WORKING GROUP ON INVESTOR PROTECTION IN PUBLIC OFFERINGS
PETITION FOR RULEMAKING: MODERNIZATION OF RULE 144

March 9, 2023

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C. 20549
VIA ELECTRONIC DELIVERY

Dear Ms. Countryman:

The Working Group on Investor Protection in Public Offerings respectfully submits this petition for rulemaking pursuant to Rule 192(a) of the Securities and Exchange Commission Rules of Practice. We ask that the SEC amend Rule 144 in light of changes in securities-offering practices and the Supreme Court's consideration of *Slack* v. *Pirani*, addressing Section 11 liability in direct listings.[1]

Our Working Group is composed of academics, former SEC officials, and legal scholars who have analyzed, overseen, and studied the development of the securities laws and have extensive expertise on the analysis of unregistered share sales pursuant to Rule 144 and reported on Form 144. Dr. Hu and Professor Zytnick both served at the SEC, and work by Professors Lynch-Levy and Taylor provided the evidentiary basis for the Commission's recent rulemaking on the reporting requirements of Rule 144:[2]

- **Edwin Hu**, Postdoctoral Fellow at the New York University School of Law, former SEC Commissioner Counsel, and former Staff in the Commission's Division of Economics, Risk and Analysis;
- **Bradford Lynch-Levy**, researcher at The Wharton School of the University of Pennsylvania;
- **Daniel J. Taylor**, Arthur Anderson Professor at The Wharton School of the University of Pennsylvania and Director of the Wharton Forensic Analytics Lab;
- **Jonathon Zytnick**, Associate Professor of Law at the Georgetown University Law Center, and former SEC Commissioner Counsel; and
- **Benjamin Alter**, **Elizabeth Crimmins**, **Matthew Kalinowski**, **Charlotte LeBarron**, and **Victor Simonte**, researchers at the New York University School of Law's Program for Corporate Law and Policy.

Dr. Hu and Dr. Taylor serve as co-chairs of our Working Group. We write in our individual capacities; our institutional affiliations are provided for identification purposes only.

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[1] *Slack Technologies* v. *Pirani*, No. 22-200 (argument scheduled April 17, 2023). We note that the Commission proposed amendments to Rule 144 in 2020, U.S. Sec. & Exch. Comm'n, Rule 144 Holding Period and Form 144 Filings, 86 Fed. Reg. 5063 (Dec. 22, 2020) [hereinafter 2020 Proposal], and Rule 144 remains on the SEC's regulatory agenda, U.S. OFF. MGMT. & BUDGET, SEC AGENCY RULE LIST (June 2022).

[2] U.S. Sec. & Exch. Comm'n, Final Rule, Updating EDGAR Filing Requirements and Rule 144 Filings, 87 Fed. Reg. 35,393, 35,396 n.28 (2022) (citing letter dated March 10, 2021 from David Larcker, Daniel Taylor, and Bradford Lynch); *see also id*. at 35,396 n.29 (same).

We differ in our views about the optimal scope of liability under Section 11—and, hence, the desirable outcome in *Pirani*. We all agree, however, with the parties and *amici* who have told the Supreme Court that the Commission can address the significant policy concerns raised by the case—and we write to urge the Commission to do so promptly.[3]

Our petition proceeds in two parts. First, we provide evidence on recent developments in the public-offering process and explain how those developments can erode investor protections long provided by Section 11. Second, we explain how SEC rulemaking can address these developments. For the reasons below, we conclude that the case for prompt SEC rulemaking in this area is strong.

I. PUBLIC-OFFERING MARKET DEVELOPMENTS AND SECTION 11

Since the Great Depression, Section 11 has provided a key deterrent against misstatements at the moment when the informational gap between issuers and investors is largest: the day a firm goes public.[4] Section 11, which the third Chairman of the SEC and longest-serving Supreme Court Justice called the Securities Act's "*in terrorem*" provision, imposes strict liability for such misstatements.[5] Plaintiffs seeking to sue under Section 11, however, must have standing. As Judge Friendly explained, to have standing plaintiffs must be able to trace their shares to the allegedly offending registration statement.[6]

For most of the last century, Section 11 tracing has been straightforward. The reason is that, in traditional initial public offerings (IPOs), agreements among issuers, insiders and underwriters known as "lockups" prohibited sales of unregistered securities during the six months immediately following the IPO.[7] Thus, plaintiffs who purchased shortly after the IPO could trace their shares to the registration statement. But two market developments—waivers of IPO lockups and direct listings that involve no lockup—today make tracing harder by producing post-offering pools of both registered and unregistered shares, leaving some plaintiffs unable to trace shares they purchased to a registration statement.[8]

