39–42; *cf.* R. Kevin Saunders II, Note, *Power to the People: How the SEC Can Empower the Crowd*, 16 VAND. J. ENT. & TECH. L. 945, 951–55 (2014) (discussing exemption and the regulation of private securities in the context of crowdfunding).

11. *See, e.g.,* Fontenay, *supra* note 1, at 445, 447–48 (describing the increasing requirements of public company compliance as a result of the SEC registration process).

12. *See* Ibrahim, *supra* note 7, at 37–39.

aggregate and intermediate between buyers and sellers at efficiencies that were not seen in the broker-to-broker transactions for private securities that predated EPMs.<sup>13</sup> The largest issuers of these kinds of securities, by the number of offerings, are companies in the technology industry.<sup>14</sup> By tapping into the power of EPMs, this Note proposes an Opportunity Securities Program (OSP) to encourage companies to register and publicly offer their securities on the world's largest stock exchanges.<sup>15</sup> Those who invest before—and for a limited time after—a company's IPO will be able to defer capital gains tax on the sale of those investments so long as the proceeds from the sale are reinvested in another company that qualifies for the OSP.

Scholars have narrowly focused on deregulation and disclosure reform as the only effective ways to revive the IPO and decrease the amount of time a company spends being privately held.<sup>16</sup> This Note builds on a simple recommendation by the SEC to reduce the capital gains tax on shares purchased during an IPO.<sup>17</sup> Instead of creating or eliminating new securities regulations, this approach will take advantage of EPMs—as a technological intermediary—and the tax code to stimulate investor demand for IPOs.<sup>18</sup> The OSP will allow investors to defer capital gains on stock that is traded on an EPM and undergoes an IPO within a reasonable period of time.<sup>19</sup> Investors will receive this tax benefit during a defined timeframe that includes earlier private investors and investors who invest in the IPO.<sup>20</sup> This is in opposition to

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13. See *id.* at 36–39.

14. See BAUGUESS ET AL., *supra* note 9, at 29 (“Issuers from the Technology industry group are the most active amongst non-fund issuers by number of offerings, comprising about 25% of all reported non-fund offerings (Figure 14) in the Regulation D market.”); see also *id.* at 2 n.2 (defining start-up as “any rapid-growth private company, which is often technology driven, that seeks funding from angel investors, venture capitalists, or venture lenders with the ultimate goal of exit through an IPO or trade sale.”).

15. See *infra* Section III.C.1.

16. See Fontenay, *supra* note 1, at 452–55 (describing the IPO slowdown as a mostly US phenomenon); Saunders, *supra* note 10, at 970–75; Gubler, *supra* note 9, at 788–90; Schwartz, *supra* note 1, at 579–81, 598–602.

17. See U.S. SEC. & EXCH. COMM'N, IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 30 (Oct. 20, 2011) [hereinafter REBUILDING THE IPO], [https://www.sec.gov/info/smallbus/acsec/rebuilding\\_the\\_ipo\\_on-ramp.pdf](https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf) [<https://perma.cc/4ZWQ-YEJH>] (presenting the entirety of the SEC's recommendation stating, “[p]olicymakers can reinforce demand for emerging growth stocks by lowering the capital gains rate for investors who purchase shares in an IPO and hold these shares for a minimum of two years. The capital gains tax rate has served as an effective tool for encouraging and rewarding long-term investing for decades, so this action would be wholly consistent with current practice.”); *infra* Part III.

18. See *infra* Part III.

19. See *infra* Section III.C.2.

20. See *infra* Section III.C.2.

the traditional academic debate around stimulating company demand for an IPO through deregulation or modified disclosure requirements.<sup>21</sup> The OSP will realign and incentivize EPMS to no longer act as holding areas or acquisition hunting grounds,<sup>22</sup> but rather as stepping-stones to public participation in emerging company growth and innovation.

Part I discusses the technological, economic, and legal circumstances that surround the downfall of the IPO in the securities markets. Part II analyzes the current and proposed attempts to remedy the problem. Following that analysis, Part III proposes the demand-based OSP to stimulate public equity offerings in the United States. It considers the mechanics of this program, as well as its unique benefits and challenges, with a specific focus on why this solution may work where others have failed.<sup>23</sup>

## I. BACKGROUND

This Part will discuss the legal and economic underpinnings that provide structure to the private market. First, it will discuss the EPM and its fundamental role within this Note. Then, it will discuss the regulatory backdrop that can constrain a company's capital raising efforts and why that encourages companies to raise money in the private market. It will then discuss the recent history and underlying economics of the IPO market.

### A. *The Star of the Show: Electronic Private Markets*

EPMS are digital platforms that enable the purchase and sale of private securities.<sup>24</sup> EPMS are often managed by well-known names in the financial industry, such as NASDAQ.<sup>25</sup> In their most basic form, they provide a matching service and gatekeeping function.<sup>26</sup> They ensure that anyone using the platform meets SEC requirements, and they work to match buyers and sellers.<sup>27</sup> Additionally, they provide advice to companies and individuals who would like to buy or sell large blocks of private securities.<sup>28</sup> These blocks of securities are usually the

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21. See, e.g., Schwartz, *supra* note 1, at 579–81, 598–602.

22. See Ibrahim, *supra* note 7, at 36.

23. See *infra* Part III.

24. Cf. *Nasdaq Private Market Solutions*, NASDAQ, <https://www.nasdaq.com/solutions/nasdaq-private-market> [<https://perma.cc/4ZZJ-JSE3>] (last visited Oct. 2, 2020).

25. See Ibrahim, *supra* note 7, at 37 n.144.

26. See *Nasdaq Private Market Solutions*, *supra* note 24.

27. See *id.*

28. See *id.*

result of a venture capital investment or employee compensation from a privately held company.<sup>29</sup>

EPMs are not regulated as stock exchanges, but as broker-dealers.<sup>30</sup> As broker-dealers, EPMS are able to provide liquidity<sup>31</sup> in securities that do not have to be registered with the SEC.<sup>32</sup> Prior to their digitization, the broker-dealers that ran these EPMS were said to provide “secondary markets” within the private or exempted securities field.<sup>33</sup> Prior to the proliferation of EPMS, private securities were difficult to buy and sell.<sup>34</sup> Most private securities holders were institutional investors, company founders, venture capital firms (VCs), and early company employees, often based in Silicon Valley.<sup>35</sup>

The volume of trading and digital attributes of EPMS differentiates them from traditional secondary market liquidity providers, such as broker-to-broker transactions and investment bank buyouts.<sup>36</sup> Broker-to-broker transactions do not have the same impact on private markets as EPMS because they involve singular, discrete transactions.<sup>37</sup>

One of the large benefits of EPMS is that they are able to aggregate buyers, sellers, and issues at a scale that is not realistic for individual broker transactions.<sup>38</sup> Buyouts, also called “trade sales” when the buyer is in the same industry, are another traditional exit opportunity that differ from EPMS.<sup>39</sup> Buyouts require the issuer to sell the entire company and, as a result, lose corporate control.<sup>40</sup> Buyouts are also not an effective way to cash out current employees’ stock

29. See Gubler, *supra* note 9, at 760–61.

30. See Ibrahim, *supra* note 7, at 36–39.

31. *Liquidity*, BLACK’S LAW DICTIONARY (11th ed. 2019) (“The quality, state, or condition of being readily convertible to cash. 2. Securities. The characteristic of having enough units in the market that large transactions can occur without substantial price variations.”).

32. See Ibrahim, *supra* note 7, at 41–43.

33. See *id.* at 3–4.

34. See *id.* at 37–39.

35. See Fontenay, *supra* note 1, at 451 n.21, 471; Ibrahim, *supra* note 7, at 16, 20. EPMS are an outgrowth of alternative trading systems (ATS), often called dark pools. See 17 C.F.R. § 242.300 (2020); Edwin Batista, *A Shot in the Dark: An Analysis of the SEC’s Response to the Rise of Dark Pools*, 14 J. HIGH TECH. L. 83, 92–93 (2014). As opposed to EPMS, a traditional ATS oftentimes facilitates trades in public securities outside of a traditional national stock exchange. *Id.* at 92.

36. See Ibrahim, *supra* note 7, at 37–39. This Note will refer to these secondary markets as EPMS to delineate the secondary market actors who provide liquidity mainly through electronic platforms and the internet.

37. See *id.* at 36–39.

38. See *id.* at 37–39.

39. See *id.* at 10.

40. See *id.* at 7–8.

options or raise working capital for the business to grow and operate independently.<sup>41</sup>

EPMs digitize what used to be a broker-to-broker process of selling private securities.<sup>42</sup> The largest EPM player is NASDAQ Private Market.<sup>43</sup> In developing its EPM, NASDAQ combined its infrastructure managing the NASDAQ Exchange with its connections to its deep client base.<sup>44</sup> The largest advantage of this digital platform is its aggregation function.<sup>45</sup> The EPM also provides the necessary regulatory and logistical support while matching buyers and sellers from its client lists and members.<sup>46</sup> NASDAQ Private Market aggregates individual sales into offerings for a block of securities and, thus, has an efficiency of scale.<sup>47</sup> NASDAQ Private Market and other EPMS, such as SharesPost, are responding to a demand for liquidity within the constraints of securities regulation and exemption.<sup>48</sup> As a result, much of the value created by emerging growth companies (EGCs) in the United States is captured by those with access to privately held securities.<sup>49</sup>

The proliferation of EPMS created a newfound liquidity in previously thinly traded private securities.<sup>50</sup> As a result, companies are pushing off or foregoing IPOs, often allowing investors to trade their shares on an EPM.<sup>51</sup> This Note presumes that the economy and society benefit in the aggregate from start-ups and IPOs and recognizes Silicon Valley's outsize presence in that market.<sup>52</sup> IPOs are large drivers of

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41. See *id.* at 12–13.

