CAN UK SMALL BUSINESSES OBTAIN GROWTH CAPITAL IN THE PUBLIC EQUITY MARKETS?—AN OVERVIEW OF THE SHORTCOMINGS IN UK AND EUROPEAN SECURITIES REGULATION AND CONSIDERATIONS FOR REFORM

BY HSE-YU CHIU*

ABSTRACT

This article deals with several aspects of the need for growth capital for small businesses in the UK. First, the article makes a comparison between equity and debt capital as financing options for a growing small business. The article then advocates the superiority of equity capital in meeting small business needs. Equity capital, supported by the legal rules on the maintenance of capital, provides small businesses a degree of permanence that is important for growth purposes. The article then examines the advantages of public equity financing and advocates the view that public equity is better suited to meet growth capital needs because it allows perpetuity in the capital provided. This degree of perpetuity is provided by the availability of secondary markets where shares could change hands. The article next explores the weaknesses in the UK and European legal infrastructure in securities regulation and why it does not meet small business needs in seeking public equity financing. These weaknesses may be further augmented if the European draft Prospectus Directive comes to pass. This article concludes by recommending that Europe should consider the modification of its one-size-fits-all mandatory disclosure rules in securities regulation and adopt a tiered disclosure regime based on issue size, akin to U.S. federal securities law, in order to facilitate small business access to the public equity markets.

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*LLB (NUS, Singapore), LLM (Cantab). Lecturer, Faculty of Law, University of Leicester. The author wishes to thank Dr. Eilis Ferran, Reader in Corporate Law, University of Cambridge, for her support and guidance, Associate Professor Hans Tjio, National University of Singapore, and Assistant Professor Lee Pey Woan, Singapore Management University, for their valuable comments.

Some sources cited in this article were unavailable for review by the Delaware Journal of Corporate Law but have been verified by the author.

I. INTRODUCTION

A small business in the United Kingdom (UK)[1] has recently been characterized by the UK Department of Trade and Industry as a company with a turnover of not more than 4.8 million GBP (Britain's pound), a balance sheet of not more than 2.4 million GBP, and employment at not more than fifty persons.[2] When a small business pushes beyond these figures, it is likely on a path of growth,[3] which can be measured in terms of turnover, profits, size of employment, and market share.[4] In the UK, small businesses[5] provide a fertile ground for innovation and are an important source of entrepreneurial inspiration. The UK government also recognizes that small businesses significantly contribute to the employment prospects and economic activity of the country.[6] Even though the growth of a small

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[1]*See* GRAHAM H. RAY & PATRICK J. HUTCHINSON, THE FINANCING AND FINANCIAL CONTROL OF SMALL ENTERPRISE DEVELOPMENT 2 (Gower 1979) (defining small businesses as enterprises typically featuring fusion of ownership and control). The Bolton Committee defines a small business as "one that has a relatively small share of its market . . . managed by its owners . . . in a personalised way, and . . . independent." *See* COMMITTEE OF INQUIRY ON SMALL FIRMS, REPORT, 1971, Cmnd. 4811, at 1 [hereinafter Bolton Committee Report].

[2]The small business definition is made in the context of proposing an exemption for small businesses from compulsory audit. *See* DEP'T OF TRADE AND INDUSTRY, FINAL REPORT ON MODERN COMPANY LAW, ¶ 2.32, at 35 (Mar. 2000) [hereinafter DTI REPORT].

[3]The life cycle of a business can be outlined as embryonic, infant, youthful, and institutionalized. *See* Tony Bovaird et al., *Market Failure in the Provision of Finance and Business Services to Small and Medium Enterprises*, *in* ROGER BUCKLAND & EDWARD W. DAVIS, FINANCE FOR GROWING ENTERPRISES 13, 18 (Routledge 1995) (quoting Nicholas Falk, *Growing New Firms: The Role of the Social Entrepreneur*, *in* 4 BUILT ENVIRONMENT 204-12 (1978) (No. 3)). The growth cycle of a small business proceeds as follows: conception, survival, profitability, growth, takeoff, and maturity. *See* Frank Dawes, *Management and Business Growth in the Small Business Sector*, *in* ENTERPRISE AND GROWTH IN THE SMALL BUSINESS SECTOR (Bolton: Bolton Business School Press, 1997).

[4]*See generally* MARK JENKINS, THINKING ABOUT GROWTH: A COGNITIVE MAPPING APPROACH TO UNDERSTANDING SMALL BUSINESS DEVELOPMENT (Cranfield School of Management, 1993) (explaining the ways in which a small business may grow).

[5]Growing firms constitute a minority of about ten percent or less of all UK small businesses. *See* Bovaird et al., *supra* note 3, at 34; David J. Storey et al., *Fast Growth Small Business: A Study of 40 Small Firms in NE England*, Research Paper No. 67 (London, Dep't of Employment, 1988). *See generally* Ivan Turok, *Which Small Firms Grow?* *in* RECENT RESEARCH IN ENTREPRENEURSHIP 29 (Leslie G. Davies & Alan A. Gibb eds., Avebury 1991).

[6]*See* Chancellor's Bank Competition Statement delivered on Mar. 14, 2002, before Parliament, *at* http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/statement/speech_statement_140302.cfm (HM Treasury's website). The Chancellor estimates that there are 3.5 million small businesses in the UK, representing about fifty percent of the nation's economic activity. *Id.*

business may be attributable to many factors,[7] growth in capital is necessary to realize the potential for expansion. Without growth capital, a small business would be deprived of the life blood necessary to its continued development.

The growth capital needs of a small business in the UK may be served by a number of options. These options include debt, equity, or a combination of both. This article suggests that a greater amount of growth capital for small businesses should come from equity capital rather than debt capital. Equity capital is superior to debt capital because the legal nature of equity capital makes equity finance compatible with the needs of growth capital, whereas debt financing is not able to meet growth capital needs due to its practical limitations.

The article then proceeds by analyzing the UK's present legal infrastructure to determine its impact on external equity financing.[8] To summarize, the legal infrastructure in the UK does not adequately serve the needs of small businesses. Presently there are only two options for small businesses in the UK to obtain external equity financing. One option is direct access to equity provided by members of the public. The second option is equity provided by investors in the non-retail market, such as venture capital or other forms of private equity. The rise of non-retail equity providers is a response to the decline in equity provided by the public; and, in terms of practical reality, small businesses have increasingly relied on private equity to supply external equity financing needs.[9]

The highly regulated public equity market is deterring to small issuers because of the high cost of compliance as compared to their relatively small issues. Private equity, though, is not a perfect substitute for public equity financing because it lacks the essential support of ready secondary markets for the private equity financier. This may result in devastating exits of capital from the small business. As a result, public equity financing has, for various reasons, become a very limited option to small businesses; however, this article argues that it is an option which should not remain virtually closed.[10] In fact, it is possible to make public

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[7]*See generally* STEPHEN ROPER, EXPLAINING SMALL FIRM GROWTH AND PROFITABILITY (North Ireland Economic Research Centre 1997) (explaining the factors which cause growth for small businesses).

[8]According to the pecking order thesis, firms typically finance their growth out of retained earnings, but there may be a limit to how much firms can self-fund growth through internal equity financing. *See infra* note 11 and accompanying text.

[9]*See Key Facts About Private Equity in the UK, BUCA Publications, at* http://www.bvca.co.uk /keyfacts/factshome.html ("£5.4 billion was invested in 2002, in nearly 1,500 companies, of which over £4.4 billion was invested in the UK.").

[10]*See infra* Part II.A.

equity financing an accessible option to small businesses without compromising regulatory and interventionist interests.

In the United States (U.S.), there is a special regime for public offerings by small businesses. This article examines whether this regime may be justified in the UK and Europe to further the interests of small businesses in obtaining public equity financing.

Finally, the article addresses the issue of whether, in the age of globalization, small businesses may be able to take advantage of the infrastructural strengths outside of the UK or Europe. This article will also identify the opportunities afforded by the Internet to meet external equity financing needs.

II. EQUITY FINANCE AS GROWTH CAPITAL

According to the pecking order theory, small businesses that need capital look to internal financing through retained earnings.[11] Internal financing is an important source of growth capital for the company, but more often than not, some form of external funding must be relied on because internal funding may be insufficient for the company's growth capital needs. Growth capital is often needed in huge amounts because increases in demand are usually in discrete, rather than continuous, steps.[12] Therefore, the result causes "jumps" in financing needs.[13] With respect to external finance, firms normally choose debt over equity.[14] The small business, however, often finds that it is not possible to rely exclusively on debt finance when external funding is needed. Thus, equity capital is more suitable to serve as growth capital in light of the practical limitations of debt finance and the legal nature of equity capital.

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[11]As a first recourse, small businesses that generate profits would rely on profits for growth and expansion because no administrative costs are involved with such internal financing. The Wilson Committee (1979) thought that retained profits were the single most important source of equity financing for the small business. *See* HAROLD WILSON, COMMITTEE TO REVIEW THE FUNCTIONING OF FINANCIAL INSTITUTIONS, INTERIM REPORT, 1980, Cmnd. 7937, at 148, ¶ 506.

[12]Martin Binks & Christine T. Ennew, *Bank Finance for Growing Small Businesses*, *in* FINANCE FOR GROWING ENTERPRISES 40, 48 (Roger Buckland & Edward W. Davis eds., Routledge 1995).

[13]*See id.*

[14]William Megginson confirms that the pecking order preference is empirically confirmed. *See* WILLIAM L. MEGGINSON, CORPORATE FINANCE THEORY 433 & n.102, 444 (Addison-Wesley 1997) ("Clearly, corporations that must raise capital through security issues greatly prefer to issue debt rather than common or preferred stock.").

A. *The Practical Limitations of Debt Finance*

Debt finance is an important source of capital for the small firm because the owner-managers are often unwilling to dilute their ownership by inviting equity participation. Small firms, though, often tie up capital in new machinery or research and development.[15] As a result, these firms require a degree of permanence in growth capital that is simply incompatible with the nature of debt finance.[16]

1. Overdrafts

The most popular form of debt finance utilized by small businesses is the overdraft. Overdrafts are extremely popular for small businesses because they are simple, flexible,[17] and may be used alongside a current bank account. An overdraft, though, is repayable on demand,[18] and the uncertainty surrounding the timing of a recall could present serious problems to a small business that has its capital tied up in illiquid situations. A recall of an overdraft in these circumstances can force a small business into insolvency.

2. Term Loans

Small business may also pursue financing through a term loan. A bank may grant a term loan for short or medium terms, up to five years. The Wilson Committee explored financing options for small businesses and stated that raising long-term capital of over five years from credit institutions had become rare.[19] Favoring prudential considerations, the Wilson Committee stated that long-term liabilities on a balance sheet are less desirable than short-term loans, which are more liquid.[20]

The cash required to pay for the interest on the term loans often defeats the purpose of acquiring growth capital. Failure to pay principal or interest is often stipulated to be an event of default in which banks may

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[15]*See* Bovaird et al., *supra* note 3, at 18-19.

[16]*See, e.g.*, BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 49 (Oxford University Press 1997) (stating that debt finance has a certain expiration date, unlike equity finance).

[17]*See* EILIS V. FERRAN, COMPANY LAW AND CORPORATE FINANCE 462 (Oxford University Press 1999).

[18]Williams & Glyn's Bank Ltd. v. Barnes, [1981] COM. L. REP. 205 (High Ct. 1981) (U.K.).

[19]ROBERT BURGESS, CORPORATE FINANCE LAW 221 (2d ed. 1992).

[20]*See id.*

recall the loan.[21] Banks also practice the discriminatory measure of levying higher interest rates on small businesses,[22] primarily because higher administrative costs are involved in these transactions. Banks must calculate for a higher return in order to compensate for the risk of failure of the small business. Additionally, the Cruickshank Competition Commission[23] pointed out several anti-competitive practices taken by banks against small businesses that increase small business administrative costs in the bundling of services by banks (e.g., requiring small business borrowers to service current accounts together with loans).[24]

Besides the high cost in servicing term loans, small businesses may find that banks negotiate for protective covenants. The purpose of protective covenants is usually to give the lender some form of control over the borrower's business so that the credit rating of the borrower does not decline while the loan is still outstanding.[25] Non-compliance would usually be drafted as an event of default, upon which the whole loan becomes immediately repayable.[26] This potential for liability is incompatible with the needs of growth capital because growth capital requires a degree of permanence and stability to explore long-term prospects.

Furthermore, term loans may grant security interests to the creditor. The collateral may be taken over fixed assets or operational assets such as floating charges,[27] stock-in-trade, or book debts.[28] In addition, where banks

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[21]*See id.*

[22]*See generally* Neil B. Murphy, *Loan Rates, Operating Costs and Size of Loan: The Evidence from Cross-Sectional Data*, *in* 42 SMALL BUSINESS FINANCE-SOURCES OF FINANCING FOR SMALL BUSINESS 51 (Paul M. Horvitz & R. Richardson Fettit eds., JAI Press 1984) (determining that dispersion in loan rates among the size of the loan and the size of the borrower results more from systematic differences in operating costs and risks rather than the exploitation of market power by lenders).