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[3] Petition for Certiorari in *Slack Technologies* v. *Pirani*, No. 22-200 (2022), at 39 ("[T]he SEC can" address these concerns, "for example, by requiring lockups preventing the sale of any unregistered shares for a set period after any direct listing,"); Brief of *Amicus Curiae* Hon. Jay Clayton & Hon. Joseph A. Grundfest in *Slack Technologies* v. *Pirani*, No. 22-200 (2023), at 32-33 ("[T]he SEC could . . . resolve[] the tracing issue . . . by requiring that exempt shares not trade" for a given period of time).

[4] Section 11 "was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering," *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 381-82 (1983); *see also* Joel Seligman & Andrew F. Tuch, *The Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers and Direct Listings*, 108 IOWA L. REV. 303 (2022). For the seminal analysis of the development of tracing doctrine, see Hillary Sale, *Disappearing Without a Trace: Sections 11 and 12(a)(2) of the '33 Act*, 75 WASH. L. REV. 429 (2000).

[5] William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 173 (1933).

[6] *Barnes* v. *Osofsky*, 373 F.2d 269, 271, 273 (2d Cir. 1967) (noting that the "key [statutory] phrase is 'any person acquiring such security," and that the Commission, in a brief authored by then-General Counsel and future SEC Commissioner Philip A. Loomis, agreed with the Court's view that this language requires plaintiffs to trace (citing Brief for U.S. Securities and Exchange Commission as *Amicus Curiae* in *Barnes* v. *Osofsky*, Nos. 306-308)).

[7] U.S. SECURITIES AND EXCHANGE COMMISSION, INITIAL PUBLIC OFFERINGS: LOCKUP AGREEMENTS (2011) ("Before a company goes public, the company and its underwriter typically enter into a lockup agreement to ensure that the shares owned by [corporate] insiders don't enter the public market too soon after the offering. The terms of lockup agreements may vary, but most prevent insiders from selling their shares for 180 days."); Alon Brav & Paul A. Gompers, *The Role of Lockups in Initial Public Offerings*, 16 REV. FIN. STUD. 1 (2003).

[8] We are not the first to observe that underwriters today weaken, and frequently waive, the traditional IPO lockups that existed for most of the last century. *See, e.g.*, Sophia Kunthara, *The Market Minute: Goodbye Six-Month Lockups*, CRUNCHBASE NEWS (2021) ("The 180-day lockup period used to be the standard for traditional IPOs. But that's quickly changing thanks to the increasing popularity of early lockup releases."); RENAISSANCE CAPITAL, THE

To examine these developments empirically, we begin by extracting data on the lockup period in recently completed traditional IPOs. Figure 1 below confirms the standard wisdom that, at first blush, many traditional IPO underwriters bargain for a six-month lockup period:

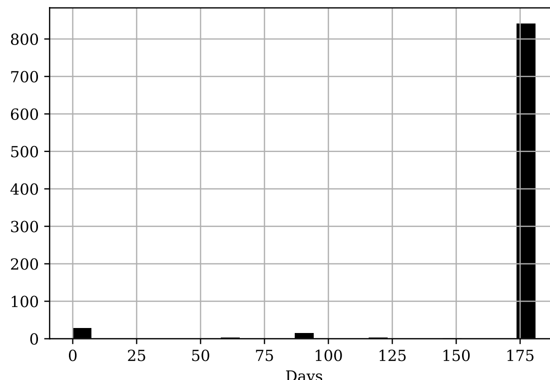

FIGURE 1. STATED LOCKUP PERIODS IN TRADITIONAL IPOS.[9]

But reported lock-up lengths can be misleading, because today underwriters can—and often do[10]—waive lockups, allowing early sales of unregistered shares.[11] One market observer has observed that early sales were five times as common in 2021 as in 2020.[12] To explore that claim more deeply, we extracted additional data on the frequency of issuer disclosure that underwriters have full discretion to waive the IPO lockup. Figure 2 shows that waivers are now a common practice:

