Private Company Lies

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Private Company Lies

ELIZABETH POLLMAN*

Rule 10b–5’s antifraud catchall has been called one of the most consequential pieces of American administrative law and one of the most highly developed areas of judicially created federal law. Although the Rule broadly prohibits securities fraud in both public and private company stock, the vast majority of jurisprudence, and the voluminous academic literature that accompanies it, has developed through a public company lens.

This Article illuminates how the explosive growth of private markets has left huge portions of U.S. capital markets with relatively light securities fraud scrutiny and enforcement. Some of the largest private companies by valuation grow in an environment of extreme information asymmetry and with the pressure, opportunity, and rationalizing culture that can foster misconduct and deception. Many investors in the private markets are sophisticated and can bear high levels of risk and significant losses from securities fraud. It is increasingly evident, however, that private company lies can harm a broader range of shareholders and stakeholders as well as the efficiency of allocating billions of dollars for innovation and new business. In response to this underappreciated problem, this Article explores a range of mechanisms to improve accountability in the private markets and ultimately argues for greater public oversight and enforcement.

TABLE OF CONTENTS

INTRODUCTION ................................................................. 354

I. THE DEVELOPMENT OF RULE 10B–5 IN A PUBLIC MARKET PARADIGM . . 360
   A. ORIGINS ................................................................. 361
   B. EVOLUTION ............................................................... 363

* Professor of Law, University of Pennsylvania Law School. © 2020, Elizabeth Pollman. For helpful conversations and comments, thanks to Yifat Aran, Miriam Baer, Carlos Berdejó, Ryan Bubb, Elisabeth de Fontenay, Jill Fisch, Jeff Gordon, Joe Grundfest, Zack Gubler, Dave Hoffman, Andrew Jennings, Renee Jones, Kate Judge, Ann Lipton, Don Langevoort, Dorothy Lund, Peter Molk, Frank Partnoy, Ed Rock, Eric Talley, Urska Velikonja, Andrew Verstein, Yesha Yadav, and participants at the Arizona State University Sandra Day O’Connor College of Law faculty workshop, BYU Winter Deals Conference, Tulane Corporate and Securities Roundtable, National Business Law Scholars Conference, Corporate and Securities Litigation Workshop, and the Law & Economics Workshop at Columbia Law School and NYU School of Law.
II. THE GROWTH OF PRIVATE MARKETS AND THE POTENTIAL FOR PRIVATE COMPANY LIES ................................................................. 368

A. THE NEW PRIVATE LANDSCAPE .......................................................... 370

B. THE POTENTIAL FOR SECURITIES FRAUD IN PRIVATE COMPANIES . . . 377

1. Pressure ........................................................................................... 379

2. Opportunity ..................................................................................... 380

3. Rationalization .............................................................................. 383

C. OBSTACLES TO RULE 10B–5 CLASS ACTIONS IN PRIVATE MARKETS . . 386

III. THE FUTURE OF POLICING FRAUD IN PRIVATE MARKETS ............... 390

A. MAINTAINING THE STATUS QUO ....................................................... 391

B. INCREASING PUBLIC ENFORCEMENT ............................................. 393

C. ADJUSTING THE PUBLIC–PRIVATE LINE ....................................... 396

D. EXPLORING ALTERNATIVE MECHANISMS TO INCREASE ACCOUNTABILITY IN PRIVATE COMPANIES .............................. 398

CONCLUSION ................................................................. 402

INTRODUCTION

One of the world’s great inventors, Thomas Edison, bemoaned the propensity of technologists to lie about an exciting new invention of the late-nineteenth century, the storage battery. In Edison’s words: “The storage battery is, in my opinion, a catch-penny, a sensation, a mechanism for swindling by stock[ ] companies. . . . Just as soon as a man gets working on the secondary battery it brings out his latent capacity for lying.”

More than a century later, CEO–founder Elizabeth Holmes of blood-testing startup Theranos found inspiration in Edison—but rather than making the world a better place, she created a company valued at over $9 billion that was nothing more than a dangerous house of cards. At age nineteen, Holmes dropped out of Stanford University to develop groundbreaking blood-testing technology that could use just a drop of blood. Over the next dozen years, Holmes became a

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3. Id.
celebrity CEO–founder, raising over $700 million from investors, building a board with high-profile directors, and claiming that she had developed a revolutionary portable blood analyzer.\textsuperscript{4}

Reporting by the \textit{Wall Street Journal} exposed a devastatingly different story told by employees who suggested that Theranos had falsified lab records to make it look like its blood-testing technology met the industry standard.\textsuperscript{5} According to employees, the vast majority of tests that Theranos offered to consumers were actually being run on commercial devices made by third-party manufacturers.\textsuperscript{6} The small number of blood tests being run on Theranos devices were unreliable and posed a public health threat to consumers.\textsuperscript{7} Under Holmes’s leadership, the company operated in a high-pressure and secretive environment,\textsuperscript{8} with “information compartmentalized so that only she had the full picture of the system’s development.” Many venture capitalists declined the opportunity to invest in Theranos when Holmes refused to provide specific information about the technology for due diligence—but that did not stop her from raising millions of dollars from an assortment of wealthy investors.\textsuperscript{10} As a matter of corporate governance, Holmes allegedly misled the board\textsuperscript{11} and had supermajority voting stock that gave her the opportunity to override any controls that might otherwise be put in place.\textsuperscript{12}

The Securities and Exchange Commission (SEC) launched an investigation, finding that in addition to misleading representations about the state of Theranos technology, Elizabeth Holmes and another executive had told investors that the company would generate more than $100 million of revenue in 2014, when in fact, Theranos had barely $100,000 of revenue that year.\textsuperscript{13} These revelations spurred the spectacular fall of the company, going from a $9 billion valuation to virtually zero.\textsuperscript{14} Holmes settled fraud charges with the SEC in 2018, still maintaining that she had done nothing wrong.\textsuperscript{15}

\footnotesize
\begin{itemize}
  \item 4. \textit{Id.}
  \item 5. \textit{See id.}
  \item 6. \textit{Id.}
  \item 7. \textit{Id.}
  \item 8. \textsc{John Carreyrou}, \textit{Bad Blood: Secrets and Lies in a Silicon Valley Startup} 33 (2018).
  \item 9. \textit{Id.} at 20.
  \item 10. \textit{See id.} at 16.
  \item 11. \textit{Id.} at 50.
  \item 12. \textit{Id.} at 298.
  \item 13. Carreyrou, \textit{supra} note 2. In addition, the SEC found that Holmes had falsely claimed that Theranos’s products were deployed by the U.S. Department of Defense on the battlefield in Afghanistan. \textit{Id.}
  \item 14. \textit{See id.}
  \item 15. \textit{Press Release, U.S. Sec. & Exch. Comm’n, Theranos, CEO Holmes, and Former President Balwani Charged with Massive Fraud} (Mar. 14, 2018), \url{https://www.sec.gov/news/press-release/2018-41} [https://perma.cc/Q7AF-LXRT]; \textit{see also} Mary McNamara, Opinion, \textit{The Elizabeth Holmes Story Is Not About the Black and the Blinks}, \textsc{L.A. Times} (Mar. 25, 2019, 1:45 PM), \url{https://www.latimes.com/entertainment/la-et-elizabeth-holmes-con-artist-20190325-story.html} (noting that several people who knew Holmes reported that Holmes believed that she was on a “noble mission,” which justified “fudging the truth” and that she would eventually succeed).}
\end{itemize}
Subsequently, the Department of Justice (DOJ) brought criminal charges against Holmes.16

Theranos rings the alarm bell on securities fraud in the private market. Telling lies in connection with the purchase or sale of stock is not new and dates back to before Edison’s time.17 But since twentieth-century securities law created the notion of a public–private company divide, securities fraud on the private side of the line has received little attention because in conventional accounts, this market features only sophisticated investors who can fend for themselves.18 A different reality, however, has started to become clear—the zone of impact extends farther and may include retail investors exposed to private companies through mutual and pension funds and employees who hold stakes in private companies through their stock options. Ripple effects reach other stakeholders as well, such as consumers who use a company’s product or services, like those who received faulty blood tests from Theranos.19 Moreover, the relative dearth of enforcement in the private market, which is surging in size and opaque with respect to the pervasiveness of securities fraud, gives rise to serious concerns about efficient capital allocation for funding innovation that drives our economic growth and deadweight costs that investors might incur to protect themselves.

