Firms Gone Dark

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The securities laws have permitted hundreds of firms to exit the mandatory disclosure system even though these firms' shares continue to be publicly traded and may be held by thousands of investors. Such exiting firms are said to "go dark" because they subsequently tend to provide little information to public investors. This Article describes the going-dark phenomenon and considers its implications for the longstanding debate over the desirability of mandatory disclosure. The Article also puts forward a new approach to regulating firms seeking to go dark: giving public shareholders a veto right over exit from mandatory disclosure.

INTRODUCTION

Most publicly traded firms in the United States are considered "reporting companies" subject to the mandatory periodic disclosure requirements of the federal securities laws.[1] Firms subject to these requirements must periodically provide financial information to the market, as well as make public information about insiders' self-dealing transactions and compensation arrangements.[2] Such periodic disclosures benefit investors by facilitating trading in the firm's shares and by enabling investors to monitor insiders, thus reducing agency costs.

Although the mandatory disclosure system has been described as a difficult-to-exit "lobster trap,"[3] a reporting company is currently permitted to terminate its disclosure obligations while remaining publicly

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1 These periodic disclosure requirements are found in § 13 of the Securities Exchange Act of 1934 and various SEC regulations implementing this statute. See 15 USC § 78m; 17 CFR § 229.301.

2 A reporting firm must disclose in its annual report detailed information on the firm's financial results, its assets and financial condition, legal proceedings against the firm, and information on the firm's officers and directors. See, for example, 15 USC § 78m; 17 CFR § 229.301 (listing types of financial data to be disclosed); 17 CFR § 229.303a (describing requirements for "[m]anagement's discussion and analysis of financial condition and results of operations" in the annual report).

3 See generally Edward Rock, *Securities Regulation As Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 Cardozo L Rev 675 (2002).

traded if two conditions are satisfied: (1) trading in the firm's securities is moved exclusively to the "Pink Sheets" over-the-counter (OTC) market, and (2) the firm does not have any class of securities outstanding with three hundred or more "holders of record."[4]

This "recordholder" test would appear to prevent any firm with three hundred or more shareholders from exiting mandatory disclosure. However, the test currently does not define a "holder of record" as the real (or "beneficial") owner of the firm's stock, but rather as the party "identified as the owner" of the security on the firm's records.[5] Most shares in publicly traded firms are held by nominees, such as banks and brokerage houses, not by the beneficial owners themselves. Each nominee, in turn, holds its shares on behalf of dozens, hundreds, or even thousands of institutional and individual investors.[6] Thus, a reporting company with thousands of beneficial shareholders can easily have fewer than three hundred "holders of record" and be eligible to exit mandatory disclosure.

Over the last several years, insiders of hundreds of US companies—some with thousands of public shareholders—have taken advantage of the current recordholder test to exit the mandatory disclosure system while their shares continue to be publicly traded. Some firms had more than three hundred recordholders shortly before exiting but used a reverse stock split or repurchase tender offer to get below the three hundred recordholder threshold. Firms exiting mandatory disclosure are said to "go dark" because, after exit, insiders generally refuse to provide any information to public investors. Not surprisingly, an announcement that a firm will exit mandatory disclosure typically causes a sharp drop in its stock price.

In 2003, a number of institutional investors petitioned the SEC to change the definition of "holder of record" under the recordholder test to "beneficial owner."[7] Such a change would prevent firms with three hundred or more beneficial owners from exiting mandatory disclosure. Revising the shareholder threshold in this manner would make it more difficult for publicly traded firms to exit mandatory disclosure without first undertaking a reverse stock split or repurchase tender offer.

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4 See 15 USC § 78l.

5 See 17 CFR § 240.12g5-1(a).

6 See Michael K. Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information about Non-reporting Issuers with Quoted Securities*, 39 Ind L Rev 309, 315–16 (2006).

7 See SEC, *Petition for Commission Action to Require Exchange Act Registration of Over-the-counter Equity Securities* (July 3, 2003), online at http://www.sec.gov/rules/petitions/petn4483.htm (visited Jan 11, 2009).

In 2006, the SEC's Advisory Committee on Smaller Public Companies addressed the issue of firms going dark.[8] Echoing the institutional investors' petition, the Committee recommended that the SEC change the definition of "holder of record" to "beneficial owner."[9] More generally, it urged the SEC to reconsider its approach to regulating exits from the mandatory disclosure system.[10] However, the SEC has yet to act on these recommendations. Thus, insiders of publicly traded firms are still able to exit mandatory disclosure even when their firms have thousands of public shareholders after exit.

The purpose of this Article is threefold: (1) to explain how a firm can go dark over the objection of its public investors; (2) to show that insiders' post-exit disclosure practices cast further doubt on the claim, advanced by critics of mandatory disclosure, that insiders can be counted on to voluntarily provide adequate information to public investors; and (3) to put forward a new approach to regulating exits from mandatory disclosure: giving public shareholders the right to veto such exits.

Part I of this Article describes the going-dark phenomenon. It explains how a firm's insiders can exit mandatory disclosure even though the firm's shares continue to be publicly traded and may be held by thousands of investors who prefer that the firm remain a reporting company. It then describes the characteristics of firms that go dark and the stock market's sharply negative reaction to going-dark announcements.

Part II examines the disclosure practices of firms that have gone dark and explores their implications for the longstanding debate in securities regulation over whether mandatory disclosure is needed. It begins by describing this debate. Critics of mandatory disclosure argue that insiders can be counted on voluntarily to provide the "firm-optimal" level of disclosure—that which maximizes the joint wealth of insiders and public investors. Defenders of mandatory disclosure disagree, arguing that insiders often have an incentive to provide less than the firm-optimal level of disclosure. Part II then briefly describes recent studies examining the effect of imposing mandatory disclosure on certain OTC firms in 1965 that previously had not been subject to these disclosure requirements. These studies' findings raise questions about critics' claim that insiders voluntarily provide sufficient information to investors. The disclosure practices of gone-dark firms, Part II shows, cast further doubt on this claim. Only a small fraction of firms that go dark provide *any* financial information publicly to their

8 See SEC, *Final Report of the Advisory Committee on Smaller Public Companies* 85 (Apr 23, 2006), online at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf (visited Jan 11, 2009).

9 See id at 83.

10 See id at 91–92.

hundreds or thousands of public investors. Part II explains why it is highly unlikely that, for the vast majority of these gone-dark firms, the firm-optimal level of disclosure is zero. The fact that stock prices drop substantially when firms announce they will exit mandatory disclosure provides further reason to be skeptical that post-exit disclosure levels are generally firm-optimal.

Part III addresses the question of how exits from mandatory disclosure should be regulated. It begins by explaining that when insiders can unilaterally decide to exit mandatory disclosure, they may have an incentive to exit even when such exit reduces firm value. The institutional investors' proposal to prohibit firms with three hundred or more beneficial shareholders from exiting mandatory disclosure, it shows, would decrease value-reducing exits but not eliminate them. Part III then puts forward a new approach to regulating exits from mandatory disclosure: requiring public investor approval before insiders can turn off the lights. Such an approach, it demonstrates, would prevent a firm from exiting mandatory disclosure as a publicly traded company unless such exit increases firm value.

I. Firms Going Dark

This Part examines the phenomenon of firms "going dark"—exiting the mandatory disclosure system even though their shares remain publicly traded and may be held by thousands of investors. Part I.A explains how insiders can cause their firms to go dark over the objection of public investors. Part I.B briefly explores the characteristics of going-dark firms and describes the stock market's reaction to going-dark announcements.

