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Legal Diversification

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ESSAY

LEGAL DIVERSIFICATION

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The greatest protection investors have from the risks associated with capital investment is diversification. This Essay introduces a new dimension of diversification for investors: legal diversification. Legal diversification of investment means building a portfolio of securities that are governed by a variety of legal rules. Legal diversification protects investors from the risk that a particular method of minimizing agency costs will prove ineffective and allows investors to own securities in a variety of firms, with each security governed by the most efficient set of legal rules given the circumstances of the investment. Diversification of investment by legal rules is possible because of the varied menu of legal rules firms can choose from when organizing and raising capital.

This Essay makes several contributions to the literature. By introducing legal diversification, it reveals a new understanding of how investors, issuers, and society can benefit from maintaining a variety of legal rules to govern investment in businesses. The corporate law scholarship has long advocated preserving a variety of rules under which firms can organize, but it has yet to consider how investors can take advantage of that variety to protect themselves before market competition has revealed the "best" rules. Legal diversification also complements recent literature emphasizing the importance of diversity in financial regulation by highlighting another reason diversity of legal rules is important to healthy capital markets. Legal diversification fills gaps in the literature that advocates regulatory diversity by offering an explanation for why that diversity is a valuable protection for investors and an indispensable mechanism for allowing firms to choose the most efficient legal rules to govern their organization and operation.

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INTRODUCTION

Diversification is the best protection investors have from the risks of capital investment. Modern portfolio theory requires that investors diversify their holdings by investing in firms whose financial returns are influenced by different factors.[1] That usually means investing in firms in different industries. The object is to identify the factors that could cause a firm's return to vary from what is expected and to invest in firms that

1. Modern portfolio theory holds that investors should construct portfolios of securities that vary in their returns differently so that the variance of one security does not threaten the return of the portfolio as a whole. Such well-diversified portfolios shield investors from firm-specific or security-specific risks. See generally Harry M. Markowitz, Portfolio Selection: Efficient Diversification of Investments (2d ed. 1991).

differ with regard to those elements of risk. By employing this investment strategy, investors can "diversify away" firm-specific risks; that is, they minimize their exposure to the risk of loss from one firm's failure by their investment in other, different firms.[2]

One of the most significant risks investors confront is the risk that firm managers will make poor decisions or appropriate the firm's capital for personal use. These agency costs are governed by different legal rules depending on the type of business form the firm adopts or the kind of securities it issues. Investors use the legal tools at hand to discipline managers, to seek a remedy when their investments are lost, and to obtain information about the firm or its securities. If the applicable legal rules are inadequate, investors' rights in the firm are less valuable. For example, public stock and private debt securities offer investors different rights to the firm's assets and different ways to protect their interests in the firm. Private general partnerships and public corporations use different methods to minimize the agency costs of management, and investors protect their interests differently in each business form. Because firms' returns can vary from the expected return according to the legal rules they have adopted to minimize agency costs, those legal rules are a useful dimension along which investors can diversify. Corporate law scholars have long touted the importance of maintaining diversity in the legal rules governing businesses.[3] Yet, to date, no one has focused on diversification among legal rules as an important investment or regula-

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2. More technically, an investor limits the variance of her portfolio's return from the expected return through diversification. See infra notes 13–16 and accompanying text (discussing modern strategy of diversification).

3. The benefits of legal diversity in corporate governance include allowing firms to choose the legal rules that best suit their needs and allowing jurisdictions to experiment with different rules in order to discover which rules are most effective. See Erin A. O'Hara & Larry E. Ribstein, The Law Market 107–09 (2009) (noting advantages of market competition between states for designing optimal legal rules); Larry E. Ribstein, The Rise of the Uncorporation 26–27 (2010) [hereinafter Ribstein, Rise of the Uncorporation] (advocating benefits of multiple distinct business association forms for entrepreneurs to choose among); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2361–62 (1998) [hereinafter Romano, Empowering Investors] (arguing states should be able to compete to provide securities regulation, just as they compete in designing corporate law statutes); Roberta Romano, The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters, 23 Yale J. on Reg. 209, 210–11 (2006) [hereinafter Romano, The States as a Laboratory] (discussing benefits of allowing states to develop different corporate governance laws); Charles K. Whitehead, Destructive Coordination, 96 Cornell L. Rev. 323, 326–30 (2011) [hereinafter Whitehead, Destructive Coordination] (arguing subjecting financial firms to identical regulations imposes additional risk); Roberta Romano, For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture 3–8 (Yale Law & Econ. Research Paper No. 452, 2013) [hereinafter Romano, For Diversity], available at http://ssrn.com/abstract=2127749 (on file with the *Columbia Law Review*) (emphasizing importance of diverse set of legal rules to regulate international financial risk).

tory priority. By introducing legal diversification, this Essay fills that hole in the literature.

"Legal diversification" is an investment strategy whereby investors purchase securities governed by different legal rules in order to diversify away the risk that any one set of legal rules will fail to adequately limit agency costs. For example, an investor might hold a diversified portfolio of stocks in different kinds of public corporations, but that portfolio would not necessarily be legally diversified. A portfolio would be legally diversified if it contained securities issued by privately held limited liability companies (LLCs), public corporations, emerging growth companies (EGCs), and various derivatives. By holding a diversified portfolio of investments in firms and securities governed by different legal regimes and regulations, investors can realize the benefits of the best each regime has to offer while enjoying protection from its weaknesses. Investing in firms with different governance structures and in securities with different legal protections is diversifying based on the legal rules governing the investments in a portfolio. The legal rules governing firms and securities constitute a new dimension for investors to consider when choosing securities for a well-diversified portfolio.

This Essay is primarily concerned with legal diversification on two planes: regulation of governance within firms and regulation of the securities those firms and other market participants issue to investors.[4] Variety in the regulation of firm governance is found in the use of different business association forms. Once a firm's organizers have chosen the law governing the management of their firm, they will then choose which regulations will govern the securities the firm issues to investors. A firm has many options available at the outset, and it can change the legal regimes under which it operates as it progresses from a relatively small,

4. There is a third very relevant level of regulation: regulation of firms that manage investments on behalf of unsophisticated investors. While some of these firms, such as mutual funds, have governance structures similar to those of corporations, they rely heavily on strong exit rights to protect investors and to provide a market for the services provided. See John Morley & Quinn Curtis, Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds, 120 Yale L.J. 84, 88 (2010) ("[Mutual fund] [i]nvestors will almost always prefer . . . to use a unique right of exit . . . ."); see also William A. Birdthistle & M. Todd Henderson, One Hat Too Many? Investment Desegregation in Private Equity, 76 U. Chi. L. Rev. 45, 49 (2009) (suggesting "easy exit reduces risks for investors . . . and therefore imposes discipline upon fund managers"). The Securities and Exchange Commission and various self-regulatory organizations also subject mutual funds, broker-dealers, and investment advisors to a variety of regulations designed to protect unsophisticated retail investors from the agency costs associated with giving someone else open-ended discretion over their savings. See Donald C. Langevoort, The SEC, Retail Investors, and the Institutionalization of the Securities Markets, 95 Va. L. Rev. 1025, 1030 (2009) (discussing differences in regulatory oversight between types of investment entities). While the regulation of these firms and the agency costs they present are important to how retail investors interact with the market, this Essay focuses instead on the menu of investment options (monetary and legal) the market provides.

fledgling business to a larger, more successful one, or as it endures financial distress and reorganizes to try again to succeed as a profitable entity. As the firm moves through its life cycle and selects different rules to govern its relationships with investors, investors are exposed to different kinds of agency costs and use different mechanisms to manage those costs. For example, a small, private LLC may have a few attentive owners who closely monitor management decisions. When those investors want to spread the risk associated with investment in the firm more widely and cash out of the firm by incorporating and offering it to the public, public reporting requirements will protect new owners; however, they are likely to be rationally apathetic and so monitor management much less closely.[5] There are advantages to both public and private securities, but they are different in how the regulatory systems impose different agency costs and risks and how they suit firms at different times and under different circumstances.

Legal rules influence returns because agency costs can affect the risk-adjusted return of a particular investment. If managers make poor decisions or misappropriate the firm's funds, investors are harmed. In order to be fully protected from the risks of each business form's failure to prevent or redress those harms, but still take advantage of the benefits of each legal regime, investors should diversify among the various legal rules governing businesses.

Robust legal diversification will allow investors, companies, and the market as a whole to find the right balance of legal protection against the inevitable agency costs of the system. If it is uncertain what the most effective governance mechanisms are, then diversification among various governance regimes will protect investors while legal rules take time to improve. Diversifying investment across different kinds of firms will correlate to diversification across different economic activities as firms choose the legal rules that serve their economic goals most efficiently.

Legal diversity provides advantages to firms as well. A diverse menu of legal regimes can help companies find the right governance or regulatory fit for their capital needs, and it allows them to send signals to investors about the kind of investment they represent. A firm that decides to go public is signaling that it is ready for enhanced disclosure obligations and monitoring. A firm that is taken private and unincorporated signals that it is undergoing reorganization and the current owners intend to extract value from the results of the turnaround. A small firm that chooses not to go public but still sells securities to institutional investors shows that it wants to tap some of the available "public" capital while still

5. See Lisa M. Fairfax, The Future of Shareholder Democracy, 84 Ind. L.J. 1259, 1268–69 (2009) ("Rational apathy refers to the notion that the cost to shareholders of informing themselves about a particular action and casting a vote in opposition to management exceeds the expected or actual benefit gained from such voting.").

choosing a governance form that relies on more direct monitoring by equity holders or relies more heavily on management ownership of the firm. This signaling allows firms to attract the right kinds of investors given their particular governance and capital needs. With a greater menu of options, firms can choose the governance structure that best suits them while also engaging the capital markets in the most effective way.

The capital markets as a whole also benefit from the promotion of legal diversification. A system that allows firms to use a variety of legal regimes benefits from experimenting with different legal rules to see what works best in particular circumstances. With a number of firms using different governance structures, the markets will be able to sort out which mechanisms best limit agency costs and then favor those mechanisms when they are most effective. Over time, various governance structures should grow to offer better protections to investors given the characteristics of a specific firm. Because the capital markets and the businesses and investors that contribute to them change over time, the law must be able to adapt to those changing circumstances. Such evolutionary processes require variety in order to adapt to unanticipated changes. Legal diversity allows firms and investors to experiment with various legal rules to learn more about what works well in certain circumstances. The lessons learned from those experiments will help the legal system design appropriate responses to new situations as they occur.

To date, the literature on diversity of legal rules has focused on the importance of giving firms the ability to choose among a diverse menu of legal rules in order to discover which legal rules are most appealing or most efficient.[6] For example, each state has its own law governing the delegation of rights and responsibilities between shareholders and directors of a corporation. States compete for firms by trying to provide the governance law more managers and investors would prefer. Scholars have advocated the expansion of this competition to many areas of the law, particularly securities regulation. Roberta Romano has suggested modeling state competition for securities law after competition for corporate law by allowing individual states to regulate key elements of secu-

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6. See, e.g., Ribstein, Rise of the Uncorporation, supra note 3, at 1–2 ("The availability of sets of default rules that fill the contracting gaps can be critical to these firms' success."); Chris Brummer, Stock Exchanges and the New Markets for Securities Laws, 75 U. Chi. L. Rev. 1435, 1438 (2008) (arguing securities law choices may increase competition and reduce transaction costs); Romano, Empowering Investors, supra note 3, at 2362 (proposing system of "competitive federalism" for securities laws to "produce rules more aligned with the preferences of investors"); Romano, For Diversity, supra note 3, at 3 (supporting flexibility in financial structure "that provides greater room for regulatory diversity and experimentation").

rities trading and disclosure.[7] Both Romano and Chris Brummer have noted the potential benefits of international competition for securities listings through securities and banking regulation.[8] In this kind of market competition, or "law market," firms must choose to be governed by the law of one jurisdiction rather than the law of another. Because more firms will choose the jurisdiction with the best law, jurisdictions have incentives to make "better" laws.

The legal diversification advocated here is distinct from the regulatory competition essential to law markets. The goal of legal diversification is not to find the one set of rules that will be best for all firms. Rather, legal diversification relies on the experimentation associated with legal diversity and encourages investors to build portfolios of investments that sample a variety of legal regimes. Firms subject to different legal rules pose different kinds and degrees of agency costs even if they are otherwise very similar. Legal diversification requires, for example, not only that our system have a number of different LLC statutes, but that it maintain a population of private LLCs next to, and distinct from, a population of public corporations. Allowing firms to move between governance forms and securities rules as their circumstances change allows companies and investors alike to find the best ways to strike the right balance of minimizing agency costs and raising capital over time.[9] It is a diversification that leads to better law and investment outcomes not by forcing regulators to compete to discover the optimal business form or governance rules, but by finding yet another way to keep investors and the legal system from putting all of their eggs in one (potentially flawed) basket. To that end, legal diversification is a complement to a relatively new trend in the literature that argues that the financial markets may be more vulnerable to systemic risk if all financial firms are forced to comply with identical regulations.[10] Diversity that allows legal rules to evolve and adapt to changing circumstances is valuable and is an important mechanism for protecting investors from the consequences of flawed, or ineffective, legal rules.

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7. Romano, Empowering Investors, supra note 3, at 2361–62 (proposing states should regulate securities registration and create related continuous disclosure regime for issuers and suggesting antifraud provisions to enforce system).

8. Brummer, supra note 6, at 1438 (noting international competition for securities laws makes foreign venues more attractive to issuers and reduces transaction costs of switching jurisdictions); Romano, For Diversity, supra note 3, at 3–8 (proposing framework for regulatory diversity in international financial system).

9. See infra Parts III, IV.

10. See Whitehead, Destructive Coordination, supra note 3, at 327 ("[A]lthough regulation and market standards can help reduce systemic risk, they themselves can also *become* a systemic risk." (footnote omitted)); Romano, For Diversity, supra note 3, at 101 ("[E]xperience indicates that . . . harmonization has increased, rather than decreased, systemic risk . . . .").

Part I of this Essay explains what legal diversification is and how legal diversity benefits firms, investors, and the capital markets. Part II argues that the public corporation is a "sticky default" and explains how that can threaten the advantages we realize from legal diversity. In particular, it points to provisions of the new Jumpstart Our Business Startups Act (JOBS Act) that may, alternatively, expand or hinder legal diversity. Part III reveals the diverse menu of business forms available to organizing firms and explains how diversification among these forms can protect investors from agency costs. Part IV examines the menu of securities laws from which issuers may select when raising capital. It shows that investors can find protection in each form of security, but gain maximum protection by diversifying among the available choices. Together, Parts III and IV demonstrate how important legal diversification is to investors, issuers, and society, and why maintaining diverse legal rules should be a priority for investors and regulators. Part V situates legal diversification within the current literature on diversity of legal rules and shows that while legal diversification is a new and distinct concept, it fits within a well-developed body of work that advocates the benefits of maintaining a variety of legal rules to govern the firms that animate the capital markets. Finally, Part VI considers the policy implications of legal diversity.

I. WHAT IS LEGAL DIVERSIFICATION?

Legal diversification is an investment strategy that contemplates diversifying investment in securities by choosing securities that are governed by different legal rules. There is a rich diversity of legal rules governing the securities traded in American markets.[11] One need not look to foreign markets to find alternative regulatory regimes. For example, an investor could purchase equity interests in a public corporation and a private LLC, and the legal rules governing her rights in those firms and protecting her interests in those assets could differ substantially.[12] Legal diversification is analogous to investment diversification, which focuses on selecting securities that are likely to vary from their expected returns at different times for different reasons, but it is not identical to investment diversification. That is, the justifications for investment diversification and legal diversification do not map perfectly onto one another. Understanding why legal diversification can be valuable to investment, and even investment return, can help scholars better understand invest-

11. See John C. Coates IV, Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis, 41 Va. J. Int'l L. 531, 550–53 (2001) (discussing high degree of tailoring among Securities and Exchange Commission disclosure and accounting regimes).

12. American investors can also invest in foreign markets, as determined by governing legal rules, which adds further to the diversity of securities available for investment.

ment and order laws to encourage, rather than discourage, diversity of legal form.