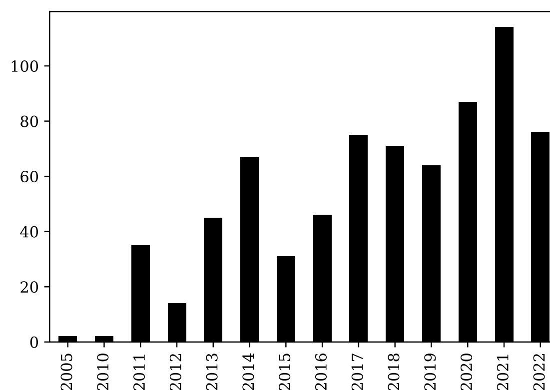

FIGURE 2.FREQUENCY OF UNDERWRITER DISCRETION TO WAIVE TRADITIONAL IPO LOCKUPS.[13]

EROSION OF THE IPO LOCKUP (2022) (noting "the explosion of early lock-up provisions" means that "IPO insiders are now able to cash out earlier than ever").

[9] Figure 1 was compiled by extracting data from Thomson's SDC database of IPOs on the New York Stock Exchange and NADSAQ between 2016-2021. Zeros appearing in this dataset occur when no number was provided in the S-1 filed in connection with the IPO. Researchers checked several registrations manually to ensure the accuracy of Figure 1's presentation.

[10] To take just one recent example, in Snap, Inc.'s IPO underwriters had sole discretion to "waive the contractual lock-up before [it] expire[d]." SNAP, INC. REGISTRATION STATEMENT ON FORM S-1 39 (Feb. 2, 2017). Six days after Snap's IPO, a pre-IPO investor sold 100,000 non-IPO shares, creating questions as to which investors, if any, would have Section 11 standing in that case. *In re Snap Sec. Litig.*, 334 F.R.D. 209 (C.D. Cal. 2019).

[11] *See, e.g.*, Patrick M. Corrigan, *Footloose with Green Shoes*, 38 YALE J. REG. 908, 965 n.206 (2021) (noting that "underwriters can release non-insider venture-capital backers of an issuer . . . without disclosure").

[12] RENAISSANCE CAPITAL, *supra* note 8.

[13] Figure 2 is based on S-1 filings from 2003–2023 which include language that provides for lock-up waivers. We include a longer sample period because, as others have shown, lock-up waivers have become especially popular in recent years. RENAISSANCE CAPITAL, *supra* note 8.

As Figure 2 shows, prior to 2010 unlimited underwriter discretion to waive lockups was rare. Over the last decade, however, underwriters have had discretion to allow early sales of unregistered shares in hundreds of traditional IPOs. To examine whether underwriters have actually used this discretion to allow pre-IPO investors to sell before a lockup's expiration, we extracted data from Rule 144 filings indicating sales under those circumstances. As Figure 3 shows, issuer affiliates can, and often do, sell shares during the lockup period in traditional IPOs:[14]

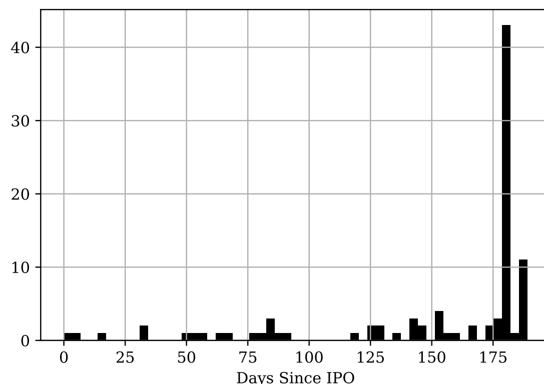

FIGURE 3. RULE 144 FILINGS INDICATING SALE INTENTION AFTER TRADITIONAL IPOS.[15]

Figure 3 shows that, in many recent IPOs, issuers' affiliates have disclosed to the Commission an intention to sell shares long before the standard 180-day lockup period expires.[16] Taken together, this evidence suggests that in recent years underwriters have frequently used their discretion to allow early sales of unregistered shares.[17] Put another way: for decades, traditional IPO lockups preserved a pool of registered shares from which Section 11 plaintiffs with standing could be drawn. Today, however, the market may include both registered and unregistered shares—even a few days after the IPO.

Against this backdrop, offering mechanisms like direct listings—which rarely feature lockups—should not be viewed as a unique case for Section 11 standing purposes but instead part of a general trend

[14] Rule 144(a)(1) defines an "affiliate" as a "person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." Affiliates are required to comply with additional requirements under Rule 144, including the "notice" requirement under Rule 144(h), which requires certain sales to be disclosed in Form 144 filings with the SEC.