A. How Firms Go Dark

I begin by describing the current reach of the mandatory disclosure regime and then explain how insiders are able to exit the mandatory disclosure system without the consent of public investors.

1. The current reach of mandatory disclosure.

Under the Securities Exchange Act of 1934[11] ("Exchange Act"), most firms selling shares to public investors in the United States are required to become "reporting companies": they must file a registration statement with the SEC and enter the mandatory periodic disclo-

11 Securities Exchange Act of 1934, Pub L No 73-291, 48 Stat 74, codified as amended at 15 USC § 78a et seq.

sure system.[12] This requirement is triggered, for example, when a firm registers a class of securities on a national securities exchange,[13] or when the firm has more than $10 million in assets and a class of securities with at least five hundred holders of record.[14]

A reporting company's disclosure obligations are extensive. The firm must periodically provide the market with information about its financial condition, such as a balance sheet and income statement, as well as publicly disclose information about insiders' self-dealing transactions, stock purchases and sales, and compensation arrangements.[15] The firm must also notify the market whenever there has been a material change in its financial condition or operations.[16]

A firm that wishes to remain publicly traded generally cannot exit the mandatory disclosure system For example, a reporting company cannot exit mandatory disclosure and remain eligible to trade on the New York Stock Exchange (NYSE) and the Nasdaq Stock Market.[17] This restriction against exit, however, does not apply if trading in a firm's shares is moved exclusively to the Pink Sheets OTC market: an electronic quotation service that provides a trading platform for thousands of companies.[18] A firm that is willing to be traded only on the Pink Sheets may generally exit mandatory disclosure as long as the firm does not have outstanding any class of securities with at least three hundred "holders of record."[19]

This recordholder test would appear to prevent firms with three hundred or more shareholders from exiting the mandatory disclosure system. However, for purposes of applying the recordholder test, the securities laws do not define a "holder of record" as the ultimate beneficial owner of the stock. Rather, a group of beneficial owners is counted as a single "holder of record" if the group's shares are held in

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12 The periodic disclosure requirements are found in § 13 the Exchange Act, as amended, and the SEC's regulations implementing the Exchange Act. See 15 USC §§ 78l, 78m.

13 See 15 USC § 78l(b). Firms whose securities trade on Nasdaq or the OTC Bulletin Board (OTCBB) markets must also be reporting companies. See Molitor, 39 Ind L Rev at 332–34 (cited in note 6).

14 See 15 USC § 78l(g); 17 CFR § 240.12g-1. A firm must also register with the SEC and enter the mandatory disclosure system if it files a registration statement to sell shares to the public under § 15(d). See 15 USC § 78o(d). See also Molitor, 39 Ind L Rev at 313–14 (cited in note 6).

15 See note 2.

16 See 17 CFR § 249.308.

17 See Molitor, 39 Ind L Rev at 332–34 (cited in note 6).

18 Id at 329–32 (cited in note 6).

19 Under the recordholder test, a firm with assets of $10 million or less is not subject to continuing mandatory disclosure requirements unless it has a class of securities with at least five hundred holders of record. See 17 CFR § 240.12g-4(a)(1)(ii). However, firms going dark often have assets exceeding $10 million. See Part I.B. Thus, for convenience, I assume throughout this Article that the applicable threshold for continuing mandatory disclosure requirements under the recordholder test is three hundred holders of record.

street name by a single financial institution.[20] As a result, a firm with thousands of beneficial shareholders may have fewer than three hundred recordholders and be able to satisfy the recordholder test for exiting mandatory disclosure.[21]

To be sure, a firm exiting the federal mandatory disclosure system is still subject to any information disclosure requirements imposed by the corporate law of the state in which it is domiciled. However, these requirements, if any, tend to be minimal.[22] Strikingly, the state that has attracted the most incorporations of public companies—Delaware—has no periodic disclosure requirements. Thus, a Delaware-domiciled firm that exits mandatory disclosure is not required to disclose any information to public investors.[23]

2. Exiting the mandatory disclosure system.

I now describe the process by which a reporting company can exit mandatory disclosure without public investors' consent and remain publicly traded. I first consider a firm that currently has fewer than three hundred recordholders, and then a firm that currently has at least three hundred recordholders.

a) Firms with fewer than three hundred recordholders. Consider a reporting company that currently has fewer than three hundred recordholders. Such a firm already satisfies the recordholder test. If the firm's stock is currently traded exclusively on the Pink Sheets, the firm can exit mandatory disclosure immediately and continue to be publicly

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20 See 17 CFR § 240.12g5-1; Molitor, 39 Ind L Rev at 315–16 (cited in note 6) (explaining that securities are typically held of record by banks and broker dealers, not the beneficial owner).

21 Once a Pink Sheets–traded reporting company has fewer than three hundred recordholders, it need only take one simple step to exit the mandatory disclosure system: filing a one-page Form 15 with the SEC indicating the provision under which the firm is exempt from these disclosure requirements. See 17 CFR § 249.323; Molitor, 39 Ind L Rev at 347 (cited in note 6).

22 See Robert B. Thompson and Hillary A. Sale, *Securities Fraud As Corporate Governance: Reflections upon Federalism*, 56 Vand L Rev 859, 867 (2003).

23 All states, including Delaware, have shareholder inspection statutes that permit individual shareholders to seek to examine the books and records of a firm. See, for example, 8 Del C § 220(b) (Michie). If access to such information were costless, and the information were complete, these inspection statutes would effectively provide periodic disclosure. However, accessing corporate information through shareholder inspection statutes is quite difficult in practice. Examinations are usually resisted by managers, requiring individual shareholders to incur expenses litigating for access to the information. See Randall S. Thomas, *Improving Shareholder Monitoring and Corporate Management by Expanding Statutory Access to Information*, 38 Ariz L Rev 331, 356–57 (1996) (noting that shareholders hoping to get access to books and records may need to spend $20,000 to $50,000 in litigation fees). Moreover, the information obtainable through shareholder inspection is limited. The Delaware statute does not even provide what information corporations should preserve for inspection. A shareholder who litigates for access to the records may thus find precious little there. As a result, state corporate law inspection rights are in no way a substitute for the periodic disclosure requirements of the federal securities laws.

traded. If the firm's stock is traded on another market, the stock must be "delisted" and trading moved exclusively to the Pink Sheets.[24] Delisting generally does not require shareholder approval (let alone the consent of *public* investors).[25] Thus, insiders of firms that have fewer than three hundred recordholders can cause these firms to exit the mandatory disclosure system over the objection of public investors, regardless of where these firms' shares are currently traded.

b) Firms with at least three hundred recordholders. Now consider a reporting firm that has at least three hundred recordholders. Like a firm with fewer than three hundred recordholders, it cannot exit mandatory disclosure as a publicly traded firm unless its shares are (or will be) traded exclusively on the Pink Sheets. Thus, insiders may need to delist the firm's shares from another market which, again, can be done without public shareholder approval.[26]

In addition, the firm must eliminate enough recordholders to get below the three hundred recordholder threshold. As I explain in more detail below, there are two possible techniques for reducing the number of recordholders, both of which involve repurchasing some of the firm's stock: (1) a reverse stock split, and (2) a repurchase tender offer. The reverse stock split sometimes does not require public shareholder approval; the repurchase tender offer *never* requires public shareholder approval. Thus, insiders can often find a way to satisfy the recordholder test without public shareholder approval.