[23]*See* Chancellor's Bank Competition Statement, *supra* note 6.

[24]*Id.*

[25]*See* FERRAN, *supra* note 17, at 470.

[26]*See id.*

[27]During the time of industrial and commercial expansion in the UK, the chancery courts developed the concept of a floating charge to aid businesses in obtaining loan finance from banks. *See* Robert R. Pennington, *The Genesis of the Floating Charge*, 23 MOD. L. REV. 630 (1960). The floating charge is described in *Illingworth v. Houldsworth*, [1904] A.C. 355, 358, as "ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject [crystallization] of the charge within its reach and grasp."

[28]In the well-known case of *Siebe Gorman & Co. Ltd. v. Barclays Bank Ltd.*, [1979] 2 Lloyd's Rep. 142, 167 (Eng. Ch. D. 1979), a fixed charge over present and future book debts was held to be good. *In re Brightlife, Ltd.*, [1987] Ch. 200, and *Re Armagh Shoes Ltd.*, [1984] B.C.L.C. 405, sought to restrict the decision. But the court of appeals in *Re New Bullas Trading Ltd.*, [1994] B.C.C. 36 (Eng. C.A. 1993), again allowed a fixed charge taken over future book debts. This was disapproved by Lord Millett in the Privy Council decision of *Re Brumark*

feel that they are inadequately protected, they may negotiate for personal guarantees to be furnished by the small business entrepreneur. This results in a form of unlimited liability as the entrepreneur is forced to take on more financial risk to protect creditors' interest. Such a personal guarantee removes the entrepreneurial incentive offered through incorporation and limited liability of the corporate form.[29]

3. Summary of the Limits in Debt Financing for Small Businesses in the UK

In accordance with the pecking order thesis, small businesses will still rely on debt finance to some extent despite the potential pitfalls. The point at which small businesses consider external equity would most commonly occur when they are unable to obtain additional debt finance. An example would be the inability to put up additional security by way of collateral or personal guarantees. Another example is where the banks simply refuse to lend to the small business because of an insufficient equity base (i.e., the gearing is too high).[30] Because of the practical limitations of exclusive reliance on debt finance, small businesses should consider expanding the equity base by inviting external equity funding when internal funding from retained earnings is insufficient.

B. *The Legal Nature of Equity Capital*

The nature of equity finance is compatible with the needs of growth capital. UK company law, following European requirements, requires the maintenance of a degree of permanence in equity capital by not allowing capital injected to be easily taken out of the company by the shareholders. Furthermore, equity finance is not cash consuming like debt finance

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Investments, [2001] 2 A.C. 701, which brought the ambit of fixed charges over book debts within the limitations of construction of the charge instrument. This development may affect a bank's readiness to lend since it would be more difficult to secure a fixed charge over book debts, which may be the only attractive security a business could provide. *See* Mark Fennessy & Lloyd Tamlyn, Case Comment, *Fixed and Floating Charges:* Brumark, 2 INSOLVENCY LAW. 56-60 (Mar. 2002); Fidelis Oditah, *Fixed Charges Over Book Debts After* Brumark, 2001 INSOLVENCY INTELLIGENCE 49, 52 (2001) (raising doubts as to the future of *Siebe Gorman*).

[29]Richard A. Booth, however, argues that limited liability does not insulate shareholders from liability because creditors usually bargain for personal guarantees from the shareholders. *See* Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 NW. U. L. REV. 140, 143 (1994).

[30]*See generally* COLIN BARROW ET AL., THE BUSINESS GROWTH HANDBOOK 185 (Kogan Page 1992) (stating that banks often insist on a 1:1 gearing to provide for a sufficient equity base of the debtor).

because there is no enforceable periodic payment that needs to be made to providers of debt.

The company law in the UK and Europe has a number of rules regarding the maintenance of capital in the company.[31] Although this is chiefly to protect creditors' interests, the maintenance rules are highly beneficial to a small business that takes in equity capital as growth capital. Because growth capital is often put to long-term and relatively illiquid uses, the maintenance rules restrict the ability of equity providers to claw back the capital. Two caveats, however, may be added here. First, it is noted that the maintenance rules are more relaxed for private companies in certain aspects. As a result, many small businesses are formed as private companies. Second, equity providers may contract for redemption rights.[32] Despite the advantages afforded to equity providers, the rules against reduction of capital, share buy-backs and redemption of preference shares found in the Companies Act of 1985 contain substantial limitations on the removal of capital from the company. They also provide a basic bedrock for the permanence of the equity capital of a small business. These legal rules protect the interests of the small business because capital may not be arbitrarily returned to shareholders.[33]

Since 1887, the consensus has been that return of capital is undesirable because it undermines creditors' interests.[34] Thus, any return of capital to an equity provider is undertaken only if certain statutory safeguards have been satisfied. Where return of capital takes the form of a proposed reduction of the company's capital, there must exist some genuine situation that calls for reduction of capital.[35] Section 135(1) of the Companies Act of 1985 provides for a restricted permission for return of capital, if authorized by the articles of association, approved by special resolution and confirmed by the court.[36] Also, reduction of capital is

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[31]*See* Companies Act, 1985, c. 6, Pt. V, c. V, § 143 (Eng.); John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law*, 63 MOD. L. REV. 355, 370 (2000); Eilís V. Ferran, *Creditors' Interests and "Core" Company Law*, 20 CO. LAW. 314, 315 (1999).

[32]Section 160(3) of the Companies Act of 1985 provides that the terms and manner of redemption of shares must be set out in a company's articles. Some equity providers, however, may be in a position to lobby for amendment to the articles. Companies Act, 1985, c. 6, pt. V, c. VII, § 160(3) (Eng.).

[33]The interests of a business may be different from the interests of its shareholders. *See* JOHN E. PARKINSON, CORPORATE POWER AND RESPONSIBILITY 76 & n.11 (Oxford University Press 1993 (citing *Re* Smith & Fawcett Ltd., [1942] Ch. 304, at 306).

[34]Trevor v. Whitworth, [1887] 12 App. Cas. 409 (H.L. Eng.).

[35]Having excess cash in the company after selling off of a division or an arm to concentrate on core activities illustrates such an example.

[36]Companies Act, 1985, c. 6, pt. V, c. IV, § 135(1) (Eng.).

subject to scrutiny and control and is not to be arbitrarily undertaken. Recent reform proposals have suggested that court confirmation could be substituted by a solvency statement signed by directors, but creditors could seek the court's intervention to protect their rights.[37] Under the proposed reform, the role of the court would be more limited. Court intervention is not automatically invoked, and checks against abuses in the return of capital are found in the constitution of the company and the collective agreement amongst the shareholders by special resolution. Collective action should be checked against self-serving initiatives by any individual shareholder whose desire to claw back equity capital may jeopardize the interests of the company.[38]

The return of capital in the form of share buy-backs is also limited by statutory safeguards. Share buy-backs are restricted under the Companies Act for both on and off-market purchases. For a small business, off market purchases are more relevant. Off market purchases may only take place pursuant to a contingent contract approved by special resolution.[39] Furthermore, only distributable profits may be used,[40] and the shares must be fully paid up.[41] The requirement of a special resolution again is based on collective action by shareholders so that the decision may more likely reflect the interests of the company. Requiring the payout of distributable profits ensures that the interests of the business itself are not jeopardized.[42] For private companies, share buyback is allowed out of capital under limited situations as well.[43] Such buy-backs have now been proposed to be consolidated under reduction of capital, and the provisions regulating limited buy-back of shares out of capital may be repealed.[44]

Equity providers may sometimes negotiate for redeemable preference shares, such as in private equity transactions. This is permitted because private equity providers do not have the benefit of being able to dispose of the shares in a ready secondary market, and such redemption by the company is often stipulated to be a mode of exit. The law, however, sets

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[37]DEP'T OF TRADE AND INDUSTRY, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: COMPLETING THE STRUCTURE ¶¶ 7.9-7.10 (Nov. 2000) [hereinafter DTI PAPER].

[38]It may be possible that all shareholders are self-serving and may take abusive action against the company's capital. The mathematical likelihood for concerted action is less than the probability of individual initiative.

[39]Companies Act, 1985, c. 6, pt. V, c. VII, § 164 (Eng.).

[40]*Id.* § 160(1)(a).

[41]*Id.* § 159(3).

[42]This also serves as a creditor-protection measure where capital returns are only possible when the company is a going concern and when such returns do not affect credit risk.

[43]Companies Act, 1985, c. 6, pt. V, c. VII, §§ 171-177 (Eng.).

[44]DTI PAPER, *supra* note 37, ¶ 7.18.

out the restrictions upon which redeemable shares may be issued and redemption may be made. Redeemable shares may only be issued if expressly authorized by the company's articles.[45] The Companies Act of 1985 also requires that the terms and manner of redemption be clearly defined in the articles of the company.[46] Thus, the company's constitution must govern the issue of redemption and the matter cannot be solely left to management discretion. Any amendment of the articles requires a special resolution and collective action by shareholders. This serves as a check against potential abuse in removal of capital. The redemption must also be in accordance with the Companies Act of 1985 (i.e., out of distributable profits or the proceeds of a fresh issue of shares). This ensures that redemption does not adversely affect the company and that such shares have been fully paid up.[47]

The maintenance rules have invested in equity finance a certain degree of permanence that is ideal for growth capital. By preventing abusive pressure from new equity providers upon small business management, and preventing owner-managers from abusing new equity capital, the maintenance rules have ensured that growth capital is kept within the business for the purposes of its operation.[48] Although courts may be robust in protecting capital (e.g., where transfers out of the company's assets were undervalued), a court's protection of capital may be contrary to maintenance of the capital rules and, therefore, be unlawful.[49]

The maintenance rules, however, do not ensure the permanence of equity capital in the sense akin to capital adequacy[50] because capital can be diminished through business operations.[51] Although the merits of the maintenance rules in the protection of creditors' interests have been

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[45]Companies Act, 1985, c. 6, Pt. V, c. VII, § 159(1) (Eng.).

[46]Section 160(3) of the Companies Act of 1985, which is in accordance with the Second Council Directive on Company Law 77/91/EEC [1977] O.J. (L 26) 1, requires that the terms and manner of redemption be set out in the company's statutes of incorporation. Companies Act, 1985, c. 6, Pt. V, c. VII, § 160(3) (Eng.). Reform, however, is proposed to this rule in the DTI Paper. *See* DTI PAPER, *supra* note 37, ¶¶ 7.16-7.18.

[47]Companies Act, 1985, c. 6, Pt. V, c. VII, §§ 159(3), 160(1)(a) (Eng).

[48]The proposed abolition of financial assistance prohibitions for private companies may raise some problems for certain equity holders, especially those who acquire shares without using their own resources.

[49]Aveling Barford Ltd. v. Perion Ltd., [1989] B.C.L.C. 626, 63. *See also Re* Halt Garage (1964) Ltd., [1982] 3 All E.R. 1016, 1017, 1045 (holding that the payment of excessive remuneration to a director-shareholder was unlawful).

[50]*See* Ferran, *supra* note 31, at 316.

[51]*See* Luca Enriques & Jonathan R. Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165, 1185 (2001).

questioned,[52] for purposes of this article, the maintenance of legal capital in a growing company is beneficial to the company itself. This is due to the relative stability provided by the legal framework of the maintenance rules, which accord with the desire to keep the capital for legitimate business operations. Moreover, equity providers, unlike debt providers, are not rewarded by enforceable periodic payments. Thus, equity capital is less cash consuming and less likely to affect the liquidity of the company. Distribution by way of dividend to shareholders is not mandatory because "[i]nvestor expectation with regard to the level of dividend depend[s] on the nature of the company, the stage of development of its business, and the type of business in which it is engaged."[53]

Dividends may only be paid out of accumulated realized profits net of accumulated realized losses.[54] Even if the company is profitable, dividends may not be paid where the company's need for growth takes precedence. For equity providers of growth capital, the expectation is more likely that they would share in the capital growth while postponing capital return when the cash consumption of growing companies is high.

Finally, an increased equity base in a small business raises the possibility of getting more debt finance if necessary. This results when banks insist on lending only at a certain gearing (e.g., 1:1) so that there is less perceived risk of having no collateral to satisfy the outstanding debt if the small firm should become insolvent. This is reinforced by the relative stability of equity capital under the maintenance of legal capital rules, which seek to provide a framework to prevent abuse of capital for illegitimate depletion.[55] An increased equity base may also provide a bank with an increased sense of confidence in the creditworthiness of the small firm.