Consider another example. WeWork, a shared workspace startup, went from having Goldman Sachs publicize a $63 to $96 billion valuation for its initial public offering (IPO) to teetering on the brink of bankruptcy within just thirty-three days.20 Upon releasing information for the planned offering, public market investors responded with scathing criticism of the company’s losses and corporate governance—WeWork shelled the IPO plans, and its private valuation of $47 billion plummeted by seventy percent almost immediately.21 The CEO—
founder attempted to parachute out of the company with a billion-dollar payout, while various investors faced steep losses—as did thousands of employees whose stock options went to zero.22 The SEC is currently investigating WeWork for rule violations in its abandoned public stock issuance—and it remains to be seen whether the extensive conflicts and irregular financial reporting that have come to light might portend possible securities fraud violations going back to the decade-long period in which the company raised money privately in relative darkness without the regulator’s scrutiny.23

Notably, the federal antifraud catchall of Rule 10b–5 applies to both public and private company securities.24 This provision makes it “unlawful for any person . . . to make any untrue statement of a material fact or to omit to state a material fact . . . in connection with the purchase or sale of any security.”25 Rule 10b–5 is “the principal font of the law of securities fraud” and “can make a plausible claim to being the most consequential piece of American administrative law.”26 Chief Justice Rehnquist famously remarked that the law of Rule 10b–5 is “a judicial oak which has grown from little more than a legislative acorn.”27 Indeed, securities fraud is “one of the most heavily judicially created bodies of federal law.”28—but


23. See Matt Robinson, Robert Schmidt & Ellen Huet, WeWork Is Facing SEC Inquiry into Possible Rule Violations, BLOOMBERG (Nov. 15, 2019, 8:46 AM), https://www.bloomberg.com/news/articles/2019-11-15/wework-is-said-to-face-sec-inquiry-into-possible-rule-violations (noting that the SEC is reviewing WeWork’s business and its disclosures to investors, and that the company was known for using “unconventional accounting metrics”). WeWork shareholders have already sued for breach of fiduciary duty and for fraud under state securities law, and the possibility of a suit for Rule 10b–5 securities fraud hangs in the air as some of the company’s investors claim to have been unaware of the extent of the alleged self-dealing, having been granted neither financial materials nor disclosures prior to the release of its IPO prospectus. See Rey Mashayekhi, WeWork’s Legal Floodgates May Have Just Opened, FORTUNE (Nov. 19, 2019, 5:30 AM), https://fortune.com/2019/11/19/wework-softbank-takeover-lawsuits/; Nicholas Rizzi, Investors Sue WeWork Over Botched IPO, COM. OBSERVER (June 4, 2020, 11:03 AM), https://commercialobserver.com/2020/06/investors-sue-wework-over-botched-ipo.


25. Id. § 240.10b–5.

26. Samuel W. Buell, What Is Securities Fraud?, 61 DUKE L.J. 511, 540 (2011); id. n.84 (“The rule has sparked thousands of lawsuits, causing billions of dollars to change hands,” has “routinely spawned headlines in the nation’s leading papers,” and has “sent hundreds of people to prison, some for decades.”).

27. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975); see also 2 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 1287–88 (6th ed. 2011) (“The Rule 10b-5 story tempts the pen, for it is difficult to think of another instance in the entire corpus juris in which the interaction of the legislative, administrative rulemaking and judicial processes has produced so much from so little.”).

28. Buell, supra note 26, at 545; see also Steve Thel, The Original Conception of Section 10(b) of the Securities Exchange Act, 42 STAN. L. REV. 385, 463 (1990) (“With the explosive growth of rule 10b-5 litigation, courts and private plaintiffs have assumed by default a substantial segment of the policy-setting powers that Congress delegated to the SEC in 1934.”).
this voluminous case law, and the related scholarly literature, has focused primarily on public corporations and markets.  

This state of the world, with Rule 10b–5 actions aimed at public corporations and little regard given to private corporations, sufficed for a time. Most corporations of significant size were publicly reporting and traded on national securities exchanges, exposed to the threat of class action lawsuits brought by plaintiffs’ attorneys using case law that enabled aggregate litigation seeking compensatory damages. By contrast, private placements were composed of sophisticated investors and there was little secondary trading of private company stock.  

Startups on average were on a timeline to be acquired or go public within a few years, and valuations did not surpass, or even approach, a billion dollars.  

This twentieth-century model of a dominant public capital market has been transformed. Capital formation through private placements has exploded in the past decade. Nonregistered securities offerings totaled more than $3 trillion in 2017—far outpacing public offerings for stocks and bonds. Companies have stayed private longer on average, fewer companies have gone public, and those that do tend to be larger in size. In simple terms, this means that a significant part of the life cycle of a growth company is typically occurring in the private rather than the public market. For example, if Amazon, Google, and Salesforce had stayed private for the “new normal”—an average of twelve years—an additional $197 billion in growth would have occurred in the private market. Venture capitalists now refer to the mega rounds of financings in late-stage startups as “private-IPOs.” Marketplaces for trading private company stock have


30. See infra Section I.B.  

31. See Darian M. Ibrahim, The New Exit in Venture Capital, 65 VAND. L. REV. 1, 21 (2012) (“Before the direct market came about, the transaction costs of trying to sell noncontrolling interests in private start-ups were prohibitive.”); Jennifer J. Johnson, Private Placements: A Regulatory Black Hole, 35 DEL. J. CORP. L. 151, 152 (2010) (“At one time, federal law confined private placements to purchasers who were sophisticated in business affairs and could, in the words of the U.S. Supreme Court, ‘fend for themselves.’” (quoting SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953))).  


33. See infra Section II.A.  


35. Id. at 26.
become part of the ecosystem. The rise of the private market has consequently sharpened scholarly and regulatory focus on the health of the public market and on democratizing retail investors’ opportunities to fund high-risk and potentially high-growth private companies.

As the SEC considers dramatically expanding retail investor access to private investments, this Article argues that it is time to examine in-depth the issue of securities fraud in private companies. Federal securities law and doctrine has oriented our system around a public–private divide with class actions serving as the driving force in securities fraud enforcement—but only against public companies. Due to a variety of obstacles and economic realities, securities fraud class actions have been absent in the private market. Although public enforcement plays an important role in policing securities fraud, there is no sign that it has kept pace with recent developments. Meanwhile, significant information asymmetries characterize stock issuances and trading in the private market, as well as the kind of pressure, opportunity, and rationalizing culture that can foster misconduct and deception.

Given the great potential for harm, particularly to unsophisticated shareholders and other stakeholders, as well as the importance of deterring fraud to ensure efficient capital allocation, this Article further argues that the status quo no longer suffices—a response is due. The path forward should aim to protect the integrity

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36. See infra Section II.A.
37. See, e.g., Donald C. Langevoort, Selling Hope, Selling Risk: Corporations, Wall Street, and the Dilemmas of Investor Protection 165 (2016) (“Also alarming for the SEC is whether economic forces are leading to an eclipse of the public corporation, so that public equity gradually becomes less available as an investment opportunity.”); Usha Rodrigues, Securities Law’s Dirty Little Secret, 81 Fordham L. Rev. 3389, 3389–90 (2013) (arguing for general public participation in the private market via mutual fund investment because inequality of investor access “lets the rich get richer, while the poor get left behind”); Jeff Schwartz, Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund’s Investments in Unicorns (and Other Startups) and the Regulatory Implications, 95 N.C. L. Rev. 1341, 1341 (2017) (arguing “that the [mutual funds’] new interest in venture investing poses several potential investor-protection concerns”).
38. See Oversight of the Securities and Exchange Commission: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs, 116th Cong. 11 (2019) (statement of Jay Clayton, Chairman, U.S. Sec. & Exch. Comm’n) [https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%2012-19-2019.pdf] [https://perma.cc/HZK9-U75A] (noting the SEC has an “obligation to explore whether we can increase opportunities for Main Street investors in the private markets while maintaining strong and appropriate investor protections”); Press Release, U.S. Sec. & Exch. Comm’n, SEC Seeks Public Comment on Ways to Harmonize Private Securities Offering Exemptions (June 18, 2019), [https://www.sec.gov/news/press-release/2019-97] [https://perma.cc/WL2W-FAGY] (stating that the SEC is considering whether to allow retail investors greater exposure to growth-stage companies and whether to revise the limitations on who can invest in exempt offerings); see also Tara Siegel Bernard, Opening the Door to Unicorns Invites Risk for Average Investors, N.Y. Times (Jan. 4, 2020), [https://www.nytimes.com/2020/01/04/your-money/investing-private-market-startups.html] (noting that the SEC granted certain individuals in the investment sector access to the private markets and expects to further open access to private markets in the future).
39. See infra Section I.B.
40. See infra Section II.C.
41. See infra Section II.B.
of the private market and those affected by securities fraud, while carefully avoiding chilling the flow of funding for innovation and new business.

Increasing public enforcement presents such a solution. It is not sensitive to the issues that impede private class actions in this context such as opaque stock pricing, judgment-proof defendants, and the difficulty of aggregating plaintiffs who might be differently situated and lack standing or incentive to bring suit. Moreover, public enforcement can help to fill the oversight gap that venture capitalists and other private investors might leave unfulfilled and can be calibrated over time and with further study.