Of course, to eliminate the required number of recordholders, the firm must have on hand (or borrow, perhaps from insiders) adequate cash. The more shareholders that must be eliminated to satisfy the recordholder test, the more cash will be needed. In certain cases, the cash requirement may be substantial enough to discourage insiders from exiting. The important point here, however, is that insiders can sometimes unilaterally exit mandatory disclosure even if the firm has three hundred or more recordholders shortly before exit.

i) Reverse stock split. The first approach to reducing the number of recordholders is to undertake a reverse stock split (for ex-

24 Because the Pink Sheets market has no listing requirements, any firm that delists itself from a stock exchange can be traded on the Pink Sheets. See Molitor, 39 Ind L Rev at 311 (cited in note 6).

25 See, for example, NYSE, *Listed Company Manual* § 806.02, online at http://www.nyse.com/Frameset.html?nyseref=http://www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html (visited Jan 11, 2009) (indicating that board approval is sufficient for firms to delist from the NYSE); Molitor, 39 Ind L Rev at 344 n 206 (cited in note 6). Shareholder approval could be required by the firm's corporate charter, but I have not been able to find any evidence of the use of such provisions.

26 See Molitor, 39 Ind L Rev at 344–47 (cited in note 6) (explaining that delisting from any trading market generally requires only board approval).

ample, giving each shareholder one new share for every thousand old shares). Under corporate law, those who would receive only a fraction of a new share in a reverse stock split (in this example, those with fewer than one thousand old shares) can be forced to accept cash in lieu of that fractional share.[27] Thus, a reverse stock split can be used to involuntarily cash out many shareholders. The price for cashed-out fractional shares, which is set by the firm, may be lower than the share's actual value.[28]

Public investors' consent is not always required for a reverse stock split. Some state corporate laws may permit a reverse stock split without shareholder approval in certain circumstances.[29] And in those states requiring shareholder approval, such approval can easily be obtained without *public* shareholder approval when insiders own a majority of the firm's shares. Public investors will thus be unable to block a reverse stock split unless: (1) the state in which the firm is incorporated requires a shareholder vote, and (2) public investors own a majority of the firm's shares.

ii) Repurchase tender offer. The second approach to reducing the number of record shareholders is to conduct a repurchase tender offer: the firm offers to buy back a certain number of shares (usually for a fixed price) from shareholders.[30] Individual shareholders decide whether or not to sell their shares back to the company. If enough public shareholders tender their shares, a firm that currently has three hundred or more recordholders can get below the three hundred recordholder threshold. Unlike a reverse stock split, a repurchase tender offer never requires shareholder approval.

Public shareholder participation in the repurchase tender offer is voluntary. Thus, public investors who prefer that the firm remain a reporting company might consider refusing to tender their shares. If enough public investors "boycott" the repurchase tender offer, the firm will not be able to reduce the number of recordholders below three hundred and exit mandatory disclosure.

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27 See id at 343 n 203.

28 If the board uses an egregiously low cash-out price, shareholders may be able to successfully sue directors for breach of their fiduciary duty of loyalty. But directors are unlikely to be found liable if they set the cash-out price to the shares' pre-split trading price. And the board can depress the pre-split trading price by announcing that the firm will go dark. Thus, insiders may well be able to use the reverse stock split to buy back shares at a bargain price.

29 See, for example, Minn Stat Ann § 302A.137(a) (West) (requiring shareholder vote for a combination of outstanding shares of a class or series into a lesser number of shares of the class or series only where each other class or series of shares is not subject to a similar combination).

30 For a discussion of the mechanics and regulation of repurchase tender offers, see Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U Chi L Rev 421, 424–32 (2000).

However, it will be risky for public shareholders to boycott the repurchase tender offer in the hope that the offer will fail. If enough other public shareholders tender their shares, the firm will be able to exit mandatory disclosure, leaving the boycotting shareholders with stock in a dark firm. Thus, individual public shareholders may feel pressure to tender even if they would prefer the firm to remain a reporting company. That is, they may feel coerced to tender their shares even if the offer price is less than the value of the stock were the firm to remain a reporting company.[31] The result is a suboptimal outcome for public shareholders as a group: enough coerced shareholders tender that the firm can go dark.[32]

B. Characteristics of firms going dark

The Pink Sheets is currently home to approximately 3,700 firms trading outside of the mandatory disclosure system.[33] Many of these 3,700 companies had previously traded as dark firms on another OTC market—the OTCBB market—but fled to the Pink Sheets around

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31 Consider Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv L Rev 1695, 1708–32 (1985) (exploring the pressure-to-tender problem in the context of hostile takeover bids).

32 For example, suppose ABC's shares are worth $12 each if ABC remains a reporting company, but only $8 if ABC goes dark. And suppose ABC offers $10 per share in a repurchase tender offer. The offer is conditional on enough holders tendering their shares that the firm can satisfy the recordholder test and go dark. If too few shares are tendered, the tendered shares are returned to the public investors and the firm remains a reporting company.

Collectively, the public shareholders prefer that ABC remains a reporting company; their stock will be worth $12 per share. But each public shareholder individually has an incentive to tender into the $10 offer. Tendering a share yields either $12 (if the offer fails, and the share is returned to the tendering stockholder) or $10 (if the offer succeeds). Failing to tender yields either $12 (if the offer fails) or $8 (if the offer succeeds and the firm goes dark). The public shareholder is thus better off tendering in the event the offer succeeds, and not worse off if the offer fails. A rational shareholder will thus choose to tender (and hope that the offer fails). But if enough shareholders tender, the offer will succeed, and public investors will get $10 per share for stock that would be worth $12 per share if the firm were to remain a reporting company.

33 Over 4,300 domestically incorporated firms trade exclusively on the Pink Sheets. See Pink Sheets, *About Pink OTC Markets*, online at http://www.pinksheets.com/pink/about/index.jsp (visited Jan 11, 2009). All domestically incorporated, reporting firms trading on the Pink Sheets are categorized as "Current Information" domestic firms, of which there are about six hundred. Id (generating 604 matches when using the search function at http://www.pinksheets.com/pink/companysearch/index.jsp (visited Jan 11, 2009), and checking only the box labeled "Pink Sheets Current" and selecting "Domestic" from the pull-down menu labeled "Security Locale"). All but a handful of the "Current Information" firms appear to be reporting companies. Thus, there are approximately 3,700 domestic firms traded exclusively on the Pink Sheets that are outside of the mandatory disclosure system.

1999 when the SEC imposed mandatory disclosure requirements on all OTCBB firms, regardless of the number of recordholders.[34]

Hundreds of these nonreporting Pink Sheet firms were previously reporting companies under the securities laws before going dark. A study by Christian Leuz, Alexander Triantis, and Tracy Wang ("Leuz study") provides data on firms that went dark between 1998 and 2004.[35] The Leuz study found that during this period almost five hundred reporting companies went dark.[36] These firms tended to be small: the average book value of the firms' assets was about $16 million when they exited the mandatory disclosure system.[37]

In explaining their decisions to go dark, insiders often cite the high costs of being a reporting company.[38] The desire to avoid such costs is a plausible reason for exiting mandatory disclosure. Firms going dark tend to be relatively small; the expense of complying with mandatory disclosure would be disproportionately burdensome for such firms. Moreover, the enactment of the Sarbanes-Oxley Act,[39] which has raised reporting costs, appears to have increased the tendency of firms to go dark.[40]

Despite these potential compliance cost savings, the market reacts extremely negatively to announcements that firms are exiting mandatory disclosure. In a ten-day window around the time firms announce their intention to go dark, abnormal (market-adjusted) cumulative returns are negative 10 percent.[41] In contrast, firms announcing going-private transactions (transacttions in which all public shareholders are cashed out) experience positive market-adjusted returns in a comparable window.[42] Over a twelve-month period beginning with the announcement, firms going dark experience abnormal negative returns of

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34 See Molitor, 39 Ind L Rev at 334 n 147 (cited in note 8); Paul Rose, *Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes-Oxley*, 41 Willamette L Rev 707, 717–18 (2006).