42. See *Nasdaq Private Market Solutions*, *supra* note 24 (“We help ensure regulatory compliance in each aspect of the business and operate as a Broker-Dealer, Alternative Trading System (ATS) and Qualified Matching Service (QMS) as interpreted in a Private Letter Ruling by the IRS.”).

43. See *2019 Mid-Year Private Company Report*, NASDAQ PRIVATE MARKET 2–3 (July 23, 2019, 2:15 PM) [hereinafter *NASDAQ Report*], <https://www.nasdaq.com/articles/2019-mid-year-private-company-report-2019-07-23> [<https://perma.cc/L8MV-2PTE>].

44. See *id.* (explaining that NASDAQ Private Markets alone facilitated \$2.3 billion in exempt securities transactions in the first half of 2019); *Nasdaq Private Market Solutions*, *supra* note 24.

45. See Ibrahim, *supra* note 7, at 36–39.

46. See *Nasdaq Private Market Solutions*, *supra* note 24.

47. See *NASDAQ Report*, *supra* note 43, at 3.

48. *Venture Exchanges and Small Cap Companies: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Hous., and Urb. Affs.*, 114th Cong. 6–8 (2015) [hereinafter *Venture Exchange Hearings*] (statement of Scott Kupor, Managing Partner, Andreessen and Horowitz).

49. *Id.*

50. See Ibrahim, *supra* note 7, at 3.

51. See Fontenay, *supra* note 1, at 456–57; Ibrahim, *supra* note 7, at 10, 28.

52. See Seth C. Oranburg, *Democratizing Startups*, 68 RUTGERS L. REV. 1013, 1028 (2016); Schwartz, *supra* note 1, at 539–40.

growth in hiring and innovation, while private acquisitions of start-ups regularly stunt these economic and innovation benefits.<sup>53</sup>

### *B. Securities Law: Only One Piece of the Puzzle*

The regulatory framework for private securities is vast and intricate;<sup>54</sup> this Note does not attempt to summarize or provide a simple solution to that body of law. This broad-brush discussion of securities law coincides with this Note's focus on providing a new and technologically enabled solution to the IPO problem.<sup>55</sup> The OSP will rely on the benefits of EPM technology to provide a tax incentive to increase the number of IPOs in the United States. This respects the status quo disclosure rules and the significant restrictions that limit the average investor's ability to invest in a private company.<sup>56</sup> Over the last two decades, the Sarbanes-Oxley Act (SOX), which brought about expensive auditing, attestation, and executive liability provisions, has been blamed for limiting the number of public offerings.<sup>57</sup> The OSP does not take the familiar path of reforming SOX in order to spur IPOs and direct listings;<sup>58</sup> instead, it focuses on increasing investor demand.<sup>59</sup>

Although certain exceptions exist,<sup>60</sup> some created or expanded by the Jumpstart Our Business Startups Act (JOBS Act),<sup>61</sup> private securities are most often bought and sold by sophisticated or institutional investors.<sup>62</sup> The OSP fits within the broader policy

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53. Schwartz, *supra* note 1, at 542.

54. See Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release Nos. 33-10649; 34-86129; IA-5256; IC-33512, 84 Fed. Reg. 30460, 30461–68 (June 26, 2019) [hereinafter SEC Concept Release]; see also 15 U.S.C. § 77(c) (2020).

55. See *infra* Part III.

56. See *Investor Bulletin: Accredited Investors*, *supra* note 3.

57. See, Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone? The Hard Life of the Small IPO*, 6 HARV. BUS. L. REV. 83, 88–92 (2016).

58. See *id.*

59. See *id.* at 88–90.

60. See 17 C.F.R. § 230.144 (2020); Lora C. Siegler, Annotation *Construction and Application of Securities and Exchange Commission Rule 144 (17 CFR § 230.144) Concerning Resales of Securities Acquired in Transaction or Series of Transactions Not Involving Public Offering in Cases Brought Under Federal Securities Laws*, 117 A.L.R. Fed. 345 (2020); see also Michael A. de Freitas, Annotation, *Exempted Securities Under § 3(a)(2)–3(a)(8) of Securities Act of 1933 (15 U.S.C.A. § 77c(a)(2)–77c(a)(8))*, 119 A.L.R. Fed. 259 (2020).

61. See Benjamin Hamel, Comment, *An Examination of the Jumpstart Our Business Startups Act: How Jobs Act Exemptions May Help Startups and Hurt Investors*, 17 HOUS. BUS. & TAX L.J. 59, 64–70 (2016).

62. See Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 739–43 (2009); Christopher R. Zimmerman, Note, *Accredited Investors: A Need for Increased Protection in Private Offerings*, 114 NW. U. L. REV. 507, 513–20 (2019).

landscape that treats EGCs differently than well-established companies seeking to access the capital markets.<sup>63</sup>

IPOs and direct listings both bring along public company status, which generally promotes economic growth<sup>64</sup> and provides the average investor with access to new and emerging companies.<sup>65</sup> Although the OSP does not lie purely within securities law,<sup>66</sup> it will address some of the recent innovations of the JOBS Act and its crowdfunding regulations in analyzing possible solutions to the IPO problem.<sup>67</sup>

### C. Economic Framework

The decline of the IPO must be viewed in the context of the golden age of IPOs in the late 1990s.<sup>68</sup> At that time, start-up employees did not need to worry when their shares in a start-up would be cashed out because venture capital firms had a short investment horizon.<sup>69</sup> VCs were the primary means by which start-ups raised capital and received strategic advice prior to their IPOs.<sup>70</sup> VCs would expect to invest in a start-up and bring it to the public market during the lifetime of their VC fund, which averaged seven years.<sup>71</sup> Most of these VCs, and by proxy company IPOs, would have a timeline of three to four years from initial investment to public exit.<sup>72</sup> This short-term horizon often meant that the general investing public could share in the prosperity and upside growth potential that awaited at an IPO and the years that followed.<sup>73</sup>

The bursting of the dot-com bubble, and to a larger extent the Great Recession, had a significant impact on the current state of the IPO market.<sup>74</sup> All time low interest rates during and after the Great Recession pushed institutional investors towards VCs and private investments.<sup>75</sup> VCs were able to provide the risk and returns that

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63. See Hamel, *supra* note 61, at 64–65.

64. See Oranburg, *supra* note 52, at 1029–36.

65. See *id.*

66. See *infra* Part III.

67. See *infra* Part III.

68. Ibrahim, *supra* note 7, at 11–15.

69. *Id.*

70. See *id.*; Jason M. Gordon & David Orozco, *Trust and Control: The Value Effect of Venture Capital Term Sheet Provisions as Risk Allocation Tools*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 195, 199 (2015).

71. Ibrahim, *supra* note 7, at 14.

72. *Id.*

73. See *id.* at 15–17.

74. See *id.* at 12–13.

75. See Bethany Mclean, *Too Big to Fail, COVID-19 Edition: How Private Equity Is Winning the Coronavirus Crisis*, VANITY FAIR (Apr. 9, 2020), <https://www.vanityfair.com/news/>

institutional investors were not receiving in the stock and bond markets.<sup>76</sup> In a reversion from the golden age of the IPO before the dot-com bubble, the low-rate environment contributed to a glut of VC capital that allowed start-ups to demand more control over their companies.<sup>77</sup> As a result, founders could pick and choose their investors and seek money from those more willing to let them keep control, which in turn allowed companies to remain private longer.<sup>78</sup>

Congress recognized the lack of IPOs and feared that it could harm US prosperity, as well as the competitiveness of US capital markets.<sup>79</sup> In reaction, Congress passed the JOBS Act, which is discussed in more detail in Section II.A.<sup>80</sup> Crowdfunding is one of the solutions that the JOBS Act implemented in order to open access to exempt securities.<sup>81</sup> It was thought to be a way to “democratize” investing<sup>82</sup> and provide start-ups with a more diverse and accessible funding method.<sup>83</sup> Crowdfunding has opened up new investments to the public, but it has not had the scale or effectiveness in pushing companies to go public that its boosters expected.<sup>84</sup>

Emerging company IPOs contribute to healthy capital markets and robust economic growth.<sup>85</sup> Public offerings give investors the opportunity to support entrepreneurial thinking, and they enable the general public to share in the economic risks and prosperity of the world’s newest innovations.<sup>86</sup> A public offering can often be a “stepping stone to achieving scale” and can have extensive positive impacts on general economic growth and overall employment.<sup>87</sup> Between 1980 and

2020/04/how-private-equity-is-winning-the-coronavirus-crisis [https://perma.cc/JX88-3UC6]; Heather Somerville, *Startup Investment to Keep Soaring After Record Year*, WALL ST. J. (July 19, 2019, 2:42 PM), <https://www.wsj.com/articles/startup-investment-to-keep-soaring-after-record-year-11563561756> [https://perma.cc/93CP-MD4H].

76. See Maxwell Gawley, Comment, *Closing the Carried Interest Loophole and the Impacts on Venture Capital*, 68 DEPAUL L. REV. 671, 684–85 (2019).

77. Cf. Cristiano Bellavitis & Natalia Matanova, *Do Interest Rates Affect VC Fundraising and Investments?*, EUROPEAN FIN. MGMT. ASS’N 16 (Nov. 30, 2017), [https://ef-maefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2017-Athens/papers/EFMA2017\\_0125\\_fullpaper.pdf](https://ef-maefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2017-Athens/papers/EFMA2017_0125_fullpaper.pdf) [https://perma.cc/MSP6-Q23C].

78. See *id.* 24–25.

79. See Oranburg, *supra* note 52, at 1029–36.

80. See *id.*; *infra* Section II.A.

81. See John S. Wroldsen, *The Crowdfund Act’s Strange Bedfellows: Democracy and Start-Up Company Investing*, 62 U. KAN. L. REV. 357, 362 (2013).