Finally, the Article explores two additional responses to securities fraud in the private market—one bold and one unconventional—both reinforcing the argument for increasing public enforcement and presenting opportunity for future regulatory change. First, the Article contributes to a growing literature that imagines redrawing the public–private line to better capture the public footprint of large corporations and possible gradations or tiers of publicness. To date, this literature has focused primarily on the need for the sunlight of public disclosure for large private corporations—by contrast, this Article highlights that securities fraud enforcement is another important consideration for redrawing the public–private line, as it represents another key mechanism for protecting investors and the general public. Second, this Article highlights that the response to securities fraud need not look the same in the private as in the public market. Alternative mechanisms to increase accountability, such as giving startup employees additional information and empowering gatekeepers to play a stronger role in monitoring, could provide finely tuned responses to information problems that could supplement increased public enforcement.

This Article proceeds as follows. Part I traces Rule 10b–5 from its origins to its evolution with the drawing of the public–private line between corporations and the emergence of the “fraud-on-the-market” class action. These developments gave rise to modern Rule 10b–5 litigation in which securities fraud is enforced by class actions aimed at public company defendants. Part II describes the growth of the private capital market, including discussion of both primary issuances and secondary trading. Further, Part II examines governance and cultural dynamics that give rise to factors that are characteristic of securities fraud and analyzes the obstacles to Rule 10b–5 class actions in private markets. Together, the picture that emerges is a large private capital market in which there is significant potential for securities fraud, but there is less scrutiny and enforcement than in the public counterpart. Part III explores a variety of responses that provide a foundation for the future of policing securities fraud in private markets.

I. THE DEVELOPMENT OF RULE 10B–5 IN A PUBLIC MARKET PARADIGM

Although the federal securities fraud prohibition broadly applies to both public and private companies, litigation and enforcement regarding the former has

42. See infra Section III.C.
predominated. The story of Rule 10b–5 has been told many times, but the distinctly public lens through which the jurisprudence and practice has developed has not been the focus of the tale. Over time, securities fraud jurisprudence and academic debate has become increasingly robust as the paucity of attention to private markets has grown more glaring.

This Part demonstrates the public company focus through which Rule 10b–5 jurisprudence and practice has evolved, growing into the modern landscape in which companies in the public capital market are subject to active scrutiny, whereas those in the private capital market are often left in the shadows of enforcement.

A. ORIGINS

The Great Crash of 1929 set in motion the adoption of the federal securities laws that remain our foundational regulatory framework today. By 1934, the time of the Securities Exchange Act’s passage, there was “widespread consensus that excessive stock market speculation and the collapse of the stock market had brought down the economy.”43 The securities acts that Congress passed in the Great Depression that followed “were primarily concerned with preventing a recurrence.”44 Together, the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act) put in place a system of mandatory public disclosure and sanctions for disclosure violations and fraud.45

First, after a series of hearings that revealed shocking financial abuses,46 Congress passed the 1933 Act “to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and . . . to promote ethical standards of honesty and fair dealing.”47 The 1933 Act replaced the existing caveat emptor philosophy with one of issuer disclosure.48 Further, the 1933 Act included Section 17(a), prohibiting fraud and misrepresentations in the offer or sale of securities.49

43. Thel, supra note 28, at 409.
44. Id.
45. See, e.g., I Loss et al., supra note 27, at 46, 57–59; Velikonja, supra note 19, at 1897 (“Modern American securities regulation has two prongs: regulation of securities markets and the securities industry; and regulation of corporate issuers, including mandatory disclosure, the prohibition of fraud, and, more recently, corporate governance.”).
49. 15 U.S.C. § 77q (2018). Section 17(a) is similar in many respects to Rule 10b–5 but is broader in that claims under Section 17(a)(2) and (a)(3) may be based on negligent conduct, and narrower in that it does not reach the “purchase” of securities or allow for private rights of action. See, e.g., Touche Ross & Co. v. Redington, 442 U.S. 560, 568–71 (1979); Maldonado v. Dominguez, 137 F.3d 1, 6 (1st Cir. 1998)
Second, in light of the apparent need for additional regulation beyond primary securities offerings from issuers, Congress passed the 1934 Act, which provides for periodic reporting requirements and a broad catchall prohibition against securities fraud in Section 10(b). This provision makes it unlawful “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance” that contravenes any rule promulgated by the SEC. As others have observed, “[t]he mandatory corporate disclosure system was adopted because of widely held beliefs that securities fraud was prevalent and that state laws often could do little to prevent or punish it.” Section 10(b) closed a loophole in the SEC’s fraud enforcement authority by allowing the agency to pursue fraud committed in connection with the purchase as well as the sale of securities.

In an oft-recounted anecdote, a staff attorney described how Rule 10b–5, which implemented Section 10(b) of the 1934 Act, was created in 1943 in response to a specific incident of fraud—an executive was buying up stock in his own company by telling shareholders that the company was doing badly, all while knowing that earnings would in fact quadruple in the coming year. Upon learning of this incident, the staff attorney and an SEC director promptly drafted a rule, combining language from Section 17 of the 1933 Act and the congressional grant of authority from Section 10(b) of the 1934 Act.

In relevant part, Rule 10b–5 makes it unlawful for any person “to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of (explaining that Section 17 actions can be brought in civil regulatory actions by the SEC and criminal prosecutions by the DOJ, but not by plaintiffs in private lawsuits); Finkel v. Stratton Corp., 962 F.2d 169, 174–75 (2d Cir. 1992) (discussing difference between Section 17 and Rule 10b–5); SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 859 (2d Cir. 1968) (en banc) (noting that Section 10(b) was intended as a broad “catchall[]” enforcement provision aimed at both buyers and sellers of securities).

50. See Tex. Gulf Sulphur Co., 401 F.2d at 859 (“Indeed, from its very inception, Section 10(b), and the proposed sections in H.R. 1383 and S. 3420 from which it was derived, have always been acknowledged as catchalls.”); 1 LOSS ET AL., supra note 27, at 58 (explaining that the 1934 Act aimed to provide “a measure of disclosure to people who buy and sell securities” and to “prevent and afford remedies for fraud in securities trading”).


52. 1 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 289–90 (4th ed. 2006); see id. at 298 (“By the end of the 1917–1920 securities fraud wave, it was obvious that state blue sky enforcement alone could have only limited success in stamping out securities fraud, primarily because no state’s law could reach by direct action or extradition a seller of fraudulent securities residing in a second state.”).


55. See id.
any security."56 As the telling goes, upon receiving the draft language, the commissioners passed it around the table and immediately approved it without controversy.57 The only comment made was by Commissioner Sumner Pike who said, “Well . . . we are against fraud, aren’t we?”58

Shortly after the SEC adopted Rule 10b–5, federal courts recognized a private right to sue for securities fraud,59 and as consensus was forming, the Supreme Court affirmed this implied right.60 Early cases brought under Rule 10b–5 resembled common law fraud claims with respect to the elements and factual allegations.61 Plaintiffs were required to prove actual reliance on a defendant’s misrepresentations, and typical cases involved face-to-face dealings and privity of contract.62

B. EVOLUTION

By the 1960s, two developments began to take root that would ultimately shape our modern landscape: the drawing of the public–private line between corporations and the emergence of the fraud-on-the-market class action that pervades modern Rule 10b–5 litigation. These regulatory and doctrinal developments converged to create a world in which securities fraud litigation is enforced by private class actions aimed at public company defendants.

Regarding the first development, both Securities Acts reflect a public–private divide, taking different approaches but together creating a public realm.63 The

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56. 17 C.F.R. § 240.10b–5 (2020). The Supreme Court has established a private cause of action under Rule 10b–5 to require “(1) ‘a material misrepresentation (or omission)’; (2) ‘scienter, i.e., a wrongful state of mind’; (3) ‘a connection with the purchase or sale of a security’; (4) ‘reliance’; (5) ‘economic loss’; and (6) ‘loss causation,’ i.e., a causal connection between the material misrepresentation and the loss.” Buell, supra note 26, at 545 (quoting Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005)).

57. See Blue Chip Stamps, 421 U.S. at 767 (Blackmun, J., dissenting).

58. Id.


61. Rose, supra note 53, at 40–41.

62. See, e.g., 2 ALAN R. BRONBERG & LEWIS D. LOWENFELS & MICHAEL J. SULLIVAN, SECURITIES FRAUD: MISREPRESENTATIONS AND NONDISCLOSURES § 4.2 (2d ed. 2019) (“The archetypal 10b-5 case is the purchase by one group in a closed corporation of the interest of another . . . .”); Donald C. Langevoort, Reading Stoneridge Carefully: A Duty-Based Approach to Reliance and Third-Party Liability Under Rule 10b-5, 158 U. PA. L. REV. 2125, 2149 (2010) (noting that before the Second Circuit’s Texas Gulf Sulphur decision in 1968, “private securities fraud litigation had arisen mainly in face-to-face dealings, with fraud by a purchaser or seller of securities and with the victims as the counterparties in the transaction”); Rose, supra note 53, at 40–41 (noting that in the early years of securities fraud jurisprudence “there was little difference between Rule 10b-5 and common law fraud claims”).