35 See generally Christian Leuz, Alexander Triantis, and Tracy Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* (ECGI Working Paper No 155/2007, Mar 2008), online at http://ssrn.com/abstract=592421 (visited Jan 11, 2009). See also Andras Marosi and Nadia Massoud, *Why Do Firms Go Dark?* *27 (University of Alberta Working Paper, Nov 2005), online at www.business.ualberta.ca/nmassoud/pdf%20docments/Dark_massoud_Nov2005.pdf (visited Jan 11, 2009) (examining firms that went dark between January 1996 and May 2004).

36 See Leuz, Triantis, and Wang, *Why Do Firms Go Dark?* at *2 (cited in note 35) (reporting that 484 firms went dark between 1998 and 2004).

37 Id at *52.

38 Id at *2.

39 The Sarbanes-Oxley Act of 2002, Pub L No 107-204, 116 Stat 745, codified in relevant part at 15 USC § 7201 et seq.

40 Leuz, Triantis, and Wang, *Why Do Firms Go Dark?* at *24–26 (cited in note 35).

41 Id at *28.

42 Id at *27–28.

16 percent, with these returns becoming more negative as the period lengthens.[43]

The Leuz study reported that, after going dark, firms typically continued trading on the Pink Sheets for several years. By June 2005, only about 14 percent of the firms that had exited mandatory disclosure during the period 1998–2004 had ceased trading.[44] Firms typically ceased trading because they were acquired, went private, were liquidated, or filed for bankruptcy.

Although firms going dark are often small, many have significant assets and more than three hundred beneficial owners when they exit mandatory disclosure. For example, United Road Services, a provider of towing and transportation services, had assets of almost $100 million and an estimated six thousand beneficial shareholders when it went dark in 2003 with 294 holders of record.[45] American Physicians Capital, Inc (ACAP), a life insurance holding company, was believed to have had over five hundred beneficial owners and almost $150 million in total assets after it used a reverse stock split to reduce the number of its holders of record below three hundred and then go dark.[46] Thus, the going-dark phenomenon is not limited to the smallest companies, nor to firms with only a handful of shareholders.

II. IMPLICATIONS FOR THE MANDATORY DISCLOSURE DEBATE

As Part I explained, hundreds of reporting firms have exited mandatory disclosure in recent years even though their shares continued to be publicly traded on the Pink Sheets market and may have been held by thousands of investors. They joined several thousand other dark firms trading on that market.

This Part examines the disclosure practices of companies that have exited mandatory disclosure as publicly traded firms and considers the implications of these practices for the longstanding debate in securities regulation over whether mandatory disclosure is necessary. Part II.A briefly describes the mandatory disclosure debate, which turns largely on the following question: will insiders of public firms, in the absence of mandatory disclosure, offer the firm-optimal level of disclosure (that which maximizes firm value)? Critics of mandatory disclosure maintain that insiders will voluntarily provide such disclosure; their opponents disagree. Part II.A then surveys recent studies that seek to address

43 Id at *35.

44 See Leuz, Triantis, and Wang, *Why Do Firms Go Dark?* at *17 (cited in note 35).

45 See SEC, *Petition for Commission Action* (cited in note 7) (describing specific firms that went dark).

46 See id.

this question statistically by examining how the extension of mandatory disclosure to certain OTC firms in 1965 affected these firms' stock prices. These studies, it shows, cast some doubt on the critics' claim that insiders will voluntarily provide firm-optimal disclosure.

Part II.B describes the disclosure choices of gone-dark firms: the overwhelming majority of these firms provide *no* information to public investors. It argues that this level of disclosure—*zero*—is unlikely to maximize firm value, given the large potential benefits and relatively low costs of disclosure. The fact that the market responds very negatively to going-dark announcements provides additional evidence that post-exit disclosure levels are not firm-optimal. All in all, the experience of gone-dark firms provides further reason to be skeptical of claims that insiders will voluntarily offer the firm-optimal level of disclosure to public investors.

A. The Debate over Mandatory Disclosure

The mandatory disclosure system was created in the 1930s.[47] All firms trading on national exchanges were required to register with the SEC and become reporting companies. In 1964, Congress amended the securities laws to require all firms (including those traded on OTC markets) with a minimum number of recordholders and meeting certain asset requirements to enter the mandatory disclosure system by 1965.[48]

1. The debate.

There appears to be little debate over whether the periodic disclosure by publicly traded firms of at least some information can increase firm value. Two important benefits of periodic disclosure are worth highlighting. First, the publication of financial information reduces public investors' trading costs. Existing shareholders considering whether to sell their shares and potential shareholders considering whether to buy shares must determine whether the stock is worth selling or buying at the current trading price. Such a determination will require each investor to obtain a considerable amount of financial information. The cost of such information acquisition aggregated across all the investors buying and selling stock is much higher than the cost

47 See generally Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J Corp L 1, 1–9 (1983) (offering a brief history of the origins of the federal securities laws).

48 See Allen Ferrell, *Mandatory Disclosure and Stock Returns: Evidence from the Over-the-counter Market*, 36 J Legal Stud 213, 214 (2007). See also Securities Act Amendments of 1964, Pub L No 88-467, 78 Stat 565, codified at 15 USC §§ 77–78.

the firm would incur making that same information (which it has on hand) publicly available.[49]

Second, the provision of information to public investors is critical for reducing insider agency costs.[50] Corporate law imposes fiduciary duties that constrain insiders' ability to engage in inefficient self-dealing transactions. But the threat of fiduciary duty litigation is unlikely to deter insiders from self-dealing unless shareholders have "conflict information"—information about insiders' transactions with the firm, compensation arrangements, and stock purchases and sales—that enables them to detect such self-dealing.[51] In addition, in those firms where insiders do not own a controlling block of shares, the disclosure of financial information is critical for monitoring (and perhaps replacing) management teams that may self-interestedly or incompetently fail to make shareholder-serving business decisions.[52] Hostile bidders or proxy challengers will not be able to identify and oust a poorly performing team if they lack an accurate and up-to-date picture of the firm's financial and operating conditions.[53]

There is, however, considerable disagreement over whether the government should make periodic corporate disclosure *mandatory*. Since the 1960s, mandatory disclosure has come under attack from a number of economists and law professors.[54] These commentators, including Professor Roberta Romano, argue that insiders can be counted

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49 See John C. Coffee, Jr, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va L Rev 717, 733–34 (1984) (arguing that mandatory disclosure "reduces wasteful duplication by establishing a central information repository"); Zohar Goshen and Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke L J 711, 738–40 (2006).

50 See, for example, Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 Va L Rev 1335, 1356–68 (1999) (describing benefits of periodic disclosure, such as greater managerial adherence to shareholder interests); Paul G. Mahoney, *Mandatory Disclosure As a Solution to Agency Problems*, 62 U Chi L Rev 1047, 1048 (1995) (arguing that periodic disclosure reduces the cost of monitoring managers' use of corporate assets for self-interested purposes).

51 See Goshen and Parchomovsky, 55 Duke L J at 716–17 (cited in note 49).

52 See Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 Law & Contemp Probs 112, 120 (1999).

53 See Goshen and Parchomovsky, 55 Duke L J at 748–49 (cited in note 49) (noting that full disclosure puts poorly performing management teams at greater risk of replacement).