This Part explains what legal diversification is and how it relates to traditional notions of investment diversification from modern portfolio theory. Rather than finding a direct analogy, this Part highlights a useful way of understanding the benefits investors can realize from legal diversity and also explains why legal diversity is beneficial to issuers and society.

A. *The Diversification Analogy*

Investment diversification refers to assembling a portfolio of securities that lowers variance, bringing actual return as close as possible to expected return.[13] This requires bringing together securities with low covariance, that is, securities that are not likely to vary from expected returns together or for the same reason.[14] Harry Markowitz launched modern portfolio theory with these observations about the benefits of diversification and how it should be achieved.[15] He emphasized diversifying "across industries because firms in different industries, especially industries with different economic characteristics, have lower covariances than firms within an industry."[16] Investment diversification focuses, then, on risk and variance from expected return. Different businesses can vary independently, so an investor can compile a portfolio of securities that limits overall variance by limiting covariance.

A common example of investment diversification is a portfolio that contains stock in a company selling sunglasses and stock in a company selling umbrellas.[17] Suppose that if it rains, the expected return of the sunglasses business is $20, but the expected return of the umbrella busi-

13. See Harry Markowitz, Portfolio Selection, 7 J. Fin. 77, 79 (1952) [hereinafter Markowitz, Portfolio Selection Article] (describing investment diversification as "rule which implies both that the investor should diversify and that he should maximize expected return").

14. See id. at 89 ("It is necessary to avoid investing in securities with high covariances among themselves.").

15. See José Martin Jara, What Is the Correct Standard of Prudence in Employer Stock Cases?, 45 J. Marshall L. Rev. 541, 571 (2012) ("In 1952, economist Harry M. Markowitz changed the theory and practice of investment management by publishing his groundbreaking article 'Portfolio Selection.'"); Karl S. Okamoto & Douglas O. Edwards, Risk Taking, 32 Cardozo L. Rev. 159, 194 n.148 (2010) (stating Markowitz "deriv[ed] the first formal diversification principles" (citing Markowitz, Portfolio Selection Article, supra note 13)). In 1990, Markowitz won the Nobel Prize in Economic Sciences for his significant contributions to modern portfolio theory. Harry M. Markowitz—Facts, Nobelprize.org, www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1990/markowitz-facts.html (on file with the *Columbia Law Review*) (last visited Oct. 9, 2013).

16. Markowitz, Portfolio Selection Article, supra note 13, at 89.

17. A slightly different version of this example appears in Stephen J. Choi & A.C. Pritchard, Securities Regulation: Cases and Analysis 21–22 (3d ed. 2012).

ness is $100. Conversely, if it is sunny, the expected return of the sunglasses business is $100, but the expected return of the umbrella business is $20. If an investor only invested in one of the businesses, the expected return for her portfolio would be $60, assuming it rains half the time and the sun shines half of the time.[18] But suppose it rains 80% of the time one year and the sun only shines 20% of the time. If the investor has only invested in the sunglasses business, her return for the year would be $36,[19] but an investor who owns stock in the umbrella business would enjoy an $84 return.[20] An investor who divided her investment equally between the two firms would enjoy a return of $60,[21] the expected return for each portfolio assuming it rained and the sun shone an equal number of days. The diversified portfolio is thereby protected from each firm's variance from the expected return and realizes the expected return for the portfolio even though the weather did not behave as expected. This is an oversimplified example, but it demonstrates the goals and benefits of investment diversification.

To be sure, legal diversification is not as easily described in numerical terms and involves many more moving parts (that move other parts, which, in turn, move other parts that might result in differences in investment return). Legal rules do not as directly influence the return of a given security or the overall profitability of a business. But legal rules can and do affect the profitability of firms; having the right legal rules for the right kind of business or at the right time in a firm's life cycle is vitally important to raising capital, operating a healthy business, or reviving a struggling business. The intuition that investments in different kinds of firms can shield an investor from the failures of one firm also rings true in the legal diversification analogy and lends important insights to investment strategy. Law is simply another dimension, among many, across which investors can diversify.

1. *Law Matters.* — The corporate governance of a firm can affect the actual return on a given security. Weak accountability for managers can lead to careless management and poor decisionmaking. It can also lead to the kind of self-dealing or misappropriation of corporate assets that most governance laws aim to prevent. Weak governance mechanisms do not guarantee that managers will perform poorly or faithlessly, of course, but there is an increased risk of bad management where accountability is weak.

With this connection in mind, scholars have conducted numerous studies testing the effectiveness of various governance mechanisms by

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18. *$20(.5) + $100(.5) = $60*

19. *$20(.8) + $100(.2) = $36*

20. *$20(.2) + $100(.8) = $84*

21. *$36(.5) + $84(.5) = $60*, which is the expected return of each individual investment.

looking at both their ability to detect problems within the firm and by looking at the returns of firms that have employed particular governance mechanisms. For example, Sanjai Bhagat and Bernard Black conducted an empirical study in which they tried to determine whether the independence of a firm's board positively or negatively affected its financial performance.[22] They found that there is no evidence that majority-independent boards correlate to greater profitability, but found that firms with a few inside directors were more profitable than those with supermajority-independent boards.[23] That study suggests that board independence is not the panacea that regulators think it could be, and that board composition matters to firm success. Other studies have shown that there is a strong correlation between independent boards and accurate financial reporting.[24] Further, there is evidence showing a correlation between the strong securities regulations supporting public markets and greater profitability in those markets than in markets that lack strong mandatory disclosure rules and insider trading prohibitions.[25] This evidence suggests that laws intended to protect investors from the misdeeds of management impact the profitability of those firms and matter to the health of the markets in which investors risk their capital.

Somewhat more controversially, some scholars have tried to prove empirically the degree of efficiency of various corporate law rules.[26] Known as "law and finance," this line of scholarship compares U.S. corporate and securities laws with legal regimes in other countries with re-

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22. Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Bus. Law. 921, 921–22 (1999).

23. Id. at 950.

24. See Robert A. Prentice & David B. Spence, Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?, 95 Geo. L.J. 1843, 1869–70 (2007) (citing several empirical studies showing increased board independence decreases financial reporting fraud by firms).

25. See id. at 1858–60 (citing Frank B. Cross & Robert A. Prentice, Law and Corporate Finance 152–89 (2007)) (discussing empirical studies indicating capital markets are improved by vigorous securities regulation).

26. See, e.g., Rafael La Porta et al., Law and Finance, 106 J. Pol. Econ. 1113, 1113 (1998) [hereinafter La Porta et al., Law and Finance] (investigating effect of strength of investor protections on dispersion of share ownership in forty-nine countries and finding countries with weaker protections have more concentrated share ownership); Rafael La Porta et al., Legal Determinants of External Finance, 52 J. Fin. 1131, 1131 (1997) [hereinafter La Porta et al., Legal Determinants] (finding countries with weak investor protections have smaller capital markets than those with more robust corporate governance laws); Brian R. Cheffins, Does Law Matter?: The Separation of Ownership and Control in the United Kingdom 37–38 (Univ. of Cambridge, ESRC Ctr. for Bus. Research, Working Paper No. 172, 2000), available at http://ssrn.com/abstract=245560 (on file with the *Columbia Law Review*) (examining connection between market regulation and rise of separation of ownership from control in United Kingdom and United States during twentieth century and concluding "law matters" thesis was neither conclusively proven nor effectively dismissed).

gard to their ability to protect investors.[27] The premise of the law and finance project is that investors will not contribute capital to companies if they think the law poorly protects their rights in the firm.[28] Law and finance studies have found that firms tend to be owned by a smaller, more concentrated group of shareholders when investor protections are weak and that markets governed by laws that provide only weak investor protections tend to be smaller.[29] Those findings make sense because when a legal system provides fewer investor protections, investors have to monitor managers more closely and cannot indulge in the rational apathy widely dispersed shareholding allows. It would seem, then, that legal rules significantly influence investors' choices. If legal protections matter to investors, then investors must believe they affect returns. If legal rules can affect returns, then they can cause actual returns to vary from expected returns and are therefore a good candidate for diversification.

The effort to establish the relevance of legal rules to returns has been strongly criticized, however. Scholars have noted weaknesses in coding the legal rules of the different countries[30] and endogeneity problems have plagued the project.[31] It is very difficult to prove that any one legal

27. See La Porta et al., Law and Finance, supra note 26, at 1115–17 (documenting law and finance research method as comparing legal regimes in multiple countries); Alessio M. Pacces, How Does Corporate Law Matter? 'Law and Finance' and Beyond 6–7 (June 18, 2013) (unpublished manuscript), available at http://ssrn.com/abstract=2260340 (on file with the *Columbia Law Review*) (describing law and finance scholarship as comparing different corporate governance systems).

28. Pacces, supra note 27, at 5–6 (explaining theory that "when . . . legal constraints are insufficient to discipline the managers' conflicts of interest with the shareholders, separation of ownership and control will be impaired"); see also La Porta et al., Law and Finance, supra note 26, at 1114 ("Law and the quality of its enforcement are potentially important determinants of what rights security holders have and how well these rights are protected. Since the protection investors receive determines their readiness to finance firms, corporate finance may critically turn on these legal rules and their enforcement.").

29. La Porta et al., Law and Finance, supra note 26, at 1146–48; La Porta et al., Legal Determinants, supra note 26, at 1149.

30. See Pacces, supra note 27, at 10 ("The most serious issue in coding is inconsistency as, for instance, default rules received different scores depending on the jurisdiction."); see also Holger Spamann, 'Law and Finance' Revisited 21 (Harvard Law Sch., John M. Olin Ctr. for Law, Econ. & Bus. Fellows' Discussion Paper No. 12, 2008), available at http://ssrn.com/abstract=1095526 (on file with the *Columbia Law Review*) (finding when coding is corrected, conclusions of *Law and Finance* study do not hold); Holger Spamann, On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Rights Index' Under Consistent Coding 69 (Harvard Law Sch., John M. Olin Ctr. for Law, Econ. & Bus. Fellows' Discussion Paper No. 7, 2006) [hereinafter Spamann, Insignificance and/or Endogeneity], available at http://ssrn.com/abstract=894301 (on file with the *Columbia Law Review*) (finding coding errors in numerous empirical studies over last ten years).

31. When the direction of causation is unclear, that is, it is difficult or impossible to determine whether one event caused or was caused by another event that occurs coincidentally, then one would say the two events are endogenous to one another. Is a pedestrian crossing the street in front of a car because it stopped, or did it stop because

rule affects returns or influences investment decisions because choice of legal rules is often endogenous to other characteristics of the firm such as its age, capitalization, and the concentration of its ownership. This endogeneity problem makes it difficult to be sure that an empiricist is measuring only the effect of the legal rule on returns. The precise effects of legal rules are extremely difficult to isolate from other factors affecting a firm's fortunes. Therefore, the "law matters" thesis has been difficult to prove empirically. Still, most of the critiques of the project have been aimed at the effort to rank corporate governance laws rather than the basic premise that law matters. There is life remaining in the "law matters" thesis, though it remains unproven.

Most legal scholars land somewhere between believing that law is the dominant force behind corporate governance success and investor protection and believing that law does not matter at all—they begin from an understanding that law is not all that matters, but it is still an important factor affecting firms.[32] Other factors affect a firm's fortunes, including the characteristics of its industry, its ability to produce and market desirable products, and its managerial skills. The law cannot protect investors from failures on those measures. But the law matters. It affects the choices firms make. It affects their ability to raise capital and the cost of that capital. If investors were offered no legal protections, they would either refuse to invest or would demand more concessions before invest-

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she looked like she was going to cross the street? In determining whether legal rules affect returns, one must first figure out if legal rules caused a governance practice that led to a difference in return or if the law was a response to a prevalent governance practice. Holger Spamann discusses endogeneity problems with some of the law and finance studies by pointing out that a particular governance practice may be more carefully restricted where it is more common and there may be no law regarding that practice at all where firms tend not to engage in that practice. Spamann, Insignificance and/or Endogeneity, supra note 30, at 12–13, 17. In determining how a particular business form affects governance practice or returns, endogeneity may pose difficulties. Does the fact that partnerships allow more involvement from owners cause partnerships to have lower agency costs than public corporations? Or do people who want to actively participate in a business they start with people they know well, and so pose a low risk of agency costs, tend to choose the partnership form because it is more convenient for them? The endogeniety of the choice of governance to other characteristics of the firm makes it difficult to reach conclusions about the direction of causation when evaluating the effectiveness of legal rules.

32. See, e.g., 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, 644–51 (1999) (noting many forces allowing shareholder dispersion to dominate U.S. system, but not necessarily capital markets in other countries); Katharina Pistor, Law in Finance, 41 J. Comp. Econ. 311, 311 (2013) ("There will always be some debate as to whether a specific law or regulation distorts or supports markets, but few would argue today that law is irrelevant to financial markets or that they could operate entirely outside it."); Cheffins, supra note 26, at 39 ("[O]ne must exercise caution before concluding that the law will be irrelevant to any future transition towards American-style corporate governance.").

ing. The degree of legal protection is, therefore, important to investors and firms.

2. *Diversification as a Useful Framework.* — If choices about business form and what securities to issue can affect return, then the returns generated, or costs incurred, can vary differently. Legal diversification avoids covariance on the basis of legal rules; that is, the returns firms realize as a consequence of the legal rules they are subject to vary from the expected return in different directions and magnitudes. By legally diversifying, an investor avoids covariance based on business form, incentives for management, means of disciplining management, and business outcomes linked to managerial incentives and discipline. Legal diversification also avoids covariance based on the choices firms make when they are at particular points in their life cycles. Investing in a young startup exposes an investor to greater risk, but also greater possible return, than investing in publicly traded stock. In times of financial distress, it may be better to invest in private equity firms that are taking public firms private to reorganize them than to only be a shareholder in publicly traded firms that are weathering the storm or filing for bankruptcy. Legal diversification also allows a single investor to observe the efficacy of different legal regimes.

The analogy to the investment diversification of modern portfolio theory is not a perfect one. All LLCs will not necessarily fail together, nor will even all LLCs in a particular jurisdiction. Of course, managerial misfeasance is a firm-specific risk, and managers operating firms under good legal rules may choose to cheat while those operating firms under more lax rules may remain honest. The fact remains that firms rarely, if ever, sink or swim on apposite legal regime alone. Indeed, one may realize many potential benefits of legal diversification by diversifying on the basis of asset class or simply by firm. An investor diversifies by asset class by investing in both debt and equity. This is also legal diversification because debt and equity are governed by different legal rules.[33] An investor can diversify away a firm-specific risk, such as managerial failure, by investing in different firms, and would not necessarily have to legally diversify to be protected from the risk of one manager's misbehavior.

Nevertheless, investment diversification provides a useful analogy and a helpful framework. Dishonest managers could indeed systematically exploit a loophole in a substandard governance regime. Some legal rules could carry harmful unintended consequences or create perverse incentives. For example, the use of option compensation has been blamed for contributing to the excessive risktaking that precipitated the

33. See infra Part IV.C (discussing importance of legal diversification and legal rules governing public debt).

financial crisis.[34] Similarly, government support of the creditors of financial institutions has removed the incentives those creditors might have to monitor, and so made financial institutions more vulnerable to managerial self-interest and risktaking.[35] In those instances, it is fortunate that all businesses are not operating under the same harmful rules. It is useful, then, to have more than one set of rules that investors can choose among. Even if investment diversification does not map perfectly onto legal diversification, it provides a useful way to think about legal rules in making investment decisions. Legal diversification is coincident to investment diversification in most instances, but is distinct from investment diversification. It should be honored as a separate investment priority and regulators should promote legal diversity in order to support diversification.

B. *Benefits to Issuers and Society*

The legal diversity that allows legal diversification of investments also benefits issuers and society. It allows issuers to choose the legal regime that fits their firms and capital needs most efficiently. It thereby provides investors a diverse set of firms to invest in and a diverse set of rights in those firms. That diversity helps investors to construct portfolios that participate in many potentially profitable securities with differing risk profiles and to invest in firms at different points in their life cycles, as those various stages bring distinct risks and benefits. Society then benefits from the efficiency and profitability gained by the choices issuers and investors can make.