[15] The data in Figure 2 were drawn from data on Form 144 filings collected by The Washington Service, which manually collects paper filings from the SEC and digitizes them. *See* THE WASHINGTON SERVICE, FORM 144 FILINGS (2023). We merge this data with our public offerings data over the same period.

[16] Although Form 144 filings are best thought of as disclosing an "intention to sell," The Washington Service supplements this data by collecting data on actual sales from other sources such as Form 4 filings. We use the approximate date of sale provided by The Washington Service—and, thus, can interpret Figure 3 as showing sales within the lock-up period.

[17] Underwriters' incentives to permit such sales may reflect a recent reduction in their relative leverage over issuers. As other scholars have noted, companies are able to stay private longer due to the growth in the size of private markets. Michael Ewens & Joan Farre-Mensa, *The Deregulation of the Private Equity Markets and the Decline in IPOs*, 33 REV. FIN. STUD. 5463 (2020). While observers often point out that the rise of large private companies may increase the bargaining power of founders versus investors, it also increases the bargaining power of issuers over intermediaries such as underwriters, exchanges, and other traditional gatekeepers. In order to compete for fees, these gatekeepers may be willing to make significant non-financial concessions to issuers—like lock-up waivers. For one recent example of these dynamics at work, *see, e.g.*, Maureen Farrell, Liz Hoffman, Eliot Brown & David Benoit, *The Fall of WeWork: How a Startup Darling Came Unglued*, WALL ST. J. (Oct. 24, 2019) (rather than inquiring about questionable governance practices at WeWork, the President of the New York Stock Exchange and CEO of Nasdaq focused on wooing the WeWork listing, with NYSE offering to eliminate plastic cups in their cafeteria and Nasdaq offering to create a new index called the "We 50").

in which tracing is increasingly difficult to establish regardless of offering type.[18] We thus agree with the SEC's recent observation that "concerns regarding shareholders' ability to pursue claims pursuant to Section 11" "due to traceability issues are not exclusive to" direct listings; instead, "purchasers following either [traditional] IPOs or direct listings may face similar difficulties in tracing their shares."[19]

For three reasons, the SEC should move promptly to address the investor-protection concerns raised by these developments. First, tracing challenges in *both* traditional IPOs and direct listings can erode Section 11 liability, presenting a uniform policy problem requiring a uniform regulatory solution. Second, issuer counsel have recognized that Section 11 liability can be limited through early sales of unregistered securities, suggesting that this problem is likely to grow if the Commission fails to act. Indeed, today issuer counsel affirmatively advises issuers to intentionally comingle the sale of unregistered and registered securities to undermine Section 11 liability and the protections it provides.[20]

Third, most observers—including the parties and *amici* in *Pirani* itself—agree that the SEC has rulemaking authority to address these issues through amendment of Rule 144.[21] We consider such an amendment below—and explain why the case for a prompt rulemaking project in this area is strong.

II. Modernizing Rule 144 in Light of Market Developments

For decades, the Commission's Rule 144 has permitted holders of unregistered shares to sell their stock to the public, providing an exemption from the Securities Act's general prohibitions of such sales.[22] As a condition of using this exemption, holders of such shares must, among other things, have held those shares for at least one year.[23] Thus, there is clear precedent for imposing a lockup on sale of unregistered shares. The Commission has, over time, amended those timing conditions in light of market developments in securities-offering practices.[24] We suggest that the SEC again amend those conditions to limit the sales of unregistered shares we have documented above.

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[18] *But see Pirani* v. *Slack Technologies, Inc.*, No. 20-16419 (9th Cir. 2021), at 13 ("[I]n contrast to an IPO, in a direct listing there is no bank-imposed lockup period [when] unregistered shares are kept out of the market").

[19] U.S. Sec. & Exch. Comm'n, Order Setting Aside Action by Delegated Authority and Approving a Proposed Rule Change to Amend Chapter One of the Listed Company Manual to Modify the Provisions Relating to Direct Listings, Release No. 34-90768, 85 Fed. Reg. 85,807, 85,814 (2020), at 35; *see also id.* at 31 (noting the New York Stock Exchange's contention that "the Section 11 and traceability concerns are due to the potential lack of lockup agreements . . . rather than anything inherent in direct listings themselves").

[20] *See, e.g.*, Boris Feldman, *A Modest Strategy for Combating Frivolous IPO Lawsuits*, HARV. L. SCH. F. ON CORP. GOV. (2015) ("[U]nderwriters would be well-advised to think about easing lock-up requirements in order to enhance the potency of the standing defense to Section 11 claims.").