1933 Act governs “public offering[s],” but does not define the term. An early SEC release provided guidance for what qualified as exempt transactions, noting as relevant factors a small offering size and close relationship between the issuer and offerees. In 1953, the Supreme Court handed down its decision in SEC v. Ralston Purina Co., ruling that offerees who could “fend for themselves” did not need the protections of the Act. This interpretation focused the 1933 Act’s public–private line on notions of qualification for private investments based on investor wealth and sophistication.

By contrast, the 1934 Act tied the periodic public-disclosure obligations to voluntarily listing on a national securities exchange and was amended in 1964 to add Section 12(g), which set a threshold for public status based on features of the issuer company—assets and number of shareholders of record. The effect of Section 12(g) was to bring over-the-counter securities trading, with “sufficiently active trading markets and public interest,” within the purview of the SEC’s public-disclosure regime. Thus, by the 1960s there were three triggers for public status: making a “public offering,” listing on a national securities exchange, and reaching the Section 12(g) threshold. As Donald Langevoort and Robert Thompson have observed: “For a time, at least, the 1964 amendments created a strong bias in favor of public status, precisely given the practical needs of most

“Truth in Securities” Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good, 36 Seattle U. L. Rev. 999, 1000–01 (2013) (noting a “mismatch” between the 1933 Act’s focus on investor protection through the registration model and the 1934 Act’s approach, which reflects a compromise between investor protection and capital formation).

64. See 15 U.S.C. § 77d(2) (2018) (stating the Section 5 registration requirement shall not apply to “transactions by an issuer not involving any public offering”); Langevoort & Thompson, supra note 63, at 343 & n.14 (noting that the 1933 Act exempts transactions not involving public offerings, transactions made intrastate, and small dollar offerings).

65. See Letter of General Counsel Discussing the Factors to Be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 33-285, 1935 WL 27785 (Jan. 24, 1935) (noting number of offerees and their relationship to each other and the issuer, size of the offering, and manner of offering as relevant factors).


68. See 15 U.S.C. §§ 78m(a), 78n(a) (2018); Langevoort & Thompson, supra note 63, at 344.

69. See Richard M. Phillips & Morgan Shipman, An Analysis of the Securities Acts Amendments of 1964, 1964 Duke L.J. 706, 715; see also 1 LOSS ET AL., supra note 52, at 307 (“Elaborate studies of the omission of material investment information by firms not subject to the mandatory disclosure system were made by the SEC between 1946 and 1963 as part of the Commission’s ultimately successful effort to persuade Congress to extend the continuous disclosure provisions of the Securities Exchange Act to all firms above a minimum size.”); Michael D. Guttenberg, 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, 168 (2013) (discussing congressional debate of the 1964 amendments); Langevoort & Thompson, supra note 63, at 345 (noting the lack of theoretical consensus on how to define publicness for purposes of Section 12(g) at the time of adoption).

growing businesses for both capital and liquidity.”

The second development that began during this period was a doctrinal shift to “unmoor the private Rule 10b-5 cause of action from its common law roots.”

As a result of a series of rulings, the fraud-on-the-market class action emerged and became the dominant force of modern securities fraud litigation.

An early step on this path was the abandonment of privity as a requirement for liability. In SEC v. Texas Gulf Sulphur Co., the Second Circuit held that a defendant need not be a counterparty or a contemporaneous trader to violate Section 10(b) or Rule 10b–5. The requirement that the fraud be “in connection with the purchase or sale of [a] security” was fulfilled by victims who were purchasers or sellers, whereas the violator could be anyone who made a material misrepresentation or omission in a manner “reasonably calculated to influence the investing public.”

Subsequently, investors began filing actions that became known as fraud-on-the-market cases, claiming the marketplace had been deceived by false representations. Furthermore, 1966 revisions to the Federal Rules of Civil Procedure enabled plaintiffs to aggregate claims in a class action under Rule 23(b)(3), provided that common issues predominated over individualized ones.

The next important doctrinal development was the Supreme Court’s recognition in Basic Inc. v. Levinson of a presumption of reliance in private Rule 10b–5 cases involving securities widely traded in “efficient” markets. Plaintiffs are entitled to this rebuttable presumption of reliance if they show that the alleged misrepresentation was material and public, the stock traded in an efficient market, and their trading occurred between the time the misrepresentation was made and
when the truth was revealed. The fraud-on-the-market theory was based on the efficient capital market hypothesis, which maintained that “the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” Thus, Basic freed public company shareholders from showing that they actually relied on the alleged misrepresentation. Instead, such plaintiffs have a presumption that they relied on the integrity of the stock’s market price.

Together, the abandonment of the privity requirement and the acceptance of the fraud-on-the-market theory transformed Rule 10b–5 litigation. Corporations that had not bought or sold stock could be defendants, despite being neither a counterparty nor contemporaneous trader. Eliminating the requirement to prove individualized reliance expanded the universe of potential plaintiffs and facilitated class actions. These class actions grew to predominate securities fraud litigation and dramatically departed from earlier case law and traditional common law fraud cases. With the availability of compensatory damages in Rule 10b–5 class actions—which allow plaintiffs to recover their full out-of-pocket losses attributable to the fraud—attorneys have a strong incentive to bring these suits against public company defendants.

Indeed, Rule 10b–5 as a tool against securities fraud has been undeniably shaped by the public company paradigm that envisions class action attorneys serving as private monitors of public disclosures affecting stock prices on an

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79. See Basic, 485 U.S. at 241–47.
80. Id. at 246. Economists developed the efficient capital market hypothesis (ECMH) in the mid-1960s as a way to explain several empirical studies that found that future changes in stock prices were a “random walk” that could not be accurately predicted based on prior prices. The ECMH “explains” the random walk by hypothesizing that prices change in response to information about a particular company’s stock. See Lawrence A. Cunningham, From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis, 62 GEO. WASH. L. REV. 546, 551–66 (1994) (summarizing the history of the ECMH and the random walk model of public capital market behavior); see also Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 609 (1984) (“observing ‘relative efficiency is a function of information costs’”). See generally Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. FIN. 383 (1970) (reviewing economics literature on the ECMH).
81. See Basic, 485 U.S. at 246–47.
82. See Rose, supra note 53, at 45–46 (noting that modern fraud-on-the-market class actions not only involve an “expanded set of plaintiffs and defendants, an altered set of elements, and the aggregation of claims” but also “involve defendants with different motives, raise different stakes, and create different incentives to sue and settle than existed in the early years of private Rule 10b-5 enforcement”).
83. See id. at 45.
84. Securities fraud class actions against public companies exploded by the 1990s, prompting regulation attempting to recalibrate the level of private litigation. See Buell, supra note 26, at 550 (“Seeking to reduce the expenses arising out of weak or meritless cases, Congress updated the ’34 Act with the Private Securities Litigation Reform Act of 1995 (PSLRA). Under the PSLRA, private plaintiffs must satisfy a heightened pleading standard with respect to the element of scienter.”) (footnote omitted)); A.C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 VA. L. REV. 925, 927–28 (1999) (noting that “the damages recoverable in such suits can be a substantial percentage of the corporation’s total capitalization, reaching the tens or even hundreds of millions of dollars” and that corporations’ complaints about their prevalence led to the Private Securities Litigation Reform Act of 1995).
efficient market. From the fraud-on-the-market presumption of reliance to “materiality” defined in terms of a “reasonable investor,” the elements of a Rule 10b–5 suit reflect the prevalence of public company cases.

And although courts certainly have not required the markers of the public company paradigm for a securities fraud action, the availability of stock price movements on a public market facilitates discovery of suits, and the prospect of large compensatory damages incentivizes such monitoring. In 2019, 382 of the 428 securities class actions involved public companies with stock traded on the New York Stock Exchange or Nasdaq. Securities class actions are trending toward larger company defendants—companies involved in cases that settled in 2019 were fifty-nine percent larger than those in the previous year, as measured by total assets—and the median settlement amount was thirty-four percent higher than the nine-year median. As the next Part explains, although these settlement amounts and corporate defendants are large, the doctrinal evolution of securities litigation toward a public company model significantly narrows the realm of capital markets being actively monitored once one takes into account the rise of the private capital market.

85. See Buell, supra note 26, at 550 (“[T]he class action dominates the modern industry of private securities litigation . . . .”).