With respect to owner-managers who are reluctant to seek external equity financing because sharing the company may dilute their proportional control, some restructuring is certainly needed when new shareholders are

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[52]Armour, *supra* note 31, at 370 (arguing that capital maintenance rules are too costly to administer and do not protect creditors of private companies who may have as many involuntary creditors as public companies).

[53]*See* FERRAN, *supra* note 17, at 408.

[54]Companies Act, 1985, c. 6, Pt. VIII, § 263-264 (Eng.).

[55]Whether the maintenance of legal capital rules really serve as a useful form of protection for creditors' interests, see Ferran, *supra* note 31, at 316, where it is argued that maintenance rules are unlike capital adequacy rules because the latter cannot be justified in the light of creditors' ability to negotiate private contractual protections for themselves. Therefore, protection of creditors may lie outside the realm of core company law. *See also* Enriques & Macey, *supra* note 51 (arguing that where abolition of legal capital rules is called for as creditor protection, private contract may already provide this protection in the form of personal guarantees by shareholders).

taken on board. Numerous studies, however, reveal that a growing small firm is largely dependent upon expansion of its managerial team to include competent individuals. Thus, a gradual split between ownership and management in the corporate structure would inevitably take place as the company grows.[56] Therefore, growth of a company is an appropriate time to take on more equity providers. There is, though, a general unwillingness for small businesses to adjust to new control paradigms. Research findings in the UK show that only about ten percent of all small firms in the UK wish to grow, and out of that number, only ten percent will actually do so.[57] Nevertheless, these firms, while representing a minority of small businesses in the UK, are often fast-growth firms that could make significant contributions to the UK economy.[58] Therefore, their financing needs deserve attention. It is for the purposes of growth of this significant group that the law should examine the effectiveness of its legal infrastructure for external equity financing.

III. OBSTACLES FACED BY UK SMALL BUSINESSES IN OBTAINING EXTERNAL EQUITY FOR GROWTH

In the previous section, the article argued that equity finance is supportive of small business growth needs. In this part, the article will examine the legal obstacles that UK small businesses may encounter in obtaining growth finance from external equity. There are two options in external equity financing for the small business. These two options are broadly categorized as direct access to participation by members of the public and participation by non-retail investors outside of the public markets. There is also the anomalous situation of the private placement, which is currently an "exemption" from public regulation but is actually in nature a non-retail type of equity participation.

Small businesses that need growth capital should be facilitated towards direct access to the public for external equity financing. This is because growth capital needs to be supported by a certain degree of perpetuity, whereas the access to growth capital may not be subject to

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[56]*See generally* JENKINS, *supra* note 4 (noting research findings to support the thesis that a growing small business needs to take on a competent managerial team and cannot continue to rely solely on founder-manager's abilities); ROPER, *supra* note 7 (explaining the various factors that influence growth in a small business, including changes in corporate structure).

[57]Catherine Hakim, *Identifying Fast Growth Small Firms*, EMPLOY. GAZETTE, Jan. 1989, at 29, 35. Growing firms constitute a minority of about ten percent or less of all UK small businesses.

[58]Robin Jarvis, *Finance and the Small Firm*, *in* ENTERPRISE AND SMALL BUSINESS 337, 341 (Sara Carter and Dylan Jones-Evans eds., Prentice Hall 1997).

short-term or unpredictable truncation by the equity provider. The availability of a ready secondary market for share investments, which is made possible by opening equity participation to the public, allows for the ready transfer of shares when an equity provider wishes to dispose of his interest. The presence of a ready secondary market supports the need for perpetuity. A ready secondary market also provides for the reflection of the value of the company which allows the shares of these companies to acquire "currency value." Growing companies may enter into transactions of mergers and acquisitions and can use their shares as collateral for the necessary debt finance or as a form of exchange for the transaction. Ready secondary market value is also a useful reference point if the transaction concerned involves a sale of the business to a third party.

As opposed to direct public equity financing, the article will discuss private equity and private placements, which are classified as non-retail equity provisions and affect the degree of commitment for the capital growth of the company.

A. *Small Businesses and Public Equity Access in the UK*

A small business in the UK is likely to raise funds through an initial public offer for sale of or subscription for its securities, or through an offer of securities to a select group.[59] This brings the offer within an "exempt public offer," otherwise known as private placements.[60] This is actually a form of non-retail external equity and does not entail the benefit of a ready secondary market accompanying the making of an initial public offer. This section will discuss whether public securities regulation in the UK meets the needs of small business in obtaining public equity financing.

The UK securities regulations are based on investor protection.[61] Before discussing whether the securities regulatory regime meets small business needs, this article will discuss another hurdle a small business has to cross if it wishes to raise capital from the public markets through an initial public offer. This additional hurdle requires a small business to convert itself into a public company in order to legally make public offers.[62]

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[59]*See* Financial Services and Markets Act, 2000, c. 8, Schedule 11 (Eng.), *available at* http://www.legislation.hmso.gov.uk/acts/acts2000/00008-az.htm#sch11.

[60]*See id.*

[61]*See* EILÍS FERRAN & CHARLES A.E. GOODHART, REGULATING FINANCIAL SERVICES AND MARKETS IN THE TWENTY-FIRST CENTURY 5 (Hart Publishing 2001).

[62]Companies Act, 1985, c. 6, pt. IV, § 81 (Eng.). *See also* Financial Services and Market Act 2000 (Official Listing of Securities), 8 Regulations 2001 No. 2956, pt. 2, § 3(a) (Eng.), *available at* http://www.hmso.gov.uk/si/si2001/20012956.htm (prohibiting a private company from obtaining a listing).

1. Conversion from Private to Public Company

The UK has maintained a private-public divide in its classification of companies. There are certain regulatory requirements under the Companies Act that are made applicable only to public companies. These companies have greater investor participation and are therefore more accountable to the public.[63] Private companies are generally less accountable to the public because shareholders are usually willing and informed investors, and shares of a private company are not easily transferable. The recent Department of Trade and Industry, Final Report on Modern Company Law (DTI Report) on company law reform has reaffirmed the public-private distinction in company law.[64] This distinction, however, is not particularly meaningful. Attainment of public status is a prerequisite of a company's ability to raise capital in the public markets, when it should actually be a *consequence* of the ability to raise capital from the public markets. The prerequisites to accessing a public market are found in the regulatory requirements such as disclosure pursuant to a public offer and the admission requirements of the primary market on which the stocks are to be traded. Thus, when a company satisfies those requirements, it should be able to gain access to the public markets. As a consequence, the company would be subject to higher regulatory requirements regarding audit and reporting due to the company's greater public presence and necessary accountability.

The UK Companies Act has instead adopted the opposite approach of subjecting a company to higher regulatory requirements while it prepares to access the public markets. Proposed company law reforms in the UK have not recommended changes to this approach, and have, in fact, proposed to augment the private-public divide by reducing regulatory requirements for private companies.[65] Small private businesses would have to cross a greater divide to become public companies before they can prepare for public fundraising. Although fewer regulatory requirements would mean less cost to small businesses when they are private companies, small businesses would find themselves at a greater cost barrier while they

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[63] *See* DEP'T OF TRADE AND INDUSTRY, MODERN COMPANY LAW: FINAL REPORT, V, ch. 2, ¶ 2.2, at 23 (July 2001).

[64] *See, e.g.*, MODERNISING COMPANY LAW, 2002, Cm. 5553-II, pt. 1, ch. 1, § 1(a)(-(d), at 1, *available at* http:/wwww.dti.gov.uk/companiesbill/whitepaper.htm (listing the four types of companies allowable under the company's bill).

[65] *See generally id.* pt. 2 (illustrating that where regulatory requirements in terms of submission of accounting reports, holding of AGMs, appointment of company secretary and restrictions on financial assistance have been substantially reduced or removed for private companies).

prepare to grow and pursue public funding. It is uncertain whether such a cost barrier would act as a greater impediment to small business growth because dramatic cost considerations may encourage path inertia in small businesses.

The justification for higher regulatory requirements put forth in the UK may not represent the full picture of the rationale behind the private-public divide. Conceptually, regulatory requirements should be a trade-off for the benefit of limited liability. Thus, the regulations should be generally applicable to all companies regardless of whether the corporation is public or private, unless the requirements specifically applicable to a public company bear a direct relationship to the company's ability to raise capital from the public. Allowing private companies to comply with fewer requirements, which have no direct relationship with the ability to obtain public financing represents a regulatory price concession. The DTI Report should have considered justification for the price concession or whether the cost to private companies for compliance is proportionate to the benefit of regulatory supervision.[66] Sufficient studies, however, have not been carried out to estimate behavioral changes in private companies and the potential cost to the regulator if the requirements are lifted.

On the other hand, small private companies are concerned about the requirement that public companies must have a minimum share capital of 50,000 GBP.[67] Of this figure, at least a quarter must be paid and all share premiums must be paid.[68] A small business would first have to bring its authorized share capital in its Memorandum or Articles of Association to the prescribed minimum level. Under Section 9(1) of the 1999 Reissue to the Companies Act, "a company may by special resolution alter its articles."[69]

For small businesses, the statutory prescriptions may be too rigid and discriminatory against those companies with lower amounts of authorized and allotted share capital. A proportional approach that takes into account small business financing needs may in fact be more sensible. The minimum capitalization requirements, however, are European[70] in origin and the minimum authorized share capital recommended in the Second

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[66]For an example of the proposed abolition of the compulsory appointment of a company secretary, see DEP'T OF TRADE AND INDUSTRY, *supra* note 63, ¶ 2.21, at 31. *But see* S.R. Wrightington, *Private Companies*, 10 A.B.A. J. 475, 476 (1924) (arguing that the private-public distinction is sound and ought to be adopted in the U.S.).

[67]Companies Act, 1985, c. 6, pt. V, c. I, § 118 (Eng.).

[68]*Id.*

[69]1999 Reissue of the Companies Act, 1985, c. 6, pt. I, c. I, § 9(1) (Eng.).

[70]Second Council Directive on Company Law, 77/91/EEC, 1977, O.J. (L 26) 1.

Company Law Directive is 25,000 euros.[71] This amount may be very insignificant when compared to minimum market capitalization requirements imposed by stock exchanges.[72] Regardless, many small businesses may seek to make public offers over a second tier market that may not have minimum capitalization requirements (e.g., the Alternative Investment Market in London). Therefore, the paradox for a small business seeking to raise funds is that it must put itself into an eligible position to raise funds by having more funds.

2. Statutory Regulation and Market Requirements in the UK

The next barrier to entry is the complex securities regulation that controls access to public financial markets. [73] The law takes the position that where the external equity providers are members of the public, information asymmetry is at its greatest. As a result, protection is needed to ensure that public investors are sufficiently informed about the financial health of a small business and its prospects before the public may be solicited for investment.[74] It is argued that prudential regulation, including mandatory disclosure of information is a "public good" that has to be made obligatory by the state.[75] This is regulation on the lowest common denominator because the law provides a level of protection according to the least savvy of investors. Investors in the public capital markets, however, may range from sophisticated institutional investors and well-informed

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[71] *Id.*, art. 6.1. The amount may be revised every five years. *Id.*, art. 6.3.

[72] EASDAQ requires a minimum capitalization of 2 million euros. *See* Dana T. Ackerly, *Easdaq—The European Stock Market for the Next Hundred Years*, 12(3) J. INT'L BANKING L. 86, 87 (1997).

[73] *See generally* Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 VA. J. INT'L L. 583, 610, 613 (2001) (arguing that securities regulation is akin to a "public law" for corporation law).

[74] The regulation of public offers is mainly predicated upon mandatory disclosure. Therefore, public offers of securities may not be made unless accompanied by a prospectus. *See* Financial Services and Markets Act 2000, c. 8, pt. VI, § 84 (Eng.), *available at* http://www.legislation.hmso.gov.uk/acts/acts2000/00008–g.htm (listing securities); Public Offers of Securities Regulations, 1995 No. 1537, regs. 5-6, *available at* http://www.legislation.hmso.gov.uk/si/si1995/uksi_19951537_en_3.htm (listing unlisted securities).

[75] CHARLES A.E. GOODHART ET AL, FINANCIAL REGULATION—WHY, HOW AND WHERE NOW? 5 (Routledge 1998). *See also* Joel D. Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 5-8 (1983) (applauding the rationale for mandatory disclosure based on the need for maintenance of market confidence and the argument that issuers would otherwise misrepresent information). *But see generally* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioural Analysis*, 68 U. CINN. L. REV. 1023 (2000) (arguing that behavioral economics does not justify mandatory disclosure and that voluntary disclosure need not spell disaster).

professionals to the ordinary public. Public securities regulation has constructed a protective framework to regulate initial public offers of securities via mandatory disclosure through prospectus and continuing disclosure obligations.[76] In contrast, where placements of shares are made with accredited or sophisticated investors, mandatory disclosure is dispensed with because it is assumed that these investors would be knowledgeable enough to protect their own interests.[77]

An intended public offer may be made over the main London Stock Exchange or over a second tier market such as the Alternative Investment Market (AIM) operated by the London Stock Exchange. The main exchanges in Europe are regarded as "listed" whereas the second tier markets are referred to as "unlisted." This is because the European directive on Listing Particulars applies only to listed markets and contains requirements significantly more onerous than those that may be imposed for unlisted markets.[78] The listed-unlisted distinction in the UK is akin to the U.S. distinction between the main exchange of the NYSE and a second tier market such as the NASDAQ.