82. See *id.* 357–59.

83. Saunders, *supra* note 10, at 950–54.

84. *Id.* at 958–60.

85. Fontenay, *supra* note 1, at 455–56.

86. See *id.*

87. *Id.*

2000, there were an average of 310 IPOs annually.<sup>88</sup> From 2001 to 2012, the annual average declined to 99.<sup>89</sup> IPOs have seen growth in recent years—up to 235 in 2019.<sup>90</sup> Even with that growth in 2019, markets debuted 14 percent fewer IPOs in 2019 than they did in 2018.<sup>91</sup>

Securities market analysts still believe the IPO market is soft.<sup>92</sup> The amount of capital that has been raised has only declined slightly, but this is because large, older firms are going public as opposed to emerging growth companies.<sup>93</sup> Although the number of high-value IPOs has grown,<sup>94</sup> public investors have still been locked out of much of the growth phase of these newly public companies.<sup>95</sup> The public offerings from these more mature firms do not typically have the same positive economic and social externalities associated with emerging company IPOs.<sup>96</sup> Accordingly, the trend of delaying IPOs has locked out many Main Street investors from high-growth companies and their monetary success.<sup>97</sup> Together, the economic and regulatory challenges of the current IPO landscape provide an opportunity for creative solutions.<sup>98</sup>

## II. ANALYSIS

The public and private capital markets in the United States have a consistent reputation for regulatory adaptation and reform.<sup>99</sup> Many of these adaptations are a result of crises in the securities markets,<sup>100</sup> but some, like the JOBS Act, were tailored to boost an emerging company's prospects in the public capital markets.<sup>101</sup> This Part will discuss various proposed solutions to the decline of the IPO and why these potential solutions are likely to be inadequate. It will

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88. *Id.* at 455.

89. *Id.*

90. Sara B. Potter, *U.S. IPOs Raised More Money in 2019, Despite a Decline in IPO Volume*, FACTSET (Jan. 9, 2020), <https://insight.factset.com/u.s.-ipos-raised-more-money-in-2019-despite-a-decline-in-ipo-volume> [<https://perma.cc/NF4K-W3L4>].

91. *See id.*

92. JJ Kinahan, *IPO Extravaganza Seen Buttressing Banks in Q2, but Soft Trading Environment Hurts*, FORBES (July 15, 2019, 11:03 AM), <https://www.forbes.com/sites/jjkinahan/2019/07/15/ipo-extravaganza-seen-buttressing-banks-in-q2-but-soft-trading-environment-hurts/#6d73297b477b> [<https://perma.cc/4KAW-Q6YV>].

93. Fontenay, *supra* note 1, at 455.

94. *See* Potter, *supra* note 90.

95. *See* McKinsey *Staying Private Report*, *supra* note 3.

96. *See* Fontenay, *supra* note 1, at 455–56.

97. *Venture Exchange Hearings*, *supra* note 48, at 7.

98. *See infra* Part III.

99. *See* Fontenay, *supra* note 1, at 463–70.

100. *See id.* at 464.

101. *See id.* at 468–70.

address the JOBS Act, current regulatory reform proposals, crowdfunding, and venture exchanges as alternatives to this Note's proposed solution of a demand-stimulating tax incentive for public offerings.<sup>102</sup>

*A. When Good Intentions Backfire: The JOBS Act Reality*

The JOBS Act did not encourage listings but instead enabled firms to remain private longer.<sup>103</sup> The JOBS Act increased certain requirements that allowed companies to delay hitting public company reporting status.<sup>104</sup> It also implemented an IPO on-ramp for EGCs meant to make the public offering process easier and less expensive.<sup>105</sup>

Another significant change brought about through the JOBS Act was a relaxation of the audited financial statement requirements of SOX.<sup>106</sup> Critics of SOX have cited the audit and attestation requirements as significant barriers to an IPO.<sup>107</sup> Now, issuers only need to provide two years of audited financial statements as opposed to three, and EGCs are not required to have management attestation of their internal controls, but beginning with their second annual report management must assess internal financial controls.<sup>108</sup> The JOBS Act made this major change, in addition to a number of other relaxations of disclosure requirements, in an effort to reduce the cost of an IPO.<sup>109</sup>

Despite good intentions, this change has not led to significant decreases in the cost of an IPO.<sup>110</sup> Investors discount the value of a company that provides fewer corporate and financial disclosures, even when those disclosures are not required by law.<sup>111</sup> Companies like Twitter decided that although they met the requirements for EGC status at their IPO, they would comply with the accounting

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102. See *infra* Part III.

103. See Fontenay, *supra* note 1, at 459–66.

104. See Michael J. Zeidel, *The JOBS Act: Did It Accomplish Its Goals?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 18, 2016), <https://corpgov.law.harvard.edu/2016/07/18/the-jobs-act-did-it-accomplish-its-goals/> [<https://perma.cc/7R7L-AW84>].

105. See *id.*

106. *Roadmap for an IPO: A Guide to Going Public*, PWC DEALS 12–13 (Nov. 2017) [hereinafter *Roadmap for an IPO*], <https://www.pwc.com/us/en/deals/publications/assets/pwc-roadmap-for-an-ipo.pdf> [<https://perma.cc/7RR9-K2D7>].

107. Bonnie J. Roe, *IPO On-Ramp: The Emerging Growth Company*, BUS. L. TODAY (May 31, 2012), [https://www.americanbar.org/groups/business\\_law/publications/blt/2012/05/04\\_roe/](https://www.americanbar.org/groups/business_law/publications/blt/2012/05/04_roe/) [<https://perma.cc/TB4M-7YEG>].

108. *Roadmap for an IPO*, *supra* note 106, at 12–13.

109. *Id.*

110. See Brian Howaniec, Comment, *The IPO Crisis: Title I of the JOBS Act and Why It Does Not Go Far Enough*, 42 PEPP. L. REV. 845, 874 (2015).

111. See *id.* at 872.

requirements used by non-EGC public companies.<sup>112</sup> Furthermore, many companies that are taking advantage of EGC treatment under the JOBS Act were likely not the kinds of companies that Congress intended to benefit.<sup>113</sup>

In the year following its enactment, the JOBS Act was called an “utter failure” because it had the immediate effect of depressing public offerings.<sup>114</sup> The JOBS Act’s negative impacts dissipated as companies realized it did not have as much impact as was initially expected.<sup>115</sup>

### B. A New Regulatory Frontier

The SEC has recognized that, despite the passage of the JOBS Act in 2012, public offerings have not regained the momentum seen in the late 1990s and early 2000s.<sup>116</sup> SEC Chairman Jay Clayton has publicly expressed his disappointment concerning the low number of companies going public early in their lifecycle,<sup>117</sup> and the SEC is trying to promote public issuances while balancing its core mission of capital formation and investor protection.<sup>118</sup> To this end, the staff of the SEC

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112. Todd Blakeley Skelton, *2013 Jobs Act Review & Analysis of Emerging Growth Company IPOs*, 15 *TRANSACTIONS* 455, 498–99 (2014).

113. *Id.* at 496. Special purpose acquisition corporations (SPACs) and mature companies, such as Manchester United, are using the IPO on-ramp meant for emerging growth companies. *Id.* at 496–97. SPACs are publicly traded shell companies that expedite the IPO process for private equity acquisitions of mature companies. See Usha Rodrigues, *SPACS and the JOBS Act*, 3 *HARV. BUS. L. REV. ONLINE* 17, 18–19 (2012), <https://www.hblr.org/?p=2488> [<https://perma.cc/TB4M-7YE6>].

114. See Zachary M. Seward, *The JOBS Act Turns 1—and It’s an Utter Failure*, *ATLANTIC* (Apr. 5, 2013), <https://www.theatlantic.com/business/archive/2013/04/the-jobs-act-turns-1-and-its-an-utter-failure/274732/> [<https://perma.cc/GH8V-2KKS>].

115. See Therese Poletti, *The Government Tried to Encourage IPOs, but It Helped Create the Age of the Unicorn*, *MARKETWATCH* (Dec. 31, 2017, 2:44 PM), <https://www.marketwatch.com/story/the-government-tried-to-encourage-ipos-but-it-helped-create-the-age-of-the-unicorn-2017-12-26>; see *infra* Section II.C.

116. See Rick A. Fleming, Inv. Advoc., U.S. Sec. & Exch. Comm’n, Address at the NASAA Public Policy Conference: Enhancing the Demand for IPOs (May 9, 2017), [https://www.sec.gov/news/speech/fleming-enhancing-demand-ipos-050917#\\_ftn16](https://www.sec.gov/news/speech/fleming-enhancing-demand-ipos-050917#_ftn16) [<https://perma.cc/66FK-75QL>]; SEC Concept Release, *supra* note 54, at 30460–61, 30465 (displaying a graph showing that the amount of capital raised in registered offerings increased, but that it was less than that of exempt offerings).

117. See Michelle Fox, *SEC Chair Jay Clayton Wants Big Firms to Go Public Earlier So Retail Investors Can Get in on the Growth*, *CNBC*, <https://www.cnbc.com/2019/04/26/sec-chair-jay-clayton-wants-big-companies-to-go-public-earlier.html> [<https://perma.cc/98V2-8L4V>] (last updated Apr. 26, 2019 4:23 PM) (“As a general long-term matter, I feel much better that people are starting to access our capital markets. I do wish that companies were looking to access our public capital markets earlier in their life cycle.”).