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34. See, e.g., Sanjai Bhagat & Roberta Romano, Reforming Executive Compensation: Focusing and Committing to the Long-Term, 26 Yale J. on Reg. 359, 359–60 (2009) ("Executive compensation . . . has moved from the agenda of shareholder activists and media commentators to that of the federal government, in the ongoing financial crisis . . . ."); Frederick Tung, Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation, 105 Nw. U. L. Rev. 1205, 1206 (2011) ("Policy analysts have decried the role of executive compensation in promoting excessive risk taking leading up to the financial crisis. . . ."); David I. Walker, The Challenge of Improving the Long-Term Focus of Executive Pay, 51 B.C. L. Rev. 435, 435–36 (2010) ("A key complaint is that executive compensation is insufficiently focused on the long term, leading to reckless, short-term decision making by executives, and, at the extreme, financial bubbles that inevitably burst . . . .").

35. See Lucian A. Bebchuk & Holger Spamann, Regulating Bankers' Pay, 98 Geo. L.J. 247, 251 (2010) ("[B]ank creditors do not have strong incentives to protect themselves because they are at least partly protected—explicitly or implicitly—by the government."); Jeffrey N. Gordon, Corporate Governance and Executive Compensation in Financial Firms: The Case for Convertible Equity-Based Pay, 2012 Colum. Bus. L. Rev. 834, 836 ("The prospect of government rescue lowers the cost of capital for large financial firms, increases the resources they deploy, and thus exacerbates the systemic harm of their failure.").

Issuers enjoy many advantages in a system that allows different legal rules to flourish. Most importantly, a firm is able to choose the legal rules that allow it to operate its business most efficiently. Its managers can choose a set of legal rules that offers investors the protections they demand and also allows the managers to run the firm with the appropriate degree of freedom of action or risktaking given their business goals. It allows managers to choose precisely how to raise capital and what restrictions will apply to that fund-raising. There is a lengthy and well-known literature arguing that different businesses have different needs and encounter different circumstances and so should be able to choose the laws to which they are subject.[36] The variety issuers have in choosing the governance rules for their business, as well as the various ways they can choose to raise capital, allows them to choose efficient rules not just once, but continuously over the lifespan of the firm.

The case that legal diversification benefits society and capital markets as a whole is consistent with the arguments in favor of law markets, and specifically the argument that diversity promotes evolution to better legal rules.[37] A society and legal system are more likely to find better legal rules if they are able to try different methods of limiting agency costs and then tweak those methods over time. Legal diversity allows trials of these different legal rules at the same time in similar contexts. The "state laboratories" justification for using state law to govern the internal affairs of corporations—that the fifty states can each try different legal rules and, over time, learn which rules are most efficient and effective—applies to diversity throughout the legal system.[38] Just as comparing the corporate laws of Nevada and Delaware might reveal something about which legal rules are most effective, comparing corporate governance and LLC governance may prove similarly instructive. The creative negotiation of

36. See D. Gordon Smith et al., Private Ordering with Shareholder Bylaws, 80 Fordham L. Rev. 125, 128 (2011) (describing "discriminating alignment hypothesis" view that, based on transaction cost economics, different firms have different attributes requiring different governance structures); see also Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1417–18 (1989) ("No one set of terms will be best for all; hence the 'enabling' structure of corporate law."); Larry E. Ribstein, Commentary, Efficiency, Regulation and Competition: A Comment on Easterbrook & Fischel's *Economic Structure of Corporate Law*, 87 Nw. U. L. Rev. 254, 265 (1992) (acknowledging presumptive efficiency of Easterbrook and Fischel's private ordering analysis of corporate governance).

37. It is through the independent actions of many different firms that one discovers which methods of business organization survive. The surviving firms have engaged in behaviors the environment—in this case, the market—has "selected" or "adopted." See Armen A. Alchian, Uncertainty, Evolution, and Economic Theory, 58 J. Pol. Econ. 211, 214 (1950) ("More common types, the survivors, may appear to be those having *adapted* themselves to the environment, whereas the truth may well be that the environment has *adopted* them.").

38. See Romano, The States as a Laboratory, supra note 3, at 210 (discussing "states as a laboratory" practice in corporate law).

preferred stock terms may demonstrate what rights and powers best protect investors, and that might reveal something about what bond covenants or shareholder rights should look like.

By acknowledging the importance of legal diversity to issuers and investors and making it a priority in structuring legal rules, the legal system will promote rules that encourage instead of undermine legal diversity, which will make markets function more efficiently and effectively and thereby benefit society as a whole. The looming threat to legal diversity is the regulatory push toward public corporation status. The next Part explains how the current legal regime may push companies to become public corporations and describes how that could threaten the benefits from legal diversity.

II. THE PUBLIC CORPORATION AS A STICKY DEFAULT

Corporate law is dominated by default rules that firms can choose among when deciding how to organize or raise capital.[39] Those organizing firms can choose among various business forms and once they have chosen a business form, the law provides default and mandatory rules to govern the rights and responsibilities of the firms' owners and managers. Default rules are essentially optional contract terms provided by statute. A firm can adopt a default rule or contract around it by designing a specific rule that will suit its purposes better. A security is a contract between an issuer and an investor regarding the kind and degree of the investor's contribution to the firm's capital, the rights the investor will have against the firm's assets, and the ability of the investor to enforce those rights. Securities regulation provides some default terms for those agreements, but those regulatory terms are focused mainly on requiring firms to make particular disclosures to investors. This Part focuses on one default rule in particular: the rule that requires firms issuing securities to file a registration statement, which in turn requires them to comply with public reporting requirements, unless they abide by an exception to the default.[40] Because "legal gymnastics" are required to avoid this public status, public corporation status can properly be considered a sticky, or difficult-to-avoid, default.[41] Using a sticky default to funnel firms into public

39. Default rules are "rules that parties can contract around by prior agreement." Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87, 87 (1989).

40. Securities Act of 1933 § 5, 15 U.S.C. § 77e (2012); Securities Exchange Act of 1934 § 12, 15 U.S.C. §§ 78*l*, 78o.

41. Robert B. Thompson & Donald C. Langevoort, Redrawing the Public-Private Boundaries in Entrepreneurial Capital-Raising 3–4 (Georgetown Univ. Law Ctr., Pub. Law & Legal Theory Research Paper No. 12-119, 2012) [hereinafter Thompson & Langevoort, Redrawing], available at http://ssrn.com/abstract=2132813 (on file with the *Columbia Law Review*) (describing legal gymnastics required under Securities Exchange Act to avoid public status).

corporation status may compromise the very diversity that is necessary to allow investors to legally diversify. This Part explains the public corporation sticky default and then argues that making the default stickier may harm investors by limiting legal diversity, and so limiting the ability to legally diversify.

A. *Sticky Default*

Ian Ayres has described a framework that explains the legal rules to which firms subject themselves as default contract terms along a continuum between optional and mandatory.[42] First, he notes that regulators give contracting parties explicit choices, or legal options, for ordering their relationship.[43] A firm and its investors are contracting parties trying to order their relationship in a way sanctioned by law. Those regulating business organizations, including state legislatures, Congress, and the Securities and Exchange Commission (SEC), publish the menus from which investors and issuers may choose their default terms and also provide methods for those firms to opt out of particular default choices—mechanisms he calls "altering rules."[44] The menu choices and the altering rules are clearly visible to the contracting parties.[45]

Because the parties have choices, and altering rules exist, not all terms are mandatory, but some are more mandatory than others. Ayres describes "sticky defaults" as being quasi-mandatory rules that regulators adopt to protect either the contracting parties themselves or third parties who may be vulnerable to negative externalities resulting from the contract.[46] A sticky default is costly to alter because regulators want parties to choose the default.[47]

In securities regulation, public corporation status is a sticky default.[48] A company does not have to be a public corporation to raise capital, but public corporation status has become a default that is difficult to opt out of.[49] Any firm that wants to issue securities must file a registration statement with the SEC unless it meets an exception.[50] Opting out of that default requires significant planning, not only in ordering the initial trans-

42. Ian Ayres, Regulating Opt-Out: An Economic Theory of Altering Rules, 121 Yale L.J. 2032, 2049–53, 2084–96 (2012).

43. Id. at 2049–53.

44. Id. at 2036.

45. This set of circumstances falls within the top left quadrant of Ayres's table describing "Permutations of Menu and Altering Rule Disclosure." Id. at 2052 tbl.3.

46. Id. at 2084.

47. Id.

48. See Brett H. McDonnell, Sticky Defaults and Altering Rules in Corporate Law, 60 SMU L. Rev. 383, 429–31 (2007) (describing difficulties associated with choosing not to become reporting company or to cease being reporting company).

49. Id.

50. Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78*l*(g) (2012).

action, but in maintaining the firm's operations in such a way that the exception continues to apply.[51]

Filing a registration statement is one way to enter the mandatory public reporting regime[52] wherein a firm has to make significant, mandatory disclosures to the market at regular intervals. Firms also incur public reporting obligations by growing to a certain size[53] or by listing on a national exchange.[54] But the choice to take on public reporting status is not permanent. Firms can "go dark" by falling below thresholds relating to their size.[55] If a firm goes dark, it only avoids public company status as long as it stays below the relevant thresholds. If it again grows beyond those thresholds by, for example, having too many beneficial shareholders and too many assets, it must again begin meeting the public reporting requirements.[56] Thus, public company status may properly be considered a sticky default because it is easy to fall into and difficult to stay out of for large or growing companies. Of course, many companies opt out of the default, but only with very careful planning.

One clear message of the public company default is that all companies should be public companies once they grow big enough.[57] While there is sound reasoning behind this stance,[58] it may eventually prove costly if it ends up funneling the wrong firms into public company status. Sticky defaults are justified where there are sufficient paternalism and externality concerns to justify pushing contracting parties toward a protective default.[59] However, opt-out should be preserved for contracting parties that do not pose those risks.[60] Congress and the SEC prefer public company status and public reporting because of the relatively significant

51. Id. (describing thresholds at which firm must enter public reporting system).

52. Id.

53. Under section 12(g) of the Securities Exchange Act, a firm must comply with public reporting requirements if it has (1) more than 499 unaccredited investors, or at least 2,000 total investors, and (2) more than $10 million in assets. Id.

54. § 78*l*(a).

55. Firms are exempt if they have fewer than 300 shareholders, or fewer than 500 shareholders and less than $10 million in assets for three years. § 78*l*(g)(1)(A), (g)(4); 17 C.F.R. § 240.12g-4 (2013).

56. § 78*l*(g).

57. See Michael D. Guttentag, Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules That Require Firms to Make Periodic Disclosures, 88 Ind. L.J. 151, 166–70 (2013) (discussing history of amendments to securities laws requiring registration by issuers meeting asset size and shareholder thresholds).

58. See id. at 193–94 (stating one motive of securities law was to "mitigate the harms to society that might otherwise be caused by large, unregulated firms").

59. See Ayres, supra note 42, at 2084 (describing standard justifications for mandatory restrictions on freedom to contract).

60. See id. at 2088 ("The goal of impeding altering rules will be to disproportionately block the more socially problematic opt-outs, while not blocking the less socially problematic opt-outs.").

paternalism and externality concerns occasioned by an investing public made up of investors facing collective action problems and informational asymmetries that prevent them from exercising significant control over issuers.[61]

B. *When Is the Default Appropriate?*

Regulators may be paternalistically worried about widely dispersed, rationally apathetic investors for several reasons.[62] Investors in large public firms are at an informational disadvantage because they rely on the firms' managers to keep them apprised of the success or failure of the businesses in which they invest. They have neither the time nor inclination to monitor those investments carefully because they are well diversified and protected by liquid public trading markets. Further, those investors are not able to coordinate to negotiate for disclosures from management because they are widely dispersed and coordination would be difficult and expensive. Unrepresented retail investors may also be significantly less sophisticated in business and investment matters than the issuers of the securities they are buying. Even though mutual funds are more sophisticated and better able to coordinate with each other to monitor management, they often find that attention to individual companies is not an efficient use of their resources.[63] They pay more attention to maintaining well-diversified portfolios and moving their substantial funds on news of trouble than to the relative success of individual firms.[64] For these reasons, regulators fear that investors in large companies with widely dispersed, relatively unsophisticated shareholders cannot

61. See Stephen M. Bainbridge, Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills, 29 J. Corp. L. 1, 29–30 (2003) (noting shareholders often follow "Wall Street Rule"—it is easier to sell stocks than to attempt to influence decisionmaking—because they suffer from collective action problems and lack incentives to gather information necessary to participate in active decisionmaking); see also Ayres, supra note 42, at 2086 (noting paternalism and concerns about negative externalities may cause lawmakers to implement "sticky defaults" that make it difficult for companies to opt out of altering rules); Donald C. Langevoort & Robert B. Thompson, "Publicness" in Contemporary Securities Regulation After the JOBS Act, 101 Geo. L.J. 337, 377–79 (2013) [hereinafter Langevoort & Thompson, "Publicness"] (describing governmental motivations for public reporting requirements).

62. See supra note 5 (defining rational apathy).

63. See Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L.J. 445, 473–74 (1991) (arguing fund managers for institutional investors do not have incentives to cooperate with one another because they compete for investors and thus are not interested in investing much in helping the whole). Institutional investors who would qualify as "accredited investors" face similar incentives and often delegate tasks such as voting the stock they hold. But these accredited investors are able to invest in private companies, so they are not the subjects of concern justifying the use of a sticky default.

64. See id. (discussing passive money managers' lack of incentives to "engage in actions that improve the performance of widely diversified funds across the board").

be counted on to negotiate for the protections and disclosures they need and so must be protected by mandatory regulation, or at least by a default that becomes quite sticky when investors are expected to be particularly vulnerable.

Large public companies can also impose externalities on the rest of the market when they contribute to systemic risk or defraud investors.[65] In addition to those who trade directly in an issuer's securities, antifraud legislation allows those who trade in derivatives whose value is affected by the value of the issuer's securities to have standing to sue in the face of material misstatements.[66] The collapse of a major company in a fraud scandal can have negative effects on the rest of the industry or the market as a whole.[67] To the extent companies and investments are intertwined in an increasingly close-knit investment community, the threat of fraud or a lack of clear, accurate disclosure can affect the market and investors beyond those who have directly purchased the offending issuer's securities. The threat of these externalities may justify making mandatory disclosure and regular reporting (subject to accuracy review and liability) a sticky default for issuers and investors.

Smaller firms have other ways to protect their investors; they must, otherwise they would have trouble attracting and keeping investors. Smaller, private firms are often more closely monitored by their investors

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65. See Iman Anabtawi & Steven L. Schwarcz, Regulating Systemic Risk: Towards an Analytical Framework, 86 Notre Dame L. Rev. 1349, 1355 (2011) (noting financial system is highly interconnected, meaning transmission of risk amongst "network" of institutions can potentially lead to systemic collapse); see also John C. Coffee, Jr., Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight, 111 Colum. L. Rev. 795, 797–800 (2011) (describing "too big to fail" phenomenon that led many firms prior to 2008 financial crisis to take on high risk and leverage, and how it contributed to systemic risk).

66. See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2012) (applying market manipulation provisions to swap agreements to same extent as they apply to securities); 15 U.S.C. § 78q(a) (setting out securities reporting requirements designed to protect investors); see also 17 C.F.R. § 240.10b-5 (2013) (including within scope of insider trading regulation all instruments, including derivatives, covered by 15 U.S.C. § 78j).

