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501 Shareholders: Redefining "Public" Companies to Help Emerging Firms

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In 2004, Google made headlines by "going public," raising $1.7 billion in what was then the biggest initial stock offering since the heady days of the tech boom.[1] Next spring, Facebook is expected to make its debut with a $10 billion initial public offering ("IPO")—one of the largest ever.[2]

Dreams of a splashy IPO may spur many entrepreneurs, but in reality, fewer and fewer companies are going public. While the stock exchange has long been the fastest and easiest way for companies to finance their growth, reaching the public market is getting tougher for emerging companies.

Thanks to a combination of legislative, regulatory, and technological changes, going public is more expensive, more burdensome, and less appealing than in the past—especially for younger, smaller, and less sexy companies that aren't expected to become Google-sized blockbusters. One recent study puts the average cost of going public at $2.5 million, plus ongoing annual costs of $1.5 million a year to keep up with paperwork and regulatory requirements.[3]

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The result has been a drought in IPOs and a crisis in access to capital for young companies seeking to grow. From 1991 to 2000, the U.S. stock markets saw an average of 530 IPOs every year.[4] Since then, the average annual number of newly-minted public companies has plummeted to about one-fourth that number.[5] In 2009, just 61 companies went public.[6] Moreover, the number of public companies listed on U.S. stock exchanges shrank from 8,000 in 1995 to 5,000 in 2010.[7]

But at the same time that going public has become tougher for younger companies, outdated rules are forcing some firms to either go public prematurely—or else radically curtail their growth to stay private. The problem is an outdated cap on the number of shareholders that a company can have before it's essentially required to go public. The so-called "500 shareholder rule"—first promulgated in 1964 to define the "public" companies in need of regulatory oversight—now poses a significant hurdle to growth for many companies. These firms may not be ready or don't want to go public but have few other options for raising capital because they can't expand their investor pool. Thus, some companies nearing the 500-shareholder threshold may face an unpalatable choice: either bear the financial and regulatory costs of going public or forego opportunities for growth.

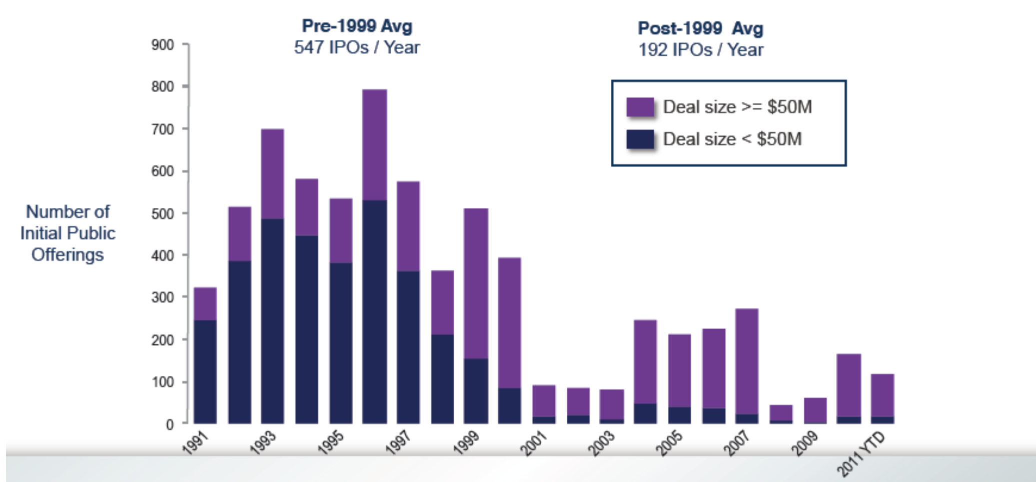
By raising the shareholder threshold to 1,000 or 2,000, as policymakers such as Sens. Tom Carper and Pat Toomey and Rep. David Schweikert have proposed, younger companies will have more room to grow, invest and create jobs, as well as more flexibility before making the plunge into going public. Coupled with other efforts to fix the broken IPO market, an amendment to this rule could give younger and smaller companies a much-needed boost toward growth.

Amending this rule would also be an important step in modernizing and reorienting the nation's overall regulatory scheme toward promoting innovation—an effort that is crucial to America's future economic renewal.[i]

The death of small IPOs

Twenty years ago, the vast majority of IPOs raised less than $50 million, and $10 million IPOs were fairly common. By 2009, according to the market analysis firm Grant Thornton LLP, the average IPO was $140 million, and IPOs under $50 million were practically non-existent.[8]

The following chart from a recent report by the IPO Task Force illustrates how mega-deals have come to dominate the IPO scene:



[i] For another example of regulation stifling growth, see Michael Mandel's report for PPI, "How the FDA Impedes Innovation: A Case Study in Over-Regulation.

In fact, in a survey of small companies by the IPO task force, just 13% said they thought "the current market is easily accessible for small companies."[9]

Analysts point to a combination of reasons for why the public markets have become much less hospitable to smaller firms. Chief among these:

- **Going public's growing price tag.**

As noted above, going public is often a multi-million dollar proposition. For a smaller company that only seeks to raise $10 million (versus $10 billion), it's increasingly not worth it—if they can afford it at all.