86. See Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 38 (2011) (discussing “materiality”); No. 84 Emp’r–Teamster Joint Council Pension Tr. Fund v. Am. W. Holding Corp., 320 F.3d 920, 949–50 (9th Cir. 2003) (stating that when a public company corrects an alleged omission or misrepresentation, the stock price movement or lack of movement is “at least telling of what a reasonable investor would consider significant”); In re Pfizer, Inc. Sec. Litig., 538 F. Supp. 2d 621, 632 (S.D.N.Y. 2008) (noting that, in an efficient market, the “total mix of information” is understood as the information available to the public market); see also DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 65 (3d ed. 2012) (noting that courts have allowed the market itself to stand in for the reasonable investor when securities are traded in an “efficient” market).


88. Notably, plaintiffs’ attorneys not only use stock price drops as a mechanism for detecting potential class action suits but also for proving the element of loss causation. See Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 347 (2005) (finding that loss causation can be established by showing that public disclosure of a fact was followed by a stock price decline); see also Jeff Schwartz, The Twilight of Equity Liquidity, 34 CARDOZO L. REV. 531, 548 (2012) (observing that “for public firms, share-price drops can trigger class-action lawsuits alleging that glowing public disclosures released prior to a collapse were fraudulent”).


II. THE GROWTH OF PRIVATE MARKETS AND THE POTENTIAL FOR PRIVATE COMPANY LIIES

The era of one dominant capital market in the United States is over.91 The public capital market remains profoundly important to the economy, but it now sits in tension with a rising private capital market that is “both unrivaled and coveted around the globe” for “substantially contrib[uting] to the competitiveness of U.S. firms.”92

Research indicates that private equity and venture capital investments have grown at twice the rate of their public counterparts in recent years.93 Venture-backed startups are staying private longer on average and reaching record-breaking private valuations in the billions of dollars, rivaling or surpassing public-industrial giants in some cases.94 Private market growth has been notably strong—“global private equity (PE) net asset value grew by 18 percent in 2018,” and overall “it has grown by 7.5 times” in the twenty-first century, “twice as fast as public market capitalization.”95

The rising private capital market not only delivers growth and innovation, however—it also poses new challenges and concerns that policymakers, academics, and market participants have only begun to address. For its part, the SEC has announced twin goals of making public capital markets more attractive while also expanding retail investors’ access to private investments.96 This policy...
stance reflects the bind that the agency finds itself in—troubled by declining numbers of public companies trading on national securities exchanges, yet also cognizant that “Main Street” investors may be shut out of the private capital market where much of the growth phase of companies’ development is occurring.\footnote{97} As the SEC has prioritized opening up access to the private capital market and harmonizing securities offering exemptions, little debate has focused on the potential for harm through securities fraud in this increasingly large section of the overall capital markets.\footnote{98}

Notably, the universe of private companies is wide and encompasses closely held corporations such as the paradigmatic family business, private equity-backed companies in which a small number of institutional investors are actively involved in management, and venture capital-backed startups aimed at high growth and exit.\footnote{99} Although securities fraud can occur in all of these types of private companies, the latter category poses particular concern as venture capital has soared to record levels while operating on a business model known to push for growth at all costs, aiming for a few homeruns and writing off failures.\footnote{100}

This Part examines the rise and growth of the private capital market, highlighting the changes that have occurred that have enabled this development and the features of this market and its participants. Subsequently, this Part gives special attention to exploring the information asymmetries, pressure for growth, and free-wheeling culture in venture-backed startups that give rise to the potential for securities fraud that could significantly impact investors and stakeholders.

\footnote{97. See id.}
\footnote{98. See, e.g., Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 33-10844, at 268 (Nov. 2, 2020), https://www.sec.gov/rules/final/2020/33-10844.pdf \[https://perma.cc/F48U-HXQV\] (“The amendments may increase aggregate potential investor losses [and] [i]ncreased offering limits under Regulation A Tier 2, Regulation Crowdfunding, and Rule 504 may make it easier for smaller, higher-risk issuers to access capital through these exemptions.” (footnote omitted)); Caroline A. Crenshaw, Comm’r, Statement on Harmonization of Securities Offering Exemptions (Nov. 2, 2020), https://www.sec.gov/news/public-statement/crenshaw-harmonization-2020-11-02 \[https://perma.cc/2T5B-JGQ9\] (“Today’s rule significantly expands private market access to investors without first putting in place appropriate investor protections. . . . The solutions this rule presents are to allow private companies to raise capital by selling more risky offerings, in greater dollar amounts, with less information, and fewer rights to unprepared and unprotected investors.”); Allison Herren Lee, Comm’r, Statement on Amendments to the Exempt Offering Framework (Nov. 2, 2020), https://www.sec.gov/news/public-statement/lee-harmonization-2020-11-02 \[https://perma.cc/3FGW-537F\] (“In recent years . . . the exception (or exemptions from registration) have swallowed the rule, with statutory and regulatory changes steadily chipping away at restrictions on private offerings and exposing more and more retail investors to their risks.”).}
\footnote{100. See Erin Griffith, The Ugly Unethical Underside of Silicon Valley, FORTUNE, Jan. 2017, at 72, 75, https://fortune.com/longform/silicon-valley-startups-fraud-venture-capital/ (“Faking it, from marketing exaggerations to outright fraud, feels more prevalent than ever—so much so that it’s time to ask whether startup culture itself is becoming a problem.”); see also 16 of the Biggest Alleged Startup Frauds of All Time, CB INSIGHTS (May 23, 2019), https://www.cbinsights.com/research/biggest-startup-frauds (“There’s almost always an element of “fake it ’til you make it” for a successful, disruptive startup. Some companies just push their luck a little too far.”).}
Finally, it examines the obstacles for traditional securities class actions to play a monitoring role in the private capital market.

A. THE NEW PRIVATE LANDSCAPE

In a recent speech, SEC Chair Jay Clayton acknowledged: “We now have two segments in our capital markets. . . . Twenty five years ago, the public markets dominated the private markets in virtually every measure. Today, in many measures, the private markets outpace the public markets, including in aggregate size.” The SEC’s analysis estimates that registered public offerings accounted for $1.4 trillion of new capital in 2018 compared to approximately $2.9 trillion raised through exempt private offerings. Public companies listed on U.S. stock exchanges have declined in number by nearly half in the past two decades, and they are significantly larger on average. These figures reflect the dramatic transformation of U.S. markets in the twenty-first century.

Venture-backed startups constitute a large portion of the private capital market and their life cycle has changed significantly. The venture capital (VC) life cycle starts with the creation of funds that raise capital from institutional and accredited investors interested in private-growth assets. The VC deploys the funds into a portfolio of startup companies, typically also playing a role in governance or otherwise supporting these innovative companies. Venture capital funds have a defined term of ten years and detailed rules about how limited partner investors can liquidate their assets at the end of that period. The goal is for the startup companies in the portfolio to grow quickly and achieve successful “exits” during

102. Id. at n.9 (citing a 2018 analysis by the SEC’s Division of Economic and Risk Analysis).
106. See Gilson, supra note 104, at 1071; Pollman, supra note 99, at 170, 172.
this period through a mergers and acquisitions (M&A) sale or IPO that makes a significant return on investment. Although M&A exits are more common, industry experts and academics have long viewed IPOs as essential for sustaining a robust venture capital industry because they provide a mechanism for obtaining high investor returns and liquidity. Venture capital is based on a business model that aims to have a few “home runs” that account for much of the fund returns.

In previous times, a startup company that survived to exit would typically be acquired or go public within about five years. Companies raised capital from public markets to fuel growth and access liquidity for VC investors and startup employees who had received stock options. Several of the world’s largest companies by market capitalization—Microsoft, Amazon, Apple, and Google—followed this exit path as venture-backed startups.

But with regulatory changes and an unprecedented influx of private capital, companies have increasingly stayed longer in the private market and tend to go to the public markets only when governance complexity builds over a period and private investors are ready to cash out. One of the most notable regulatory changes facilitating staying private longer was the JOBS Act of 2012, in which Congress raised the Section 12(g) threshold of the 1934 Act from 500 to 2,000

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109. See, e.g., Black & Gilson, *supra* note 107, at 245 (arguing that “a well developed stock market that permits venture capitalists to exit through an initial public offering (IPO) is critical to the existence of a vibrant venture capital market”); Ibrahim, *supra* note 31, at 11 (“IPOs are the gold standard in VC success.”).

110. See PETER THIEL, *ZERO TO ONE: NOTES ON STARTUPS, OR HOW TO BUILD THE FUTURE* 86–87 (2014) (“[T]he best investment in a successful fund equals or outperforms the entire rest of the fund combined.” (italics omitted)); Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., Nov.–Dec. 1998, at 131, 136 (“Given the portfolio approach and the deal structure VCs use, however, only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate. . . . In fact, VC reputations are often built on one or two good investments.”).