67. See Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 Stan. L. Rev. 1, 12 (2003) ("Immediately after the Enron and WorldCom scandals in the United States, the net volume of money flowing into mutual funds actually turned negative . . . even though the holders of diversified mutual funds are unlikely to suffer any significant reduction in their returns from fraud at any particular company."); see also Anabtawi & Schwarcz, supra note 65, at 1360 (describing how tight interconnectedness of nonbank financial institutions such as Bear Stearns, Lehman Brothers, and AIG contributed to 2008 financial crisis). For example, the collapse of Lehman Brothers threatened the rest of the investment banking industry because of the banks' propensity to trade with each other and the degree to which investment banks' capital was tied up in the same investments or derivatives transactions. See, e.g., Adam J. Levitin, In Defense of Bailouts, 99 Geo. L.J. 435, 456–58 (2011) (describing collapse of Lehman Brothers as example of "counterplay contagion," or domino effect, because it led to collapse of many other financial institutions that depended on Lehman Brothers's line of credit).

because those investors have entrusted more of their wealth to an individual firm and so have stronger incentives to monitor.[68] They do not and cannot count on a liquid market to protect them from agency costs and so must actively monitor management themselves. Investors in small private firms also require that the managers of those firms have more personal wealth at stake in the business's success. Many prefer the freedom managers have when they do not have to contend with the judgments of the "public" or pesky litigation spawned by zealous plaintiffs' attorneys. Because private companies are not bound to public disclosure requirements, and the increased risk of litigation that comes with them, they may be able to attract better managers at lower cost.

Investors in these smaller firms are aware that they are not protected by public reporting requirements or the public markets. Indeed, a firm may only opt out of those requirements if there are relatively few investors and/or those investors are particularly sophisticated.[69] Private firms, in most instances, do not pose the same paternalism or externality concerns as larger public firms do and so do not justify the application of a sticky default.[70] As such, not only is it worthwhile for them to opt out, but it makes sense for the law to let them. It is this heterogeneity among business forms that makes the use of a default rule, rather than a mandatory one, sensible.[71] Because businesses have different characteristics, and thus different needs, and interact with the market differently, "one size fits all" regulation is not appropriate.

C. *Sticky Default as Threat to Diversity*

Elements of the new JOBS Act may have the harmful effect of funneling firms that do not pose paternalism or externality risks into the public reporting regime. It aims to draw more companies into public company status through an on-ramp for relatively small firms. It does so by creating emerging growth companies, companies with less than $1

68. See infra Part III.B (comparing unincorporated firms with those that have incorporated).

69. 17 C.F.R. §§ 230.501–230.506; see 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation § 4.20 (6th ed. 2009) (noting "accredited investors" are not counted toward purchaser minimums in SEC Rules 505 and 506); see also id. § 4.25 (describing exemption in Rule 506 for offer and sale of securities to less than thirty-five purchasers).

70. See Ayres, supra note 42, at 2084, 2088 (discussing justifications for restrictions on freedom of contract and lawmakers' motivation for using sticky defaults rather than mandatory rules).

71. See id. at 2088 ("[W]hy not simply prohibit contracting for these disfavored outcomes? The simple answer is heterogeneity. Contracting parties may experience heterogeneous private benefits from contracting around, they might produce heterogeneous amounts of externalities, or they might produce heterogeneous paternalistic concerns.").

billion in total annual gross revenues,[72] and allowing those companies to offer securities to the public while also enjoying exemptions from several reporting requirements.[73] For example, among other differences, EGCs are able to make a public offering of securities with only two years' worth of audited financial statements and financial data, whereas companies that do not qualify for the EGC exemptions must provide three years of statements and five years of data.[74] EGCs are also subject to less stringent accounting and disclosure standards than other public companies.[75] The EGC can enjoy this quasi-public status until it either has annual gross revenues of $1 billion or more, reaches the fifth anniversary of when it issued securities pursuant to an effective registration statement, has issued more than $1 billion in convertible debt, or is considered a "large accelerated filer."[76] The new grace period for EGCs gives a new public company time to adjust to reporting requirements and to enjoy a period of relief from some of the substantial costs associated with public company status.

The EGC provisions of the JOBS Act provide small companies an inducement to issue shares to the public even if they are not ready to realize the full costs of public status, and hence may encourage them to "go public" before they are ready to and even before it is necessary for them

72. Section 2(a)(19) of the Securities Act now defines an "emerging growth company" as

> an issuer that had total annual gross revenues of less than $1,000,000,000 (as such amount is indexed for inflation every 5 years by the Commission to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics, setting the threshold to the nearest 1,000,000) during its most recently completed fiscal year.

15 U.S.C. § 77b(a)(19) (2012).

73. See, e.g., § 77e(d) (allowing EGCs to communicate with accredited investors prior to filing for registration); § 77g(a)(2)(A) (requiring only two years of audited financial statements for registration statement); § 77g(a)(2)(B) (exempting EGCs from disclosure and accounting standards in section 2(a) of Sarbanes-Oxley Act of 2002).

74. Compare § 77g(a)(2)(A) (requiring only two years of audited financial statements and selected financial data for registration statement for initial public offering of EGC), with § 77g(a)(1) (requiring three years of financial statements for registration statements generally).

75. § 77g(a)(2)(B) ("An emerging growth company . . . may not be required to comply with any new or revised financial accounting standard until such date that a company that is not an issuer . . . is required to comply with such new or revised accounting standard . . . .").

76. Id. § 77b(a)(19)(A)–(D). A "large accelerated filer" is defined as an issuer that has "an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter," and has been subject to the requirements of sections 13(a) (i.e., 15 U.S.C. § 78m(a)) or 15(d) (i.e., 15 U.S.C. § 78o(d)) for at least a year; has filed at least one annual report in accordance with section 13(a) or 15(d); and cannot use the requirements for smaller reporting companies. 17 C.F.R. § 240.12b-2 (2013).

to opt into the public company default. Emerging growth companies may want to access the public capital markets, but they are firms that may have remained private under the old rules. Once they go public, it is expensive to go private again and it may not be possible to raise the funds necessary to do so after a small firm has been publicly traded for five years.[77] It can be difficult to shrink a firm that has been allowed to grow in assets and shareholders for years. Therefore, a firm that may have trouble complying with the full array of public reporting requirements will struggle both in trying to go dark[78] and in staying public.

While public company status is an increasingly sticky default, it should still only draw companies that pose externality or paternalism concerns. As the JOBS Act entices more companies to access the public markets at temporarily lower costs, there is a risk of pushing too many companies to adopt a set of rules that does not serve them efficiently. If it is sensible for some companies to adopt an intermediate level of reporting, then making that new status temporary seems less so. However, if after a trial period, the on-ramp level of reporting seems to be sufficient for companies of a certain size, then that intermediate level of "publicness" would add yet more diversity and allow companies to have access to capital at lower cost. The potential advantages of the on-ramp approach and other policy considerations relevant to legal diversification are discussed in Part VI. For now, it is only important to understand how moving all firms to the same regulatory regime can be harmful and inappropriate.

The next Parts of this Essay argue that there are benefits to having a variety of different reporting forms and legal rules for different companies to choose from for the purpose of helping firms adapt to changing circumstances and protecting investors from the consequences of failed legal policies. Governance choices and decisions about which securities to issue matter and, if a variety of legal rules are available, parties will be able to choose the most efficient rules to govern their circumstances. This goal of diversity of legal rules should be honored as a separate and important priority.

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77. This, of course, would require that the firm make an error in judgment in deciding whether to go public. Firms are notoriously overoptimistic, though, especially with regard to IPO decisions. For example, recent IPOs from Facebook, Zynga, and Groupon performed much worse than their firms anticipated. Evelyn M. Rusli, Facebook Crossed Its $38 IPO Price, Wall St. J.: Digits (July 31, 2013, 9:35 AM), http://blogs.wsj.com/digits/2013/07/31/facebook-bounces-back-to-38-ipo-price/ (on file with the *Columbia Law Review*). It is not hard to imagine that a firm's management would overestimate the firm's expected gains upon entering the public markets.

78. "Going dark" means intentionally opting out of the public reporting requirements by falling below the statutory shareholder and asset thresholds. See supra notes 55–56 and accompanying text (explaining concept of "going dark").

III. DIVERSIFICATION AMONG LEGAL RULES GOVERNING BUSINESS FORMS

Companies seeking capital investment have a rich variety of choices when deciding what legal rules will govern the terms of their relationships with investors. Those organizing new companies make important choices about what business form to use. The choice subjects the issuer and its investors to different legal rules governing their relative rights and responsibilities. Issuers make the choices that determine the legal rules that apply to investment in their firm and investors are able to choose in which firms they invest. The market thereby imposes pressure on the issuer to sell securities worth buying and to find the mix of legal rules that allows the firm to function well while offering investors enough rights to protect their investment and hopes for return. This Part of the Essay will consider the merits of these various choices and how they differ from each other to create a diverse menu of business forms from which investors can build well-diversified portfolios.

A. *The Corporation*

With the widely dispersed, rationally apathetic investor in mind, the law governing corporations, particularly publicly traded corporations, offers regulations designed to ensure that directors and officers will not appropriate corporate funds to personal use and that they will be held accountable to further the interests of corporate wealth maximization.[79] Its design accommodates a wide separation of ownership and control.[80] Because shareholders hold the residual claim, they are considered the owners of the firm, but a ready market for shares means shareholders can exit the firm if they are unhappy with management. A board of directors, elected by shareholders, is charged with monitoring the senior officers who make day-to-day business decisions for the firm. Shareholders are thus responsible neither for daily business decisions nor for overseeing such decisions.[81] By choosing and monitoring directors, shareholders are

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79. The corporation is the business form of choice for large operating companies with widely dispersed shareholding. See Ribstein, Rise of the Uncorporation, supra note 3, at 65 (observing corporate structure helped firms grow larger during Industrial Revolution); Margaret M. Blair, Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century, 51 UCLA L. Rev. 387, 389 (2003) (arguing corporate structure was integral in development of modern industrial economy).

80. See Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 4 (1932) ("The corporate system appears only when this type of private or 'close' corporation has given way to an essentially different form, the quasi-public corporation: a corporation in which a large measure of separation of ownership and control has taken place through the multiplication of owners.").

81. Shareholders do have the power to vote to approve (or disapprove) certain major corporate actions such as the issuance of new stock or a merger. See, e.g., Del. Code Ann. tit. 8, § 251(c) (2011); Julian Velasco, The Fundamental Rights of the Shareholder, 40 U.C. Davis L. Rev. 407, 416–20 (2006) (discussing limited control rights of shareholders).

supposed to be able to protect their investment from managerial incompetence and disloyalty, while the ability to exit provides them a quick way to avoid the costs of corporate failure.

The most significant governance advantage corporate law claims over partnerships is the mandatory fiduciary relationship between corporate directors and the firm.[82] Corporate directors are said to owe fiduciary duties of loyalty and care to the corporation and have an obligation to act in good faith in all corporate matters.[83] The duty of loyalty, in its most basic form, prohibits conflicts of interest between directors and the corporation.[84] Any potential conflicts must be disclosed and approved by a disinterested majority of shareholders or directors if the conflicted director is to avoid liability.[85] Fiduciary duties are supposed to fill the gap in the corporate contract left by placing broad discretion in the hands of directors who are not carefully monitored by shareholders. The corporation relies on these amorphous duties, then, or some understanding of what they should be, to discipline managers in place of direct monitoring by owners.

The corporate form encourages investment by rationally apathetic shareholders and offers protections from the risks of their apathy. Because ownership is designed to be so widely dispersed, shareholders can easily diversify their investments among a number of corporations and rely on the protections provided by that diversification and a liquid market rather than having to invest in closely monitoring management. While investment in the stock of corporations can be profitable, many investors diversify further by participating in noncorporate opportunities. They find it worthwhile to invest funds in enterprises with fewer owners to realize the advantages of the flexibility provided by the governance structures of other business forms.

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82. See Ribstein, Rise of the Uncorporation, supra note 3, at 68–69 (discussing differences between fiduciary duties of corporate directors and managing partners).

83. E.g., 2 Jonathan R. Macey, Macey on Corporation Laws 16-136 to -141 (2013-3 Supp. 2013) (discussing varying standards courts have applied to duties of loyalty, care, and obligation of good faith).

84. E.g., Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988) ("It is a basic principle of Delaware General Corporation Law that directors are subject to the fundamental fiduciary duties of loyalty and disinterestedness. Specifically, directors cannot stand on both sides of the transaction nor derive any personal benefit through self-dealing."); see also Larry E. Ribstein, Fencing Fiduciary Duties, 91 B.U. L. Rev. 899, 901–03 (2011) (narrowly defining fiduciary duties to include only the duty to refrain from self-dealing).

85. Tit. 8, § 144(a) (discussing disinterested requirement). The disinterested requirement has been read in by courts. See, e.g., Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976) (rejecting argument against reading disinterested requirement into § 144(a)).

B. *Uncorporations*

"Uncorporations"[86] are unincorporated firms such as general partnerships, LLCs, and limited partnerships (LPs).[87] The general partnership is the most basic business form. General partnerships impose unlimited liability upon the partners who own the firm, meaning partners are personally liable for the debts of the partnership.[88] General partners actively participate in management and control of the firm and are able to take their proportionate share of the value of the firm's assets with them upon exit from the firm.[89] Partnership capital is not "locked in" to the firm as corporate assets are.[90] The abilities to directly manage the firm and to directly claim a proportionate share of firm profits and assets are fundamental benefits of the partnership form over the corporate form. Further, partnerships enjoy "flow-through" taxation, which means that partnership profits are taxed only once, as individual income for each partner.[91] Corporate profits, on the other hand, are taxed twice—once at the corporate level and again, individually, when gains are

86. Larry Ribstein coined this term to describe unincorporated firms including general and limited partnerships, limited liability companies, and other variations on those entities. Ribstein, Rise of the Uncorporation, supra note 3, at 1.

87. Larry E. Ribstein, The Uncorporation's Domain, 55 Vill. L. Rev. 125, 125 (2010) [hereinafter Ribstein, Uncorporation's Domain].

88. See Larry E. Ribstein, Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs, 73 Wash. U. L.Q. 369, 379 (1995) [hereinafter Ribstein, Statutory Forms] (noting general partners have "agreed to be personally liable for the firm's debts"); see also J. William Callison & Maureen A. Sullivan, Partnership Law and Practice: General and Limited Partnerships § 23:20 (2012) ("'Except as provided in this [Act], a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons other than the partnership and the other partners.'" (quoting Revised Unif. Ltd. P'ship Act (RULPA) § 403(b) (1985))).

89. Unif. P'ship Act § 602(a) (1997) ("A partner has the power to dissociate at any time, rightfully or wrongfully, by express will pursuant to Section 601(1)."); id. § 807(b) ("Each partner is entitled to a settlement of all partnership accounts upon winding up the partnership business. In settling accounts among the partners, profits and losses that result from the liquidation of the partnership assets must be credited and charged to the partners' accounts."); Ribstein, Uncorporation's Domain, supra note 87, at 125.

90. See Margaret M. Blair, Reforming Corporate Governance: What History Can Teach Us, 1 Berkeley Bus. L.J. 1, 23–24 (2004) (discussing limited capital lock in of Limited Liability Partnerships (LLPs) and Limited Liability Limited Partnerships (LLLPs)); Ribstein, Uncorporation's Domain, supra note 87, at 125 (distinguishing corporations from uncorporations on basis of capital lock-in).

91. Ribstein, Statutory Forms, supra note 88, at 384 ("[F]irms that adopt statutory partnership features are taxed as partnerships on a flow-through basis rather than as separate entities like corporations."); Victor E. Fleischer, Note, "If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification, 96 Colum. L. Rev. 518, 522–23 (1996) [hereinafter Fleischer, Corporate Resemblance] ("Flow-through entities, on the other hand, do not pay tax at the entity level: income earned by the entity flows through to the partners or members and is taxed only at the individual level.").

distributed to shareholders.[92] Pass-through taxation is a significant advantage to choosing uncorporate business forms.[93]

The most widely used uncorporate business forms combine the tax advantages of the partnership form with the limited liability of corporations. These "hybrid" business forms include limited liability companies and limited partnerships and contemplate active management or monitoring by owners.[94] Because these uncorporations typically have a relatively small number of owners, those owners can participate more directly in the management of the firm. They have strong incentives to watch their investment closely because they have not spread the risk of loss so widely. The relatively small number of owners also makes it easier for those owners to communicate with each other and coordinate plans for the business.[95]

An uncorporation does not have to be managed by all or any of its owners, however. Uncorporations can designate managing owners to take primary responsibility for making business decisions.[96] For example, in an LP, a general partner is responsible for making business decisions while the limited partners are passive investors who do not control the day-to-day business of the firm.[97] LLCs may be member-managed or manager-managed and frequently hire nonowner managers to operate the firm.[98] This makes larger LPs and LLCs possible.[99] As ownership of the

92. Ribstein, Statutory Forms, supra note 88, at 404; Fleischer, Corporate Resemblance, supra note 91, at 522–23.

93. Mohsen Manesh, Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs, 37 J. Corp. L. 555, 573 (2012) ("Firms utilizing the alternative entity form, over the corporate form, do so chiefly because of the favorable 'pass-through' partnership tax treatment that is afforded to alternative entities."); Ribstein, Uncorporation's Domain, supra note 87, at 131 ("[T]he double corporate tax . . . motivated firms to seek . . . single-level partnership taxation . . . . The ultimate result was new uncorporate business . . . .").