Currently, if an intended public offer is to be made over the main London Stock Exchange, the small business would have to comply with the general mandatory disclosure requirements prescribed by statute[79] and other onerous requirements applicable to the listed market.[80] Where a small business intends to make an initial public offer over an unlisted market, the entry requirements imposed by the second tier market (e.g., minimum capitalization, record of trading and minimum percentage of shares offered to the public) are less stringent and less costly. The applicable mandatory disclosure requirements, however, are equally stringent[81] by virtue of the

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[76]Council Directive on Public Offers, 89/298/EEC, 1989 O.J. (L 124) 8.

[77]*See* Howard M. Friedman, *On Being Rich, Accredited and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 299 (1994) (arguing that sophisticated investors are under protected). A wealthy investor with at least $1 million of net income would be deemed "sophisticated" even if such an investor is actually not savvy enough to gain access to much of the financial information that would be necessary to make an informed judgment about the pricing of the privately placed shares.

[78]Council Directive on Listing Particulars, 80/390/EEC, 1980 O.J. (L100) 1.

[79]Financial Services and Markets Act, 2000, c. 8, pt. VI, § 84(1) (Eng.), *available at* http://www.legislation.hmso.gov.uk/acts/atsf2000/00008--g.htm.

[80]Adherence to the European listing requirements are necessary.

[81]Financial Services and Markets Act, 2000, c. 8, pt. VI, § 80 (Eng.), *available at* http://www.legislation.hmso.gov.uk/acts/acts2000/00008--g.htm (dealing with unlisted securities). Public Offers of Securities Regulations 1995 No. 1537, reg. 9 (Eng.), *available at* http://www.legislation.hmso.gov.uk/si/si1995/uksi_19951537_en_3.htm. Regulation 9 of the Public Offer of Securities Regulation applies to unlisted securities, and it mirrors Section 84 of the Financial Services and Markets Act. This point illustrates that the mandatory disclosure requirements applicable to listed and unlisted offerings are equally stringent.

European requirement.[82]

Small businesses usually try to offer their securities on the unlisted market because the entry requirements are lower. Whether it is a large or small issuer, however, the statutory mandatory disclosure requirements imposed are the same under the Financial Services and Markets Act and its Schedules. The onus upon unlisted issuers may be slightly mitigated because prospectuses for listed issuers need pre-vetting and approval, but prospectuses issued by unlisted issuers need not require pre-vetting. In light of the fact that the scope of mandatory disclosure for all issuers is the same, small businesses would still incur a certain amount of fixed cost in making mandatory disclosure. For instance, costs are incurred in engaging accountants, lawyers, and other professionals[83] to prepare the prospectus and other financial documents.[84] There are also potential costs involved in liability for misstatements and omissions in the prospectus.[85]

Small businesses may also incur less cost than a large company seeking listing. This is so because a large company would usually engage an investment bank to book build and underwrite the issue, thereby paying for the cost of such reputational intermediaries to verify the stock.[86] The support of a reputational investment bank, however, may be crucial to the popularity of the stock. Even small businesses must carefully consider if they should engage such an investment bank. On the whole, the cost incurred by a small business in making a public offer is less than a large company, but it may not be by a significant amount. Major cost savings are derived from less onerous admission requirements to second tier markets[87] and stricter statutory disclosure requirements.

Initial cost for floating on the AIM is expected to be 75,000 to

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[82]Council Directive on Public Offers, *supra* note 76, at 4.

[83]Martin Sabine has a useful chapter detailing the actual costs that are incurred in the process of engaging various professionals to prepare a public offer. *See* MARTIN SABINE, CORPORATE FINANCE—FLOTATIONS, EQUITY ISSUES AND ACQUISITIONS ch. 5(II) (Butterworth & Co. (Publishers) Ltd., 2d ed. 1993).

[84]*See* Hans R. Stoll, *Small Firms' Access to Public Equity Financing*, *in* PAUL M. HORVITZ & R. RICHARDSON PETTIT, SMALL BUSINESS FINANCING 187 (JAI Press 1995) (discussing the prohibitive costs for small firms to have their shares traded in secondary markets).

[85]*See* Financial Services and Markets Act 2000, c. 8, pt. XXVII, § 397(1), (8) (Eng.), *available at* http://www. legislation.hmso.gov.uk/acts/acts2000/000008-al.htm.

[86]Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1568 (2000).

[87]For example, the Alternative Investment Market run by the London Stock Exchange reduces costs for small business issuers by requiring only a nominated broker and nominated adviser for trading and compliance purposes. *See* AIM Requirements, *available at* http://www.londonstockexchange.com/aim/how_to_join.asp.

100,000 GBP.[88] In comparison, entrance costs of at least 8.5 million GBP for listed companies would usually be incurred in an initial public offer of about 100 million GBP. The actual figures seem favorable to small business issuers trying to enter a second tier market, until the cost is compared to the average amount of finance that small growing companies are trying to raise. For a listed market, the amount of finance sought to be raised averages 100 million GBP. A recent small business survey revealed that most small businesses in the high technology manufacturing sector, conventional manufacturing sector, high technology services sector, and conventional services sector seek median amounts of equity financing from 60,000 GBP to 150,000 GBP.[89] Thus, the entrance costs for a small business needing 60,000 GBP would exceed the financing needs. Therefore, there is a gap between small business financing needs and lowering the costs of entrance into the AIM.

Why then is there such a high fixed cost for entry into a direct public equity market? The initial public offer attracts the same type and amount of mandatory disclosure due to European requirements. Hence, there would be a minimum amount of costs expended toward legal compliance that would be fixed to a certain extent. Although listed issuers would incur even more cost because pre-vetting and underwriting costs are high, the amount of finance sought on the listed market is usually higher than the cost incurred and would compensate for the expense of statutory compliance. The amount sought by smaller enterprises may be only a fraction of the amount of finance sought by a listed issuer. As a result, if cost is not similarly lowered to a fraction of what would be incurred by the listed issuer, it would be too high for the small business. By adopting a one-size-fits-all approach in mandatory disclosure, small businesses and large firms both have minimum compliance costs. This amount may be more easily borne by the large firm, but may be onerous for the small business. Although it achieves homogeneity, there may not be any economic justification for levying a similarly high fixed cost upon both large and small issuers.

Securities issues vary greatly in size. They may be very small or of an intermediate size. The issuer, limited by its size and turnover, will not be able to make issues of a large size comparable to the listed entities.

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[88]BRIAN FINCH & GRAHAM WOOLFMAN, GUIDE TO THE ALTERNATIVE INVESTMENT MARKET 165 (Butterworths 1995).

[89]Hughes A. Alan & Brian Moore, *Growth and Performance of Small Hi-Tech Firms in the UK Economy*, *in* ANDY COSH & ALAN HUGHES, BRITISH ENTERPRISE IN TRANSITION, GROWTH, INNOVATION AND PUBLIC POLICY IN THE SMALL AND MEDIUM ENTERPRISES SECTOR 1994-99 (2000).

Where the offer is small, the cost should be proportionate to the benefit gained. Otherwise, the issue is meaningless because the company would incur a greater loss. Furthermore, from a public policy point of view, the smaller the offering, the less likely that total investor loss would be great. Therefore, does the potential of a small investor loss warrant the high cost of protection?

It may be difficult to measure what level of regulation would be the minimum for achieving the goal of investor protection, but because there is no market for regulatory services (i.e., consumers are unable to indicate how much they would pay for regulatory services), the supply of regulation cannot be estimated accurately to meet actual investor demand. Thus, regulators may, out of self interest, over regulate since regulation is seen as a "free good."[90]

3. Second Tier Markets and Small Businesses in the UK

The UK has not been oblivious to the needs of small businesses for some regulatory modification. Although the UK is constrained because of its mandatory disclosure regime under the Public Offers Directive, the UK government has supported small business needs in capital formation by the establishment of unlisted second tier markets with lower regulatory requirements for admission. Therefore, the overall cost of entry into these unlisted secondary markets would not be insurmountable.

Small businesses welcome the second tier markets because the requirements for admission to trading are much less onerous than the main exchange for trading of listed securities.[91] Only the more medium sized enterprises of the small business sector who are seeking to float an issue of considerable size, however, would be prepared to commit at least 75,000 GBP in the offering process. Thus, there is a category of smaller businesses that may need to raise finance and would not be able to surmount the fixed costs of mandatory disclosure. This has caused second tier markets not to be attractive to enter. Also, the fixed costs of mandatory disclosure have resulted in many small businesses bypassing the requirements by not making initial public offers, but instead making private placements. These shares are then placed to trade on second tier markets.

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[90] *See* GOODHART ET AL., *supra* note 75, at 61. The term "free good" is used in the context of explaining that the beneficiaries of regulation, assuming that they are consumers of regulation, are not able to signal what they are prepared to pay for regulation. There is no market to measure how much the consumer of regulation would be prepared to pay for regulation. Thus, the impression is created that regulation is a free good. *Id.*

[91] For example, the AIM has no requirement on minimum capitalization. *See* AIM Requirements, *available at* http://www.londonstockexchange.com/aim/how_to_join.asp.

By bypassing the initial public offer, small businesses are unable to reap the benefits of making themselves known to the public. Thus, the second tier markets feature many stocks of which the public is unaware. This has resulted in thin trading and relative illiquidity of demand, which, in turn, has caused the second tier markets to be unprofitable trading platforms.

This problem had existed since the time of the Unlisted Securities Market and the Third Market, which were the predecessors of the AIM. The Unlisted Securities Market was established in 1980 to provide a junior market to serve small and growing companies' needs. This was followed by the Third Market for even smaller companies in 1987. The Unlisted Securities Market was initially viewed as successful because companies which could not be listed on the official exchange could actually find a niche for themselves in this market.[92] Buckland and Davis, however, who did significant studies on small businesses on the Unlisted Securities Market, reported that average expenses for entry to the Unlisted Securities Market in the 1980s was about 90,500 GBP, a significant sum for small businesses. The Third Market was thus introduced to reduce entry costs even further. The Unlisted Securities Market and the Third Market, however, found small firm equities to be illiquid in nature and not very actively traded. Buckland and Davis suggested that the issues were relatively small compared to public offers over the main exchange. Thus, they were less attractive to institutional investors who preferred to trade in larger volumes so as to take advantage of the economies of scale.[93] Thin trading, however, may be a result of investor unfamiliarity with the traded entities on the market, possibly due to small businesses bypassing the initial public offer to save costs and opting for private placements instead. These privately placed shares, when admitted to trading, would be virtually unknown to the public.

The decline of the Unlisted Securities Market and the Third Market almost made the London Stock Exchange decide to close down the second tier markets. Immense government and public pressure to provide for a second tier market for small issues, however, was applied because venture capitalists insisted on maintaining a second tier market for ease of their potential exit from a small business.[94] Thus, the London Stock Exchange set up the Alternative Investment Market (AIM) to replace the Unlisted Securities Market. The UK government, however, has not given due

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[92]*See* Neil McClure, *Is the USM Here to Stay?* 94 ACCT. 74 (May 1983).

[93]Edward W. Davis, *The Stock Exchange and the Unlisted Securities Market*, *in* FINANCE FOR GROWING ENTERPRISES, *supra* note 12, at 135.

[94]RANALD C. MICHIE, THE LONDON STOCK EXCHANGE: A HISTORY 618-19 (Oxford University Press 2001) (1999).

consideration to the factors for the failure of the Unlisted Securities Market and the Third Market. The lax requirements imposed by these junior markets did not help small businesses sufficiently. Also, review of the entire securities regulatory structure should have been undertaken to determine how to unburden small businesses from entering public markets. The AIM was set up with even less onerous requirements, but without fully reviewing the needs of small businesses as part of a holistic inquiry. Therefore, the AIM is founded upon the assumption that admission to trading requirements are by themselves the key factor to improve small business access to capital. This may be erroneous.

The AIM was set up in 1995 with lower barriers to entry as compared to the Unlisted Securities Market. Statistics show that 682 companies are currently traded on the AIM.[95] Finch and Woolfman, however, estimate that only ten percent of the trading entities on the AIM made initial public offers, and about seventy percent are offered through introductions or private placements.[96] This is probably because small businesses find that the AIM entry costs are still too high and try to bypass the costs associated with public offers by finding private places to admit their stocks for retail trading after placements have been made. The AIM's experience demonstrates that simplifying admission requirements to reduce cost is not sufficient. The crucial issue, therefore, lies with the fixed costs associated with statutory compliance of mandatory disclosure for an initial public offer.