111. See Ritter, *supra* note 94, at tbl.4 (tracking the median age of venture-backed companies at IPO from five years in 1999 to ten years by 2019); It’s Definitely a Marathon – Venture-Backed Tech IPOs Take Seven Years From First Financing, CB INSIGHTS (Nov. 7, 2013), https://www.cbinsights.com/research/venture-capital-exit-timeframe-tech (noting that the average time from the first funding round to exit via M&A in 2007 was over five years).

112. See, e.g., Smith, *supra* note 108, at 352 (“The primary justification for an IPO is to raise money, usually in anticipation of a substantial expansion in the company’s operations, but the IPO has many ancillary benefits. In addition, to the obvious benefits that accompany the liquidity of public capital markets, companies may find that publicly traded stock is useful in recruiting new managers and acquiring other companies.”).


114. See Pollman, *supra* note 99, at 209–16; see also Matt Levine, *Something Is Lost when Companies Stay Private*, BLOOMBERG (Apr. 4, 2018, 1:00 AM), https://www.bloomberg.com/opinion/articles/2018-04-04/something-is-lost-when-companies-stay-private (“Private markets are the new public markets. That’s a thing that I say a lot. . . . You stay private to raise money and build your business and grow; you go public to allow your investors to cash out.”).
shareholders of record, of which no more than 499 can be unaccredited investors. Employee stock option holders and shareholders are not counted in this tally. In 2018, the SEC also raised the Rule 701 threshold to require financial disclosures to stock option holders only once a company grants more than $10 million in options during a twelve-month period.

The upshot of these changes is that significant amounts of capital are tied up for long periods in essentially illiquid or semi-illiquid markets with little transparency. The average time to M&A and IPO exits have doubled since the late 1990s, and as noted, fewer companies have gone public. Going public has become a choice rather than an inevitability even for large corporations as the Section 12(g) threshold no longer “forces” any companies over the line. The 2,000 holders-of-record limit is sufficiently high such that a shareholder base can be managed to stay below it—particularly as “special purpose vehicles” (SPVs) and other planning tools are used to aggregate holdings.

Companies tend to be larger when they enter the public market, with more of their growth trajectory occurring as private companies. With record-breaking amounts of private capital available, and a competitive market to invest in the


118. See Ibrahim, supra note 31, at 14 (noting that the average time two decades ago for venture capital-backed companies to exit was three to four years); Ritter, supra note 94, at tbl.4 (charting the declining number of IPOs).

119. See William K. Sjostrom, Jr., Questioning the 500 Equity Holders Trigger, 1 HARV. BUS. L. REV. ONLINE 43, 43 (2011) (explaining that the practical effect of the previous threshold was “to force certain types of firms into the public markets”); cf. Rodrigues, supra note 70, at 1530 (finding that the previous threshold of 500 shareholders of record may have affected only about three percent of companies going public).

most buzzworthy startups, private valuations have been high—leading to speculation of a tech bubble and overpriced IPOs. 121

A greater diversity of investors has also entered the private markets. Whereas in the past, startups were typically funded by family and friends, angel investors, and venture capitalists, in recent years these investors have been joined by family offices, hedge funds, mutual funds, pension funds, and sovereign wealth funds. 122 These newcomers expose retail investors to the private markets, and as institutional investors, they are sophisticated but do not have long track records of investing in this asset class, the special challenges they pose, and their distinctive style of governance and contracting practices.

These developments have affected both primary issuances and secondary trading of private company stock. 123 At the core, companies staying private longer and reaching higher valuations means that there is a greater volume of transactions and dollars invested, 124 and correspondingly more opportunity for securities fraud. In addition, the greater diversity of investors in late-stage rounds of financing has expanded the universe from the Silicon Valley community of VCs that are repeat players in a reputational market to a global mix of institutional investors that resembles public markets in some respects. The enormous amount of private capital seeking to invest in the best deals, combined with new investors in the space, has created leverage for companies to choose which investors to accept and to limit disclosures—adding to information asymmetries which can also enable securities fraud.

Primary issuances to investors occur through private placements relying on an exemption from registration—typically Regulation D in connection with offers of securities to “accredited investors” or Section 4(a)(2) which exempts “transactions by an issuer not involving any public offering” as interpreted by the

121. See Gornall & Strebulava, supra note 94, at 120, 135, 136 tbl.7 (finding that after adjusting for valuation-inflating terms in preferred stock financings, almost half of “unicorns” lose their status as billion-plus valued companies); Matt Phillips, Stephen Grocer & Erin Griffith, Wall Street Deflates America’s Favorite Start-Ups, N.Y. TIMES (Sept. 30, 2019), https://www.nytimes.com/2019/09/26/business/tech-ipo-market.html (discussing fear of a bubble and that “the verdict from the stock market is that it’s the private investment binge that has gone too far”); David Trainer, The Unicorn Bubble Is Bursting, FORBES (Oct. 7, 2019, 9:21 AM), https://www.forbes.com/sites/greatspeculations/2019/10/07/the-unicorn-bubble-is-bursting/#e3f3f34f388198 (“There does not appear to be any appreciation for risk of bidding up the price of unicorns too high.”).


123. See James J. Park, Reassessing the Distinction Between Corporate and Securities Law, 64 UCLA L. REV. 116, 144–45 (2017) (“After a security has been distributed to the public, it trades in a secondary market. Such transactions involve trading between investors rather than a sale from the issuer to an investor.”); Pollman, supra note 29, at 183–202 (discussing secondary trading in private company stock).

124. For example, a notable recent study of 135 unicorn companies found that the average unicorn has eight share classes, indicating many rounds of financings. Gornall & Strebulava, supra note 94, at 121.
Supreme Court in *SEC v. Ralston Purina Co.* There are no specific disclosure requirements for private placements under Section 4(a)(2) or Regulation D offerings to accredited investors, creating the possibility of negotiations for limited disclosures and extreme divergences in the information known about the company.

Employees are typically not financially sophisticated and do not qualify as accredited investors who would be permitted to participate in a private placement of their employers’ securities. Rule 701 exempts grants of share-based compensation to employees. Most companies will satisfy the minimal disclosure requirement of Rule 701 by merely providing a copy of the relevant stock option plan. Companies that issue more than $10 million worth of securities under the exemption in a twelve-month period are required to provide a summary of the material terms of the compensatory plan, a list of risk factors associated with investing in the company’s securities, and financial statements. Scholars have criticized these disclosure requirements as inadequate and poorly tailored to employees’ needs, particularly in unicorn companies that have reached sizeable valuations and may have large numbers of employees with little access to information.

Although the changing private market landscape has impacted primary issuances, the bigger transformation has been the rise of secondary trading in private company stock. A decade ago, the private secondary market had been notably illiquid and ad hoc, with occasional transfers done as carefully negotiated

125. See 346 U.S. 119, 120, 125 (1953) (holding that application of the exemption “should turn on whether the particular class of persons affected needs the protection of the [Securities] Act”); id. (“An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’”); THERESE H. MAYNARD, DANA M. WARREN & SHANNON TREVINO, BUSINESS PLANNING: FINANCING THE START-UP BUSINESS AND VENTURE CAPITAL FINANCING 218–23 (3d ed. 2018) (explaining private placements and accredited investor status); James C. Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 311 (2009) (“The very essence of private equity is exemption from the public securities laws: funds make investments in nonpublic portfolio companies, and the funds themselves are typically structured as limited partnerships.”).


127. Id. § 230.701(c).

128. See id. § 230.701(e); Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107, 182 (2019).

129. 17 C.F.R. § 230.701(e).


131. See Ibrahim, supra note 31, at 3; Pollman, supra note 29, at 181–82. Earlier periods noted a lack of secondary trading in private company stock as a limiting factor on securities fraud litigation. See Steinberg, supra note 29, at 762 (“The application of rule 10b-5 to close corporations, where lawsuits typically relate less directly to the purchase or sale of a security, has been a major cause of uncertainty over the rule’s scope. Because there is no secondary trading of [private company] securities, the rule 10b-5 close corporation lawsuit is more likely to contain corporate law issues.”).
affairs. An opportunity arose for intermediaries to facilitate such trading, however, with two developments—internet-platform technology and rule changes that eased resale restrictions. Specifically, in 2007, the SEC shortened the holding period for the transfer of private company stock to one year with no conditions. The agency further provided a regulatory exemption for resales to “qualified institutional buyers”—allowing unlimited transactions with no holding period. By 2009, two platforms, SecondMarket and SharesPost, launched as online intermediaries, taking a small fee while reducing the search and transaction costs for secondary trading. With companies staying private longer and using stock and stock options as incentive-based compensation, the possibility for secondary trading to liquidate some stock ownership became increasingly important to startup participants. Employees, former employees, angel investors, and VCs used these sites to identify accredited buyers willing to buy their private company stock. The platforms were quickly doing large amounts of transactions.