[21] *See, e.g.*, Petition for Certiorari in *Pirani*, *supra* note 1, at 39; Brief for Petitioner Slack Technologies, Inc. in No. 22-200, at 18 (noting that policies addressing "practical difficulties in tracing purchases of registered shares" are "for Congress or the SEC to adopt"); *id.* at 46 (arguing that the "SEC [has] ample tools at its disposal to address the concerns addressed" by lower courts with respect to tracing," including, as we propose here, "mandat[ing] a lockup period whenever registered shares first become available for trading on a public exchange").

[22] Rule 144 exempts an affiliate or other persons' transactions from being deemed a distribution, and hence not underwriter under § 2(a)(11), making § 4(a)(1) available. *See, e.g.*, Brent J. Horton, *Spotify's Direct Listing: Is it a Recipe for Gatekeeper Failure?*, 72 SMU L. REV. 177, 194 n. 145 (2019).

[23] *See* 17 CFR § 230.144(d)(ii) ("If the issuer of the securities is not, or has not been for a period of at least 90 days immediately before the sale, subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, a minimum of one year must elapse between the later of the date of the acquisition of the securities from the issuer, or from an affiliate . . . and any resale of such securities.")

[24] Most recently, the Commission proposed to reset these holding periods for certain convertible market-adjustable securities, such that the Rule 144 holding period would not begin until the occurrence of the conversion or exchange. *See* 2020 Proposal, *supra* note 1, at 86 Fed. Reg. 5063, 5069. The Commission proposed these changes, in part, to limit the risk of "unregistered distributions in connection with sales of those securities." *Id.*

Specifically, the Commission should amend Rule 144 such that, upon the effectiveness of a registration statement, holding periods are reset to the later of: (1) 90 days or (2) the next 10-Q or 10-K. Our proposed holding period is approximately half the length of the stated lockup period for most traditional IPOs—but gives ample time in which only registered shares trade, addressing the tracing problems modern offering practices have produced and retaining the deterrence that Congress designed Section 11 to achieve. At the same time, under our proposal issuers have the flexibility to effectively shorten the holding period by releasing post-offering financials.

There is little doubt that the Commission has authority to promulgate such a rule. The SEC has repeatedly amended Rule 144 since its adoption in 1972, often explicitly in response to evolving market practices like those described here.[25] Indeed, the SEC has before interpreted the original Rule 144 itself to limit its availability to sellers until the passage of 90 days after the effective date of a registration statement.[26] That is why many observers agree that the SEC has authority to take this step.[27]

In addition, we expect the costs of our proposed rule to be modest. The marginal costs of registering additional shares for issuers choosing to do so are relatively trivial.[28] And holders of unregistered shares will be free to continue to sell if they can prove their investment intent and are not attempting to evade the registration process.[29] For those who cannot get their shares registered or prove investment intent, we recognize that our proposal result in an increase in liquidity costs, but we note that there is reason to expect such costs to be relatively small.[30]

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[25] The Commission's 1997 amendments to Rule 144 made sweeping changes to the required holding periods for restricted securities. SEC, Revision of Holding Period Requirements in Rules 144 and 145, Release No. 33-7390; File No. S7-17-95; 62 F.R. 9242 (Feb. 20, 1997) (shortening holding periods for resale of restricted securities under Rule 144 from two years (for any person) and three years (for those who were not affiliates and had not been affiliates during the preceding three months) to one and two years, respectively). The SEC further reduced the holding period to six months for reporting issuers and one year for non-reporting issuers in 2008. *See* SEC, Revisions to Rules 144 and 145, Release No. 33-8869; 72 Fed. Reg. 71,545 (Dec. 17, 2007).

[26] SEC, Securities Act Release No. 5306 at Section VI (A)(1) (Sept. 26, 1972) ("Rule 144 will not be available to [an owner of restricted stock] until at least 90 days after the effective date of [the issuer]'s 1933 Act registration statement.").

[27] Brief of *Amicus Curiae* Hons. Clayton & Grundfest, *supra* note 2, at 32-33 (concluding that the Commission has authority to address this subject).

[28] *See* U.S. SEC. & EXCH. COMM'N, FILING FEE RATE (Oct. 1, 2022); *see also* NEW YORK STOCK EXCHANGE RULE 902.03, FEES FOR LISTED EQUITY SECURITIES (2022).