In this light, it should be considered whether a special disclosure regime based on small sized offerings may be carved out of the general mandatory disclosure framework. This special regime could address small business concerns and allow small businesses to make cost-effective initial public offers without compromising necessary investor protection. Although the UK cannot independently change European requirements, it may be timely for Europe to consider this issue of prospectus requirements. Comparative observations about the regime for small offerings in the U.S., however, should be made.

B. *Special Small Offerings Regime*

As discussed above, the costs of an initial public offer for small businesses have been kept high because the mandatory disclosure requirements apply to all issuers regardless of size, capacity of the business,

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[95] *See* August 2002 AIM Market Statistics, *available at* http://www.londonstockexchange.com/cmsattach/1057.pdf.

[96] FINCH & WOOLFMAN, *supra* note 88, at 153.

and the size of the issue. If a special disclosure regime may be carved out of the one-size-fits-all approach, similar to the initiatives adopted by the Securities Exchange Commission (SEC) in 1992 pursuant to the Small Business Initiatives Proposal,[97] it may bring immense cost savings to small businesses in making an initial public offer without compromising investor interests.

1. Justifications for a Tiered Disclosure Regime

Given the size of small business offerings, potential investor loss is not as great as the conventional listed company offering to warrant costly regulatory compliance.[98] One may argue that the amount of potential loss is small or not should not affect the amount of protection given to investors. This would be a principled objection to a more economic analysis of whether the cost of protection is warranted as compared to the potential loss. Moreover, there needs to be a balance between reducing the cost of a small business offer to achieve greater economic efficiency and the potential cost increase associated with fraud.[99]

If small business issues may be made under a special disclosure regime that is less exacting than the disclosure regime applicable to a larger, listed-entity type issuer, investors would be informed of the difference because of the transparency of regulation. An investor may choose not to invest if the level of disclosure offered is not at his level of comfort. Thus, a tiered disclosure system empowers investors to choose their investments. Regulators should also consider if a one-size-fits-all approach in securities regulation is appropriate given the changing profile of investors.[100] Where the market consists of different groups of investors

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[97]*See generally* Keith J. Mendelson & Cindy R. Shepard, *The SEC's Proposed Small Business Initiatives—Bold Reform or Opportunity Foregone?* INSIGHTS, July 1992, at 12 (summarizing the "small business initiatives" proposed by the SEC which reduce government regulation and facilitate capitalization of small businesses).

[98]*See generally* C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591, 614-18 (1996) (arguing that because mandatory disclosure attracts a fixed cost, there would be economies of scale for a larger offering). Moreover, investor benefits increase with mandatory registration only with increases in investment.

[99]Fraud caused significant losses to investors in cases where companies were thus exempted from disclosure requirements. *See* Seligman, *supra* note 75, at 35. *See also* Black, *supra* note 86, at 1567-68 (noting a cost to the exchange where investor confidence drops due to fraud).

[100]*See, e.g.*, Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 659-66 (1995) (describing the changing landscape of the modern market in the U.S.). Professor Seligman notes that there has not only been an increase in institutional investor shareholding, but also an increase

with varying degrees of sophistication, a one-size-fits-all approach may be too paternalistic and thus inappropriate.

A one-size-fits-all disclosure regime, based on the lowest common denominator in the investor base, is not without cost. Should the cost be borne by issuers because the regulator adopts a policy of protecting all investors equally? Regulation based on the lowest common denominator would also be susceptible to the critique that there is an assumption that investors' needs and demands are homogeneous because the law assumes that sophisticated investors and ordinary investors are subject to the same information asymmetries. In today's complex market landscape, regulators should take cognizance of the fact that different groups of investors need different levels of protection and that there is regulatory waste in a one-size-fits-all approach. Such an approach is most prejudicial to small business issuers because they would find it most difficult to bear the cost of this regulatory waste.

Tiered disclosure requirements are not adverse towards investor protection because investors are empowered to decide according to their own comfort levels. In fact, it has been suggested that U.S. mandatory disclosure requirements are inefficient, and perhaps investor regulation would better address the goal of investor protection.[101] Under such a regime, issuers would have to provide information based on the type of investor seeking to invest, and issuer cost in making public offers could settle at a realistic level. Under these circumstances, there would not be more regulations than the amount necessary for investor protection.[102] The assumption made is that more sophisticated investors would require less disclosure. Thus, there is a school of thought that recognizes different types of investors in the market and bases disclosure requirements upon the lowest common denominator. This may not be as effective as a market driven regime.

A tiered disclosure regime does not need to eliminate disclosure altogether. The small business issues regime adopted by the SEC in 1992 utilizes many standard formats for disclosure in order to save small business cost.[103] By so doing, the SEC has selected the most salient and

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in individual shareholding. *Id.* Although an increase in individual shareholding may signal a need to adopt regulation on the lowest common denominator, the proportion of varying degrees of sophistication amongst investors should be considered carefully before concluding that a one-size-fits-all approach is appropriate.

[101] *See* Stephen J. Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 282 (2000).

[102] *See id.* at 334.

[103] *See infra* Part II.B.2.

indispensable information that still ought to be made known, which provides the minimum safeguards to investors' interests.

The SEC's justification for the 1992 reforms was based on concern for the future of small American enterprises. The reforms have been in place for ten years and their liberality remains intact . From the point of view of administration of regulation, this article would argue that carving out tiered disclosure levels need not entail much regulatory cost because the tiered levels require less disclosure. The administrative work may be more in the area of verifying that entities are entitled the benefit of the relevant tier, but the onus can be shifted onto those who claim the benefit.

In the UK, institutional investors dominate the retail market. As a result, the nature of the capital market in the UK is sophisticated and caters to large value transactions. Could it then be argued that carving out a special regulatory regime for small businesses would not meet its purposes because market demand for small time stocks is lacking? Sophisticated market players may demand more information be provided and more thorough insights into the business be disclosed. Market demand may itself dictate the level of cost that a business has to incur to attract investment. This would be quite opposite from the presumption that sophisticated investors need to know less. In fact, market demand may require standards to "race to the top."[104] If that is the case, freedom of competition may push small businesses into an unattractive position because small businesses would not be able to expend the same amount of capital as a larger issuer. Regulatory adjustments may be warranted in order to help small businesses. The argument for lower cost of entry for small businesses would be based on public policy, which is driven by a desire to keep the small issues competitive, protect the jobs that small issuers provide, and stimulate this section of the economy.

Small offerings may also arguably entail less systemic concerns than the failure of a large corporation. Nonetheless, cumulative failures of many small offerings can lead to a stock market crash. The failure of the technology start-ups and dotcoms in the 1990s, however, may not be attributable to a failure in regulation for investor protection. One commentator argued that analysts who hyped up "folksy" reports of prospects of these firms that had no trading record was detrimental to investors and the market.[105] Investors could not discern the true quality of such disclosure and aggressive punting further hyped up prices of these

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[104]Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999-Part I*, 56 BUS. LAW. 653, 664-65 (2001).

[105]Andres Rueda, *The Hot IPO Phenomenon and the Great Internet Bust*, 7 FORDHAM J. CORP. & FIN. L. 21, 72-73 (2001).

stocks. These hyped up prices inevitably had to settle at realistic levels after some time. The dotcom crashes show that investor protection also has its limits and cannot instruct investor choice. Thus, maintaining an unnecessarily high level of disclosure for a small issuer may be more punishing for a small issuer than it is beneficial to an investor. This article does not argue in favor of deregulation, but argues in favor of regulation that is sensitive to small business needs and not a one-size-fits-all approach. If left to free market forces, sophisticated investors may demand small business disclosure to reach the same standard as expected of large businesses. Therefore, regulatory intervention is beneficial for small businesses because regulators could decide the most cost-efficient level of disclosure for small businesses.

2. Tiered Disclosure under the U.S. Securities Act of 1933

The reforms brought about by the SEC's acceptance of the Small Business Initiatives in 1992 carved out a simplified regime for small business issues. This simplified regime for disclosure adopted a three-tiered approach in the level of disclosure depending on the amount of the offering. A larger issue would require more disclosure. An added caveat is that isolation from the totality of the securities regulation regime in the U.S. consists of blue sky state laws and exchange listing requirements.

The simplest tier[106] is an exemption from mandatory disclosure requirements if the issue is under US $1 million on a per year basis. The issuer is able to carry out general advertising and solicitation. There is no restriction on secondary trading of these shares. Prior to the reform, Rule 504 prohibited free transfer of these securities and there could be no general solicitation or advertising.[107] The prior position is an exemption for a *limited* offer. With the amendment to the Rule, the new regime is effectively an exemption for the very small *public* offer. The rationale for the total exemption for such small issues is that small issues do not warrant the participation of intermediaries at all since intermediary costs in underwriting and prospectus preparation may exceed the amount of the offer. The absence of limitations on secondary trading of these shares would be attractive to investors. This would probably be very useful for the typical small technology manufacturing firm highlighted earlier that needs a median amount of finance at about 60,000 GBP.

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[106]Federal Securities Act of 1933, § 5.04, *available at* http://www.law.uc.edu/ccl/33actrls/rule504.html.

[107]*See* David T. Mittelman, *Testing-the-Waters: How Warm is Regulation A's Model for Soliciting Investor Interest?* 32 SUFFOLK U. L. REV. 233, 241-42 (1998).

The next tier of disclosure would be under Regulation A. Until 1992, Regulation A of the Securities Act of 1933 provided that a small offering of up to USD $1.5 million could be made with a less complex prospectus. Regulation A has been amended to allow small offerings below US $5 million, on a per year basis, to proceed with a limited disclosure document in three options. The most popular option is a simplified document in a question and answer format that is easy to complete for submission. There is no requirement for submitted financial statements to be audited, thereby allowing small businesses to save on professional fees. There is, however, a limitation of USD $1.5 million on sales by existing security holders.[108] Regulation A also allows issuers to utilize Rule 254 to test the waters. Testing the waters involves circulating information to the public for ascertainment of the level of public interest in the shares before the offer is made. This innovative step helps to ensure that commitment of financial resources to the public offer would be warranted.[109]

As the disclosure requirements are more limited in nature and are kept to a simple format, small business offers under Regulation A facilitate in-house preparation and may result in cost-savings because professional advisers do not necessarily need to be retained. Although involvement of professional advisers may be a form of investor protection,[110] the public should decide its significance for investment decisions. The simple prospectus required under Regulation A also facilitates the possibility of offerings made directly to investors through the Internet by posting of the required information electronically. This achieves publicity without having to incur excessive marketing costs.

For example, Spring Street Breweries Ltd. (Spring Street) introduced its first Internet Direct Public Offer (Internet DPO) in 1995 in eighteen states in the U.S. after concluding that it could not afford to raise finance via the traditional method on exchange.[111] The DPO was made under Regulation A of the U.S. Securities Act of 1933 and the jurisdictional supervision of the SEC. It was also registered in eighteen states in the U.S. Spring Street by-passed all intermediaries by using in-house preparations and by posting and disseminating the required information via the Internet.

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[108]Federal Securities Act of 1933, Rule 251.

[109]This was applauded in Mittelman, *supra* note 107, at 261. *But see* Jeffrey A. Brill, *"Testing the Waters"—The SEC's Feet go from Wet to Cold*, 83 CORNELL L. REV. 464, 469-70 (1998) (analyzing criticism of the testing-the-water rule and concluding that the SEC acted too hastily).

[110]*See* Black, *supra* note 86, at 1568.

[111]Daniel E. Giddings, *An Innovative Link between the Internet, the Capital Markets, and the SEC: How the Internet Direct Public Offering Helps Small Companies Looking to Raise Capital*, 25 PEPP. L. REV. 785, 785-86 (1998).

The Internet DPO resulted in substantial cost-savings. Spring Street raised $1.6 million in the first tranche and almost $5 million after a second offering.[112] Spring Street's success created a stir on Wall Street.[113]

Although there are still teething problems with respect to the use of the Internet in the sale of securities,[114] especially with respect to Internet fraud, lack of liquid secondary markets and potential under pricing of the offer in order to attract investors are not the result of the limited disclosure regime under Regulation A. It is noted that many Internet DPOs using Regulation A were less successful than the Spring Street offering. One commentator, however, provides a balanced view in favor of using the Internet as a gradual process that may benefit small businesses in the long run.[115] The Internet is well-placed for the cost-effective conduct of virtual road shows or testing the waters, even if not immediately for making public offers.