In turn, many startups responded by putting in place contractual trading restrictions on their stock in order to manage their shareholder base and the valuation and information issues that can arise with an active secondary trading market for private company stock. The SecondMarket business model evolved to work with companies to facilitate liquidity events such as share buybacks and third-party tender offers, rather than functioning as online auctions or bulletin boards for connecting buyers and sellers. In 2014, Nasdaq launched a private market initiative as a competitor and by the following year had acquired SecondMarket.

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133. See 17 C.F.R. § 230.144(d)(2) (2020); Jones, supra note 117, at 175 (describing the SEC’s series of reforms shortening the Rule 144 holding periods); Pollman, supra note 29, at 193 (noting that “[t]he combination of the lengthened period of time companies stay private, securities law exemptions for the resale of restricted stock, and information technology” created the opportunity for online marketplaces for trading private shares).

134. See 17 C.F.R. § 230.144A(b), (d)(1). Qualified institutional buyers are companies that in the aggregate own and invest at least $100 million in securities of nonaffiliated issuers and registered broker-dealers. Id. § 230.144A(a)(i).


137. See Pollman, supra note 29, at 205–18 (discussing information issues in secondary trading of private company stock and the potential for insider trading); cf. Rodrigues, supra note 70, at 1539 (“Because these transactions took place not on a public exchange like the NYSE, but instead in a private market limited to accredited investors, they could transpire outside the reach of the SEC’s 1999 rule on OTC trading. No disclosure necessary.” (footnote omitted)).

and repositioned itself as the private parallel to its public exchange counterpart. Nasdaq works with companies to facilitate “liquidity programs” that allow a company to impose guidelines, limitations, or restrictions around the sale of stock.

The rest of the secondary market evolved as well. SharesPost continues to function as an over-the-counter marketplace and has added an offering to invest in late-stage, venture-backed companies through a proprietary, closed-end interval fund. Additional private company marketplaces have sprung up to compete, each with their own variations on facilitating private company secondary deals and liquidity for private company employees.

Finally, the level of secondary activity and complexity of the transactions are noteworthy. The overall size of these secondary markets is significant and the trend is increasing—over $4 billion in transaction volume was executed in 2017 by the four main players. In 2018, Nasdaq Private Market alone did $12 billion in transaction volume and saw a significant increase in the number of third-party tender offers. Moreover, the combinations of company buybacks, third-party tender offers, and intermediated purchases, such as through SPVs, has grown and resulted in new norms as well as different information flows and pricing. For example, late-stage startups commonly plan a primary issuance in a financing round to be timed with a secondary market liquidity program for selected


143. LARCKER ET AL., supra note 142, at 3.


employees.146 Companies are often simultaneously negotiating with new investors—disclosing limited information and setting prices—and buying back employee stock or facilitating a third-party buyer to do so.147 Although these transactions allow companies to raise capital or increase liquidity, they may also provide opportunities for deceiving investors and employees.

B. THE POTENTIAL FOR SECURITIES FRAUD IN PRIVATE COMPANIES

The private capital market is now characterized by an unprecedented amount of money and stock transactions. Given regulatory and contractual restrictions on trading, the result is neither a liquid and efficient market nor one completely lacking these features.148 In light of the lack of mandated disclosure, however, far less information is available than in the public context and extreme information asymmetries can exist between trading parties. The discussion now turns, therefore, to exploring this large and relatively dark market in terms of its potential for securities fraud.

At the outset, it must be acknowledged that it is, quite naturally, impossible to know the extent of the problem.149 State enforcement actions provide one indication of magnitude—private offerings have been the most common source of securities fraud.150 And, anecdotally, numerous startup stories have made headlines that reveal alleged misconduct that could have potentially touched upon stock purchases or sales. In addition to the examples already highlighted, the past few years have revealed a host of issues: NS8, a cyber-fraud software company, allegedly had a CEO who defrauded investors by fabricating the company’s bank statements for years to grossly inflate the amount of customer revenue;151

147. Companies may be exposed to risk, like employee lawsuits, to the extent that they reap significant premiums from the “spread” between what employees are willing to sell for and what investors are willing to pay. See Lax & Neville LLP, Tech Unicorns Engaging in Stock Buybacks Has Some Securities Law Experts Worried, N.Y. SEC. LAW. BLOG (Mar. 15, 2017), https://www.newyorksecuritieslawyerblog.com/tech-unicorns-engaging-stock-buybacks-securities-law-experts-worried [https://perma.cc/GCR4-US75] (“Uber appear[ed] to be profiting off of [a] buyback, due to differing liquidity expectations of the buyers and sellers, and the subsequent wide spread between the bid and ask of these private stock offerings.”).
148. See Gubler, supra note 116, at 758–61. Although different, the public and private markets may act as substitutes for certain purposes. See id. at 752 (“The two securities markets—the public and the private—serve many of the same functions (capital raising, liquidity generation, and price creation) and therefore act as substitutes (albeit imperfect ones).”).
149. See, e.g., Michael D. Guttentag, Protection from What? Investor Protection and the JOBS Act, 13 U.C. DAVIS BUS. L.J. 207, 254 (2013) (“The JOBS Act . . . [p]rovisions will make it possible for many more firms to have freely traded securities without any affirmative federal periodic disclosure obligations. The impact of this change on the extent to which investors will be harmed by an increase in fraudulent activity is uncertain. The main reason for this uncertainty is our limited understanding of what causes fraud.”).
150. See Bernard, supra note 38.
LendingClub falsified loan transactions and failed to disclose the CEO–founder’s conflict of interest;\(^{152}\) Zenefits, a human resources startup, admitted that its employees cheated on mandatory compliance training central to its business model;\(^{153}\) WrkRiot’s CEO–founder pleaded guilty to defrauding employees by forging wire transfer documents;\(^{154}\) Skully’s founders faced a lawsuit alleging that they engaged in fraudulent bookkeeping and widespread misuse of funds;\(^{155}\) Jumio, a mobile payments identification company, allegedly overstated its revenues to investors before going bankrupt,\(^{156}\) and Hampton Creek, a “sustainable food” unicorn, raised venture capital using sales figures that reflected the company’s practice of secretly buying back huge amounts of its own products from supermarket shelves.\(^{157}\)

Although it is possible that these anecdotes of misconduct are exceptional, it is worth exploring the factors that might contribute to the existence or prevalence of securities fraud in the private market. The widely adopted framework known as the “fraud triangle” identifies three main factors behind workplace fraud: (1) pressure, (2) opportunity, and (3) rationalization.\(^{158}\) As the below discussion


\(^{156}\) Lucinda Shen, This Founder Just Agreed to Pay $17 Million to Settle a Fraud Charge. Now He’s Heading an A.I. Startup, FORTUNE (Apr. 3, 2019, 11:13 AM), https://fortune.com/2019/04/03/jumio-silicon-valley-fraud-sec. The former CEO of Jumio, Daniel Mattes, paid over $17 million to settle SEC charges that he defrauded investors. Id.


highlights, each may be present in venture-backed startups.\footnote{159}

1. Pressure

Although much is made of the pressure on public company managers in light of quarterly earnings and the threat of shareholder activism, such pressure is comparable to or perhaps even less than that commonly experienced by startup managers pushed for survival and growth.\footnote{160} Startups are typically unprofitable for long periods of time and “burning” money, which means many startups are frequently operating on the brink of insolvency.\footnote{161}

Furthermore, by its nature, the venture-backed governance model tends to encourage risk-taking and aiming for potentially unattainable goals.\footnote{162} Theranos founder Elizabeth Holmes, for example, famously dazzled investors with her promise of developing a blood-testing device that required just a single drop of blood.\footnote{163} Given the high rate of startup failures, each investment in a VC’s portfolio needs to potentially account for the fund’s entire return.\footnote{164}

159. Some scholars and criminologists have expanded the fraud triangle into a “fraud diamond” with a fourth prong of “capability,” which refers to the personal traits necessary to turn an opportunity for fraud into reality. See David T. Wolfe & Dana R. Hermanson, The Fraud Diamond: Considering the Four Elements of Fraud, CPA J. (Dec. 2004), https://digitalcommons.kennesaw.edu/cgi/viewcontent.cgi?article=2546&context=facpubs [https://perma.cc/3N9Z-8SER]. Accordingly, in exploring the application of the fraud triangle to the private company context, this Article’s discussion also highlights that the capabilities that are often prized in entrepreneurs for business success—intelligence and hustle—are the same needed to engage in fraud. See infra notes 187–90 and accompanying text.