[29] Courts have held that holders of restricted stock who have held the stock for at least three years demonstrate "conclusive" investment intent. *Ackerberg* v. *Johnson*, 892 F.2d 1328 (8th Cir. 1989). Thus, resales directly to accredited investors with a mandatory three-year holding period can meet both the investment intent and distribution requirements of the resale doctrine. To be sure, Rule 144 may still be preferable where the reseller wishes to use the services of an intermediary such as a broker, or where the buyer does not want to be subject to a three-year holding period. In these instances, a reseller may be forced to offer a significant liquidity discount.

[30] Many large investors and early employees will have their shares registered as part of the going-public process. Therefore, we do not expect the residual category of holders of unregistered shares to be large and to meaningfully impact the cost of capital to issuers. Some holders of unregistered shares may be concerned about the opportunity cost of not being able to sell on the first day to take advantage of the long-documented "IPO pop." Recent empirical evidence examining IPO performance from 1980–2020 estimates that the average first-day pop is 18.4%. Jay R. Ritter, INITIAL PUBLIC OFFERINGS: UPDATED STATISTICS, tbl. 19 (February 3, 2023). However, we note that the same evidence shows that the price increase from the IPO pop is persistent, and IPO firms continue to outperform similar size- and value-matched firms over the next six months, earning an additional 1.2–2.6% after the initial pop. *Id.*, tbl. 20. Thus, a holding period of 90 days may not adversely affect the ability of those few individuals whose shares were not registered as part of the going-public process to capture such gains.

Others have endorsed a solution like ours—but have argued instead that a one-day holding period is sufficient for these purposes.[31] We do not think a one-day period is appropriate as a matter of policy. As a practical matter, a period that short would significantly constrain the number of investors with standing under Section 11. The result would be to preserve the theoretical possibility of Section 11 liability—while, in reality, weakening the deterrence that Congress designed the statute to achieve.

The Commission could, of course, consider an even longer, 180-day holding period in light of the prevailing stated market lockups documented in Figure 1. As noted above, however, we recognize that the erosion of lockup enforcement in practice reflects investors' increasing demands for liquidity. That reality should be reflected in the SEC's rules in this area. We believe a 90-day period would best balance the interests of issuers and early investors with meaningful preservation of Section 11's deterrence function.

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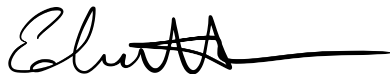
However the Supreme Court resolves *Slack* v. *Pirani*, market developments will continue to erode Section 11's investor protections in *both* IPOs and direct listings in the absence of SEC action. Accordingly, the Commission should promptly initiate a rulemaking project to amend Rule 144 to limit the sales of unregistered securities after the effectiveness of a registration statement.

Should the Commission or the Staff have any questions, or if we can be of assistance in any way, please feel free to contact our Working Group's co-Chairs at any time. Edwin Hu can be reached at edwin.hu@nyu.edu and Daniel Taylor can be reached at dtayl@wharton.upenn.edu.

Sincerely,



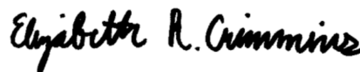
Edwin Hu
Postdoctoral Fellow, NYU School of Law
Former SEC Commissioner Counsel and
Staff, Division of Economics, Risk and Analysis

Daniel J. Taylor
Arthur Anderson Professor
Wharton School of Business
University of Pennsylvania

Bradford Lynch-Levy
Researcher
Wharton School of Business
University of Pennsylvania

Jonathon Zytnick
Associate Professor of Law
Georgetown University Law Center
Former SEC Commissioner Counsel

Benjamin Alter
Researcher
NYU School of Law
Program on Corporate Law and Policy



Elizabeth Crimmins
Researcher
NYU School of Law
Program on Corporate Law and Policy

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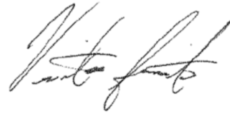
[31] *See* Brief of *Amicus Curiae* Hons. Clayton & Grundfest, *supra* note 2, at 32-33.

Matthew Kalinowski
Researcher
NYU School of Law
Program on Corporate Law and Policy

Charlotte LeBarron
Researcher
NYU School of Law
Program on Corporate Law and Policy



Victor Simonte
Researcher
NYU School of Law
Program on Corporate Law and Policy

Copied:

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Hon. Mark T. Uyeda, Commissioner
Hon. Jaime Lizárraga, Commissioner
Erik Gerding, Director, Division of Corporation Finance