118. *What We Do*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/Article/whatwedo.html> [<https://perma.cc/NFE8-QBRJ>] (last visited Oct. 4, 2020).

has issued a Concept Release seeking comment from the public on how to harmonize the private securities exemption regulations.<sup>119</sup> This demonstrates an attempt to make private offerings more efficient and less legally cumbersome.<sup>120</sup> Following a comment period, the SEC proposed new rules; however, the proposed rules address an issue distinct from the IPO problem.<sup>121</sup> These proposed rules are meant to address concerns regarding compliance with the myriad of private marketing offering requirements.<sup>122</sup> Many of these exemptions can be confusing and have overlapping provisions that limit the amount of capital a company can raise using different exemptions.<sup>123</sup> These proposed rules are meant to address those concerns.<sup>124</sup> The recently proposed rules work to limit contradictions and pitfalls in the private offering process, but they do not prioritize IPOs and do not address the role of EPMs in detail.<sup>125</sup>

### *C. The Rise of Crowdfunding and Its Shortcomings*

Following the Great Recession, crowdfunding was one of the technological solutions to the slowdown in public offerings and the changing landscape of start-up investing.<sup>126</sup> Crowdfunding has been touted as part of the solution to the IPO problem.<sup>127</sup> Commercial crowdfunding is a concept where an unfunded project or company raises money by soliciting small investments from a large number of dispersed individuals.<sup>128</sup> Crowdfunding has a long history and has been implemented in both commercial and philanthropic endeavors.<sup>129</sup> The internet has accelerated crowdfunding into the mainstream by intermediating between the entity raising money and investors spread across the country and around the world.<sup>130</sup> Many states have their own crowdfunding laws, and SEC Regulation 147A grants a safe harbor

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119. See SEC Concept Release, *supra* note 54, at 30460–61.

120. See *id.*

121. See Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17956, 17957–58 (proposed Mar. 31, 2020) [hereinafter SEC Proposed Rules].

122. See *id.* at 17957–59.

123. See *id.* at 17964–66.

124. See *id.* at 17964–67.

125. See *id.* at 17958; SEC Concept Release, *supra* note 54, at 30460–65.

126. BAUGUESS ET AL., *supra* note 9, at 42–44.

127. See Oranburg, *supra* note 52, at 1014–17.

128. Cf. Saunders, *supra* note 10, at 946–47.

129. Cf. *id.* at 946–50.

130. Cf. *id.* at 948–49.

from the federal securities laws for intrastate crowdfunding even if the issuer performs the offering over the internet.<sup>131</sup>

### 1. The Inadequacies of Crowdfunding

Born out of the JOBS Act, Regulation Crowdfunding, proposed and implemented by the SEC, is a system that allows issuers to sell their securities in limited amounts to the general public on a nationwide basis through regulated crowdfunding intermediaries.<sup>132</sup> These are securities that in all likelihood would only be available to accredited and institutional investors under any other circumstances.<sup>133</sup> This new system, which is in addition to state crowdfunding laws, has its requirements and limitations.<sup>134</sup> Regulation Crowdfunding sets the maximum offering amount for national crowdfunding by issuers (\$1.07 million in a twelve-month period), limits the amount individuals can invest,<sup>135</sup> and creates a framework that regulates intermediaries that facilitate crowdfunding.<sup>136</sup> Regulation Crowdfunding also has filing and disclosure requirements.<sup>137</sup> It requires information on an issuer's officers, directors, and beneficial owners, as well as the issuer's financial condition.<sup>138</sup> The intermediary platforms must be SEC-registered broker-dealers or registered funding portals.<sup>139</sup> Regulation Crowdfunding created registered funding portals as intermediaries for crowdfunding transactions that fall within a safe harbor for broker-dealer registration.<sup>140</sup> As a result, crowdfunding intermediaries can facilitate crowdfunding offerings but cannot solicit

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131. See Exemptions to Facilitate Intrastate and Regional Securities Offerings, Securities Act Release No. 33-10238, Exchange Act Release No. 34-79161, 81 Fed. Reg. 83494, 83495, 83494 (Nov. 21, 2016).

132. U.S. SEC. & EXCH. COMM'N, REPORT TO THE COMMISSION: REGULATION CROWDFUNDING 3, 6 (2019) [hereinafter SEC CROWDFUNDING REPORT], [https://www.sec.gov/files/regulation-crowdfunding-2019\\_0.pdf](https://www.sec.gov/files/regulation-crowdfunding-2019_0.pdf) [<https://perma.cc/XTR8-PKC6>].

133. Cf. 17 C.F.R. §§ 227.100(a), 230.501 (2020).

134. See SEC Concept Release, *supra* note 54, at 30499–504.

135. See 17 C.F.R. § 227.100(a). “Limits on how much each investor may invest over the course of a 12-month period in the aggregate across all crowdfunding offerings depend on the investor’s annual income or net worth. If either the investor’s annual income or net worth is less than \$107,000, the limit equals the greater of \$2,200 or five percent of the lesser of the annual income or net worth. If both the investor’s annual income and net worth are at least \$107,000, then the limit equals ten percent of the lesser of the annual income or net worth, up to a maximum of \$107,000.” SEC CROWDFUNDING REPORT, *supra* note 132, at 6–7.

136. SEC CROWDFUNDING REPORT, *supra* note 132, at 6.

137. See 17 C.F.R. §§ 227.201, 227.203 (2020).

138. See *id.*

139. SEC CROWDFUNDING REPORT, *supra* note 132, at 10.

140. See 17 C.F.R. §§ 227.400–402 (2020); SEC CROWDFUNDING REPORT, *supra* note 132, at 10.

offers, give investment advice or recommendations, or compensate promoters or others for soliciting the securities they list.<sup>141</sup>

Opening access to crowdfunding democratizes investing in start-ups,<sup>142</sup> but it does not go far enough in making a significant impact on the trajectory of the IPO market.<sup>143</sup> Crowdfunding's small scale shows that it is likely not providing the general investing public with the opportunity to participate in the emerging company growth experienced in prior decades.<sup>144</sup> In 2017, US businesses raised about \$35 million in all forms of crowdfunding, whereas companies raised in total over \$2.4 trillion in private markets.<sup>145</sup> Companies raised around \$1.8 trillion of that total through traditional private placements to mainly accredited and institutional investors under the Regulation D exemptions to the federal securities laws.<sup>146</sup> Even with the recently proposed SEC rules meant to relax the investor limits and raise the threshold for how much issuers can raise,<sup>147</sup> crowdfunding is still likely not a viable alternative to the traditional private markets or a solution to the IPO problem.

Crowdfunding faces a systemic contradiction in its attempt to both democratize investing and stimulate public offerings.<sup>148</sup> It is supposed to give retail investors access to new and high-growth investment opportunities and stimulate IPOs, but, in reality, it grants access to unaccredited investors without providing those unaccredited investors with adequate information or professional guidance.<sup>149</sup> Crowdfunding evangelists did not foresee that the new structure of these platforms would prevent investors from getting the kind of information they needed to take the risk of entering the crowdfunding space.<sup>150</sup> A crowdfunding company's digital portal oftentimes cannot advise on the status of the market or provide information to investors outside of the bare-bones disclosures that crowdfunding issuers are

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141. See 17 C.F.R. § 227.402.

142. See Oranburg, *supra* note 52, at 1030–31; Saunders, *supra* note 10, at 947.

143. See Fontenay, *supra* note 1, at 469.

144. See Jean Eaglesham & Coulter Jones, *The Fuel Powering Corporate America: \$2.4 Trillion in Private Fundraising*, WALL ST. J. (Apr. 3, 2018, 10:40 AM), <https://www.wsj.com/articles/stock-and-bond-markets-dethroned-private-fundraising-is-now-dominant-1522683249> [<https://perma.cc/UUL7-6RYG>].

145. *Id.*

146. BAUGUESS ET AL., *supra* note 9, at 1–4 (2018).

147. SEC Proposed Rules, *supra* note 121, at 17993–94.

148. See David Groshoff, *Equity Crowdfunding as Economic Development?*, 38 CAMPBELL L. REV. 317, 332 (2016); Wroldsen, *supra* note 81, at 393.

149. See Groshoff, *supra* note 148, at 332–33; Wroldsen, *supra* note 81, at 382.

150. See Wroldsen, *supra* note 81, at 380–86.

required to publish.<sup>151</sup> Some of the securities law literature has argued that the “wisdom of the crowd”<sup>152</sup> will substitute for analysis and brokerage advice.<sup>153</sup> If that is the case, it has not adequately encouraged investment in crowdfunding, which can be seen by crowdfunding’s disappointing volume.<sup>154</sup>

In reality, retail investors do not have access to the information that could be acquired from a broker or analyst.<sup>155</sup> Unlike broker-executed transactions for exempt securities, crowdfunding platforms cannot advise on any aspect of the securities issued.<sup>156</sup> A broker can oftentimes provide market information or point investors towards analysts who follow the industry.<sup>157</sup> For public companies, much of the analysis and advice surrounding the viability of an issuance is in the public domain.<sup>158</sup> This information asymmetry is one of the main reasons that crowdfunding, despite its digital advantage and democratic targeting, has played a negligible role in increasing private company access to the public markets.<sup>159</sup>

When the JOBS Act legitimized crowdfunding at the federal level, it was in some ways a direct response to the IPO problem.<sup>160</sup> Scholarly observers and market participants saw crowdfunding as a way to grant the public access to the high-growth companies found in private markets,<sup>161</sup> but crowdfunding activity has been limited in comparison to traditional private markets.<sup>162</sup> Crowdfunding pales in comparison to the number of securities that are handled by NASDAQ

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151. *See id.*

152. *See* Saunders, *supra* note 10, at 964–65. The “wisdom of the crowd” is the idea that when a crowdfunding campaign draws a large number of potential investors, the aggregate information gathering power of those individuals is able to weed out potentially unsuitable investments. *See id.*

153. *See* Wroldsen, *supra* note 81, at 382–83.