54 For economically oriented legal scholarship critical or skeptical of mandatory disclosure, see, for example, Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 Theoretical Inquiries L 387, 389 (2001); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L J 2359, 2361 (1998); Stephen J. Choi and Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S Cal L Rev 903, 916 (1998); Frank H. Easterbrook and Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va L Rev 669, 687 (1984); Henry Manne, *Insider Trading and the Stock Market* (Free Press 1966). For economists critical of mandatory disclosure, see George Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 Am Econ Rev 132 (1973); George Stigler, *Public Regulation of the Securities Markets*, 37 J Bus 117, 133 (1964).

on to adopt what might be a called a "firm-optimal" level of disclosure—that which maximizes firm value (the joint wealth of insiders and public investors).[55] Absent such disclosure, they contend, the stock price will drop because of a "lemons" problem: buyers will fear that no news is bad news.[56] Thus, it is argued, insiders of public firms will have no choice but to offer a desirable level of disclosure. On this view, mandatory disclosure is unnecessary and could actually reduce firm value by requiring the firm to make disclosures whose costs exceed their benefits.

Supporters of mandatory disclosure generally reject this view. They suggest several reasons why insiders may sometimes offer less than the firm-optimal amount of disclosure, even if such suboptimal disclosure depresses the stock price.[57] First, while insiders are generally net sellers of stock and thus tend to prefer a higher price, insiders wishing to buy large amounts of stock (directly, or indirectly through a cash-out merger) may have an incentive to reduce disclosure to acquire the stock more cheaply.[58] Second, even when insiders would otherwise prefer a higher stock price, they may be willing to put up with a lower stock price if reducing disclosure enables them to extract more private benefits. For example, the failure to disclose compensation arrangements, stock transactions, and the like may make it easier for insiders to transfer value from public investors through various forms of self-dealing. In short, supporters of mandatory disclosure argue, the "insider-optimal" level of disclosure may often be less than the "firm-optimal" level of disclosure.

55 See Romano, 107 Yale L J at 2367 (cited in note 54) (arguing that promoters taking firms public will "select the regime that maximizes the joint welfare of promoters and investors").

56 See Romano, 2 Theoretical Inq L at 418 (cited in note 54); Easterbrook and Fischel, 70 Va L Rev at 683 (cited in note 54).

57 See, for example, Coffee, 70 Va L Rev at 722 (cited in note 49); Goshen and Parchomovsky, 55 Duke L J at 760–61 (cited in note 49).

Some defenders of mandatory disclosure, such as Professor Merritt Fox, appear to agree with Professor Romano that, absent mandatory disclosure, firms will offer the firm-optimal level of disclosure. See Merritt B. Fox, *The Issuer Choice Debate*, 2 Theoretical Inquiries L 563, 566 (2001) (writing that, for purposes of his debate with Professor Romano over whether firms will voluntarily choose the socially optimal level of disclosure, he is willing to assume that firms going public would voluntarily adopt disclosure arrangements that maximize their share price). However, he argues that mandatory disclosure is justified because disclosure is likely to confer positive externalities on other firms. Thus, while firms have an incentive to offer the firm-optimal level of disclosure, they do not have an incentive to offer the *socially optimal* level of disclosure, which will tend to be higher. See id at 568–69.

58 See Coffee, 70 Va L Rev at 722 (cited in note 49).

2. Recent empirical studies.

The desirability of mandatory disclosure thus largely turns on an empirical question: do insiders not subject to mandatory disclosure generally provide the firm-optimal amount of disclosure? Researchers initially sought to answer this question by examining the disclosure practices of OTC firms that were exempt from mandatory disclosure until 1965, when mandatory disclosure was extended to all firms meeting certain asset requirements and having more than a minimum number of recordholders.[59]

Studies of OTC firms' pre-1965 disclosure practices suggest that disclosure was not always firm-optimal. According to a 1957 SEC study of 125 publicly traded insurance companies not subject to mandatory disclosure, some with as much as $3 billion in assets, almost 50 percent did not provide an income statement to shareholders.[60] Moreover, size did not appear to correlate with the quality of financial reporting. In 1963, the SEC randomly sampled 20 percent of the OTC firms in which trades had been made during the last quarter of 1961. More than 25 percent of firms did not provide any information on the firm's financial position or results.[61] Defenders of mandatory disclosure have pointed to these studies as demonstrating that insiders will not always provide adequate information to investors.[62]

At least one critic of mandatory disclosure was not persuaded by the SEC's studies. Writing in 1998, Professor Romano argued that these studies demonstrated merely that insiders voluntarily choose to disclose less than what the SEC deems adequate, not that insiders provide too little information to shareholders. According to Romano, "There is little tangible proof of the claim that corporate information is 'underproduced' in the absence of mandatory disclosure."[63] However, she acknowledged that if the imposition of mandatory disclosure requirements on these firms in 1965 was found to have a significantly positive effect on stock prices, such a finding would be "probative" that prior disclosure had been inadequate.[64]

59 See Ferrell, 36 J Legal Stud at 214 (cited in note 48) (describing the 1964 legislation).

60 See Seligman, 9 J Corp L at 39 (cited in note 47) (discussing a 1957 SEC study that found that many insurance companies did not disclose income statements to shareholders).

61 See id at 39–40 (reporting that the 1957 SEC study found that "more than 25 percent of the issuers responding did not disseminate any financial information to shareholders at all.").

62 See, for example, id at 39–42.

63 See Romano, 107 Yale L J at 2373 (cited in note 54).

64 See id at 2376–77.

Two recent studies examining the effect of the imposition of mandatory disclosure on OTC firms in 1965 find such a stock price effect.[65] One study estimated that affected OTC firms experienced statistically significant, positive abnormal returns ranging between 11 percent and 22 percent during the period from January 1, 1963 (around the time regulatory change began to appear likely) through November 15, 1965.[66] The second study reported a 6 percent abnormal return for 1963.[67] These studies thus suggest that, contrary to the claims of mandatory disclosure's critics, insiders of nonreporting firms before 1965 had failed to voluntarily offer firm-optimal disclosure to investors.

To be sure, the fact that public investors' wealth increased substantially when these firms were forced to enter the mandatory disclosure system does not prove that prior disclosure had been suboptimal; it is possible that the imposition of mandatory disclosure reduced insiders' wealth by an even larger amount, thereby reducing firm value (the joint wealth of insiders and public investors). But unless insiders' wealth decreased by more than the increase in public investors' wealth at every firm, these studies suggest that the imposition of mandatory disclosure increased the value of at least some of the affected firms.

B. Gone-dark Firms

Having seen evidence suggesting that the disclosure practices of many OTC firms were unlikely to have been firm-optimal before they entered the mandatory disclosure system in 1965, we now turn to consider the disclosure practices of publicly traded firms after they exit the mandatory disclosure system. I first describe these practices and then explain why they provide further reason to be skeptical of the claim that insiders not subject to mandatory disclosure will provide a firm-optimal level of disclosure.

1. Insiders' post-exit disclosure choices.

Once a firm has exited mandatory disclosure, insiders are essentially free to choose what information to disclose to investors.[68] Indeed, noth-

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65 See Ferrell, 36 J Legal Stud at 214 (cited in note 48); Michael Greenstone, Paul Oyer, and Annette Vissing-Jørgensen, *Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments*, 121 Q J Econ 399, 403 (2006).

66 Greenstone, Oyer, and Vissing-Jørgensen, 121 Q J Econ at 402–03 (cited in note 65) (stating that OTC firms that faced certain new reporting requirements under the 1964 legislation experienced "abnormal excess" returns of 11.5 percent to 22.1 percent during the period of time around the enactment of that legislation).