94. See Ribstein, Uncorporation's Domain, supra note 87, at 131–33 (discussing emergence and popularity of limited liability firms); see also Larry E. Ribstein, The Evolving Partnership, 26 J. Corp. L. 819, 823–24 (2001) [hereinafter Ribstein, Evolving Partnership] (stating LLCs have many partnership characteristics while also having certain corporate features).

95. See Ribstein, Uncorporation's Domain, supra note 87, at 128 (noting contracting costs are lower and private ordering is easier in closely held firms, as opposed to firms with many owners); see also Robert W. Hillman, The Bargain in the Firm: Partnership Law, Corporate Law, and Private Ordering Within Closely-Held Business Associations, 2005 U. Ill. L. Rev. 171, 179 (describing partnership as firm with small number of owners, which allows owners to interact with each other to manage firm).

96. Michael J. Garrison & Terry W. Knoepfle, Limited Liability Company Interests as Securities: A Proposed Framework for Analysis, 33 Am. Bus. L.J. 577, 582 (1996).

97. See id. at 585–86 ("[G]eneral partnerships are managed directly by the partners. . . . [L]imited partners usually do not participate in the running of the limited partnership."); Ribstein, Evolving Partnership, supra note 94, at 842–43 (describing functions of general and limited partners).

98. Garrison & Knoepfle, supra note 96, at 581–83.

firm becomes more widely dispersed, agency costs increase and the governance mechanisms designed to constrain those costs become important.

Direct monitoring is just one way uncorporations limit the agency costs of management. Uncorporations also use incentive compensation by giving managers ownership stakes that align their incentives with those of the residual claimants.[100] Even nonowner managers are paid in a way that depends on the returns those managers generate on the investments of others. A significant portion of the pay uncorporate managers earn is a function of the profits that their efforts realize for the firm's owners.[101] For example, hedge fund managers, the managers of another kind of uncorporate firm, are often paid 2% of the value of the assets under management and 20% of the returns those assets generate under management.[102]

In contrast to corporations, uncorporations do not rely heavily on fiduciary obligations.[103] The rights and obligations of owners and managers are fixed by agreement, and courts and organizing statutes allow the parties great flexibility in designing the terms of their relationship.[104]

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99. See generally Larry E. Ribstein, Uncorporating the Large Firm (Univ. of Ill. Coll. of Law, Ill. Law & Econ. Research Paper No. LE08-016, 2008) [hereinafter Ribstein, Uncorporating the Large Firm], available at http://ssrn.com/abstract=1003790 (on file with the *Columbia Law Review*) (examining uncorporate governance structures of large firms).

100. See Ribstein, Uncorporation's Domain, supra note 87, at 126–27 (discussing incentives for managers who are given ownership stakes).

101. See Ronald J. Gilson & David M. Schizer, Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, 116 Harv. L. Rev. 874, 880 (2003) (discussing manager compensation in venture capital (VC) startups); Sandra K. Miller, The Duty of Care in the LLC: Maintaining Accountability While Minimizing Judicial Interference, 87 Neb. L. Rev. 125, 181 (2008) (noting some LLC managers' compensation is tied in part to performance); Ribstein, Uncorporation's Domain, supra note 87, at 126–27 (explaining incentives and penalties for poor performance by managers); Houman B. Shadab, The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection, 6 Berkeley Bus. L.J. 240, 262 (2009) (noting hedge fund manager compensation is largely performance based).

102. See Mercer Bullard, Regulating Hedge Fund Managers: The Investment Company Act as a Regulatory Screen, 13 Stan. J.L. Bus. & Fin. 286, 288 (2008) ("For example, hedge fund managers often receive the right to twenty percent of the investment performance of a fund that exceeds a minimum performance floor, or 'hurdle rate.'"); Ribstein, Uncorporating the Large Firm, supra note 99, at 22 ("Fund partners earn an average two percent fee based on assets managed and twenty percent of the fund's profits, or 'carry,' over a threshold amount.").

103. Ribstein, Rise of the Uncorporation, supra note 3, at 219–22 (explaining uncorporations rely on other governance devices to minimize agency costs).

104. See Saul Levmore, Uncorporations and the Delaware Strategy, 2005 U. Ill. L. Rev. 195, 205–07 (noting partnership law is more flexible than corporate law); Larry E. Ribstein, The Uncorporation and Corporate Indeterminacy, 2009 U. Ill. L. Rev. 131, 142–

Owners and managers may define their fiduciary obligations by contract or may even waive them entirely.[105] This stands in stark contrast to the mandatory fiduciary duties in the governance structure of the corporation.[106] Uncorporate firms do not have to rely on fiduciary duties because they have more direct, reliable monitoring methods to use. Uncorporate owners can negotiate directly, and renegotiate if necessary, about the obligations managers will owe, how owners will monitor and discipline management, and how owners will be able to exercise their power over the firm's assets.[107]

C. *Diversifying Among Corporations and Uncorporations*

The governance structures of uncorporations and corporations are very different. Uncorporations rely on contracts, owner control, incentive compensation, and direct monitoring by owners while the corporate form relies heavily on fiduciary obligation to constrain the agency costs imposed by professional managers on widely dispersed, rationally apathetic shareholders. Publicly traded corporations must adhere to strict requirements for the board of directors, set by federal law and securities exchanges, and must engage in detailed, periodic, public reporting of important information about the firm.[108] Uncorporations, on the other hand, are able to take advantage of smaller, relatively attentive groups of equity holders to monitor and discipline managers who are much more likely to hold a significant equity stake in the firm themselves, or to be paid almost entirely with compensation that gives them strong incentives to maximize the value of the residual claim.[109] Clearly delineated exit

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43 (observing greater flexibility in uncorporations for establishing fiduciary duties through customized agreements).

105. Callison & Sullivan, supra note 88, § 12:12 ("[C]ase law makes it clear that fiduciary obligations among partners . . . may be altered by agreement if the alteration is specifically contemplated by the partners."); Ribstein, Rise of the Uncorporation, supra note 3, at 171–78 (detailing availability of opt-outs of fiduciary duties in various business organizations); Celia R. Taylor, Berle and Social Businesses: A Consideration, 34 Seattle U. L. Rev. 1501, 1509–10 (2011) (explaining, subject to limited statutory constraints, "uncorporations can contractually limit or eliminate fiduciary duties").

106. See Jeffrey N. Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. 1549, 1553 (1989) ("[M]any features of corporate law, great and small, are mandatory."); Ribstein, Uncorporation's Domain, supra note 87, at 127 ("[C]orporate statutes are generally phrased in mandatory terms with specific exceptions where the agreement controls . . . .").

107. Ribstein, Rise of the Uncorporation, supra note 3, at 8, 153, 171–78.

108. See id. at 186–89, 199–203 (detailing history of corporations' disclosure regulations and restrictions on board of directors); see also Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, 28, and 29 U.S.C.); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78kk (2012).

109. Ribstein, Rise of the Uncorporation, supra note 3, at 208 ("Consistent with the general uncorporate strategy of tying discipline to markets, partners have both upside opportunity and downside risk." (emphasis omitted)).

rights substitute for the liquid markets available to investors in public firms by giving equity holders access to the firm's capital.[110] The variety provides different ways to address agency costs and allows each firm to select the governance form that best suits its needs.

These different legal regimes suit different kinds of businesses at different times. Young companies, for instance, are more likely to be organized as uncorporations with a small group of attentive founding owners who guard their investments through direct monitoring and control[111] and can choose not to worry about amorphous fiduciary duties, as they may want to pursue other business opportunities simultaneously.[112] As a company grows and matures, those owners may want to spread the risk of loss more widely or may want to cash out their investment. That is when the firm's owners may choose to incorporate to take the firm public.[113] Then, the corporate form may make more sense in order to attend to the needs of a widely dispersed group of owners.

Further, different forms may suit different kinds of businesses. Professional firms, such as law firms and accounting firms, are required by law to be partnerships and so have adopted the limited liability partnership (LLP) to maintain the partnership business form with limited liability.[114] Investment firms may operate better as uncorporations because of the size of the investments made by owners and the direct incentives given to managers. An investment firm would not want to place primary responsibility for running the firm with independent directors, but would rather closely monitor professional investors who will manage the firm's assets in order to realize the greatest possible gain. As noted above,

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110. Id. at 5 ("This power to cash out of the firm is, in effect, a powerful control mechanism that augments the minority's voting rights."); Morley & Curtis, supra note 4, at 88 ("When a shareholder redeems, the fund pays the underlying assets to the shareholder, the fund correspondingly declines in size, and the shares are extinguished.").

111. See generally Ribstein, Rise of the Uncorporation, supra note 3, at 226–28, 246 (noting young firms are more likely to be VC firms and detailing structure of and rights in VC firms); Daniel S. Goldberg, Choice of Entity for a Venture Capital Start-Up: The Myth of Incorporation, 55 Tax Law. 923 (2002) (discussing advantages of partnership and LLC forms for startups).

112. See Paul A. Gompers & Josh Lerner, The Venture Capital Cycle 73–79 (2d ed. 2004) (discussing types of covenants utilized by VC firms to protect firm from self-dealing); Ribstein, Rise of the Uncorporation, supra note 3, at 5 ("In modern uncorporations, the owners' limited liability lets them be passive, delegate control to managers, and hold their interests as part of a diversified portfolio of investments.").

113. Ronald W. Masulis & Randall S. Thomas, Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance, 76 U. Chi. L. Rev. 219, 236 (2009) (noting risk sharing is one benefit of going public).

114. See Robert W. Hillman, Organizational Choices of Professional Service Firms: An Empirical Study, 58 Bus. Law. 1387, 1387, 1394–95 (2003) (discussing popularity and protections of LLP model); Larry E. Ribstein, Partnership Governance of Large Firms, 76 U. Chi. L. Rev. 289, 307 n.86 (2009) ("State law currently prohibits law firms from having nonlawyer owners." (citing Model Rules of Prof'l Conduct R. 5.4 (2008))).

those managers are then compensated according to the profits their efforts generate.[115]

An investor may want to take advantage of the gains riskier business enterprises realize, while maintaining greater exit rights and monitoring abilities, and then also seek comfort in larger, more established, less risky investments that do not need to be monitored as carefully. The advantages of the uncorporate form allow firms to engage in a different kind of management and allow them to take different kinds of business risk. The ability of owners of uncorporate firms to opt out of fiduciary duties means that those firms can attract entrepreneurs who may have some potentially conflicting business interests but who may also bring a talent for the business and valuable connections to the firm. The flexible, contract-based nature of uncorporate firms also means that they are able to experiment with different governance forms and different contracts among owners and between owners and managers. Those experiments may reveal governance structures that maximize profitability in new and different ways.

Investors should participate in these experiments. They should sample among them to take advantage, at least to a small extent, of innovations in business operations and in limiting the agency costs of management. New and flexible business forms allow experimentation with governance that may uncover better ways to maximize profit while limiting agency costs. Through legal diversification, investors can participate in that experimentation while also investing in better-established, well-known governance forms.

While all Delaware public corporations will not collapse at the same time because of the governance rules to which they are subject, a systematic failure of that governance regime could cause Delaware public corporations, on average, to experience more governance problems, and thus higher agency costs, than other kinds of firms. For example, a significant decision by the Delaware Supreme Court refusing to impose liability against managers for a certain kind of troubling behavior could increase the risk that shareholders will suffer an injury at the hands of managers of Delaware corporations. Or, a well-intentioned governance policy, such as options compensation, could have unintended consequences leading a large number of managers subject to that kind of compensation to systematically cause the firms they manage to take ill-advised risks. Given that risk exists, particularly when governance is far from perfect and the system has yet to find ways to completely eradicate the agency costs of firm governance, an investor is well advised to invest in a number of kinds of firms and of securities in order to profit from the advantages each set of legal rules provides investors.

115. See supra notes 100–102 and accompanying text (discussing how managers of uncorporations are compensated based on firm's profits).

Business form is not the only way to diversify among legal regimes governing investment. An investor may also diversify by legal regime governing particular securities. Even within a single firm, an investor may buy securities governed by different legal rules. The next Part examines the different rules governing securities and considers how an investor may diversify among them.

IV. LEGAL RULES GOVERNING SECURITIES

Regardless of the business form chosen, a firm must raise capital by issuing securities or borrowing money. If the firm issues debt or equity securities, it must decide whether those securities will be publicly or privately held, thereby deciding what legal rules will govern the relationship between the issuing firm and the investors who purchase the securities. Investors may decide to hold different kinds of securities governed by different legal rules not only because they represent different kinds of capital investments, but also because of the different legal protections provided for each kind of security. For instance, holding private equity may allow an investor to capture a larger proportionate share of the gains generated by a particular company and to avoid the costs the company would incur in honoring public disclosure obligations, but that investor would miss out on the advantages of the liquid trading markets accompanying public equity.[116] Public debt may have advantages in that it is less risky than public equity in many instances, and bondholders are represented by indenture trustees who can help them overcome the collective action problem affecting widely dispersed groups of investors, but the lower risk associated with bonds may mean lower returns, and bondholders do not benefit from corporate fiduciary duties or shareholders' voting rights.[117] Holding a diverse set of different kinds of securities may help an investor diversify risk, but it will also allow investors to hold securities with fundamental characteristics that differ, not only in where they fall in a capital structure, but also with regard to the rights investors have against the firm and the protections from agency costs. This Part demon-

116. See Steven E. Hurdle, Jr., Comment, A Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures, 53 UCLA L. Rev. 239, 245–48 (2005) (explaining holding private equity can enable investor to meet exemptions under Securities Act of 1933 and Investment Company Act of 1940); see also 15 U.S.C. § 77d(a)(2) (2012) (exempting from reporting requirements transactions that do not include public offering); id. § 80a-3(c)(1) (exempting private equity firms from disclosure and reporting requirements).

117. Yakov Amihud, Kenneth Garbade & Marcel Kahan, A New Governance Structure for Corporate Bonds, 51 Stan. L. Rev. 447, 469–70 (1999) (suggesting new governance structure to overcome current collective action problems); Steven L. Schwarcz & Gregory M. Sergi, Bond Defaults and the Dilemma of the Indenture Trustee, 59 Ala. L. Rev. 1037, 1037–38 (2008) (discussing role of indenture trustee in mitigating collective action problems amongst bondholders).

strates how an investor can diversify among different kinds of securities by considering the important legal protections each kind of security offers and showing how those legal features can be profitable in different circumstances. An investor legally diversifies in important ways when she invests in securities governed by different legal rules because she is buying different legal protections against risks of loss and is buying different legal rights to the assets of the firms.

A. *Public Equity*

A firm issuing equity securities must register those securities with the SEC before offering them to the public unless it can show that the issuance is a private placement or fits into another exception to the registration requirement.[118] Under the Securities Exchange Act, an issuer with at least 2,000 shareholders, no more than 499 of whom are unaccredited investors, and more than $10 million in assets must enter the periodic disclosure system and make annual and quarterly disclosures to the market.[119] The securities laws apply in full force to companies with publicly traded equity and are designed to offer significant protections to investors in the capital markets.