154. *See* Eaglesham & Jones, *supra* note 144; Katia Moskvitch & Richard Priday, *After High-Profile Failures, Can We Still Believe Crowdfunding Hype?*, WIRED U.K. (June 12, 2018), <https://www.wired.co.uk/article/crowdfunding-risks-sugru-ossic> [<https://perma.cc/6M3S-AN3A>].

155. *See* Wroldsen, *supra* note 81, at 380–82.

156. *See id.* at 382–85.

157. Saunders, *supra* note 10, at 957.

158. *See* Wroldsen, *supra* note 81, at 380–86.

159. Saunders, *supra* note 10, at 962–63 (explaining that because crowdfunded offerings are small, they fail to attract professional brokerage analysis, which has suppressed crowdfunding’s effectiveness); *see* Wroldsen, *supra* note 81, at 380–82; *cf.* Fontenay, *supra* note 1, at 468–70 (alluding to how even the implementation of crowdfunding has most likely hurt the US IPO market more than it has helped it).

160. Saunders, *supra* note 10, at 950–53.

161. *Id.*

162. *See* Eaglesham & Jones, *supra* note 144.

Private Market alone.<sup>163</sup> Unfortunately, despite crowdfunding's ambitious aspirations, in many ways it has not lived up to its hype. On its own, crowdfunding is not a viable solution to the IPO problem.<sup>164</sup>

*D. Venture Exchanges: A Solution Disconnected from the Problem*

The launch of the United States' first venture exchange, the Long-Term Stock Exchange, has been another attempt to spur IPOs and public offerings.<sup>165</sup> This exchange was recently approved for national exchange status by the SEC.<sup>166</sup> A venture exchange is meant to be an alternative forum for IPOs and direct listings of emerging company stock.<sup>167</sup> Unlike an EPM, shares issued or traded on a venture exchange are publicly traded and must meet the registration requirements of the SEC.<sup>168</sup> A venture exchange is not a forum to issue or trade exempted securities.<sup>169</sup> Venture exchanges are meant to compete with the New York Stock Exchange and NASDAQ for public offerings of emerging technology companies.<sup>170</sup> Other than providing a national exchange platform run by venture capitalists and technology executives,<sup>171</sup> infant venture exchanges do not provide incentives to investors to increase demand for IPOs and are not as well tested or used as EPMs.<sup>172</sup> Venture exchanges have been referred to as "a solution in search of a problem."<sup>173</sup> Once they are active, venture exchanges might be able to

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163. See *NASDAQ Private Market Sets New Transaction Record in the First Half of 2019*, GLOBENEWSWIRE (July 23, 2019, 10:05 AM), <https://www.globenewswire.com/news-release/2019/07/23/1886533/0/en/Nasdaq-Private-Market-Sets-New-Transaction-Record-in-the-First-Half-of-2019.html> [<https://perma.cc/27YV-VQRW>] (stating that NASDAQ Private Market facilitated over \$3 billion in transactions on its platform in the first half of 2019).

164. See Moskvitich & Priday, *supra* note 154.

165. *Venture Exchange Hearings*, *supra* note 48, at 4–8 (statement of Stephen Luparello, Director, Division of Trading and Markets, Securities and Exchange Commission) (statement of Scott Kupor, Managing Partner, Andreessen and Horowitz); see *In the Matter of the Application of Long Term Stock Exchange, Inc.; for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission*, 84 Fed. Reg. 21841, 21853 (May 10, 2019), [hereinafter *Venture Exchange Registration*].

166. *Venture Exchange Registration*, *supra* note 165, at 21853.

167. See *Venture Exchange Hearings*, *supra* note 48, at 6–7.

168. See *Venture Exchange Registration*, *supra* note 165, at 21850–51.

169. See *id.*

170. See *id.*

171. See *Venture Exchange Hearings*, *supra* note 48, at 6–8.

172. See *id.* at 8–13 (statement of Nelson Griggs, Executive Vice President, Listing Services, Nasdaq OMX Group).

173. See *id.* at 13 (statement of Sen. Mark R. Warner).

encourage emerging companies to go public, but this Note looks to provide a more substantial and potentially disruptive solution.<sup>174</sup>

Venture exchanges are new and untested.<sup>175</sup> Unlike EPMs,<sup>176</sup> venture exchanges are not directly backed by brokerage or exchange firms with the knowledge and experience to facilitate trading.<sup>177</sup> They are staffed with former employees of exchanges, but the exchange's birthplace is in the minds of venture capitalists, not brokers or market-makers.<sup>178</sup> The most successful EPMs are managed as subsidiaries of national exchanges that have significant brokerage and market-making experience.<sup>179</sup> This expertise differs significantly from that of traditional VCs.<sup>180</sup> VCs usually earn fees from investments in direct proportion to their fund's returns and assets under management.<sup>181</sup> EPMs derive their revenue from advisory services.<sup>182</sup> They also generate revenue by facilitating difficult-to-price and illiquid transactions; EPMs earn a spread or discount on each transaction.<sup>183</sup> The EPM's expertise advantage over venture exchanges<sup>184</sup> provides a compelling reason to focus regulatory reform efforts and incentives towards EPMs over untested venture exchanges.

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174. See *infra* Part III.

175. See *Venture Exchange Hearings*, *supra* note 48, at 1 (statement of Sen. Mike Crapo).

176. See *Nasdaq Private Market Solutions*, *supra* note 24.

177. See *Team*, LONG-TERM STOCK EXCH., <https://ltse.com/team/> [<https://perma.cc/Q6EP-HDY7>] (last visited Oct. 3, 2020).

178. See *Venture Exchange Hearings*, *supra* note 48, at 6–8; *Team*, *supra* note 177.

179. See *Nasdaq Private Market Solutions*, *supra* note 24; *Frequently Asked Questions*, SHARESPOST FIN. CORP., <https://sharespost.com/about/faqs/> [<https://perma.cc/R5K5-K5PT>] (last visited Oct. 3, 2020).

180. See Kate Litvak, *The Going-Private Phenomenon: Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 161–62 (2009) (providing a comprehensive study of venture capital asset management compensation arrangements).

181. See *id.* at 161.

182. See *Frequently Asked Questions*, *supra* note 179.

183. *Selling Your Startup Shares: Comparison of Secondary Stock Marketplaces*, HARNESS WEALTH (Apr. 29, 2020), <https://www.harnesswealth.com/articles/selling-your-startup-shares-comparison-secondary-stock-marketplaces/> [<https://perma.cc/YPR4-2H2M>] (explaining that SharesPost's fees for facilitating transactions are 5 percent of the closing price from the seller in transactions over \$100,000 and a \$5,000 flat fee for transactions below that threshold). There is no publicly available information on how NASDAQ Private Market prices its transactions, but since SharesPost and NASDAQ are the two market leaders, pricing is likely to be competitive between the two. See *id.* Also, neither company illustrates how it collects fees in advisory and market-making within the private markets which is likely a lucrative business given liquidity issues and information asymmetries. See *id.*

184. Cf. *Nasdaq Private Market Solutions*, *supra* note 24; *Further Disclosures*, SHARESPOST FIN. CORP., <https://sharespost.com/further-disclosures/> [<https://perma.cc/R5K5-K5PT>] (last visited Oct. 3, 2020).

As opposed to certain EPMs like NASDAQ,<sup>185</sup> venture exchanges have no track record of accurate pricing.<sup>186</sup> NASDAQ Private Market and its competitors have fairly long track records of accurately pricing securities and matching buyers with sellers.<sup>187</sup> Were venture exchanges to be subsidized or given a regulatory advantage over EPMs, the regulators would favor a less proven concept with no current track record of success.<sup>188</sup>

Many also complain that venture exchanges are designed to retain founder control, even after an IPO.<sup>189</sup> This control is maintained through dual-class equity structures that provide founders with stock that possesses supermajority voting power<sup>190</sup> while shares with one-to-one voting power are sold to the public.<sup>191</sup> Stock exchanges, such as the New York Stock Exchange, restrict companies from having outstanding dual-class voting shares unless they existed prior to their IPO.<sup>192</sup> In addition, the Standard & Poor's 500 index has prospectively banned any company from its index that has a dual-class equity structure.<sup>193</sup> Institutional investors have voiced their concerns that the Long-Term Stock Exchange's goal is not really to support emerging companies, but rather to protect the founders' and VC's managerial interests.<sup>194</sup> This lack of shareholder control is a significant concern for institutional investors.<sup>195</sup>

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185. See *Nasdaq Private Market Solutions*, *supra* note 24.

186. See Kevin J. Delaney, *A Group from Silicon Valley Has a Serious Plan for Creating a Totally New US Stock Exchange*, QUARTZ (June 13, 2016), <https://qz.com/704657/eric-ries-ltse-long-term-stock-exchange/> [<https://perma.cc/Y3UE-MXSZ>] (explaining the features of the Long-Term Stock Exchange that make it the first of its kind).

187. See *NASDAQ Report*, *supra* note 43; *Further Disclosures*, *supra* note 184.

188. See *Venture Exchange Registration*, *supra* note 165, at 21849.

189. See Letter from Jeffrey P. Mahoney, Gen. Couns., Council of Institutional Invs., to Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Jan. 22, 2019) [hereinafter CII Letter], [https://www.cii.org/files/issues\\_and\\_advocacy/correspondence/2019/20190109%20SEC%20Letter%20LTSE%20Application.pdf](https://www.cii.org/files/issues_and_advocacy/correspondence/2019/20190109%20SEC%20Letter%20LTSE%20Application.pdf) [<https://perma.cc/QH7T-9WBA>] (illustrating the position of long-term asset managers on the issues that may arise from tiered voting shares in general and on the Long-Term Stock Exchange in particular).