67 Ferrell, 36 J Legal Stud at 246 (cited in note 48).

68 Insiders may still be subject to any state law disclosure requirements, which tend to be minimal. See Part I.A.1.

ing prevents insiders from offering a level of disclosure similar to that required of reporting companies. For example, insiders could opt to provide periodic disclosure of financial and conflict information, as well updates of material changes in their firms' financial condition, on their firms' websites or on pinksheets.com, the information repository maintained by the Pink Sheets market for firms quoted on that market.

However, the Leuz study finds that firms that exit mandatory disclosure subsequently provide little if any information to public shareholders. Only 10 percent of the approximately five hundred firms that went dark between 1998 and 2004 provided *any* financial statements to investors on a website, and not all of these statements were audited.[69] The researchers also telephoned gone-dark firms to check whether the firms would provide information via regular mail. Only 4 percent of firms were willing to provide information in this manner.[70] And there is no indication that any of these firms were willing to provide public investors with conflict information—information about executive compensation, insider stock transactions, or self-dealing arrangements—that is critical for controlling inefficient self-dealing by insiders.[71]

The practices of the five hundred or so firms in the Leuz study do not appear to diverge substantially from those of the other approximately 3,200 nonreporting firms trading on the Pink Sheets. In 2007, the Pink Sheets began categorizing firms based on the amount of information they provide to public investors. The three categories relevant for domestic firms trading outside the mandatory disclosure system are:

> *Current Information.* Firms that provide "Adequate Current Information" via the OTC Disclosure and News Service website, including both financial and conflict information;[72]

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69 See Leuz, Triantis, and Wang, *Why Do Firms Go Dark?* at *33 (cited in note 35).

70 Id at *33–34 (reporting that, in response to telephone calls, 22 of the 484 gone-dark firms were willing to mail information to potential investors).

71 Some of these firms may privately provide financial information to nonshareholder parties, such as creditors, to assist these other parties in monitoring the firms. But any such arrangements cannot adequately substitute for the provision of information to a firm's public investors. First, information given to other parties does not reduce investors' trading costs. Second, creditors' interest is limited to seeing their loans repaid. They have no incentive to monitor insiders to ensure that the insiders do not skim off large private benefits for themselves at the expense of public investors, unless the self-dealing is large enough to also impair the firm's ability to repay its debt.

72 See generally Pink Sheets, *Guidelines for Providing Adequate Current Information* (Aug 31, 2007), online at http://www.otcdealer.com/pinkdocs/Pink_Sheets_Guidelines_for_Providing_Adequate_Current_Information.pdf (visited Jan 11, 2009) (laying out guidelines for providing adequate "Current Information"); Pink Sheets, *OTC Market Tiers*, online at http://www.pinksheets.com/pink/otcguide/investors_market_tiers.jsp (visited Jan 11, 2009) (defining "Current Information" companies as "[r]eporting companies that submit filings to regulators with powers of review

Limited Information. Firms that have provided limited information on the OTC Disclosure and News Service website or have made a SEC filing within the previous six months;[73] and

No Information. Firms not providing current disclosure to the Pink Sheets.[74]

As of late 2008, only a small number of the 3,700 or so nonreporting firms trading on the Pink Sheets provided "Current Information," about five hundred provided "Limited Information," and about 3,200 were considered to provide "No Information."[75] Even if those firms listed as providing "Limited Information" were in fact providing firm-optimal amounts of information to the market, the Pink Sheets' own data suggest that the vast majority of nonreporting firms trading on the Pink Sheets, like most of the firms in the Leuz study, provide little or no information to public investors.

2. Could zero disclosure to public investors be firm-optimal?

The failure of insiders of most gone-dark firms to provide *any* information to their public investors—either financial information or conflict information—raises significant doubts about the claim that insiders will voluntarily provide firm-optimal amounts of information to public investors.

To begin, for any given firm the benefits of providing at least some information is likely to outweigh the costs. As Part II.A.1 explained, there is little debate that periodic corporate disclosure provides substantial benefits to investors by reducing investors' trading costs and enabling public shareholders to better monitor insiders, thereby reducing agency costs. At the same time, the direct costs of disclosing information are low. The firm already has all the information at hand.

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and that make the filings publicly available or non-reporting companies that make current information publicly available through the OTC Disclosure and News Service").

73 The "Limited Information" tier includes

> companies with financial reporting problems, economic distress, or in bankruptcy to make the limited information they have publicly available. The Limited Information category also includes companies that may not be troubled, but are unwilling to meet Pink OTC Markets' Guidelines for Providing Adequate Current Information. Companies in this category have posted limited financial information not older than six months through the OTC Disclosure and News Service or have made a filing on the SEC's EDGAR system in the previous six months.

Pink Sheets, *OTC Market Tiers* (cited in note 72).

74 See id.

75 I used the Pink Sheets search function on October 19, 2008 to count the number of domestic stocks in each tier. See Pink Sheets, *Advanced OTC Company Search*, online at http://pinksheets.com/pink/companysearch/index.jsp (visited Jan 11, 2009). Approximately six hundred firms were considered to be providing "Current Information," but all but a handful of these firms are reporting firms under the securities laws that happened to be trading on the Pink Sheets.

Of course, the disclosure of certain financial information might reveal information to competitors or other parties that could be used to the disclosing firm's disadvantage.[76] Thus, it may not be firm-optimal to disclose certain types of financial information. However, given the substantial benefits provided by disclosure, it is highly unlikely that across a wide variety of firms the optimal level of disclosure of both financial information and conflict information is zero, particularly since conflict information is crucial for controlling agency costs and is unlikely to reduce firm value by benefiting competitors. To my knowledge, no commentator has ever asserted that the optimal level of disclosure to investors in a publicly traded firm could be zero.[77]

The stock market's highly negative reaction to going-dark announcements provides further reason to be skeptical that post-exit disclosure levels are firm-optimal. The reaction suggests that the anticipated change in the level of disclosure is likely to make public investors worse off.[78] Moreover, it suggests that the cost to public investors from the expected reduction in disclosure is greater than any benefit to them from eliminating the expenses of complying with the mandatory disclosure rules. Interestingly, the stock price reaction to going-dark announcements is similar in magnitude (although opposite in direction) to that reported in the studies examining firms that were forced to enter mandatory disclosure in 1965.[79]

To be sure, the market's negative reaction to going-dark announcements cannot prove that anticipated post-exit disclosure is less than firm-optimal, just as the market's positive reaction to the imposition of mandatory disclosure on certain OTC firms in 1965 cannot prove that the previous level of disclosure was suboptimal. Theoretically, the reduced level of disclosure following exit could increase insiders' wealth by more than it reduces public investors' wealth, there-

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76 See Fox, 85 Va L Rev at 1345–46 (cited in note 50); Goshen and Parchomovsky, 55 Duke L J at 756 (cited in note 49).

77 One could argue that it might be firm-optimal to avoid disclosing *any* financial and conflict information to the market because such disclosure could expose the firm to "strike" lawsuits (nonmeritorious lawsuits brought solely to extract a settlement) alleging fraud. But lawyers are unlikely to find strike suits against Pink Sheets firms profitable. Given these firms' small trading volumes, the potential damages to selling (or buying) shareholders of any misrepresentation will tend to be very low. And even if there is some risk of a strike suit, the expected cost associated with such litigation is likely to be far smaller than the cost to public shareholders of having *no* information about the firm's financial condition and insider self-dealing transactions.