Investors derive many benefits from the disclosure requirements. Most significantly, the federal securities laws require public companies to disclose material information to the market to allow investors to reliably value companies' securities, facilitating informed decisions about whether to buy or sell those securities and what prices to use.[120] Regular disclosures from the company allow shareholders, or their representatives, to monitor management and can help shareholders decide when changes should be made to the firm's executive team.[121] Sophisticated stock analysts can follow publicly traded companies, inform investors of the condition of those companies, and give advice about how to trade in the company's securities. Because the disclosures are public and analysts and institutional shareholders pay attention to them, the information

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118. Section 5 of the Securities Act of 1933 requires all nonexempt offerings to be registered. 15 U.S.C. § 77e(c).

119. Securities Exchange Act of 1934 §§ 12(g), 13(a)(2), 15 U.S.C. §§ 78*l*(g), 78m(a)(2).

120. See William K. Sjostrom, Jr., Carving a New Path to Equity Capital and Share Liquidity, 50 B.C. L. Rev. 639, 643–45 (2009) (describing various disclosure laws intended to protect investors through public availability of information); see also 15 U.S.C. §§ 77a–77z-3 (regulating creation, use, and registration of securities); id. §§ 78a–78mm (setting out extensive regulation of securities exchanges).

121. Sjostrom, supra note 120, at 643–45 (describing disclosures required annually, quarterly, and as needed).

disclosed will be incorporated into stock prices even if lay investors never hear of them.[122]

Given the protections securities regulations provide, the public corporation can be a particularly safe option for rationally apathetic investors. They have the protections of state corporation law, which give them an independent board to oversee managers on their behalf, and they have teams of sophisticated professionals monitoring those firms through the public disclosures those companies are required to make. A rationally apathetic investor could assure diversification and then let her investments virtually take care of themselves. The market liquidity provided by active markets in publicly traded stock allows investors to more easily diversify their stock holdings and to exit firms when a particular security is underperforming.[123] This liquidity also helps the market value securities in a reasonably reliable way so that investors feel confident trading in stock at given prices. The antifraud regulations enforcing the accuracy of required disclosures support the prices the market sets for publicly traded stock.[124]

The regulations governing the issuance of public equity and compliance with the mandatory reporting system impose significant costs on issuers, costs that prevent many issuers from opting into the public company regulatory regime. There are, therefore, great, profitable companies that remain private. Indeed, many firms find that the advantages of remaining private allow them to exploit different business opportunities or to operate more profitably than they could if they were forced to comply with public company regulation.[125] The gains available through investment in private equity may entice investors away from the highly regulated public market, providing another avenue for diversification.

122. See Eugene F. Fama, Efficient Capital Markets: II, 46 J. Fin. 1575, 1575 (1991) (defining market efficiency hypothesis as statement that security prices fully reflect all available information); see also Basic Inc. v. Levinson, 485 U.S. 224, 246 (1988) ("'[C]ompeting judgments of buyers and sellers as to the fair price of a security brings *[sic]* about a situation where the market price reflects as nearly as possible a just price.'" (alteration in *Basic Inc.*) (quoting H.R. Rep. No. 73-1383, at 11 (1934))).

123. All stocks are essentially fungible. See Claudio Loderer et al., The Price Elasticity of Demand for Common Stock, 46 J. Fin. 621, 621 (1991) ("A common assumption in finance theory is that individual assets have perfect substitutes."). But see Alicia Davis Evans, The Investor Compensation Fund, 33 J. Corp. L. 223, 263 n.204 (2007) (questioning Loderer's statement that all stocks have perfect substitutes).

124. See *Basic*, 485 U.S. at 246–47 (finding market price of shares reflects all publicly available information, and thus, any material misrepresentations).

125. See infra notes 151–154 and accompanying text (discussing Dell's buyout and its ramifications).

B. *Private Equity*

Because issuing public securities is expensive, both initially and for the duration of the issuance, companies often try to avoid public company status by keeping their ownership shares privately traded. Staying private can take some careful planning and often requires turning to sophisticated investors in order to raise substantial capital. A firm may organize its equity issuance so that it fits within an exception to the registration requirements of the Securities Act.[126] In doing so, firms focus on finding sophisticated, or "accredited," investors to invest in the company's equity.[127] These accredited investors can be institutional investors who are representing large numbers of retail, or unaccredited, investors such as pension or retirement funds.[128] They can also be wealthy individual investors who are investing a relatively small portion of their wealth in the firm.[129] In a private placement, less sophisticated investors may participate, but they must be close to the issuer and have access to detailed information about the issuer to facilitate careful monitoring of the firm.[130] When trying to stay private after issuing stock as a private company, firms focus on keeping the number of equity holders in the firm

126. Regulation D contains exemptions from the section 5 registration requirements. 17 C.F.R. § 230.501 (2013). Rule 504 provides an exemption for the offer and sale of up to $1 million of securities in a twelve-month period. § 230.504. General offerings and solicitations are permitted under Rule 504 as long as they are restricted to accredited investors. Id. Rule 505 provides an exemption for offers and sales of securities totaling up to $5 million in any twelve-month period. § 230.505. The issued securities are restricted, in that the investors may not sell them for at least two years without registering the transaction. Id. General solicitation or advertising to sell the securities is not allowed. § 230.502(c).

127. The federal securities laws define the term "accredited investor" to include investment banks, pension funds, retirement funds, insiders of the issuer, and individuals with net worth exceeding $1 million. § 230.501(a).

128. See 1 Stuart R. Cohn, Securities Counseling for Small and Emerging Companies § 6:17, at 260 (2012) (providing examples of institutional investors under 17 C.F.R. § 230.501(a)(1)); Roberta S. Karmel, Regulation by Exemption: The Changing Definition of an Accredited Investor, 39 Rutgers L.J. 681, 684 (2008) (noting problems with "accredited investor" definition and resulting changes); So-Yeon Lee, Note, Why the "Accredited Investor" Standard Fails the Average Investor, 31 Rev. Banking & Fin. L. 987, 1007 (2012) (explaining institutional investors currently dominate market); Greg Oguss, Note, Should Size or Wealth Equal Sophistication in Federal Securities Laws?, 107 Nw. U. L. Rev. 285, 295 (2012) (detailing which institutions are "qualified institutional buyers" under Rule 144A).

129. See Oguss, supra note 128, at 293–94 (stating wealthy individual investors also qualify under Securities Act's "accredited investor" definition).

130. See 17 C.F.R. § 230.501(h) (providing requirements of purchaser representative); Hazen, supra note 69, § 4.25, at 577 (noting nonaccredited investors "must have such knowledge and experience in financial and business matters that the purchaser . . . is capable of evaluating the merits and risks of the prospective investment").

below the public reporting thresholds,[131] limiting the trading of their securities, and ensuring that their securities are held by accredited investors.[132]

Scholars are beginning to pay more attention to online secondary markets in these privately traded securities.[133] Elizabeth Pollman points out that the presence of a liquid market without the protections provided in the public markets leads to the same problems one would expect from an active, unregulated market in securities—asymmetric information and insider trading.[134] But the ease and lower costs associated with being able to avoid public reporting and registration status by trading on private markets instead enable smaller firms to raise capital and provide liquidity to their investors on a scale they could not achieve if they were forced to go public as a consequence.[135]

It might seem unfair that only sophisticated, accredited investors are able to invest in private equity, and so enjoy the significant profits those firms can generate.[136] To the contrary, not only can most individuals participate in private offerings and private equity through the sophisticated institutional investors that manage their investments (often through managed retirement accounts),[137] but "unsophisticated"

131. Section 12(g) of the Securities Exchange Act exempts firms not trading on a national exchange that have less than $10 million in assets held by fewer than 2,000 persons or 500 unaccredited investors. 15 U.S.C. §§ 78*l*(g), 78m(f) (2012).

132. See 17 C.F.R. § 230.501(a) (defining "accredited investor"); Jasmin Sethi, Another Role for Securities Regulation: Expanding Investor Opportunity, 16 Fordham J. Corp. & Fin. L. 783, 800 (2011) (discussing accredited investor requirement for hedge fund investment); Hurdle, supra note 116, at 246 (noting Regulation D safe harbor rule letting firm "enter into a partnership with an unlimited number of 'accredited investors' and up to thirty-five additional investors who are 'sophisticated'" (footnote omitted)).

133. See, e.g., Langevoort & Thompson, "Publicness," supra note 61, at 349–50 (discussing emergence of secondary markets for trading private securities); Elizabeth Pollman, Information Issues on Wall Street 2.0, 161 U. Pa. L. Rev. 179, 180 (2012) (same); see also Darian M. Ibrahim, The New Exit in Venture Capital, 65 Vand. L. Rev. 1, 15 (2012) (explaining possibility of emergence of secondary markets as "potential game changer in venture capital").

134. Pollman, supra note 133, at 207, 216 (noting lack of information present in private secondary markets can result in information asymmetry and insider trading).

135. Id. at 203–05, 235 (explaining secondary markets enabling companies to remain private can increase liquidity in private company stock, which in turn assists private companies in raising capital).

136. See Usha Rodrigues, Securities Law's Dirty Little Secret, 81 Fordham L. Rev. 3389, 3390–91 (2013) ("The dirty little secret of U.S. securities law is that the rich not only have more money—they also have access to types of wealth-generating investments not available, by law, to the average investor."); Lee, supra note 128, at 987 ("Surprisingly, U.S. securities regulations award special investment privileges to the already affluent, resulting in a legal system that makes it even easier for them to amass wealth.").

137. See Langevoort, supra note 4, at 1030 ("Increasingly . . . retail investment decisions relate to investing in a mutual fund or insurance product, making retirement

individuals are also predominantly the owners of small, local businesses that never go public. Even in larger private firms, employees make up a significant share of the owners.[138] Investors are trusted to fend for themselves in these investments because of their close knowledge of the issuer and their particularly strong ability to monitor the firm and its management. Retail investors can also seek the profits of private firms by investing in public holding corporations that invest in privately traded stock.[139] Berkshire Hathaway is an example of the public holding company model, but newer firms are springing up with the specific goal of investing in smaller, younger private firms.[140] Granted, many unsophisticated investors are not engaging in the secondary market trades in private equity, nor are they investing *directly* in private equity funds or hedge funds, but to say they have no access to those markets does not quite tell the whole story.

Private equity plays important roles at different points in a company's life cycle. Many firms begin with venture capital support.[141] Venture capital firms that supply initial investment expect to exit the firm eventually, either by selling the firm to another (often publicly traded)

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plan elections, or deferring to account management by a brokerage firm or investment adviser, rather than investing directly in issuers' securities.").

138. See Pollman, supra note 133, at 194 n.82 ("Just prior to the date of this publication, SecondMarket released third quarter data indicating that companies are engaging in share buy-back programs and that an increasing percentage of sellers are current employees."); see also The Q3 2012 SecondMarket Report, SecondMarket (Nov. 9, 2012), https://www.secondmarket.com/education/reports/q3-2012-secondmarket-report (on file with the *Columbia Law Review*) (demonstrating companies are engaging in share buyback programs and increasing percentage of sellers are current employees).

139. See Tomio Geron, With GSV Fund, the Little Guy Can Shoot for the Next Facebook, Forbes (May 16, 2011, 1:57 AM) [hereinafter Geron, Little Guy Can Shoot], http://www.forbes.com/sites/tomiogeron/2011/05/16/with-gsv-fund-the-little-guy-can-shoot-for-the-next-facebook/ (on file with the *Columbia Law Review*) (describing how new "publicly-traded closed-end mutual fund" will allow unaccredited investors to invest in private companies).

140. See Tomio Geron, GSV Capital Investment Values Facebook at $70 Billion, Forbes (June 27, 2011, 1:38 PM), http://www.forbes.com/sites/tomiogeron/2011/06/27/gsv-capital-investment-values-facebook-at-70-billion/ (on file with the *Columbia Law Review*) (describing how "publicly-traded, closed-end mutual fund" will "give retail investors access to new high growth tech companies" (internal quotation marks omitted)); Geron, Little Guy Can Shoot, supra note 139 (describing how "new publicly-traded closed-end mutual fund" GSV was formed to allow "retail investors to invest in new growth companies"); Randall Smith, GSV Capital, Placing Bets on Start-Ups, Falters, N.Y. Times: Dealbook (Aug. 29, 2012, 8:35 PM), http://dealbook.nytimes.com/2012/08/29/gsv-capital-placing-bets-on-start-ups-falters/ (on file with the *Columbia Law Review*) ("GSV, short for Global Silicon Valley, is the largest of several closed-end mutual funds that offer ordinary investors a chance to own stakes in privately held companies, at least indirectly.").

141. See Ronald J. Gilson, Engineering a Venture Capital Market: Lessons from the American Experience, 55 Stan. L. Rev. 1067, 1070–71 (2003) (providing overview of venture capital cycle); Pollman, supra note 133, at 184 (explaining venture capital cycle).

company or by taking the firm public on its own.[142] The startup money is vitally important to the firm as it begins and grows, and the timing of exit is important to the venture capital firm.[143] Investing in these firms at this early stage can be very lucrative.[144] Of course, most investors will never be able to invest in a firm at this early stage, but the legal terms of the investment are still vitally important to its success. Pushing companies to go public too soon or forcing them all to be corporations would undermine essential characteristics of this important phase of development.

Private equity funds that invest in publicly traded businesses to take those businesses private also play an important role at a different point in a firm's life.[145] For example, private equity firms often take public firms private when they are experiencing financial difficulty.[146] The private equity firm reorganizes the troubled firm, often cutting costs and reorganizing its capital structure, before selling the firm to another company or offering its stock to the public again.[147] This public-private-public cycle can serve as an alternative to bankruptcy and can reap significant, relatively short-term[148] profits for the private equity fund's investors. Allowing investors to participate in these funds and allowing those firms to remain private enable investors to diversify in a different way. When firms file for bankruptcy protection, the equity position is usually minimal or nonexistent and shares are typically considered worthless. When a firm goes private to reorganize, those who can invest in the private firm are able to realize the profits from reorganization. Investing in private equity can be a way for investors of all kinds to hedge against the risk of financial failure and even to diversify away some risk of market- or industry-wide fi-

142. See Victor Fleischer, The Missing Preferred Return, 31 J. Corp. L. 77, 83 (2005) (stating venture capital firm's "ultimate goal is to take the portfolio companies public or sell the companies' stocks or assets to another company"); see also Ibrahim, supra note 133, at 11–15 (describing decreasing availability of traditional exits employed by venture capital firms); Pollman, supra note 133, at 184 (stating goal for venture capital "start-up" companies is to achieve successful exits).

143. See Gompers & Lerner, supra note 112, at 168 (explaining why firms turn to venture capitalism over more traditional financing).

144. Rodrigues, supra note 136, at 3397–401 (explaining angel investments and venture capital investments in "budding" company can be very profitable).

145. See Jonathan R. Macey, Corporate Governance: Promises Kept, Promises Broken 246 (2008) (describing increasing importance of private equity investors in corporate governance in light of cost and difficulty involved in company going public).

146. See id. at 241 (stating private equity firm will typically delist public company it invests in and hold it private in order to reorganize it).

147. Id. ("During that period, the private equity firm works with management to reshape its strategy, restructure its organization, [and] strengthen its corporate governance . . . . [T]he private equity firm then 'unlocks the value' of the investment by selling the company in a public or private offering . . . .").

148. The time horizon to recoup these investments is generally three to five years, which is considered short-term. See id. at 249 (stating typical time frame for private equity investor is five years, and hedge funds attempt to recoup even quicker than five years).

nancial downturn. They can recoup lost profits through the profits generated for private equity through reorganization.

Many are skeptical of the net societal benefits of private equity.[149] This Essay is not concerned with establishing whether these funds always do what is best for society or even whether they do more good than bad. There are certainly valid concerns about leveraged buyouts that would qualify as effective fraudulent conveyances and inappropriate payouts to managers.[150] The point this Essay is making is that those funds can realize profits from reorganizing a firm and that it would be beneficial to diversification of investment portfolios to allow investors to participate in those profits.