190. See *id.*

191. See *id.*

192. LISTED COMPANY MANUAL RULE 313.10, N.Y. STOCK EXCH., [https://nyse-guide.srorules.com/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D-WKUS\\_TAL\\_5667%23teid-100](https://nyse-guide.srorules.com/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D-WKUS_TAL_5667%23teid-100) [<https://perma.cc/W8Q4-5RW2>] (last visited Oct. 4, 2020).

193. See Trevor Hunnicutt, *S&P 500 To Exclude Snap After Voting Rights Debate*, REUTERS (July 31, 2017, 8:44 PM), <https://www.reuters.com/article/us-snap-s-p-idUSKBN1AH2RV> [<https://perma.cc/L846-UWBN>].

194. See CII Letter, *supra* note 189.

195. See *id.*

Venture exchanges, including the Long-Term Stock Exchange, leave regulatory hurdles in place.<sup>196</sup> They may provide a unique trading platform for newly listed companies, but venture exchanges are still national exchanges under the Securities Exchange Act of 1934.<sup>197</sup> Therefore, they do not reduce the burden of registering offerings with the SEC or the disclosure requirements of public company status.<sup>198</sup> If companies are waiting to go public due to regulatory expenses, having a new place to list will likely not put pressure on managers and major shareholders to push for an IPO. The OSP would encourage public offerings rather than simply provide a new landing zone for registered securities.<sup>199</sup>

### III. SOLUTION: AN OPPORTUNITY ZONE FOR PUBLIC LISTINGS

This Part will propose the OSP, an opportunity zone for private company securities, in order to encourage more companies to go public and shorten the length of time before companies undergo an IPO. First is an explanation of the background motivations for the Program and a discussion of its legal inspiration, the opportunity zone fund, and its proposed statutory basis. Following this discussion, the mechanics of the OSP are distinguished from the extensive shortcomings of the opportunity zone fund program. Section III.A then discusses the parameters of the OSP, specifically its mechanics, requirements, and restrictions. Finally, Sections III.D and III.E of this Note analyze the OSP's unique positive attributes, shortcomings, and challenges.

In its basic form, the OSP will encourage private investors to buy start-up opportunity securities before an IPO and encourage public investors to purchase shares after an IPO. If the issuer and purchaser follow specific requirements, including trading on an EPM, then the capital gains tax on the sale of those securities can be deferred, and the value rolled into another private or public investment within the OSP.

#### *A. Background*

Most solutions to the problem of declining IPOs focus on the front and middle of an emerging company's timeline by reducing the regulatory burden. Although the SEC has formerly mentioned lowering capital gains tax rates on IPO shares with certain holding periods, that solution was buried in a research report from 2011 with no detailed

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196. Venture Exchange Registration, *supra* note 165, at 21850.

197. *See id.* at 21853.

198. *See id.*

199. *See infra* Part III.

implementation plan.<sup>200</sup> This Section builds on the SEC's proposal and provides significant improvements and modifications to make any future proposal more effective and sustainable.<sup>201</sup> The OSP would focus on the middle to back end of the private company timeline by stimulating demand for securities. It would only be available if the company becomes publicly traded in a sustainable manner within a specified timeframe.

This solution borrows some ideas from the 2017 Tax Cuts and Jobs Act's Opportunity Zone Program. The OSP differs significantly in both substance and implementation. The proposed OSP would be far narrower and better tailored in order to reduce perverse incentives present in the Opportunity Zone Program.<sup>202</sup> The traditional Opportunity Zone Program allowed investors to sell appreciated assets, invest the proceeds, and simultaneously defer capital gains taxes.<sup>203</sup> Investors are allowed to purchase stock and partnership interests in businesses within the opportunity zone, but those purchases have been rare; instead, these funds have focused on real estate investment and development.<sup>204</sup>

The solution proposed will differ significantly from the Opportunity Zone Program because it is working to solve a different problem,<sup>205</sup> and it will be tailored to the unique structure of the market for emerging company stock.<sup>206</sup> One significant difference between the OSP and the Opportunity Zone Program is that, unlike in opportunity zones, opportunity securities can only be purchased with cash or with the sale and rollover of deferred capital gains from previous opportunity securities.<sup>207</sup> This restriction will limit the downsides that have materialized with opportunity funds that predominately serve as tax shelters for wealthy investors.<sup>208</sup>

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200. REBUILDING THE IPO, *supra* note 17, at 30.

201. *See infra* Section III.D.

202. *See* Michael Hirschfeld & Philip R. Hirschfeld, *Qualified Opportunity Zone Funds a Tax Investment Worth Considering*, 33 PROB. & PROP. 12, 12–14 (2019) (providing an overview of the tax deferral program implemented by the 2017 tax reform law that allows tax deferral of capital gains on the sale of any kind of appreciated investment asset so long as it is reinvested in a qualified opportunity fund); Jesse Drucker & Eric Lipton, *How a Trump Tax Break to Help Poor Communities Became a Windfall for the Rich*, N.Y. TIMES, <https://www.nytimes.com/2019/08/31/business/tax-opportunity-zones.html?auth=login-email&login=email> [https://perma.cc/7FZQ-H5W4] (last updated Sept. 27, 2020).

203. *See* Hirschfeld & Hirschfeld, *supra* note 202, at 12.

204. *See id.*

205. *See* Drucker & Lipton, *supra* note 202.

206. *See supra* Part II.

207. *See* Drucker & Lipton, *supra* note 202.

208. *Id.*

EPMs are the fundamental component of the OSP because they provide unique capabilities and will hopefully be realigned and incentivized to encourage public offerings. The requirement that OSP securities trade on an EPM harnesses the technology and expertise of EPM platforms and their participants. EPMs ensure there is adequate interest in the security and that there is an active and liquid market. An EPM intermediary that ensures adequate interest and liquidity in the underlying securities provides benefits to both issuers and purchasers. Issuers will be able to raise money faster and cash out key employees, whereas purchasers following the IPO or direct listing in the public markets will be able to purchase a security that has had its attractiveness and business plan tested by the private markets.

The OSP will also benefit accredited investors and others who can purchase exempt securities because it means that more securities will trade on EPMs, thus contributing to price discovery in a market that is less liquid than a national exchange. Additionally, private investors will inherently encourage public offerings. When private investors actively trade on an EPM they will ensure that a company's securities will qualify for the OSP.

### *B. Statutory Basis*

Under I.R.C. § 1031(a), the Internal Revenue Code allows the deferral of gain on real property that would result from a sale so long as a like-kind exchange occurs within a statutory period.<sup>209</sup> This allows taxpayers to effectively roll their capital gains into the new property and immediately take advantage of their gain's additional buying power.<sup>210</sup> The 2017 Tax Cuts and Jobs Act limited § 1031 to real property.<sup>211</sup> Prior to 2017, personal and other kinds of property used in a trade or business or for investment could defer capital gains through a like-kind exchange.<sup>212</sup> Stocks, bonds, and other securities have always been explicitly excluded from taking advantage of this kind of tax

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209. 26 U.S.C. § 1031(a) (2020).

210. Bradley T. Borden, *Safe Harbors and Careful Planning Make Deferred Exchanges a Valuable Tool*, 25 J. TAX'N INVS. 43 (2008) (providing an overview of deferred exchanges in the context of real property transactions).

211. The Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13303(a) 131 Stat. 2123 (codified as amended at I.R.C. § 1031 (2018)) [hereinafter 2017 Tax Reform Law] (amending § 1031(a)(1) by striking "property" each place it appears and inserting "real property").

212. 47A C.J.S. Internal Revenue § 122 (2020).

treatment, except in rare and economically inconsequential circumstances.<sup>213</sup>

The OSP would apply § 1031 to private market shares that are trading on an EPM in very specific circumstances in order to encourage IPOs and direct listings of exempt securities. The method of this solution is to rely on the technological advantage that EPMs provide.

These private markets are run by reputable broker-dealers that are registered and regulated by the SEC.<sup>214</sup> The mere fact that shares are allowed to trade on these exchanges means that financial professionals at these firms likely have exposure to the intricacies of the business beyond an ordinary private market investor.<sup>215</sup> By using this additional layer of vetting facilitated by technological advancement, the tax code can be used to subsidize the investors in these companies should the company be listed on a large exchange in the future.<sup>216</sup> The fundamental differences between the OSP and the current Opportunity Fund Program are the key to ensuring that this solution works properly without the adverse impacts of the Opportunity Fund Program.<sup>217</sup>

### *C. The Opportunity Securities Program: Mechanics*

In order for a purchase or issuance of securities to qualify as an opportunity security that receives like-kind treatment, the purchase or issuance will have to meet certain requirements. The conditions discussed below are meant to limit negative externalities and tailor the impact of this proposal. Additionally, these restrictions fundamentally differentiate the OSP from the Opportunity Fund Program in scope, implementation, and purpose.<sup>218</sup>

EPM requirements establish how the securities will need to be traded on an EPM platform to qualify for “opportunity status.”<sup>219</sup>

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213. 26 U.S.C. § 1036(a) (2020) (“[N]o gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation.”).

214. See *Nasdaq Private Market Solutions*, *supra* note 24; *Frequently Asked Questions*, *supra* note 179; Eaglesham & Jones, *supra* note 144.