The next tier of disclosure is a limited form of disclosure with audited financial statements in standardized formats for offers by small business issuers up to US $10 million on an annual basis.[116] This privilege is only accorded to companies that fall within the "small business issuer" definition, which caps turnover at US $25 million and a market capitalization of less than US $25 million.[117] Actually, this is part of an integrated disclosure system for small businesses which facilitated the provision of standardized formats for disclosures pursuant to offers and continuous disclosures. This simplifies the obligations of small business issuers and results in substantial cost savings. The final tier of disclosure would apply to small business issuers as defined above for issues of any

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[112] Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?* 2 J. SMALL & EMERGING BUS. L. 57, 75 (1998). *See generally* Gavin *Internet Direct Public Offerings—New Opportunities For Small Business Capital Finance*, 27 MANITOBA L.J. 297 (2000) (analyzing the assets and liability of Internet DPO as they affect Canadian businesses).

[113] *See* Stephen Knute Gregg, *Regulation A Initial Public Offerings on the Internet: A New Opportunity for Small Businesses?*, 1 J. SMALL & EMERGING BUS. L. 417, 420-21 (1997) (citing Dinah Zeiger, *Going Public in Cyberspace: Internet Offers Way to Launch Startups*, DENV. POST, June 10, 1996, at E12, *available at* 1996 WL 6695714).

[114] Internet DPOs may be shunned by the general public where the soundness of a stock is unclear from poster information. *See* Fisch, *supra* note 112, at 77-78. *But see* Jeffrey J. Hass, *Small Issue Public Offerings Conducted Over the Internet: Are They "Suitable" for the Retail Investor?* 72 S. CAL. L. REV. 67, 71-72 (1998) (arguing that retail investors are less equipped to judge a public offer that has bypassed the intermediaries' assessment).

[115] *See generally* Mark A. Allebach, *Small Business, Equity Financing, and the Internet: The Evolution of a Solution?*, 4 VA. J.L. & TECH. 3 (1999) (arguing for using the Internet in making a public offer).

[116] 17 C.F.R. § 228.10 (2003).

[117] *Id.*

amount.[118] The level of disclosure required would be analogous to the mandatory disclosure requirements generally, except that standardized formats are provided for such disclosure and continuing disclosure.

C. *A Tiered Disclosure Regime for Europe?*

The European movement harmonizes securities offerings regulation throughout regulated markets whether on the main or second tier. This removes the fragmentation of markets in the interest of completing the internal European market and seeks to achieve a greater level of harmony among the markets. The desire here is to make the European passport more meaningful and to promote greater freedom of movement of capital within Europe.[119]

1. European Draft Prospectus Directive

The most recent draft Prospectus Directive[120] has called for elimination of the distinction between admission to listing and admission to trading. It seeks to formulate one set of disclosure standards for the trading of all securities. These standards[121] have also been finalized on the side of rigor and stringency.[122]

The likelihood of standardized disclosure requirements applying across regulated markets gives rise to the potential for erosion of the AIM. For instance, the London Stock Exchange, now a for-profit commercial enterprise,[123] may not wish to continue maintaining two markets with

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[118] *Id.*

[119] *See* NIAMH C. MOLONEY, EC SECURITIES REGULATION 11 (Oxford University Press 2002).

[120] The most recent draft Prospectus Directive was adopted by the European Parliament on July 2, 2003. *See* Parliamentary Notes, *available at* http://www2.europarl.eu.int/omk/sipade2?pubref=-//ep//text+press+dn-20030702-1+0+doc+xml+v0//en&level=2&nav=s#section2.

[121] In the light of regulatory competition, the standards of disclosure maintained in Europe are high. Some commentators suggest that the European regime is trying to "race to the top." *See* Jackson & Pan, *supra* note 104, at 657-58.

[122] Prospectus disclosure standards would be based on the International Disclosure Standards approved in 1998 by the International Organization of Securities Commissions (IOSCO). *See* IOSCO, *Objectives and Principles of Securities Regulation* (Sept. 1998), *available at* http://www.iosco.org/libraryindex.cfm?whereami=pubdocs.

[123] The London Stock Exchange was demutualised in 2000, changing it from a mutual held organization to a for profit commercial enterprise. For the effects of demutualization, see Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 372 (2002); Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497, 511 (2001).

identical entry requirements because it may not be cost efficient to do so. In this scenario, will small businesses be deprived of a platform for their issues? One possible advantage of streamlining the markets may be that when the listed/unlisted distinction is removed, investor bias against unlisted securities would be eradicated and investors will have to judge each offer on its own merits. The key concern, however, is that the standards for entry have been finalized on the side of rigor and stringency, thereby the standards require more costly compliance than that required under the current regime for unlisted issues. Thus, the draft Prospectus Directive regime may actually narrow opportunities for the small business issuer, let alone European opportunities.

Critique has been levied against the draft Prospectus Directive as the one-size-fits-all disclosure regime would leave small business issuers out in the cold. Thus, amendments were made to the draft to redefine "public offers" so that offers below 2.5 million euros would not be considered a public offer.[124] At first glance, this may seem to cater to smaller issuers because their issues are relatively small and they could evade the cost associated with making a public offer. Redefinition, however, does not help small issuers. The draft Prospectus Directive does not actually state that offers below 2.5 euros are exempt from the prospectus requirements. Thus, can a small offer of less than that amount be marketed to the public? Or is it to be treated as a non-retail offer which can only be made to sophisticated investors?

Small business issues have relied greatly on private placements. It is quite another thing to assume that exclusive reliance should be made on private placements. To funnel small offers of 2.5 million euros and below outside the realm of "public offers" is insensitive to small business capital needs. Furthermore, it would trim out legitimate needs in the interest of creating a manicured harmonized regime. The empirical reliance by small businesses on non-retail equity does not reflect a lack of access to public equity markets. The lack of such access is largely due to the cost of compliance with disclosure requirements. This can be addressed by modifying the disclosure regime into tiered levels that would require less costly compliance depending on issuer or offer size. As a result, the draft Directive's assumptions about small business capital needs may require amendment.

In the light of harmonization, it is perhaps timely for the draft Prospectus Directive to consider the likelihood of a pan-European tiered disclosure regime that takes into account small business needs. The

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[124] *See* Andrew Crooke, *Brussels Report to Suggest 60 Changes to Prospective Directive* (Dec. 2, 2001), *available at* http://www.legalmediagroup.com.

validity of such a suggestion derives support from the fact that a convergence of standards can be achieved even if these standards are tiered.

Another concern in the latest harmonization movement is preventing fragmentation of markets. The development of second tier markets not subject to harmonized pan-European requirements has been seen as an impediment to freer capital flows in the internal market. Thus, by harmonizing standards, Europe hopes to achieve unitary markets for the free movement of capital. Although the fragmentation of second tier markets is a real concern, the potential absorption of second tier markets, such as the Alternative Investment Market, into main markets would deprive issuers of a choice for a laxer entry regime with lower costs. In fact, this may cause pockets of trading in small business stocks to arise on an ad hoc basis depending on need, and this would still create fragmentation within the market. Second tier markets should be preserved and coupled with a tiered disclosure regime that applies throughout Europe. This could be accomplished by small business issuers gaining access to the public in Europe on an even regulatory footing. Furthermore, Europe could develop a pan-European primary market for small business issuers that could serve as a convergence model for other second tier markets in individual European jurisdictions. Perhaps such a pan-European market may be found by adapting EASDAQ[125] to fit the needs of small issuers.

2. EASDAQ as a Pan-European Primary Market for Small Offerings

The EASDAQ is a pan-European exchange for small business stocks that was established in 1995.[126] A pan-European small offerings regime for initial public offers, however, was not formulated simultaneously with the pan-European market. EASDAQ allows the admission of securities which have been already issued in accordance with home state rules.[127] Thus, EASDAQ is not a primary pan-European special market regime for small business issues—it merely provides a pan-European platform for secondary trading.[128] The fact that EASDAQ allows the quotation of European

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[125]In November of 1994, several investment banks and securities firms led by the European Venture Capital Association (EVCA) established the European Association of Securities Dealers (EASD) to create EASDAQ. The EU Commission provided financial and political support for the project, and in March 1995, Easdaq S.A. was incorporated in Belgium. *See* Ackerly, *supra* note 72, at 86-87.

[126]*Id.* at 86.

[127]*Id.* at 88.

[128]*Id.*

securities without the issuer's consent also underpins its secondary market emphasis.

The possibility that EASDAQ could be an appropriate primary market for a pan-European regime for the regulation of small business offers should be considered. The implementation of a special disclosure regime for small issues and small business offerings through EASDAQ would also make it possible for EASDAQ to absorb a concentrated amount of small business issues. This could minimize fragmentation across markets where small issuers seek out alternative small pools of liquidity.

One foreseeable issue that may forestall the implementation of an integrated small business offerings regime through a pan-European market like EASDAQ would be that there is no universal European regulator[129] for both the issuers and the market. A universal European regulator is not likely to be created in the future because it concerns the sensitive matter of sovereignty.[130] This poses the intriguing question of who should administer the regime? Would EASDAQ be in an appropriate position since it is a for-profit organization that is run for commercial objectives and the maximization of its shareholder value?[131] A for-profit organization would not have investor protection as its primary objective.[132] Furthermore, the "public interest" in this regard would be across the internal borders of Europe, which may be extremely diverse depending on the maturity of the investor base in each market.

A universal European regulator, though, is not always necessary for a pan-European market. Now that national exchanges have demutualised and are involved in mergers and acquisitions,[133] they have emerged out of their hitherto exclusive national characters and have therefore become European or even global institutions. National securities regulators, however, still oversee the parts of the institutions that fall within the relevant national jurisdiction.[134] It is also possible to achieve consolidated

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[129]*See* Gilles Thieffry, *Towards a European Securities Commission*, 1(7) J. INT'L FIN. MARKETS 300 (1999) (arguing that "[w]ith the existence of a single currency and a single market, the lack of a single regulator is a dangerous absurdity").

[130]*See* Roberta S. Karmel, *The Case for a European Securities Commission*, 38 COLUM. J. TRANSNAT'L L. 9, 31, 39 (1999) (discussing the difficulties Europe would face in deciding whether a pan-European regulator should be established).

[131]*See* Caroline Bradley, *Demutualization of Financial Exchanges: Business As Usual?* 21 NW. J. INT'L L. & BUS. 657, 695, 701 (2001) (doubting that for-profit exchanges would continue to perform a central regulatory role).

[132]*Id.* at 701.

[133]For example, Euronext is a merger of the Amsterdam, Brussels, and Paris bourses.

[134]For example, Euronext has three platforms in the three jurisdictions, operating different niche markets. Each market is subject to a national regulator.

and joint supervision of exchanges and issuers by coordinated efforts amongst the national and European community regulators.[135]

D. *External Equity Financing in Non-Retail Markets*

In this section, this article will explore why private equity is not as ideal as public equity as a form of growth capital. Although private equity is immensely popular, it is not the perfect substitute for public equity financing. The two areas that will be discussed are private placement and private equity.

1. Private Placements

The private placement is a rather anomalous creature because it is couched as an "exempt public offer." Private placements are placements of shares with sophisticated investors sought out by an appointed broker, and may be exempt from prospectus requirements if such a placement is made with investment professionals. Investment professionals consist of a restricted circle of "sufficiently knowledgeable persons" or less than fifty persons.[136] The label of an "exempt public offer" suggests that the private placement is actually a public offer, but it is exempt from regulatory requirements because the investors sought are limited in scope and are sufficiently knowledgeable to protect their own interests.

Moreover, private placements are not likely to be caught by financial promotion restrictions, which require the production of a prospectus if made with high net worth individuals, companies or certain sophisticated investors.[137] An initial private placement would likely bypass the regulatory requirements relating to initial public offers and allow small businesses to place shares with investors without incurring the costs of regulatory compliance. This, however, is purely theoretical because private placements are often done through financial advisers and there is some

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[135]*See* Yannis V. Avgerinos, *Towards a Pan-European Securities Market for SMEs: The EASDAQ and Euro: NM Models*, EUR. BUS. L. REV. 8, 20-21 (Jan./Feb. 2000).

[136]Financial Services and Markets Act 2000, c. 8, Schedule 11, arts. 3, 4, & 6 (Eng.), *available at* http://www.legislation.hmso.gov.uk/acts/acs2000/00008-02.htm. *See also* Financial Services and Markets Act 2000 (Financial Promotion) Order 2001, §§ 48, 50 (Eng.), *available at* http://www.legislation.hmso.gov.uk/cgi_gin2/hmso_hl?DB=hmso-new&stemmer=en&wo.... (providing that financial promotion restrictions (i.e., the requirement of the production of a prospectus where financial promotion is carried out by authorized persons under the Act) would not apply to communications or solicitations made to high net worth individuals, companies or certain sophisticated investors).

[137]*See* Financial Services and Markets 2000 (Financial Promotion) Order 2001 No. 1335, §§ 48, 50.

form of prepared information that is required for investors to make an informed choice. Therefore, the disclosure obligation could be dictated by market demand and may be less onerous.