The private status of private equity funds is essential to the success of this reorganization process. Those who work so hard to reorganize troubled firms would not have the incentives to do so if they had to share their profits with millions of public shareholders, nor would they want to incur the expense of complying with public disclosure requirements. For example, Dell recently announced that it was going private.[151] The motivation for the move was to reorganize the troubled company and to do so, in part, by taking bold business risks that public shareholders might not tolerate.[152] The firm could then attend to the difficult business of redefining its operations beyond the judgmental eye of the public cap-

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149. See, e.g., Michelle M. Harner, Corporate Control and the Need for Meaningful Board Accountability, 94 Minn. L. Rev. 541, 554–55 (2010) [hereinafter Harner, Corporate Control] (noting concerns regarding impact of private fund activism on long-term corporate value); see also Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1083–87 (2007) (describing "short-termism" concerns regarding private equity funds).

150. See Harner, Corporate Control, supra note 149, at 558–59 (noting activism in private funds can lead to conflicts of interest and self-dealing behavior by stakeholders in times of corporate distress); see also Michelle M. Harner, Activist Distressed Debtholders: The New Barbarians at the Gate?, 89 Wash. U. L. Rev. 155, 167–68 (2011) (describing hazards of debt-to-equity play by private equity firms and noting recent cases in which fraudulent conveyance claims have emerged after leveraged buyouts).

151. Michael J. de la Merced & Quentin Hardy, Dell Shares Rise on News Company May Go Private, N.Y. Times: Dealbook (Jan. 14, 2013, 2:20 PM), http://dealbook.nytimes.com/2013/01/14/dell-shares-surge-after-report-of-possible-buyout/?hpw (on file with the *Columbia Law Review*) ("Bloomberg News reported that the beleaguered personal computer [company] was in talks with at least two private equity firms over a potential buyout."); see Ben Worthen & Anupreeta Das, Dell: From PC King to Buyout Fodder, Wall St. J. (Jan. 17, 2013), http://online.wsj.com/article/SB10001424127887324595704578244174200133296.html (on file with the *Columbia Law Review*) (explaining "buyout group would include [a] private-equity firm").

152. See de la Merced & Hardy, supra note 151 ("While a buyout would not solve any of Dell's problems, it would enable the company to take radical measures without the harsh glare of shareholders."); see also Worthen & Das, supra note 151 (predicting buyout will allow Dell to act without regard to quarterly earnings).

ital markets.[153] The reorganization may well be profitable, to the tune of a potential 20% return on investment.[154] However, it is a risky and debt-laden process, not a risk unsophisticated investors would be well advised to take on their own.

The use of institutional investors as "accredited" or "sophisticated" investors allows the rationally apathetic retail investor to participate in these profits in some way, even though she would not be able to invest in these private firms directly.[155] The accredited investor requirement aims to protect retail investors from the lower level of regulation to which private equity is subject.[156] This is one way in which the securities laws try to pinpoint when opting out of the public company default is less likely to impose externalities. The presence of sophisticated traders, whether or not they are representing unsophisticated traders, should help to protect investors without resort to mandatory disclosure. The sophisticated intermediary will stay informed about the firm and make necessary investment decisions. While the unsophisticated beneficial owners or beneficiaries may be vulnerable to agency costs resulting from the delegation of investment authority to the institutional investor, they may also be better at monitoring the performance of their investment account or choosing among advisors than they are at carefully monitoring an operating company.[157] The delegation may make sense, then, even in the face of additional agency costs, and the ability to diversify investment to yet another very active part of the market may more than make up for additional risks and the costs of forgoing the protections of public reporting requirements.

Although there are fewer protections for retail investors in private equity, and access to private equity is relatively limited, it is very important that investors be given access to this sector of the market for the benefits of diversification it provides. Usha Rodrigues's suggestion to open the private markets to mutual funds may prove a promising avenue

153. See de la Merced & Hardy, supra note 151 (explaining Dell stock suffered while Dell tried to cut reliance on PC business); see also Worthen & Das, supra note 151 ("Going private could allow Mr. Dell to continue reorienting the company around hardware, software and services for businesses, without having to worry about keeping up quarterly earnings during the process.").

154. Worthen & Das, supra note 151 ("Even if Dell's free cash flow drops off, its private-equity investors could achieve returns of 20% on a deal . . . .").

155. See supra notes 127–132 and accompanying text (discussing "accredited" investors and how retail investors can invest in private firms through them).

156. See 15 U.S.C. § 77d (2012) (outlining transactions exempted from restrictions and prohibitions on securities exchanges); Hazen, supra note 69, § 4.24 (describing private placement exemption).

157. See D. Bruce Johnsen, Myths About Mutual Fund Fees: Economic Insights on *Jones v. Harris*, 35 J. Corp. L. 561, 605 (2010) (stating institutional clients are willing to directly monitor their managers, or hire sophisticated consultants to do so, in order to guarantee high quality management).

for legal diversification as well.[158] Investment in private equity allows investors to realize benefits from investing in particular parts of a company's life cycle, and it also allows investment in firms with goals and risk preferences that would be ill suited to the public markets. Investment in private equity could then fit nicely into a well-diversified portfolio for both investment and legal purposes. The freedom from legal regulation enjoyed by private equity firms allows them to take bigger risks and to attract large investments from sophisticated parties relatively quickly. This legal advantage correlates to higher returns in important ways. Thus, legal diversification is an important component of investment diversification.

C. *Public Debt*

The Trust Indenture Act of 1939 governs the issuance of public debt securities.[159] An indenture trustee acts on behalf of the firm's public bondholders,[160] helping them overcome their collective action problem by representing their interests to management and enforcing the covenants of the indenture.[161] While the indenture trustee is relatively weak and inactive through most of the firm's life, it can become particularly powerful if the issuing firm files for bankruptcy.[162] Then, indenture trustees often sit on the powerful Committee of Unsecured Creditors and can heavily influence the reorganization of the firm.[163] The indenture trustee is one advantage bondholders have over similarly dispersed public shareholders. The fixed claim and liquidation preference of debt are others.

Again, it is not just the position in a firm's capital structure or the relative risk profile of a security that can provide an advantage to investors in that security. The legal rights those investors have also provide

158. Rodrigues, supra note 136, at 3430–34 (suggesting possible solution to limited access of private investors to private equity is to alter regulations, specifically liquidity requirements, currently deterring mutual funds from investing in sector).

159. 15 U.S.C. §§ 77aaa–77bbbb.

160. See id. § 77jjj(a)(4) ("In the case of certificates of interest or participation, the indenture trustee or trustees shall have the legal power to exercise all of the rights, powers, and privileges of a holder of the security or securities in which such certificates evidence an interest or participation.").

161. See Schwarcz & Sergi, supra note 117, at 1043–45 (describing various duties of indenture trustee and how Trust Indenture Act of 1939 enabled public bondholders to overcome collective action problem).

162. See Efrat Lev, The Indenture Trustee: Does It Really Protect Bondholders?, 8 U. Miami Bus. L. Rev. 47, 108–11 (1999) (describing trustee's many responsibilities in bankruptcy context).

163. See id. at 110 (noting many trustees serve on creditors' committees and trustee also has standing to seek changes in size and membership of committee or appoint additional committee); see also 11 U.S.C. § 1102 (2012) (describing appointment of committees of creditors and role of such committees).

advantages that may suit the investor in different ways in different circumstances. The use of an indenture trustee to represent bondholders gives them the ability to directly monitor and negotiate with the firm's managers in ways shareholders cannot.[164] The indenture trustee enforces the covenants in the bond indenture, covenants that give bondholders the authority to limit corporate action in times of financial distress.[165] Thus, not only do bondholders have the advantage of the fixed claim and liquidation preference afforded debt, but they are also able to directly influence managers' decisionmaking and corporate action when the firm is at or near insolvency. These particular advantages are conferred by the legal rules that apply to bond indentures and the ways those indentures are enforced. Investing in the set of legal rules that governs bonds is another important way for investors to legally diversify.

D. *Derivatives*

Investors, unsophisticated and sophisticated alike, flock to derivatives trading to hedge risk and to engage in speculation and arbitrage.[166] While some particularly complex derivatives are blamed in part for the systemic risk the economy faced in 2007 to 2008, trading in options has proven a successful way to hedge the risk of many investments.[167] The derivatives market is the world's largest market, but is still relatively lightly regulated.[168] While derivatives are securities subject to antifraud regulation, they are privately traded and many are completely private,

164. Shareholders often free ride on the monitoring of management creditors. See Charles K. Whitehead, Creditors and Debt Governance, *in* Research Handbook on the Economics of Corporate Law 68, 75–76 (Claire A. Hill & Brett H. McDonnell eds., 2012) ("Trading among a small group of informed investors, however, can still result in the public release of a substantial amount of private information through competitive pricing. Others can rely on that information to make their own investment decisions . . . .").

165. See Schwarcz & Sergi, supra note 117, at 1045 ("The indenture trustee must notify bondholders of a payment default, but need not notify bondholders of lesser defaults if it determines in good faith that withholding such notice is in the interests of bondholders.").

166. See William A. Klein et al., Business Organization and Finance: Legal and Economic Principles 403 (11th ed. 2010) (describing widespread investment in derivatives).

167. M. Todd Henderson, Credit Derivatives Are Not "Insurance," 16 Conn. Ins. L.J. 1, 23 (2009) (describing options as insurance hedging against risks for multiple parties).

168. Klein et al., supra note 166, at 403; see id. at 455 (discussing proposed regulatory reforms of requiring some derivatives to be traded on centralized clearing houses and related regulation of credit rating agencies, "which played a prominent role in the creation and sale of complex financial instruments").

undisclosed, unregulated securities that are known only to the parties involved.[169]

Derivatives are contracts between counterparties to take certain actions based on the performance of some other, underlying security.[170] Their value then "derives" from the underlying security.[171] Parties to derivatives can participate in financial gains and losses on other instruments without ever investing in the underlying security.[172] This allows investors to participate in investment returns at a much lower up-front cost.[173] Derivatives can also help investors shift risk or insure themselves against some investment risk to which they are already exposed.[174] Investment in derivatives is an important investment diversification strategy, and provides yet another opportunity for investors to define the terms and protections of their investment by contract and without regard to heavy federal regulation.

All of the securities presented in this Part provide different levels of protection, risk, and return for investors. Well-diversified investors could invest in all of them and benefit from the various levels of protection. Investors may choose to invest in different places in one firm's capital structure or can invest in both privately and publicly traded equity securities issued by different companies. Investors can also directly hedge against risks or take advantage of arbitrage opportunities at relatively low cost with derivatives. Overall, the various opportunities for diversification allow investors to invest in the same company in different ways, in different companies with similar traits, or in different companies in different stages of their life cycles. The legal rules governing these securities correlate to the levels of risk and investor protections in important ways that allow investors to diversify across different investment characteristics more meaningfully.

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169. See id. at 455 (describing role of credit rating agencies in creating and selling derivatives and proposed reforms to eliminate regulator dependence on ratings from these agencies).

170. See id. at 403 (discussing two types of derivatives, options and forwards, representing two different types of obligations to take certain actions based on performance of underlying securities).

171. Id.

172. See id. at 404 ("Speculators frequently use derivatives as a more efficient or less costly means of getting financial exposure to the underlying asset.").

173. Id.

174. See id. at 403–04 (describing hedging through example of farmer using futures or forwards to lock in price at which he will sell his wheat harvest at specified future date).

V. LEGAL DIVERSIFICATION AS A COMPLEMENT TO OTHER MARKET DIVERSITY PRIORITIES

Mark Roe has argued that the American legal system has deliberately chosen a decentralized system of corporate and financial governance that consists of ownership and control widely dispersed among various investors, including institutional investors.[175] He has pointed to many rules in the system that discourage or prohibit large institutional investors from owning controlling blocks in corporations.[176] Recent regulation has continued to favor decentralization. The Dodd-Frank Act includes regulations that do even more to prevent banks from owning large portions of the securities market and to decentralize investment to mitigate systemic risk.[177] This focus on decentralization prevents a small number of institutions from controlling an outsize share of the U.S. capital markets and aims to protect investors from the systemic risk they cannot diversify away. Again, American corporate and financial laws have favored decentralization and diversity (in types of investors and investments) as a means of protecting the integrity of the financial markets, as well as mitigating the risk of catastrophic systemic failure, much in the way investment diversification does for individual investors.

Scholars have recognized that society can realize similar benefits by promoting the decentralization of regulation. Some argue that securities regulation should be decentralized, or even privatized, so that individual jurisdictions (such as states or securities exchanges) can enact a variety of securities regulatory schemes, and that the resulting experimentation will reveal the optimal form of regulation.[178] Others argue that securities laws should be stripped down significantly to regulate investors and allow those investors to make market choices about how they want companies to behave[179] or to focus only on antifraud regulation to allow investors to

175. Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10, 11 (1991).

176. Id. at 26–29 (outlining restrictions on control under Securities Exchange Act).

177. See 12 U.S.C. § 1852 (2012) (mandating concentration limits on large financial firms); see also Michael S. Barr, The Financial Crisis and the Path of Reform, 29 Yale J. on Reg. 91, 99 (2012) (stating new Dodd-Frank amendments subject major firms to "new concentration limits, which will prohibit mergers or acquisitions that would result in one firm's liabilities exceeding 10 percent of the liabilities of financial companies as a whole").

178. See Coates, supra note 11, at 532 (describing academic debate over devolution of securities regulation); see also Stephen J. Choi & Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 S. Cal. L. Rev. 903, 907 (1998) (proposing highly decentralized global regulation of capital markets); Paul G. Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1453, 1455 (1997) (proposing decentralized regime with more authority devolved to securities exchanges); Romano, For Diversity, supra note 3, at 3 (advocating diversity in global securities regulation to reduce systemic risk).

179. See, e.g., Stephen Choi, Regulating Investors Not Issuers: A Market-Based Proposal, 88 Calif. L. Rev. 279, 280 (2000) (proposing less mandatory regulation for

negotiate with firms over other rights.[180] In a similar vein, growing trends in the financial regulation literature illuminate the risk imposed by coordinated regulation of financial firms and markets and urges diversity in that regulation to avoid the costs of too much coordination.[181]

Legal diversification as a platform is consistent with, but distinct from, the goals of decentralization. Whereas decentralization promotes competition among legal regimes as a means of identifying optimal regulatory schemes, legal diversification promotes the proliferation of regulatory frameworks to mitigate the risk of financial loss associated with the failure of any one system. Rather than using diversity to find the best set of rules, legal diversification emphasizes the importance of making different legal rules available to issuers and investors as part of a wise investment strategy to mitigate the risk of financial loss associated with the failure of any one system to adequately protect investors. Because legal diversification is an important feature of investment in its own right, it should be an important goal of regulation. This Part situates legal diversification within the existing literature on law markets and coordination of financial regulation. It submits that promoting legal diversification should be an important regulatory objective.

A. *As Opposed to a Law Market*

Corporate law scholars have long thought in terms of law markets[182]—legal regimes with alternative rules that allow individuals or firms to choose which legal rules to adopt to govern their behavior.[183] Individuals and firms can make this choice through decisions about where to live or where to organize, or by including choice of law or choice of forum terms in their contracts.[184] Corporate law presents such a law market because it is a creature of state law.[185] States can choose different corporate governance laws and firms can then choose where they want to incorpo-

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experienced investors with good information on risks and returns offered through particular issuers).

180. See, e.g., Alan R. Palmiter, Toward Disclosure Choice in Securities Offerings, 1999 Colum. Bus. L. Rev. 1, 4 (advocating increased party choice in disclosure practices).

181. See Whitehead, Destructive Coordination, supra note 3, at 326–27 (examining unintended costs of coordination of financial firms and markets); Romano, For Diversity, supra note 3, at 37–100 (advocating greater flexibility in international financial regulation).

182. E.g., O'Hara & Ribstein, supra note 3, at 107 ("Scholars have long studied the state competition for corporate law as a distinct phenomenon. The basic idea is that because U.S. companies can choose to incorporate in any state, states end up competing with one another for the provision of corporate laws.").