For smaller companies that do go public, it's also now tougher than it used to be to "make a market" in their shares.

Public companies face a wide range of regulatory burdens that can be particularly overwhelming for smaller firms. Going public requires companies to hire a squadron of lawyers and accountants to put together the documents necessary for "registering" securities with the SEC (e.g., an "S-1" registration statement that complies with the SEC's rules on disclosures about the company's business, includes audited financial statements, etc.). Companies must also hire a syndicate of investment bankers to help sell the shares and prepare listing applications if the shares will be traded on an exchange (such as NASDAQ or the New York Stock Exchange). Companies may also need to clean up their corporate structure and generally ready themselves for the bright light of public and regulator scrutiny.

After going public, companies must then comply with the SEC's rules for keeping shareholders up to date on material developments involving the company. The reporting regime requires filings of annual and quarterly reports, filings reporting current "material" events (such as a merger or acquisition), filings for the purchase or sale of stock by major shareholders, and filings of annual proxy statements for the election of board members. In addition, directors, officers and major shareholders face restrictions on when they can sell their shares. Further adding to this complexity are the two major pieces of financial services reform legislation passed in the last decade—Dodd-Frank and Sarbanes-Oxley. While both laws introduced valuable reforms to the nation's capital markets, they also introduced a host of new requirements that require even more expert help for deciphering and compliance.

According to the IPO Task Force's 2011 survey of public company CEOs, 92 percent said the "administrative burden of public reporting" was their biggest challenge post-IPO.[10] While these burdens affect every public company, they are especially daunting for smaller firms.

- **E.F. Hutton versus E-trade**

For smaller companies that do go public, it's also now tougher than it used to be to "make a market" in their shares. If people are not buying or selling a company's stock, it becomes that much harder for a company to sell new shares to raise capital for expansion or growth.

A major part of what's pushing smaller companies out of the public markets is the advent of "high-frequency trading" and other computerized stock trading strategies that take advantage of short-term swings or other opportunities in stock prices (a phenomenon that Grant Thornton LLP calls "casino capitalism"). According to some estimates, high-frequency trades now account for as much as 60 percent of the seven billion shares traded daily in the United States.[11]

The dominance of high-frequency trading hurts smaller public companies in several ways. First, electronic trading is biased toward big companies with lots of stock and market capitalization, not smaller companies with a limited number of shares and much less liquidity. This is because high-frequency traders need to get in and out of positions quickly (sometimes in a matter of seconds). Thus, while buyers are flocking to big company stocks, smaller companies risk getting no buyers at all.

Second, as the IPO Task Force points out, the short-term nature of high-frequency trading means that fewer investors are looking at companies as long-term investments based on their fundamental prospects for growth.[12] (Gone are the days when someone might have bought five shares in IBM and hung on to them for 30 years because they suspected computers might someday be important.) In 1970, public market investors held stock for an average of five years; today investors hang on to a stock for an average of less than three months.[13]

Third, while electronic trading has "democratized" access to the public markets—now anyone can open an E-trade account—it also accelerated the demise of traditional stockbrokers who were once a reliable conduit for smaller companies trying to spread the word to investors.[14] Not only could traditional stockbrokers not compete with the lower prices charged by online brokerages, they could no longer afford to invest in researching smaller companies as prospective investments. While big, brand-name companies have no difficulty getting ordinary investors, emerging public companies now have much more trouble getting average investors to buy their shares.

Arrested development: The 500-shareholder rule as a lid on growth

In addition to public markets becoming an increasingly hostile environment for smaller companies, younger firms are facing another lid on their growth: an outdated, arbitrary rule on the number of shareholders a company can have before it's essentially required to go public.

Section 12(g) of the Securities Exchange Act of 1934 requires any company with total assets exceeding $1 million (now $10 million) and "a class of equity security… held of record by five hundred or more" to register with the SEC.15

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There are several reasons why the 500-shareholder threshold is damaging to emerging companies:

- **500 shareholders of record is the wrong measure for determining if a company is "public."**

This "500 shareholder rule" was enacted as part of the Securities Act Amendments of 1964, which came about to regulate what was then a brand-new, booming and (at the time) unregulated "over the counter" market for stocks not listed on major exchanges. Too many shares were being traded over-the-counter without SEC oversight, leading to concerns of fraud. The 1964 legislation was intended to broaden the SEC's reach over this market by essentially erasing the distinction between securities traded over the counter and securities traded on an exchange.[16]

As the SEC itself has noted, Section 12(g) registration requirements "were aimed at issuers that had 'sufficiently active trading markets and public interest and consequently were in need of mandatory disclosure to ensure the protection of investors.'"[17]

But as Professor William Sjostrom writes in the *Harvard Business Law Review,* what may have been a "sensible proxy" in 1964 is not the right proxy today.[18]