Private placements may subsequently admit the shares to trading on an unlisted market to create liquidity in the securities and to obtain the benefit of having reference to secondary market value.[138] Historically, this primarily occurred on the AIM.[139] Thus, these shares may effectively be accessed by the public without an initial public offer.[140]

As illustrated by the USM and the Third market, though, private placement shares have not been popular with the public, and trading of these shares has been illiquid and thin. Thus, the bypassing of publicity, which is generated out of the initial public offer process, may have detrimental effects on the subsequent liquidity of the securities.

Recent European developments may also put an end to the anomalous nature of the private placement. The draft Prospectus Directive has proposed to exclude private placements and small offerings below 2.5 million euros from the definition of "public offer." As such, private placements may not be regarded as an exempt public offer, but rather as a non-public offer that is off the retail market. This may pose problems to the current practice of admitting placed shares onto an unlisted market for trading because such admission may constitute an initial public offer. The draft Directive also proposed eliminating the difference between admission to listing and admission to trading. Instead, the draft Directive proposes to implement one set of rigorous mandatory disclosure standards for all public offers. This may end the practice of admitting privately placed shares to subsequent trading on the AIM and prevent issuers from by-passing the mandatory requirements of disclosure. This is because any application for admission to trading would have to be accompanied by mandatory disclosure. In fact, privately placed shares may be effectively kept off the retail market unless the cost of mandatory disclosure is borne for its admission to the public market.

Unregulated second tier markets may still continue to arise and operate, despite the enforcement of the draft Prospectus Directive, which may provide an outlet for the disposal of small business stocks that have

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[138]If the issuer seeks to admit the securities to the AIM for the first time by making a public offer, a prospectus would be required. Privately placed shares, however, are exempt from the mandatory disclosure requirements for public offers and such shares may thereafter be traded on the second tier market by the placees. *See* FINCH & WOOLFMAN, *supra* note 88, at 156.

[139]*See* discussion *supra* Part III.B.

[140]This is the case only if the placees wish to trade their shares without the issuer's consent. Where the issuer wishes to admit the shares for trading, it would be considered an initial public offer and the regulatory requirements would be applicable.

been privately placed. Markets such as the OFEX,[141] and other over-the-counter markets, may still provide additional pools of liquidity for small business stocks. It is uncertain whether reforms would reach these smaller electronic trading systems because the Financial Services Authority is concerned with the fragmentation of formal exchanges into non-formal trading systems.[142] For the purposes of this article, however, the future of the alternative electronic trading systems will not be discussed. But if the alternative elective trading system should give rise to sufficient pools of liquidity away from regulated markets to support the secondary trading activity for small business stocks, then the market for private placements may still be attractive for small businesses. Because the AIM is the major second tier market for UK small businesses,[143] the draft Prospectus Directive regime may deal small businesses a blow. This is especially due to new disclosure standards under the AIM. The possible closure of this avenue would undermine the attractiveness of these placements to investors.

The next section discusses why private equity is not a perfect substitute for public equity financing, even though the volume of private equity in the market has been increasing over the years. The main problem with private equity arrangements involves exit from the respective private equity arrangement. The exit problem is the main thrust of this article's argument that private equity is not a perfect substitute for public equity. In fact, private equity operates as a stepping stone to help small businesses reach the size and capacity to achieve flotation.

2. Private Equity

The development of private equity in the 1980s can be attributed to the need for external finance to support smaller firms that emerged from restructured large firms during the merger and acquisition activity of that decade.[144] Private equity investors include private equity institutions such

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[141]The OFEX is an example of a thriving secondary trading market, not related to the London Stock Exchange, that deals in unlisted and unquoted shares in the UK. The history, rules of, and trading activities on OFEX is *available at* http://www.ofex.com.

[142]FESCO proposed a set of common standards for these alternative trading systems in a June 2001 paper, but the FSA's response was that these systems would not be separately regulated and would be licensed as investment firms. *See* Dick Frase, *The Legal Structure of Financial Markets*, *in* EXCHANGES AND ALTERNATIVE TRADING SYSTEMS 15-16 (Dick Frase & Helen Parry eds., Sweet & Maxwell 2002).

[143]As of September 2002, 682 companies are traded on the AIM currently. *See* August 2002 AIM Market Statistics, *supra* note 95.

[144]*See* Gordon Murray, *Third-Party Equity—The Role of the UK Venture-Capital Industry*, *in* FINANCE FOR GROWING ENTERPRISES, *supra* note 12, at 106-07.

as venture capitalists, individual corporations and high net worth individuals (e.g., business angels).

As in the case of private placements, external equity sought in non-retail markets are regulated by the UK restrictions on financial promotion.[145] The restrictions, however, will be irrelevant if investment professionals, sophisticated investors or high net worth individuals are sought after by small businesses for private equity.[146] The private equity arrangements are largely determined by private contract. The relative absence of regulatory strictures removes many fixed costs that small businesses must incur in regulatory compliance. As for private placements, however, private equity investors may also require the preparation of information and business plans. They may also carry out investigatory processes at the expense of the small business to ascertain its potential profitability. These costs, however, would probably not be as high as the fixed costs imposed in the case where an initial public offer is made.

Statistical evidence has revealed that small businesses often rely on non-retail investors for both start-up or growth capital.[147] In light of the failures of many high technology start-ups which were popular with venture capitalists in the late 1990s, private equity financiers are now more enthusiastic about injecting capital into companies for growth and development as opposed to infancy.[148] Thus, private equity is a popular option for growing small businesses.[149]

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[145]Section 21 of the Financial Services and Markets Act prohibits financial promotion except for authorized persons or certain forms of exempted communication. Financial Services and Markets Act 2000, c. 8, pt. II, § 21 (Eng.), *available at* http://www.legislation.hmso.gov.uk/acts/acts2000/00008--c.htm. The Financial Services and Markets 2000 (Financial Promotion) Order 2001 sets out the details of permitted financial promotion and it may be envisaged that if financial promotion is made to investment professionals, of whom many private equity organizations are a part of, the prohibitions against financial promotion would be lifted. Financial Services and Markets 2000 (Financial Promotion) Order 2001 No. 1335, §§ 48, 50 (Eng.).

[146]*See* Financial Services and Markets 2000 (Financial Promotion) Order 2001 No. 1335, §§ 48, 50 (Eng.).

[147]The British Venture Capital Association estimates that some 5.5 billion GBP were invested in venture capital in 2003 and eighty-one percent of companies who received private equity assistance in 2003 attributed growth to the funding by private equity. *See* BVCA, *The Economic Impact of Private Equity in the UK 2003*, under "Newsroom," BVCA website at http://www.bvca.co.uk.

[148]JOHN ORMEROD & IAN BURNS, RAISING VENTURE CAPITAL IN THE UK 35 (Butterworths 1988); Adrian Beecroft, *The Role of the Venture Capital Industry in the UK*, *in* NICHOLAS DIMSDALE & MARTHA PREVEZER, CAPITAL MARKETS AND CORPORATE GOVERNANCE 195, 200 (Oxford University Press 1994).

[149]Some venture funds such as 31 have gained considerable market share in the venture capital industry. The 31 fund has invested in sectors from software to internet and oil and gas. *See* PAUL BYRNS, ENTREPRENEURSHIP AND SMALL BUSINESS 342-43 (New York: Palgrave 2001).

The growth of the popularity of private equity for small businesses may be attributed to the following factors.[150] First, the growth of large firms and their dominance on the London Stock Exchange has attracted retail investors to these "blue chips." As a result, retail investment in the stocks of smaller companies has comparatively declined. The second factor relates to the disappearance of "Aunt Agatha" investors amongst the circle of family or friends of the small business entrepreneur. With the rise of various investment instruments and banking products, these persons prefer to invest in managed funds such as pension funds, insurance frauds, and collective investments.[151] Thirdly, push factors resulting from the high costs associated with the entry into retail markets prompt the development of alternative methods of external equity financing that are not subject to such rigorous regulation. Finally, as a result of the waive factors, private equity institutions have started to grow to fill the lacuna in small business financing. These fund management institutions derive monetary investments from banks, pension funds, insurance companies, and other pooled investment vehicles such as unit trusts or collective investment schemes. In effect, private equity is a form of indirect pooled public investment.

It may be argued that when investors delegate management of their portfolios to knowledgeable experts direct participation in the public equity markets may be undermined. Thus, small business issuers seeking greater access to public equity financing may find that their efforts would be futile because the investor base is thinning. The changing landscape of the investor market may have replaced individual investors with institutional investors and funds. Nonetheless, the actual quantity of capital flows to the market have diminished. Small business stocks represent an option in portfolio diversification for funds and institutional investors. It would be too early to conclude that there is no demand for them. For example, the small technology stocks that performed spectacularly on the NASDAQ in the early 1990s revealed that demand can be substantial for small business stocks. Besides, with the internationalization of marketplaces in the UK, the investor base may consist of foreign investors and European investors. Therefore, it would be too early to conclude that it is futile for small businesses to seek direct access to public equity financing.

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[150] Martin Binks et al., *Tripartite Funding and the Constriction of Enterprise*, *in* TERRY FAULKNER ET AL., INTRODUCTION TO FINANCE FOR THE NEW FIRM: READINGS IN SMALL BUSINESS 1, 4-5 (Gower 1986).

[151] *Id.*

a. *Lack of Permanence in Venture Capital or Business Angel Finance*

Venture capitalists may provide small businesses with growth capital out of the funds that they manage for others, such as pension funds, insurance funds or other collective investment funds. Therefore, venture equity participation is of a fixed duration. This fixed duration is usually tied to the maturity of the funds managed. A typical duration of venture investment is about ten years,[152] but may be longer depending on the duration of the underlying fund managed. Although venture equity may be of a longer duration than a medium term loan, it is not a perpetual form of capital.

On the other hand, business angels are high net worth individuals who are willing to put modest to relatively substantial sums of capital in a small business to facilitate growth and development. Business angels are also typically willing to wait a number of years to realize the investment.[153]

The primary concerns of the venture capitalist or the business angel is the profitability of the small business and the options for exit from it. Thus, the venture capital or angel deal is usually structured as equity participation in the form of redeemable preference shares at the expiry of a stipulated period or convertible preference shares into debt finance. The use of preference shares are desirable because they ensure that in the event of liquidation, the preference shareholders would rank ahead of ordinary shareholders in the company.[154] The venture capitalist or business angel would also negotiate for various situations of exit other than the stipulated ending time period. Examples include deemed liquidation events when the company sells off a substantial portion of its assets.

As the venture capital or angel contract is a private agreement between the parties, there is no regulatory framework that may determine or adjust the positions taken by either party. The law would be unable to intervene even if the exit of the venture capitalist or business angel is devastating to the small business. An example would be when, in a put scenario, a company is forced to buy out the venture capitalist's shares, or the small business is forcibly acquired as a result of the venture capitalist's liquidation of its investment.

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[152] *See* Beecroft, *supra* note 148, at 198.

[153] A profile of business angels is found in Richard T. Harrison & Colin M. Mason, *The Role of Informal Venture Capital in Financing the Growing Firm*, *in* FINANCE FOR GROWING ENTERPRISES, *supra* note 12, at 79.

[154] Venture capitalists often negotiate for preference shares so that the dividend preference would work well in good times while the liquidation preference maintains senior status in extreme distress situations. *See* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 893 (2002).

The central weakness of the private equity alternative to public equity participation is that the private equity lacks perpetuity. Furthermore, the difficulty of exit also prompts venture capitalists or business angels to protect their exit options and rights in a highly structured manner,[155] which may be disruptive and devastating to the small business when the exit is made. Finally, the private equity financier's preference for liquidation of investment via the secondary market after flotation supports the argument that private equity is not a perfect substitute for public equity financing. Also, many private equity financiers see the purpose of injecting capital as a stepping stone to the realization of their investment upon flotation. This was the case when the London Stock Exchange decided to close down the Unlisted Securities Market in the 1990s, thereby provoking severe reactions from the venture capital quarter, which saw the Unlisted Securities Market as an exit route for their investments. The London Stock Exchange then replaced the Unlisted Securities Market with the AIM.[156] It may be argued, however, that at least the provision of venture capital for the ten year period would have helped a growing company to nurture its growth vision. After that time period, it may be of sufficient profitability and size to absorb the costs associated with an initial public offer. Thus, private equity may still be a useful form of "interim" growth finance that creates a bridge for small business to reach the appropriate size for a public offer.

IV. SMALL BUSINESS OPTIONS OVERSEAS OR ON A GLOBAL PLATFORM

In light of the current limitations to gain public equity financing in the UK and Europe, could small businesses in the UK or Europe take advantage of options for making public offers overseas or over the Internet? In today's globalized world, issuers, investors, intermediaries, and stock markets may no longer be confined to domestic jurisdictions of an exclusively national character. In an age where the movement of capital is no longer confined to home jurisdictions and cross-border transactions frequently take place, issuers may be able to reach out of the domestic confines of the UK or Europe. The Internet revolution may also provide a more global platform for marketing of securities and this presents the possibility of direct access to public equity financing worldwide.