215. See *Nasdaq Private Market Solutions*, *supra* note 24.

216. See *id.*

217. Unlike the opportunity funding program there will be no “opportunity zones” selected by lobbyists and regulators. See Drucker & Lipton, *supra* note 202. Therefore, companies will not be able to lobby to be included in the program since it will apply to all private companies that trade on an EPM. See *id.* Additionally, investors will not be able to invest the value of appreciated assets unless those assets were opportunity securities. See *id.* This limitation will discourage tax sheltering and tailors the subsidizing nature of this program. See *id.*

218. See Drucker & Lipton, *supra* note 202.

219. See *infra* Section III.C.1.

Listing requirements delineate the kinds of securities that qualify and where securities will have to trade once they are publicly listed.<sup>220</sup> Purchaser requirements, on the other hand, describe the obligations of a buyer of securities in ensuring they take the necessary steps to have their transactions qualify for tax deferral.<sup>221</sup> To make this incentive program effective, only common stock, preferred stock, and convertible debt will qualify for opportunity treatment because they are the primary securities that feed into an IPO and the means by which start-ups raise capital privately and publicly.<sup>222</sup> Opportunity security status for convertible debt will not apply to convertible debt instruments themselves.<sup>223</sup> Instead, the program will apply to the securities received as a result of the conversion of that debt instrument, so long as the securities received during the conversion contain the same economic and governance rights as common shares or preferred shares. The following requirements will work together to create an effective and consistent system to bring about positive and technologically driven change in the securities markets.

### 1. Issuer Requirements

An issuer wishing to qualify for OSP status must maintain its securities on an EPM, most likely either SharesPost or NASDAQ Private Market.<sup>224</sup> The securities will have to trade on an EPM for

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220. See *infra* Section III.C.1.

221. See *infra* Section III.C.2.

222. See Scott Edward Walker, *Everything You Ever Wanted to Know About Convertible Note Seed Financings (But Were Afraid to Ask)*, TECH CRUNCH, <https://techcrunch.com/2012/04/07/convertible-note-seed-financings/> [https://perma.cc/UG4U-JEFS] (last updated Apr. 7, 2012 4:42 PM).

223. A convertible debt instrument is a contract for debt that allows the creditor to convert their debt investment into equity of the issuer upon a conversion event. *Id.* A conversion event is a specified contractual circumstance embedded in the instrument that will trigger the conversion. *Id.*

224. See *Nasdaq Private Market Solutions*, *supra* note 24; *Further Disclosures*, *supra* note 184. As of now SharesPost has a very similar business model and platform as NPM. See *Nasdaq Private Market Solutions*, *supra* note 24; *Frequently Asked Questions*, *supra* note 179. That being said, SharesPost started out as an auction board for private securities, where buyers and sellers would list prices and share quantities and the platform would match orders. Vanessa Schoenthaler, *SharesPost: The Evolution of a Broker-Dealer*, 100 F ST. (Mar. 5, 2012), <http://100fstreet.com/index.php/2012/03/sharespost-the-evolution-of-a-broker-dealer/#:~:text=SharesPost%20started%20out%20in%20June,and%20execute%20their%20own%20transactions.&text=Their%20role%20was%20to%20facilitate%20transactions%20between%20buyers%20and%20sellers> [https://perma.cc/K7EH-8XLG]. Although this matching service is at the core of SharesPost's platform, it now provides advisory and brokerage services similar to NPM in order to facilitate larger scale aggregated transactions, such as private offerings and employee cash-outs. *Frequently Asked Questions*, *supra* note 179.

longer than twelve but less than thirty-six months. During that time, the security will have to trade with a certain level of liquidity, measured on a sliding scale based on market capitalization, in order to demonstrate investor sentiment and future potential.<sup>225</sup> This requirement is necessary for three reasons. First, it encapsulates all of the benefits of EPMs that have driven companies away from public markets. Second, it ensures liquidity prior to a public listing. Third, it provides a timeline for an offering by ensuring that companies are not forced to go public too early but also that they do not wait too long to go public and fail to accomplish the goal of increasing public offerings.

The twelve-month minimum will be purposefully inflexible to ensure that companies are using the EPM platform as a way to test the waters and solidify investor sentiment and liquidity rather than as a tax shelter. The maximum will be flexible for smaller companies below certain market capitalizations. These twelve-month waivers will be renewable once and, thus, provide twelve to twenty-four months beyond the standard timeline. To qualify for a waiver, the issuer will have to submit an IPO plan to the EPM. The waivers will require the approval of the EPM with the highest volume of transactions in that particular security.

To qualify as an opportunity security, the issuer's securities must undergo an initial or direct listing on the NASDAQ, the NYSE, a liquid over-the-counter market,<sup>226</sup> or a foreign equivalent of any of the above. Alternatively, the company may become a reporting entity under the Exchange Act of 1934 or a foreign equivalent, which will facilitate public access to its securities.<sup>227</sup> These two liquidity events underlie the

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225. For example, a company with less than \$500 million in market capitalization may be eligible for a two-year waiver and a company with a \$3 billion market capitalization could apply for a one-year waiver.

226. An over-the-counter market is a market for securities that are publicly traded, but are not listed on a national exchange, such as NASDAQ. See Randall Dodd, *Markets: Exchange or Over-the-Counter*, INT'L MONETARY FUND, <https://www.imf.org/external/pubs/ft/fandd/basics/markets.htm> [<https://perma.cc/U45A-J673>] (last updated Feb. 24, 2020). These securities are traded by brokers on behalf of clients without exchange intermediaries, but the securities must still be registered with the SEC. See *id.* Many smaller start-ups and early public companies that do not have the market capitalization to trade on a larger exchange trade over the counter and are disadvantaged. See *id.*

227. *Exchange Act Reporting and Registration*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/smallbusiness/goingpublic/exchangeactreporting> [<https://perma.cc/W6QY-2QBJ>] (last visited Oct. 4, 2020) ("Even if your company does not have an effective registration statement for a public offering, it could still be required to file a registration statement and become a reporting company under Section 12 of the Exchange Act if: it has more than \$10 million in total assets and a class of equity securities, like common stock, that is held of record by either (1) 2,000 or more persons or (2) 500 or more persons who are not accredited investors or it lists the securities on a U.S. exchange."). Public company status allows unaccredited investors unlimited access to an investing opportunity. See *id.*

entire prospect of resolving the IPO problem. In order for any solution to ensure greater access to these investment opportunities, the securities must become available to public investors in a reasonable amount of time.

## 2. Purchaser Requirements

To make a qualifying purchase, an investor must buy a security that has been designated an opportunity security. These securities will either be purchased on an EPM or within one year of a public offering. Purchasing the securities in the private market on an EPM exposes the investor to the risk that the company will never list or will not list in the timeframe required to receive opportunity security status. If that possibility becomes reality, the securities will no longer qualify for tax deferral.<sup>228</sup> For public market participants, opportunity securities will be those securities purchased within one year of a public listing that had previously traded on an EPM and that satisfy all other opportunity security requirements.

In order to sell an opportunity security and receive tax deferral, an investor must comply with the following requirements. The purchaser in either the public or private markets must have held the security for at least one year while the security was publicly traded. Then, within six months for private market purchasers and within one year for public market purchasers, the investor must purchase new opportunity securities from a different issuer or a different class of securities from the previous issuer to receive tax deferral. Those opportunity securities can either be private securities already designated as opportunity securities, or they can be securities that have been publicly listed within the last twelve months.

## 3. Restrictions

In order to ensure that the program captures the appropriate benefits and incentives, the program requires certain restrictions. For example, an investor will only be allowed to purchase opportunity securities with cash or with the qualified rollover of funds from the sale of securities that were previously part of the OSP.<sup>229</sup> One of the most

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228. See *supra* Section III.C.1.

229. This is in direct opposition to the problems of the Opportunity Zone Fund Program. See Drucker & Lipton, *supra* note 202; see also *Opportunity Zones Frequently Asked Questions*, U.S. INTERNAL REVENUE SERV. [hereinafter *IRS Opportunity Zone FAQ*], <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions#general> [<https://perma.cc/H8AQ-ZKWB>] (last visited Oct. 3, 2020).

controversial aspects of the current opportunity fund program is that it allows an investor to roll over already appreciated assets into an opportunity fund to further defer taxes and diversify the investor's portfolio.<sup>230</sup> Critics, with significant credibility, have portrayed the traditional Opportunity Zone Program as a tax haven for wealthy investors.<sup>231</sup> In order to limit that negative externality and encourage the widespread benefit of this program, opportunity securities will avoid this problem entirely. Legal compliance will be facilitated in the same way that brokerage firms provide segregated retirement accounts<sup>232</sup> or how § 1031 qualified intermediaries hold funds in trust to ensure compliance with the like-kind qualifications.<sup>233</sup> Although it will not be without administrative compliance costs, the OSP will not add additional costs beyond the general compliance regime that will be necessary to ensure the program is implemented properly.

Beyond these mandatory restrictions, there are two additional restrictions that, while not essential to the fundamental functioning of the program, policy makers should consider implementing in the future. First, the program could preclude founders from participating. This has the benefit of encouraging founders to divest control of their company into public hands because they would likely sell more shares in order to have a greater demand boost from the tax subsidy in a public offering. Additionally, precluding founders would limit over-subsidization. Company founders in the United States are essentially able to convert labor income into capital income taxed at a preferential rate through entrepreneurship.<sup>234</sup> The OSP would be another incentive on top of that tax benefit that may not provide a marginal benefit to society. On the other hand, allowing founder participation may encourage serial entrepreneurship by providing streams of capital for future reinvestment on a tax-deferred basis, thus benefiting society and the economy. A similar debate arises when looking to apply an early bound restriction on securities that would have to be purchased by private market participants.<sup>235</sup> This might encourage capital investment from

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230. See Drucker & Lipton, *supra* note 202.

231. See *id.*

232. See *Retirement Offerings*, TD AMERITRADE, <https://www.tdameritrade.com/retirement-planning/retirement-suite.page> [<https://perma.cc/L97H-YUPD>] (last visited Oct. 4, 2020).