183. Id. at 3 ("Parties, in effect, can shop for law, just as they do for other goods.").

184. Id. at 107–08.

185. Id.

rate. The theory is that firms (and investors) will gravitate toward the state with the most efficient laws.[186]

The primary justification for allowing different states to have different corporate laws rather than enacting a federal corporate law is that states can serve as individual legal laboratories, each trying out different legal rules.[187] Firms will then choose to incorporate in the state offering the legal regime that allows them to be most profitable and, the theory goes, this law market will favor the states with the "best" corporate law.[188] Some have argued that the law market has resulted in a "race to the bottom," with states competing to have the corporate law that is most lenient for management because managers decide where to incorporate.[189] Others have dismissed this claim, arguing instead that Delaware law dominates public corporations because it best serves that constituency.[190] Close corporations tend to incorporate in their home jurisdictions, but larger firms can shop for the right jurisdiction and a large plurality choose Delaware.[191]

While this Essay will not directly address the state corporate law market or competition among states for incorporations, the principles at work in that market provide a useful complement to the legal diversification proposed here. The argument that a system can discover optimal legal rules by trying several different rules in different jurisdictions leads to the conclusion that it can reach better rules through variety and flexibility than by trying one rule at a time. Managers choose to organize under certain governance rules based on their estimation of which rules best suit their business purposes. Investors can then vote on whether they think the firms have made the right choice by investing in firms that

186. Id.

187. Romano, The States as a Laboratory, supra note 3, at 210.

188. Id. at 214.

189. See William J. Carney & George B. Shepherd, The Mystery of Delaware Law's Continuing Success, 2009 U. Ill. L. Rev. 1, 74–75 (arguing Delaware corporate law no longer possesses many superior qualities enabling it to continue dominating legal market); William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663, 668–69 (1974) (stating Delaware's aim is to create comfortable environment for management in order to attract incorporations).

190. See Romano, The States as a Laboratory, supra note 3, at 213 (arguing Delaware's success is due in part to responsiveness to corporate interests); see also Roberta Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709, 720–23 (1987) (providing various reasons large number of firms choose to incorporate in Delaware); Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251, 256 (1977) (rejecting William Cary's "race to the bottom" argument and claiming firms will always choose state whose laws are most favorable to shareholders in order to protect stock value).

191. See O'Hara & Ribstein, supra note 3, at 120 ("[A]bout half of larger closely held corporations . . . incorporate outside their principal place of business (the majority in Delaware) . . . ."); Romano, The States as a Laboratory, supra note 3, at 213 (noting many large firms are incorporated in Delaware).

seem to have opted in to the most efficient regimes. The law market encourages variety—and acknowledges that firms and investors make important choices in the face of that variety—and so is a useful predicate to the notion of legal diversification.

The availability of different business forms also exposes investors to different methods of constraining agency costs. Investing simultaneously in a variety of governance regimes may allow an investor to participate in the experimentation a law market encourages. Through legally diversified investment, an investor will find different levels of optimal apathy that a particular firm's governance regime allows. For example, an investor would have to be more actively involved in an investment in a private general partnership than she would in a public corporation, and may find an intermediate level of engagement and monitoring is appropriate in a private, closely held corporation. As firms tinker with what governance mechanisms work best for them, they find the most effective ways to reduce agency costs. A legally diversified investor may be able to diversify away some of the firm-specific risks of agency costs, or even the agency costs inherent in a particular governance form.

Legal diversification within one legal system is different than a law market across different jurisdictions, however. Legal diversification encourages a single investor to take advantage of a broad range of legal rules at once. Because these legal rules are available to a single investor, they are considered, for the purposes of this Essay, to be within the same system. The legally diversified investor does not try to discover and invest in only the "best" legal rule, but rather invests in firms and securities governed by a wide variety of rules, in part because she is not sure which rules are "best." So, while scholars might think of individual states competing on the basis of the business association laws they offer, a U.S. investor could simultaneously invest in a number of companies subject to a variety of state business association laws. The relevant system, then, is the U.S. securities markets, both public and private.[192] The variety within the system helps investors by allowing them to take advantage of the efficiencies offered by the different sets of legal rules.

The law market, on the other hand, focuses more on allowing investors to choose a favorite among a variety of legal rules. The goal is to find the most efficient set of legal rules through revealed investor preferences. A law market does not value diversity as an end in itself, but only as it helps society discover the optimal set of rules, supposing an optimal set of rules, or optimal rule, exists. A law market can coexist with a system

192. Of course, a U.S. investor could also legally diversify by investing in foreign markets. See Brummer, supra note 6, at 1462 ("[S]peed also makes trading on foreign markets not only possible but practical."). This Essay focuses instead on the U.S. system because a goal of the Essay is to show the importance of maintaining a variety of legal rules within the U.S. capital markets.

that prioritizes legal diversification because both value legal diversity. Legal diversity is an important independent goal within an understanding of legal diversification because it allows legal rules to evolve over time to adapt to changing and unpredictable circumstances. States can compete over who has the most efficient LLC-organizing statutes, but investors will still benefit from being able to invest in LLCs as well as other business forms, and may even benefit from being able to invest in LLCs in two different states, particularly as it remains uncertain what "good" or "the best" LLC law may be.

B. *A Complement to Diversity in Financial Regulation*

In another adaptation of the argument that diversity should be maintained as a regulatory priority, a recent scholarly movement has advocated diversity in financial risk regulation.[193] From slightly different perspectives, Roberta Romano and Charles Whitehead have argued that diversity in regulation best manages financial risk, particularly as the risks both faced and imposed by financial firms can be so unpredictable and difficult to understand.[194] The overall theme of this line of reasoning is that world markets are best protected from financial risktaking when diversity of regulation within an individual country's market is encouraged and the markets of different countries are regulated by completely different regimes. Whitehead focuses on the effects of regulatory coordination on systemic risk within the U.S. financial markets.[195] He points out that using the same metrics to regulate all financial firms may cause them to coordinate their actions to the detriment of the system as a whole.[196] Romano builds on Whitehead's insights and argues that international financial markets should be regulated by a diverse set of laws adminis-

193. See Whitehead, Destructive Coordination, supra note 3, at 326 ("By promoting coordination, regulations and standards can erode key presumptions underlying financial risk management, reducing its effectiveness and magnifying the systemic impact of a downturn in the financial markets."); Romano, For Diversity, supra note 3, at 3 ("This article . . . challenges the present-day enthusiasm for international regulatory harmonization and the view that harmonization is a panacea for reducing systemic risk and advances . . . the need for a more flexible financial architecture that provides greater room for regulatory diversity and experimentation . . . .").

194. See Whitehead, Destructive Coordination, supra note 3, at 325–28 (noting potentially destructive nature of coordination); Romano, For Diversity, supra note 3, at 3–9 (arguing need for flexibility and experimentation).

195. See Whitehead, Destructive Coordination, supra note 3, at 325–26 (explaining role of coordination and regulation in banking).

196. See id. at 326–28 ("[G]reater coordination impair[s] each firm's ability to manage its own risk exposure. In short, although regulation and market standards can help reduce systemic risk, they themselves can also *become* a systemic risk." (footnotes omitted)).

tered by different countries.[197] Her argument follows the familiar law market reasoning: Future financial risks are unknown, so it makes sense to try a variety of laws. This would allow for the comparison and reevaluation of regulatory choices so that different regimes could learn from each other and the entire system would not collapse if one regulatory regime proved ineffective.[198]

These ideas relate and contribute to legal diversification in different ways. For instance, Romano's idea is that the entire world economy can avoid vulnerability to a single crisis or failure if different ways of confronting risk can be adopted.[199] Diversity of regulation allows experimentation and tailoring. If different regimes operate simultaneously, it may be easier to switch more quickly from a bad one to a good one as the community learns how to improve its responses to unforeseeable problems. There is more flexibility, then, once the community acknowledges different regimes can be effective, especially if firms and investors are allowed to choose the rules that will govern them.

Legal diversification capitalizes on the diversification available within one system and offers an application of Romano's global point within the U.S. legal system. John Coates has pointed out that there is a good deal of diversity within the securities and corporate governance system.[200] Investors and issuers have plenty of legal rules to choose among in designing their portfolios.[201] More is known about corporate governance and securities regulation than about international financial risk, but the perfect way to minimize agency costs has not yet been devised. While it is still not known how managers may fail or be unfaithful, the flexibility provided by different legal regimes allows a quicker and more appropriate response to those failures. That flexibility arises from the ability to quickly switch to a regime that works better by moving investments there. If a number of systems work simultaneously to try to respond to various agency costs and one fails, an investor can choose to invest in firms governed by the more effective regime. The legal rules that are better at limiting agency costs may also be helpful by giving examples of how to im-

197. See Romano, For Diversity, supra note 3, at 3 ("This article . . . challenges the present-day enthusiasm for international regulatory harmonization and . . . advances an alternative regulatory solution. The focus is the need for a more flexible financial architecture that provides greater room for regulatory diversity and experimentation . . . .").

198. See id. at 5–8 ("The diversity mechanism would have decisive benefits over the present-day . . . framework for improving the quality of financial regulatory decisionmaking. It would increase not only the flexibility but also the adaptability and consequently, the resilience of the international financial regulatory architecture.").

199. See id. (noting diversity can mitigate risk of future crises).

200. Coates, supra note 11, at 543, 550–53 ("[E]xisting law provides for far more issuer choice about the level and nature of securities disclosure regulation than devolution proponents have acknowledged . . . .").

201. See id. (noting current rules provide numerous flexible obligations).

prove governance in other kinds of firms. The failed regime may be able to adopt those more efficient rules more quickly if it is apparent how the superior rules work and are implemented than if courts and legislatures have to try to innovate on the spot. Legislative change takes a long time,[202] but allowing multiple systems to operate simultaneously may allow the system to respond more quickly and efficiently to ineffective legal rules. Encouraging investors to stake out different roles in limiting agency costs, and to protect themselves in different ways through different investments, allows them to directly benefit from the relative advantages of different sets of legal rules.

Romano's argument builds on Whitehead's observation about the nature of financial risk: that the "random walk" of stock prices and lack of coordination among financial actors are important to a market's health and ability to absorb risk.[203] Uniform regulation can undermine the "random walk" and result in "destructive coordination."[204] Whitehead's piece focuses much more specifically on the nature of financial risk, particularly the paradox presented when financial market participants uniformly adopt the same risk management technique that itself assumes randomness.[205] When all of the financial firms coordinate in their risk assessment, the necessary randomness is compromised and risk evaluation is therefore much less effective and reliable.[206]

While the particular points Whitehead makes about risk management do not necessarily apply to governance and securities regulation, the intuition does. By pushing business firms and investors into a single, uniform investment option, the "random walk" that the market supposes is lost. Legal diversification provides another way for investors to respond to different market shocks in different ways. The more difficult it is to legally diversify, the harder it will be for investors to diversify away the risks associated with a particular kind of investment. An important lesson from Romano's and Whitehead's insights, and indeed the primary lesson from the 2008 financial crisis, is to not put all of one's eggs in one basket. Legal diversification is yet another way to avoid this mistake.

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202. See id. at 562–63 (noting legislative change can take up to three years).

203. See Whitehead, Destructive Coordination, supra note 3, at 336–37 ("Much of modern financial economics is premised on a world without coordination. Rational individuals separately seek to maximize wealth, each guided by their own self-interest. The . . . result is an optimal allocation of resources to those who can use them most productively.").

204. See id. at 330 ("[I]ndividual portfolio managers act independently and . . . their actions affect neither asset prices nor the actions of others.").

205. See id. ("[I]n a world that presumes randomness, regulation and market standards that promote coordination can also be destructive.").

206. See id. at 347, 352–58 (noting uniformity of investor response to recent Bear Stearns crisis increased "downward spiral" and uniform financial regulation "can increase systemic risk").

VI. POLICY IMPLICATIONS OF LEGAL DIVERSIFICATION

Recent securities legislation has the potential to either expand or contract the legal diversity available to issuers and investors. As discussed above, the JOBS Act contains some provisions that would entice companies to go public, but it also contains others that make it easier for some firms to remain private. If more firms remain private, that should promote legal diversity, while pushing more firms into public corporation status would undermine diversity. Policymakers should be aware of whether they are promoting or stunting legal diversity. Where the optimal legal rule has not yet been discovered, or where multiple rules may be necessary to serve the relevant population, legal diversity should be maintained and encouraged.

In addition to the on-ramp to public corporation status,[207] the JOBS Act also includes provisions that will make it easier for some firms to stay private by increasing the number of accredited investors to whom a firm can issue securities without entering the public disclosure regime.[208] The JOBS Act also removes the ban on general solicitation to accredited investors in certain private offerings.[209] These provisions make it much easier for a firm to generate unlimited capital from a great many accredited investors without going public. If firms use the large umbrella provided by these new provisions to avoid going public, then they will have more flexibility in choosing their business form when organizing and raising capital.

The intermediate form of public reporting provided to EGCs can also create an avenue for diversity. If it is observed that the limited disclosures EGCs provide are sufficient for companies of that size, Congress could well decide to make the intermediate level of public reporting permanent. Creating another level of public firm would increase diversity and provide grounds to experiment with a different level of disclosure in order to determine what the optimal level of disclosure for firms and investors is. Of course, it is uncertain what the most common result of the JOBS Act will be, but there are opportunities to increase diversity and, given the trouble the public corporate form has had in recent decades, it seems likely firms and investors would benefit from that diversity.

207. See supra notes 72–78 and accompanying text (noting JOBS Act aims to bring more companies into public status).

208. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012) (describing threshold for registration of private companies).

209. See id. § 201(a)(1), 126 Stat. at 313–15 ("[T]he prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors."). See generally Thompson & Langevoort, Redrawing, supra note 41 (discussing provisions of JOBS Act).

Legal diversification has implications for investment and policymaking beyond corporate and securities law. Investors need not limit their legal diversification to corporate governance rules or securities laws. In any area of law where jurisdictions are able to legislate independently and firms are subject to different rules governing similar circumstances, legal diversity may be helpful, and investors may be able to diversify along those dimensions in choosing investments. Policymakers could also take this broader view and, when uncertain what the best path may be, could design in negative correlations between policy outcomes—that is, enact directly opposed policies in different jurisdictions in order to determine which works best, meanwhile enjoying the hedging of risk that diversification allows.[210] If one policy fails, the other will not, so society and investors are protected from the total loss one failed policy may cause while enjoying the advantage of being able to experiment with different rules. Seen this way, the framework legal diversification provides could help answer a number of questions about how best to invest and legislate.

CONCLUSION

In order to have truly well-diversified portfolios, investors must be able to invest in firms and securities that are governed by a variety of legal rules. Firms organize into particular business forms, each form governed by a different set of legal rules. Later, when raising capital, firms issue various securities, each giving investors particular rights against the firm's assets and protections from agency costs and informational asymmetries. Thus, these legal rules respond to distinct risks firms impose on investors and offer investors different protections. Investors can protect themselves more completely from the risk of the failure of any one set of legal rules by investing in firms and securities that are governed by different rules. In this way, investors can realize some of the benefits of investment diversification through legal diversification, or diversification across the legal rules governing investments.

The U.S. capital markets are currently home to a variety of legal rules governing firms and their securities, so investors have a broad, varied menu to choose from in constructing a legally diversified portfolio. The JOBS Act threatens this variety, however, by enticing firms to take an on-ramp to public corporation status earlier in their life cycles than they otherwise might. This increases the stickiness of the public corporation default by pushing more firms toward that one regulatory regime. The more firms opt into public corporation status, the less legal variety investors will have to choose from in fully diversifying investment. Different firms have different governance and capital requirements, so they should be able to choose the rules that are most efficient for their goals and cir-

210. The author is grateful to David Schleicher for this insight.

cumstances. That way, investors can invest in a portfolio of securities representing a variety of firms in different stages, thriving under different circumstances, or pursuing different business objectives. Regulatory variety protects investors and maintains efficiency in legal rules that govern firms.

Diversity in regulation is a prominent theme in recent corporate law scholarship. However, no one has focused on the advantages of legal diversification for investors, or even acknowledged that legal diversification should be a distinct investment and regulatory priority. Maintaining variety in the rules that govern businesses benefits investors, issuers, and society. Diversifying investment across legal rules is vitally important to the ability of investors to take advantage of their greatest protection from risk: diversification.

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