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[155] *See generally* George W. Dent Jr., *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029 (1992) (discussing the venture capital arrangement and the legal issues arising from certain covenant and terms).

[156] *See* JOSH LERNER, VENTURE CAPITAL AND PRIVATE EQUITY 376 (2000).

During the 1990s, when technology start-up companies were tipped to succeed, many Israeli companies obtained a flotation exclusively on the NASDAQ to raise finance.[157] This signifies that foreign flotation for the small business is possible. In fact, globalization presents new opportunities for the small business issuer. It may be that the small business issuer could shop for a more cost-effective regime than its home state. This will allow the small business to achieve flotation and gain direct access to the public at lower cost. That may be possible if regulatory competition between regimes promotes a race towards more relaxed standards to attract more issuers. There is very little evidence, however, that this race to the bottom is taking place.[158] It should be noted that Steve Wallman, the Commissioner of the SEC, has stated emphatically that regulators would not, in the face of global competition, forego their standards in such a manner that would compromise the integrity of the entire market.[159] It has been argued that foreign listings are made in jurisdictions with reputably stringent securities regulation so as to add value to the firm.[160]

A. *Does the World Present More Opportunities for Small Business Offerings?*

Some commentators have suggested that regulatory competition among different regimes of securities offers may result in the development of a regime allowing issuer choice.[161] Issuer choice refers to the ability of an issuer to choose any disclosure regime that it wishes to comply with in its offering, despite the offering being foreign or domestic. As a result, issuers are not compelled to comply with the costly disclosure requirements in their national jurisdiction if they do not wish to do so. They could

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[157] *See* LEN S. SEALY, BRITISH COMPANY LAW & PRACTICE ¶ 17-600 (CCH Editions Ltd. 2001).

[158] *See* Jay D. Hansen, *Other International Issues: London Calling?: A Comparison of London and U.S. Stock Exchange Listing Requirements for Foreign Equity Securities*, 6 DUKE J. COMP & INT'L L. 197, 199-200 (1995). *See also* Jackson & Pan, *supra* note 104, at 657-58 (suggesting that European exchanges seem to be racing to the top).

[159] *See* Steven M.H. Wallman, *Global Finance and Markets: What is Next* 21 FORDHAM INT'L L.J. 404, 413 (1997).

[160] *See* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 49 UCLA L. REV. 781, 782-83 (2001); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 674 (1999).

[161] *See* Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 935 (1998); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2393 (1998); Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 389 (2001).

choose a regime that imposes less costly compliance. It would then be up to the investors to determine the disclosure standards they prefer if a particular regulatory regime is not perceived to be as reputable as other regimes. Thus, a small business in the UK could, under a regime of issuer choice, choose to comply with the less costly disclosure standards of a developing country and float its issue on the NASDAQ. It would then be up to the investors to assess the credibility of the issuer. Using this market-based approach, issuers would be able to match assess the level of disclosure to the level demanded by investors, and regulators would also know which rules are cost effective.[162]

It has been argued, however, that issuer choice will not be able to meet the objectives of investor protection because issuers would be permitted to choose not to disclose information at a socially optimal level whenever the private cost of disclosure seems to outweigh the social cost of such disclosure. An example would be the cost of a competitor being able to take advantage of the information disclosed to take actions that would reduce the competitive benefit that the issuer might have had if there were no disclosure.[163]

Issuer choice may remove the burden of cost of compliance under the mandatory disclosure regime. It would allow the small business issuer to choose a less costly regime and achieve public flotation. This is the most desirable form of external equity financing because of the support of the ready secondary markets. Small businesses, however, should not be lulled into believing that market-based approaches would definitely work in their favor. The market may come down hard on such a choice by reflecting a poor demand or unwillingness to pay at such a discounted rate. Market-based approaches and deregulation may not actually allow the small business to achieve the opportunity to gain a flotation at a comfortably low cost. Small issuers compete against large issuers that may choose rigorous regimes to comply with and enhance share value and investor demand for those shares. The optimum level of disclosure may settle at a high level depending on investor response. In a free market, the small business may not gain a share of the market pie at all. An interventionist and

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[162]Professor Romano relies on Benston's finding that because firms need capital and investors need information, firms have powerful incentives to disclose information if they are to compete successfully for funds against alternative investment opportunities. *See* George J. Benston, *An Appraisal of the Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements*, 41 LAW & CONTEMP. PROBS. 30, 51-52 (1977).

[163]*See* Merritt B. Fox, *Protecting Investors in a Global Economy—The Issuer Choice Debate*, 2 THEORETICAL INQUIRIES L. 563, 594 (2001). *See also* Merritt B. Fox, *The Securities Globalization Disclosure Debate*, 78 WASH U. L.Q. 567 (2000) (advocating that issuer nationality would be the more sensible approach).

paternalistic approach, which takes special notice of small business concerns and grants regulatory concessions to small business issues, occurred in 1992 with the Small Business Initiatives of the SEC.

Practically speaking, however, issuer choice would probably not satisfy regulators because it undermines the objective of national securities regulation. National securities regulation is intended to protect investors within national territory.[164] National securities are viewed as a public good, not a private service for issuers of securities and their investors to determine the optimum price to be paid for the securities.[165]

B. *Small Business Offerings and Internet Possibilities*

In an Internet age where the world may be accessed without borders, the Internet may offer an international platform, not tied to any jurisdiction, for the sale of securities to the world's retail investors. This platform would operate similarly to the way that goods can be sold over the Internet, practically escaping custom duties and restrictive domestic legislation such as licensing. Furthermore, the Internet could level the competitive playing field because it is not costly to set up websites to sell shares of large and small enterprises.

The sale of securities over the Internet, however, may not be the best alternative option for the small business seeking public equity finance for a number of reasons. First, there may not be favorable investor responses. By analogy to the Internet DPOs in the U.S., Internet direct offerings tied to a particular jurisdiction, and made under a specified regulatory regime (i.e., Regulation A under the Securities Act 1933), have not really garnered much investor demand.[166] Despite Spring Street Breweries, the first Internet DPOs failed to raise significant sums of capital. Second, from a public policy point of view, such liberal and unregulated sales of securities over the Internet would undermine the securities regulatory efforts of many jurisdictions. In fact, efforts have been stepped up to combat any regulatory evasion.

Moreover, investors are generally afraid of Internet fraud. As a result, investors may prefer traditional types of offerings via intermediaries over an exchange because these intermediaries serve a "reputational

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[164] *See* James D. Cox, *Premises for Reforming the Regulation of Securities Offerings: An Essay*, 63 LAW & CONTEMP. PROBS. 11, 29-30 (2000).

[165] *Id.*

[166] *See* Michelle V. Rafter, *The Cutting Edge—Online IPOs Falling Short of Expectations Internet: What Seemed Like a Promising Way for New Firms to Raise Money, Has Produced Disappointing Results so Far*, L.A. TIMES, May 26, 1997, at D1.

verification" function.[167] Investors may also be deterred by the lack of a ready secondary market for such Internet offers, as illustrated in the U.S. following the initial offers of the Internet DPOs.[168] Even if there is some demand, investors may only be willing to purchase such securities at a huge discount. Such under pricing would affect not only the amount of capital raised, but also the value of the firm. Professor Choi, however, believes that with the rise of the Internet, there would be issuers that offer market securities at a low cost to the widest public audience.[169] Professor Choi conversely believes that investors would correspondingly demand safeguards for such offers in order to determine the price that they are willing to pay relative to the risk of Internet fraud.[170] As such, the market would respond to investor demands for safeguards, and private securities accreditors may arise over the Internet to provide the "verification" service to retail investors. This is analogous to the verification provided by credit rating agencies. Public regulation would still play a role in the "accrediting" process and together with private forms of checks, they could act as gatekeepers in the global securities market to satisfy investor demands. This is, however, a "chicken-and-egg" issue because investors' demand would probably not be high in the absence of such private gatekeepers. Yet, private gatekeepers would not arise as a market response unless there is sufficient investor demand for Internet securities.

Internet stocks may also be unattractive because there are no secondary market for these stocks. Even with a bulletin board on the Internet to quote prices for these stocks, the liquidity in such ad hoc markets cannot be compared with exchanges in which market-making activities are conducted.[171]

Small business issuers should also not be lulled into thinking that they are exempt from public securities regulation merely because they have placed themselves on the Internet platform. The Internet presents many

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[167]Black, *supra* note 160, at 781.

[168]In the case of Spring Street, a bulletin board was set up in-house and posted over the Internet to facilitate the creation of a secondary market. It, however, cannot act as a secondary market under the SEC regulations. *See* Jack A. Rosenbloom, *Direct Public Offerings on the Internet: A Viable Means of Obtaining Capital?* 2000 COMP. L. REV. & TECH. J. 85, 93, 97 (2000).

[169]*See* Stephen J. Choi, *Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation*, 2 J. SMALL & EMERGING BUS. L. 27, 38-40 (1998).

[170]*Id.*

[171]*See generally* James D. Cox, *Commentary: Brands vs Generics: Self-Regulation by Competitors*, 19 COLUM. BUS. L. REV. 15 (2000) (arguing that the NYSE and NASDAQ are poised to develop themselves as brand names to compete effectively against ad hoc markets).

difficulties for legal enforcement,[172] particularly for private international conflicts. These issues, however, are not insurmountable.

Securities regulators in many jurisdictions have agreed to undertake information sharing to assist one another in the enforcement against unlawful securities marketing over the Internet. Home-state regulators have also formulated rules to extend their territorial jurisdiction to issuers overseas whose activities are targeted towards domestic residents or would be likely to produce effects within the home jurisdiction.[173] The UK has also enacted extra-territorial legislation against persons who commit Internet fraud in order to induce investments, if the effect of the inducement is felt within territorial boundaries.[174] Besides the UK, other jurisdictions also have extra-territoriality legislation in securities regulation.[175]

Thus, small businesses should not undertake Internet marketing and solicitation for investment at large because they may suffer the consequences of costly liability due to the operation of extraterritorial legislation against them. Some pro-market commentators have argued that extra-territorial legislation inhibits competition of regulatory regimes and thus impedes the development of optimal rules for both investors and issuers.[176] It is, however, unlikely that regulators would be comfortable with predominantly market-based self-regulation in which the sector concerned may have a systemic impact on the jurisdiction.[177]

V. CONCLUSION

Small businesses in the UK need external equity financing because there are practical limitations to debt financing. Although debt financing remains highly popular, the legal nature of equity capital provides a framework that ensures a degree of permanence in the capital available to small businesses. Equity capital is available through public markets, chiefly through initial public offers, or in private non-retail markets;

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[172]*See* John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1223 (1997) (discussing new problems the Internet brings including hidden identity of properties and foreign proprietors).

[173]IOSCO, *Report of the Technical Committee: Securities Activity on the Internet*, pts. IV(A)-(B) (Sept. 1998), *available at* http://www.iosco.org/libraryindex.cfm?whereami=pubdocs.

[174]Financial Services and Markets Act 2000, c. 8, pt. XXVII, § 397(1)-(2), (6) (Eng.), *available at* http://www.legislation.hmso.gov.uk/acts/acts2000/00008.al.htm.

[175]For example, U.S., Australia, and Singapore.

[176]*See* Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207, 208 (1996).

[177]One of the IOSCO objectives is the reduction of systemic risk in securities markets through securities regulation. *See* IOSCO, *Objectives and Principles of Securities Regulation* (Sept. 1998), *available at* http://www.iosco.org/libraryindex.cfm?whereami=pubdocs.

however, there are significant advantages to public equity markets. In private equity financing arrangements, exit of the equity provider may adversely affect the long-term prospects of the small business. Moreover, public equity financing is supported by ready secondary markets which imbue a quality of perpetuity in the capital provided by allowing shares to be easily transferred.

The main obstacle to small businesses gaining public equity financing lies in the fixed costs associated with mandatory disclosure requirements that are applied to all forms of issuers. Although the UK has initiated second tier markets with lower entrance requirements and costs for small business issuers, the mandatory disclosure requirements cannot be evaded once an initial public offer is to be made. Therefore, there is a limitation on the capping of cost that the second tier markets may provide. This would suggest that the U.S. approach in introducing a small business public offer regime should be adopted in the UK. The U.S. approach sets cost at a more realistic level for small business issuers. Moreover, the regime is a tiered disclosure structure which allows the use of standardized formats for disclosure to reduce the costs of preparation.

Finally, in the absence of reform in the public offers regime, small business issuers could take advantage of opportunities overseas or on the Internet. These developments are new and, at present, do not seem to open up a cost-effective opportunity to the small business issuer. Therefore, a small business public offer regime that is sensitive to small business needs should be considered on an European level so that public equity financing for small businesses may be revived.