233. See Treas. Reg. § 1.1031(k)-1 (2020).

234. See, e.g., Victor Fleischer, *Taxing Founders' Stock*, 59 UCLA L. REV. 60, 62–63 (2011) (describing the well-known phenomenon that founders are often compensated with equity in their enterprise instead of or in substitution for part of their labor income, which has the effect of converting labor income into capital income for income tax purposes).

235. See *supra* Section III.C.2.

mid-to-late-stage investors, but it may discourage VCs from providing issuers with their capital and expertise early on.

#### *D. Challenges, Costs, and Shortcomings*

Although the OSP would make significant and beneficial changes to the securities markets, it will likely face a number of challenges. The political, economic, and administrability challenges of this solution are not insignificant. The OSP would require the rare cooperation of the executive and legislative branches alongside private sector collaboration. The status quo has harmed investors and prior solutions have been inadequate, so cooperation between the political branches could become more realistic in the near future. The benefits of the OSP would outweigh its shortcomings, as well as the shortcomings realized by previously implemented solutions.

##### 1. Political Shortcomings

The largest political impediment to the OSP is that it requires congressional legislation.<sup>236</sup> As of 2017, Congress scaled back the tax deferral of § 1031 by removing deferral for like-kind exchanges of tangible property used in a trade or business or held for investment purposes.<sup>237</sup> Section 1031 now only provides deferral for real property.<sup>238</sup> A presidential administration could attempt to undertake this endeavor through administrative rulemaking. Given that Congress has played an essential role in shaping § 1031,<sup>239</sup> there are likely no areas of discretion for the executive branch to unilaterally implement the OSP.

Although both Democratic and Republican administrations have pushed to ease the burden of public company status for smaller companies, recent administrations have favored a deregulatory approach.<sup>240</sup> Providing this tax deferral could easily cost billions of

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236. Congress limited like-kind exchanges in 2017, which is not encouraging for further expansion of this provision to opportunity securities. 2017 Tax Reform Law, *supra* note 211, Stat. 2054, 2123. *But see id.* at § 1400Z-2(a) 131 Stat. 2054, 2184 1400Z-2 (codified as amended at I.R.C. § 1400Z-2) (describing the capital gains incentives built into the Opportunity Fund Program).

237. 2017 Tax Reform Law, *supra* note 211, Stat. 2123.

238. *Id.*

239. *See* Zeidel, *supra* note 104.

240. *See* Frank Partnoy, *The Death of the IPO*, ATLANTIC (Nov. 2018), <https://www.theatlantic.com/magazine/archive/2018/11/private-inequity/570808/> [<https://perma.cc/CT2V-FSV6>]; Oranburg, *supra* note 52, at 1018–19; Saunders, *supra* note 10, at 952–53.

dollars.<sup>241</sup> Despite these costs, there are technological externalities that result from start-ups that are not easily quantified in economic growth figures and tax expenditures. If this program creates the funding necessary to bring about the creation of the next Google or Genentech,<sup>242</sup> society may be better off despite the fiscal costs.

## 2. Administrative and Economic Challenges

The OSP will likely face a shell company problem. Entrepreneurial tax dodgers could be tempted to create shell corporations traded on EPMs with no economic activity in an attempt to provide a tax deferral mechanism with no economic substance. Since EPMs are broker-dealers regulated by the SEC,<sup>243</sup> this is a place where SEC rulemaking could prescribe various revenue and business activity benchmarks that a company would have to meet in order to issue securities that qualify for the opportunity program, much like the tax shelter crackdowns of the 1980s and 1990s.<sup>244</sup>

Blocking shell companies from utilizing this program may not deter all forms of misuse of this program. That restriction does not foreclose the possibility that sophisticated investors will find ways to take advantage of the tax benefits available through the OSP in a way that is contrary to public policy. This is where active management by the Internal Revenue Service (IRS) and the SEC, through rulemaking, would have a role. These agencies would be tasked with creating standards for the opportunity securities so that investors know what securities qualify upfront. Moreover, if enterprising tax avoiders try anything sneaky, they do so at their own peril.

One aspect of this program where policy makers and the public may take issue is that the OSP will effectively subsidize EPMs. Despite the cost, EPMs are essential to this solution. EPMs play a role not only in price discovery and liquidity, but also in placing companies in front

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241. See Chuck Marr, *The Tax Loophole of 2016: Like-Kind Exchange*, CTR. ON BUDGET & POL'Y PRIORITIES (May 18, 2016, 4:30 PM), <https://www.cbpp.org/blog/the-tax-loophole-of-2016-like-kind-exchange> [<https://perma.cc/7MEY-6ZWA>] (explaining that the § 1031 like-kind exchange exemption costs the government billions of dollars each year in forgone tax revenue).

242. "Genentech is a biotechnology company dedicated to pursuing groundbreaking science to discover and develop medicines for people with serious and life-threatening diseases." *About Us*, GENENTECH, <https://www.gene.com/about-us> [<https://perma.cc/22QN-SXGK>] (last visited Oct. 4, 2020).

243. See *Nasdaq Private Market Solutions*, *supra* note 24.

244. See DEPT OF TREASURY, *THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 25-30* (1999), <https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Corporate-Tax-Shelters-1999.pdf> [<https://perma.cc/2VQ8-A6XB>].

of investors and in forcing start-ups to seek investment banking and capital raising advice early and often.<sup>245</sup>

Furthermore, the SEC may have to subject EPM pricing to regulation,<sup>246</sup> as it is possible that EPMS could charge such a high gatekeeper fee that many companies would not be able to access the EPM and thus obtain the benefits of the opportunity program. Without intervention, this would limit the participants in the OSP and could dull the desired effects on the IPO market. This shortcoming could be mitigated by effective SEC regulation,<sup>247</sup> enabled by the fact that EPMS are registered broker-dealers subject to SEC regulation.<sup>248</sup>

Finally, some critics could claim that this program would unfairly subsidize investments made by VCs, wealthy individuals, and corporations because it offers a way to defer taxation when they sell their investments.<sup>249</sup> There is tremendous investment inequality, specifically in relation to the households that are and are not invested in the stock market.<sup>250</sup> Although this may increase investment concentration in the short term, it will encourage better and more diverse investment opportunities for the investing public in the long term.

### *E. Unique Benefits*

This program, despite its shortcomings, would provide unique economic benefits over the current public offering process. This program would encourage IPOs and public offerings more broadly. It would also not be subject to the same lobbying carveouts as the Opportunity Fund Program<sup>251</sup> because it is a blanket incentive for any privately held company. A large portion of the efforts to incentivize public offerings have been deregulatory in nature.<sup>252</sup> Unlike prior solutions, the OSP

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245. See *Frequently Asked Questions*, *supra* note 179.

246. Cf. *Rulemaking: How It Works*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/fast-answers/answersrulemakinghtm.html> [<https://perma.cc/H3UB-9S2D>] (last modified Apr. 6, 2011) (explaining the SEC rulemaking process, which could be used by the SEC to limit fees that EPMS charge should Congress delegate it that power).

247. Cf. *id.*

248. See Ibrahim, *supra* note 7, at 36–40.

249. Cf. Joshua Gans, Andrew Leigh, Martin C. Schmalz & Adam Triggs, *Market Power and Inequality*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 23, 2019), <https://corpgov.law.harvard.edu/2019/01/23/market-power-and-inequality/> [<https://perma.cc/S4MN-B9QL>].

250. *Id.*

251. See Drucker & Lipton, *supra* note 202; see also *IRS Opportunity Zone FAQ*, *supra* note 229.

252. See *supra* Sections II.A, II.B, II.C.1.

prioritizes disclosure and market integrity by maintaining the current regulatory structure.<sup>253</sup>

If regulation is viewed as a tax,<sup>254</sup> one way to get the benefits of regulation while minimizing costs is to “offset” that tax in other areas. The OSP would offset its “regulatory taxes” with increased investor demand. The OSP has the ability to increase the demand for public offerings, and it ensures that US securities laws are not watered down. The SEC will not have to further erode investor protections in order to stimulate economic growth and capital formation. By focusing on spurring demand, an issuer’s securities will be more valuable in the aggregate; therefore, the cost of regulation per share issued will be lower. This would simultaneously increase the number of public listings and broaden access to new, high-growth investment opportunities, and the OSP would do all of this without watering down current disclosure and anti-fraud protections. This solution does not require wholesale upheaval of the securities laws in the United States and would address the lack of public offerings head on. Additionally, the OSP is investor-centric and issuer-neutral. The OSP focuses on influencing investor behavior rather than issuer behavior, and it provides equal benefits to individual, accredited, and institutional investors. Should this public offering problem continue or get worse, this innovative solution is the answer.

#### IV. CONCLUSION

The decline of IPOs in the United States has limited investment opportunities and long-term technological and economic growth. So far, attempts to deregulate and exempt issuers from certain regulations have not proven successful.<sup>255</sup> Many of these regulatory changes have produced effects contrary to their intended outcome.<sup>256</sup> In order to jumpstart public offerings, policy makers should consider a demand-based approach. The OSP would fulfill that goal. The OSP would convert EPMs from marketplaces where companies stay private forever, locking out the public, to drivers of public offerings. By focusing on investors and encouraging them to provide additional demand for the public securities of new companies, this solution provides a novel avenue for reform. Following this change, systemic pressure for public offerings would no longer come from governments and pundits, but

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253. See *supra* Sections II.A, II.B, II.C.1.

254. Cf. Hester Peirce, *Meeting Market Structure Challenges Where They Are*, 43 IOWA J. CORP. L. 335, 336, 362–65 (2018).

255. See *supra* Part II.

256. See *supra* Part II.

rather from investors who will benefit from investment growth and tailored tax incentives. The OSP is not without its challenges, but it is a bold step in reforming our current securities markets. If implemented, the OSP would ensure that investors have equal access to investment opportunities and would continue to support the social and technological innovations pioneered by start-ups.

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