78 The negative stock price response to a going-dark announcement may in part reflect new information about the "disclosure-independent" value of the firm transmitted by the announcement. In particular, firms that choose to exit mandatory disclosure may have worse business prospects than those that do not, whether or not they exit mandatory disclosure. To the extent the going-dark announcement communicates unfavorable information about the firm's "disclosure-independent" value, the market's reaction is not entirely attributable to the exit itself.

79 See Part II.A.2.

by increasing firm value. But unless insiders' wealth increases by more than public investors' wealth declines at every firm, at least some going-dark firms are moving to a less desirable level of disclosure.

Importantly, the evidence does not suggest that insiders will always offer a suboptimal amount of disclosure if given the choice. For example, there are many reporting firms with fewer than three hundred holders of record.[80] The insiders of such firms should be seen as voluntarily providing the relatively high level of disclosure required by the securities laws, as they could easily exit mandatory disclosure but choose not to do so. Nor does the evidence imply that the SEC's current mandatory disclosure regime is the most desirable disclosure regime—it may well require too much disclosure.[81] However, the failure of most gone-dark firms to provide any disclosure to public investors and the market's sharply negative reaction to going-dark announcements do cast further doubt on the claim that insiders generally can be counted on to voluntarily provide the firm-optimal level of disclosure.

III. A NEW APPROACH TO REGULATING EXITS FROM MANDATORY DISCLOSURE

We saw in Part I that the securities laws currently permit insiders of a publicly traded firm to exit the mandatory disclosure system even when the firm's shares remain publicly traded and may be held by thousands of shareholders. We then saw in Part II that, after such an exit, insiders generally do not appear to provide a firm-optimal level of disclosure, hurting public investors.

This Part proposes a new approach to regulating exits of publicly traded firms from mandatory disclosure. Part III.A shows that enabling insiders to unilaterally exit mandatory disclosure may lead to undesirable exits. In particular, insiders may exit mandatory disclosure even when exit reduces firm value—the joint wealth of insiders and public investors. It also explains that adoption of the institutional investors' 2003 proposal to tighten the recordholder test would reduce, but not eliminate, value-decreasing exits.

Part III.B puts forward the new approach to regulating exits from mandatory disclosure: requiring firms to obtain public shareholder approval for any such exit. Giving public shareholders veto rights, it de-

80 See Leuz, Triantis, and Wang, *Why Do Firms Go Dark?* at *14–15 (cited in note 35) (noting that the control sample used in the paper's regression analysis consists of over two thousand firms that could have exited mandatory disclosure under the applicable recordholder limits).

81 See, for example, Romano, 107 Yale L J at 2375 (cited in note 54) (discussing evidence suggesting that a number of the SEC's disclosure mandates are unlikely to be cost-effective).

monstrates, should completely eliminate undesirable exits of publicly traded firms from mandatory disclosure, and should do so at little cost.

A. The Problem with Insider Control over Exits

The current rules enabling insiders to unilaterally decide when firms exit mandatory disclosure as publicly traded companies is likely to lead to value-decreasing exits. Adoption of the institutional investors' proposal to tighten the recordholder test will reduce value-decreasing exits, but not eliminate them.

1. Under current rules.

The exit of a publicly traded firm from the mandatory disclosure system could either increase or decrease firm value (defined as the joint wealth of insiders and public investors). Unless the firm commits in advance to provide a firm-optimal level of disclosure after it exits mandatory disclosure,[82] exit is likely to a lead to a suboptimal level of disclosure that increases both insider agency costs and public investors' trading costs, reducing firm value. However, exit is likely to provide benefits by eliminating the compliance costs associated with being a reporting company. The net effect of exit on firm value could therefore be positive or negative, depending on the relative magnitudes of these costs and benefits.[83]

The problem with giving insiders the ability to unilaterally exit mandatory disclosure is that insiders may benefit from a value-decreasing exit. As Part II.A explained, moving to a suboptimal level of disclosure may enable insiders to extract more private benefits. And the stock price drop caused by suboptimally low disclosure may enable insiders, who know the shares' actual value, to accumulate stock at a bargain price.[84] The stock market's sharply negative reaction to exit announcements is consistent with insider-driven exits reducing firm value.

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82 A firm exiting mandatory disclosure could commit to provide post-exit disclosure by, for example, putting a provision in its charter obligating the board to provide certain information to public investors that could not be waived or modified without the consent of those investors.

83 If insiders must first eliminate a certain number of public shareholders to satisfy the recordholder test, exit may have additional effects—either positive or negative—on firm value arising from the cashing out of these shareholders. For example, if the firm uses its existing assets to cash out some of its public investors and the cash would generate higher (lower) returns in the hands of shareholders than in the firm, such distribution will increase (reduce) firm value. These additional effects would need to be considered in determining whether a particular exit increases or decreases firm value.

84 See Coffee, 70 Va L Rev at 722 (cited in note 49). Insiders' ability to buy stock directly from public investors after the firm exits mandatory disclosure is somewhat restricted by Rule 10b-5, which makes it illegal for insiders to buy stock on the basis of material, nonpublic information. See *Chiarella v United States*, 445 US 222, 227–33 (1980) (describing circumstances under

To be sure, insiders' exit incentives may often be aligned with firm-value maximization. Some exits may both benefit insiders *and* increase firm value.[85] And in many cases both insiders and the firm are better off remaining in the mandatory disclosure system.[86] But the key point is that insiders cannot be *counted on* to make exit decisions that maximize the joint wealth of insiders and public investors. As a result, enabling insiders to decide whether their firms exit mandatory disclosure can lead to value-decreasing exits.

2. Institutional investors' proposal.

As noted in the Introduction, a number of institutional investors petitioned the SEC in 2003 to change the definition of "holder of record" in the recordholder test to "beneficial owner." This recommendation, if implemented, would prohibit firms from exiting mandatory disclosure unless they have fewer than three hundred beneficial owners.

Adoption of the institutional investors' proposal may well reduce the number of value-decreasing exits. Firms with three hundred or more beneficial owners that might be permitted to exit mandatory disclosure under the current recordholder test could no longer exit mandatory disclosure without first conducting a reverse stock split or repurchase tender offer to reduce the number of recordholders to below three hundred. The requirement that insiders cash out some public investors prior to exit would, among other things, reduce the amount of value these firms' insiders could divert from public investors by going dark. It should thus reduce insiders' incentive to engage in value-decreasing exits.[87]

which Rule 10b-5 creates a duty to disclose or abstain from trading when a person possesses material nonpublic information). But it may not be illegal for insiders to buy stock in the public market before the firm exits mandatory disclosure, after the going-dark announcement causes a significant drop in the stock price. And once the firm has gone dark, insiders might not be deterred from buying stock directly from public investors in violation of Rule 10b-5. Because the firm has exited mandatory disclosure, insider stock transactions are no longer publicly reported. Thus, it will be extremely difficult, without commencing expensive litigation, for public shareholders to even know whether insiders are buying shares. Insiders contemplating buying the firm's stock in violation of Rule 10b-5 may therefore reasonably believe that the probability of detection and punishment is quite low.

85 Note that an exit could be value-increasing even when post-exit disclosure is not firm-optimal. For example, the elimination of compliance costs associated with being a reporting company could outweigh the reduction in benefits from reduced disclosure. Of course, in this case, exit would be even more value-increasing if post-exit disclosure were firm-optimal.

86 For example, when insiders expect to sell shares (either directly or indirectly, through a secondary public offering by the firm), they will generally be better off not exiting the mandatory system, which would depress the stock price and reduce the proceeds they can get from selling shares.