Many companies today approaching the 500-shareholder threshold are not "public" because there is no widespread interest in their shares and their shares are not actively traded. Instead, in many cases, these companies' shares are held by venture capital firms and "angel" investors who are in for the long haul. As Professor Sjostrom puts it, the "disappearance of the small IPO market" means "many companies are forced to remain private for much longer than similar companies in the past. As a result, these companies have to do more rounds of private equity financing with each round adding more shareholders and getting the company closer to the 500-shareholder trigger."[19]

On the other hand, it's also possible for a company to have fewer than 500 shareholders "of record" and still be very "public" in the amount of interest it generates. That's the case with Facebook, which although technically still a private company is one of the best-known companies in the world. Columbia University Law Professor John Coffee argues that the very concept of "shareholder of record" is archaic. [20] A bank or broker-dealer who holds a block of shares on behalf of hundreds of clients is still technically just one shareholder "of record," even though that intermediary's clients are the true "beneficial" holders of the stock.[ii]

In any event, "500 shareholders of record" is a poor barometer of whether a company is "public" enough to mandate the extensive investor protections required by federal securities laws. For some smaller companies, the effect of the shareholder rule is to put an arbitrary limit on the venture financing it can do (and may desperately need) to grow the company successfully.

- **The current rule limits companies' flexibility as they grow.**

Another problem with the 500-shareholder rule is that it limits options for companies as they grow, especially if they decide that staying private is the right strategic decision.

One example is Wawa, Inc., a 200-year-old family-owned company that now runs a string of nearly 600 convenience stores on the East Coast. As the company's chief financial officer recently testified in Congress, breaching the 500-shareholder threshold would force the company "to choose between becoming a public reporting company" or "initiating a costly, time consuming corporate restructuring… at the expense of future growth." [21] On the other hand, having the flexibility to stay private would allow companies such as Wawa "to use scarce resources on research and development, new store growth and job creation, rather than on regulatory compliance costs." [22]

The contortions that companies are forced into to avoid the 500-shareholder threshold may also go as far as curtailing hiring. Options are often a major inducement for workers joining a start-up, and option-holders do not in fact count toward the 500-shareholder limit. But once an option-holder exercises his or her options and becomes a shareholder, they count toward the 500-shareholder threshold. As a result, some companies either won't hire or won't award options, thereby potentially passing up valuable talent.[23]

- **The rule limits the growth of alternative markets for investments in emerging companies.**

[ii] Some have argued that lifting the 500-shareholder rule might encourage some currently public companies to "go dark"—i.e. go private. However federal regulations (specifically Rule 12g5-1) clearly state that companies can't hide behind a holder of record if they are trying "primarily to circumvent" the registration requirements of Section 12(g).

Even as public markets are becoming less hospitable to smaller companies, smaller companies are still hungry for capital.

Recent years have seen some potentially innovative ways to create an alternative to an IPO for emerging companies. These efforts include the creation of the NASDAQ Portal Alliance (144A PIPO) and Entrex markets[24] as well as the birth of firms such as SecondMarket. All of these efforts are largely aimed at connecting "accredited" investors and "qualified institutional buyers"—i.e., the types of sophisticated investors that need less protection from federal securities laws—with investment opportunities in emerging companies.

While the unfettered growth of these alternative markets is potentially cause for concern, the 500-shareholder limit unnecessarily limits the ability of these alternative markets to match growing companies in need of capital with new, sophisticated investors. Moreover, in the absence of these alternative mechanisms for raising capital, emerging companies may find their growth irreparably stunted.

Conclusion: 501 Shareholders... Or More

Increasing the 500-shareholder limit to 1,000 or 2,000 is a simple, sensible step that could provide immediate relief.

The original drafters of the 500-shareholder rule never actually intended for this limit to act as a lid on the growth of emerging companies. Yet given the changes in the public markets and the difficulties young companies now face, a lid on growth—and future jobs—is exactly what this rule has become.

To their credit, regulators have begun to recognize the problem, and the Securities and Exchange Commission ("SEC") recently convened a task force on "small and emerging companies"[25] to solicit advice. Nevertheless, the young companies that need capital today can't afford to wait for regulators to act. The drought in IPOs presents a potential crisis for young companies seeking to grow, especially in the current economy.

While eliminating the cap altogether would go too far in gutting the framework of federal securities laws, a simple, sensible step that could provide immediate relief is to increase the 500-shareholder limit to 1,000 or 2,000, as a bipartisan group of lawmakers in both houses of Congress has suggested.[26] These proposals would also exempt employee shareholders from counting toward the limit so that increases in company headcount aren't penalized. These modest changes would provide many growing companies with more space to breathe while also giving investors the protections that federal securities laws are meant to provide.

About the Author

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The Progressive Policy Institute (PPI) is an independent research institution that seeks to define and promote a new progressive politics in the 21st century. Through research and policy analysis, PPI challenges the status quo and advocates for radical policy solutions.

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[26] See, for example, H.R. 2167 and S. 1824, both titled the Private Company Flexibility and Growth Act.