87 By definition, value-decreasing exits shrink the size of the pie. Thus insiders can benefit from such an exit only if: (1) the exit enables insiders to expropriate more value from public investors, and (2) such additional expropriation is large enough to offset insiders' share of the loss of firm

However, adoption of the institutional investors' proposal would not eliminate insiders' incentives to undertake value-decreasing exits in order to expropriate value from public investors. First, it would have no effect on insiders' ability to conduct value-decreasing exits in firms that currently have fewer than three hundred beneficial owners. Second, in other firms the institutional investors' proposal would require only that enough public investors be eliminated to get below the three-hundred-owner threshold; insiders could still divert value from the remaining public investors after the firm goes dark. Third, as Part I explained, reverse stock splits and repurchase tender offers conducted in the shadow of an anticipated insider-driven exit from mandatory disclosure can be used to cash out public investors at less than the actual value of their shares. Thus, under the institutional investors' proposal, insiders' ability to exit mandatory disclosure still could be used to extract value from public investors *even before* the firm exits. In short, while the institutional investors' proposal would reduce value-reducing exits from mandatory disclosure, it may not eliminate them.

B. The Shareholder-veto Approach

Because any regime in which insiders of publicly traded firms can unilaterally choose to exit mandatory disclosure is likely to lead to value-reducing exits, I now put forward an alternative approach: giving public shareholders the right to veto exits from mandatory disclosure. Such an approach, I show, should eliminate value-decreasing exits without undesirably trapping firms in the mandatory disclosure system.

1. The proposed approach.

Under the shareholder-veto rule I propose, a firm could exit mandatory disclosure as a publicly traded firm only if it obtains the consent of a majority of the firm's public shareholders. By "public shareholders," I mean shareholders other than the firm's insiders (officers, directors, controlling shareholders, and related parties). A firm that no longer has public shareholders need not hold such a vote before exiting mandatory disclosure.

Not all public investors could be expected to participate in such a shareholder vote. For example, individual investors holding relatively few shares may decline to participate on the belief that their votes are

value caused by exit. To the extent the institutional investors' proposal reduces insiders' ability to expropriate value from public investors, it will make fewer undesirable exits attractive to insiders.

unlikely to matter. Thus, firms seeking to go dark would be required only to obtain the approval of a majority of the public shares voted.[88]

Obtaining public shareholder approval would not be sufficient to exit mandatory disclosure; the firm would still need to be otherwise eligible to terminate reporting obligations at the time of the vote. Thus, for example, the firm would need to have fewer than three hundred recordholders when the vote is held.[89] For this purpose, a "recordholder" would be defined (as the institutional investors' 2003 proposal recommends) as a beneficial owner. The shareholder-veto approach may thus prevent a firm from exiting mandatory disclosure that could exit under the institutional investors' proposed rule.

Importantly, the proposed approach would not affect the ability of firms to exit mandatory disclosure by eliminating all public shareholders through a going-private transaction. For example, insiders could still cash out all of a firm's public investors in a freeze-out merger or equivalent transaction (for example, selling the firm's assets to an acquirer and distributing the proceeds of the sale to all shareholders pro rata). The veto rule would apply only in those cases where public investors continue to own shares in the firm when it seeks to exit mandatory disclosure.

The intuition behind the proposed shareholder-veto approach is quite simple. When purchasing a firm's shares, public investors likely believed that the firm would continue to be a reporting company as long as they remained shareholders. These investors should have a voice in deciding whether the firm exits mandatory disclosure as a publicly traded company, potentially leaving them in the dark.

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88 For the shareholder-voting rule to reflect public shareholders' true preferences as shareholders, it is critical that the vote not be tied to a transaction that discriminates between those shareholders voting approvingly and those voting disapprovingly. For example, insiders should not be permitted to conduct a repurchase tender offer that requires public investors' tendering their shares, before receiving payment, to vote their shares in favor of the firm exiting mandatory disclosure. Such a coupling of the vote to payoffs would create a prisoners' dilemma problem that may cause public shareholders to vote for an exit they oppose.

89 I suggest a recordholder threshold of three hundred to conform the proposal as closely as possible to current rules for exiting mandatory disclosure. Other thresholds may be considered. However, it is worth noting that the use of a threshold of five hundred or more recordholders would conflict with mandatory disclosure's "entry" rules. Currently, any firm with at least five hundred recordholders and more than $10 million in assets must register with the SEC and enter the mandatory disclosure system. See notes 12–14 and accompanying text. It would be inconsistent with these entry rules to permit firms with at least five hundred recordholders to exit mandatory disclosure through a public shareholder vote.

2. Effect of the proposal on value-decreasing and value-increasing exits.

The shareholder-veto approach should eliminate value-decreasing exits from the mandatory system by publicly traded firms while preserving these firms' ability to engage in value-increasing exits. Consider an exit that would reduce firm value—the joint wealth of insiders and public investors—but that would benefit insiders. By definition, such an exit would make public investors worse off. Thus, if insiders propose such an exit, public investors would be expected to vote against it. Anticipating this outcome, insiders might not even bother proposing such an exit to public investors. In either case, the shareholder-veto approach should prevent the value-reducing exit. One might be concerned that the shareholder-veto approach would prevent value-increasing exits from mandatory disclosure by publicly traded firms. Consider an exit that increases the joint wealth of insiders and public investors but makes public investors worse off. Because public investors would have an incentive to reject any proposed exit that makes them worse off, they could be expected to veto this proposed exit, even though it is value-increasing.

But if an exit were in fact value-increasing, insiders should be able to obtain public shareholder approval by taking steps to ensure that public shareholders are not made worse off. For example, insiders could agree to put a provision in the firm's charter that commits the firm to continue to provide a certain amount of information to the market after the firm exits mandatory disclosure. Such a provision, in turn, would increase public investors' wealth by reducing their post-exit trading costs and by diminishing the value that insiders can divert from public investors after exit. In addition (or alternatively), insiders could promise to make a dividend payment to shareholders as the firm exits mandatory disclosure to ensure that public investors share some of the surplus created by exit. If insiders are unable to obtain public investors' consent to a proposed exit from mandatory disclosure, that exit is unlikely to be value-increasing for the firm.

Finally, it is worth repeating that the requirement of public shareholder approval for exiting mandatory disclosure would not affect a firm's ability to exit mandatory disclosure by going private. As under current law, insiders could always exit mandatory disclosure by eliminating *all* public shareholders through a merger or other transaction in which each of the firm's shareholders, including the firm's public investors, receives cash for their stock. Once public investors have been eliminated, a firm could exit mandatory disclosure without holding a vote. The shareholder-veto approach would only block a proposed exit from mandatory disclosure when: (1) insiders refuse to cash out all public shareholders, and (2) a majority of the firm's public shares are voted against the exit.

CONCLUSION

The securities laws have permitted insiders of hundreds of firms to exit the mandatory disclosure system even though their firms' shares continue to be publicly traded and may be held by thousands of investors. Such exiting firms are said to "go dark" because they subsequently provide little information to public investors. This Article has addressed the going-dark phenomenon. It has explained how firms currently can go dark over the objection of their public investors. It has also shown that insiders' post-exit disclosure practices undermine the claim, advanced by critics of mandatory disclosure, that insiders can be counted on to voluntarily provide adequate information to investors. Finally, it has put forward a new approach to regulating going-dark firms: giving public shareholders the right to veto exits from mandatory disclosure. Such an approach, this Article has shown, should prevent undesirable exits from mandatory disclosure by publicly traded firms while preserving these firms' ability to engage in value-increasing exits.