160. See, e.g., Thiel, supra note 110, at 87 (discussing importance to venture capitalists of investing only in startups that have “the potential to succeed at vast scale”); Ranjay Gulati, The Soul of a Start-Up, HARV. BUS. REV., July–Aug. 2019, at 84 (describing how “[t]he urgent need for survival and then pressures to scale up the business” can crush “the start-up spirit”); Prayag Narula, It’s Time to Talk About Stress at Venture-Backed Tech Startups, FORBES (Apr. 20, 2019, 9:00 AM), https://www.forbes.com/sites/forbestechcouncil/2018/04/20/its-time-to-talk-about-stress-at-venture-backed-tech-startups/#125028457ac (discussing the “[s]tress-induced mental health challenges,” including lack of sleep and depression, which affect founders of venture-backed startups); Startup = Growth, PAUL GRAHAM (Sept. 2012), http://www.paulgraham.com/growth.html [https://perma.cc/5HHU-KX3W] (“A startup is a company designed to grow fast.”).

161. See Thiel, supra note 110, at 45 (noting that startups “often lose money for the first few years: it takes time to build valuable things, and that means delayed revenue”); Pollman, supra note 99, at 167.

162. See Griffith, supra note 100, at 76 (“Even a founder with a strong moral compass and a heart full of good intentions has to persuade investors, engineers, and customers to believe in a future where their totally made-up idea will be real.”); Pollman, supra note 99, at 202–03 (discussing increasing governance tensions that arise over time in venture-backed startups and how “[s]tartups must grow fast to achieve an exit that benefits all participants without putting them at odds with each other”).


164. See SCOTT KUPOR, SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT 37–38 (2019) (explaining how the distribution of deals in a fund follow the “power-law curve” in which a small number of investments drive its success and “VCs are completely wrong about half the time and lose most or all of the money that their investors entrusted to them as a result”); Thiel, supra note 110, at 87 (noting that “every single company in a good venture portfolio must have the potential to succeed
capitalist from the prominent firm Andreessen Horowitz explained, “all we really care about is the at bats per home run”—meaning “the frequency with which the VC gets a return of more than ten times her investment.” Venture capitalists—with these incentives to push for mega hits for their own survival, profit, and ability to raise successive funds—sit on and sometimes control the startup’s board.

CEO–founders often have invested seed money of their own or have relationships with investors, some of whom may be friends and family, which adds to stress about losing investor money and raising new money to keep the company going. Employees are also invested in the company through equity-based incentive compensation such that the potential payoff for the whole team, often personally recruited by the CEO–founder or executives, is typically at stake if the company cannot continue to show enough promise to raise successive financing. Further, startups are clustered in the technology sector and at the growth stages of the life cycle—adding to challenges, the uncertainty of outcome, and the potential of failure.

In sum, startups are often pressure cookers, and most, if not all, startup participants have some form of equity or “skin in the game” that adds to the urgency of performance. In combination with other factors, this incessant pressure for growth may cultivate securities fraud in venture-backed startups.

2. Opportunity

Free from mandatory reporting requirements, private companies have enormous ability to take advantage of information asymmetries—they can publicize unaudited financials, share promising information about the company, or not report at all.

Because VCs stage their investments to deal with the uncertainty inherent in innovative startups, rounds of financing typically occur every twelve to twenty-four months, and disclosures to investors are negotiated as part of this transaction. Standard financing documents include a stock purchase agreement that includes representations and warranties, with a schedule of exceptions that acts as

\textit{at vast scale’’}; Zider, \textit{supra} note 110, at 136 (discussing the VC business model searching for mega hits).

165. \textit{Kupor}, \textit{supra} note 164, at 39–40 (illustrating this point by noting that a venture capitalist that invested in early-stage, pre-IPO Facebook “could be wrong on everything else and still have a top-performing fund”).


168. See Gornall & Strebulaev, \textit{supra} note 94, at 121 (noting the typical frequency of startups raising rounds of financing); Smith, \textit{supra} note 108, at 323 (describing staged financing).

an information-forcing device.\textsuperscript{170} These documents have tended to be relatively lightly negotiated by lawyers in an effort to keep transaction costs down, particularly as VCs take a portfolio approach to investments and many startups ultimately fail.\textsuperscript{171} One consultant who helps investors conduct due diligence on startups estimates that “[t]hree-quarters of the 150 early-stage startups he has investigated have pitched investors with misleading or purposely incomplete information.”\textsuperscript{172}

In recent years, some high-profile startups have had leverage to keep information confidential—providing an opportunity to share misleading information and conceal or delay disclosing bad news. Investors in one of Uber’s late-stage rounds reportedly received no financial information beyond a set of risk factors.\textsuperscript{173} Shareholders in WeWork claimed the CEO–founder’s conflicts of interest were not disclosed prior to the release of its IPO prospectus—once disclosed, these issues, among others, were deemed so problematic by public market investors that the company’s valuation was adjusted down from its last private valuation of $47 billion to a suggested $20 billion, a number that still received so much skepticism that the public offering failed to get out of the gate.\textsuperscript{174}

A number of other transactions, such as share buybacks, tender offers, and M&A deals, pose similar issues concerning the information that is disclosed to investors and provide an opportunity for material misrepresentations by the company. For example, when Good Technology sold to BlackBerry, employees

\begin{itemize}
\item \textsuperscript{171} See John F. Coyle & Joseph M. Green, Contractual Innovation in Venture Capital, 66 HASTINGS L.J. 133, 140 & n.24 (2014). These representations can be a minefield, however. For example, representations that a corporation is in legal compliance are common, but startups frequently bump up against regulatory issues, sometimes even purposely operating in legal gray areas or in violation of legal requirements. See, e.g., Elizabeth Pollman, Corporate Disobedience, 68 DUKE L.J. 709, 731–39 (2019) [hereinafter Pollman, Corporate Disobedience] (discussing corporate disobedience related to innovation and entrepreneurship); Elizabeth Pollman & Jordan M. Barry, Regulatory Entrepreneurship, 90 S. CAL. L. REV. 383, 398–403 (2017) (discussing regulatory entrepreneurship and breaking the law or taking advantage of legal gray areas); NAT’L VENTURE CAPITALIST ASS’N, supra note 170, at 12 (including representation that “[t]he Company is not in violation or default . . . [to its knowledge.] of any provision of federal or state statute, rule or regulation applicable to the Company, the violation of which would have a Material Adverse Effect”); see also Elizabeth Pollman, The Rise of Regulatory Affairs in Innovative Startups, in THE HANDBOOK ON LAW AND ENTREPRENEURSHIP IN THE UNITED STATES (D. Gordon Smith et al. eds.) (forthcoming) (manuscript at 1) (identifying developments contributing to the rise of regulatory affairs in startups).
\item \textsuperscript{172} Griffith, supra note 100, at 76.
\item \textsuperscript{173} Id. at 76–77.
\end{itemize}
learned that, although company executives had assured them “not to worry” because the company had pathways to success, including an IPO, the company was actually lowering financial forecasts in investor documents and sliding toward a sale that demolished the value of the employees’ stock options.\footnote{175} Some employees had exercised their stock options and paid taxes based on a common stock valuation ten times its ultimate worth—resulting in the situation that employees were “essentially . . . paying to work for the company.”\footnote{176}

Furthermore, without periodic reporting and stock analysts, the mix of information available in the private capital market may be spotty at best, and a company’s “hype” to the media could have a disproportionate or misleading effect. Such disclosures could be strategically used to pump valuations or hide misconduct or bad performance. Alternatively, insiders might trade on a secondary market without company-coordinated disclosures.\footnote{177}

Although the regulatory framework used to bifurcate more clearly the set of startup participants holding stock or options to those who were sophisticated or had access to information, now it is more likely that some of the shareholders or option holders will be in neither position and may be more easily misled or kept in the dark. Furthermore, companies may have not only the opportunity but also an incentive to mislead startup employees into believing that their stock options are worth more than they actually are. Startups may convince employees to accept relatively meager salaries with the promise of stock options and to keep them in their jobs to vest or receive refresh grants.\footnote{178} They might promise employees liquidity events such as a planned IPO or buybacks.

While private, Palantir’s offer letter, for example, “gave new hires the ability to choose among three different pay packages, with lower cash salaries corresponding to higher amounts of stock options,” alongside a set of hypothetical valuations of the stock option grant imagining Palantir’s valuation were to grow to $50, $100, or even $200 billion.\footnote{179} The letter noted: “Although the values in the

\footnote{176. \textit{Id.}}
\footnote{177. See Pollman, supra note 29, at 216–18 (discussing the potential for insider trading in private company stock).}
table below are hypothetical and inherently uncertain, we want to emphasize our belief in Palantir’s potential to become a $100 billion company." The potential for mischief is apparent.

Finally, the governance structure of venture-backed startups might present opportunity for carrying out securities fraud. Startup boards are typically dominated by founders and VCs—they typically allocate only one-quarter or fewer seats to independent directors. Some of the largest startups by valuation have dual-class structures that give control to founders through supervoting shares, further weakening governance mechanisms for oversight and discipline, as illustrated by the Theranos case. Empirical literature studying public companies has linked financial misconduct to corporate boards lacking independence or financial and accounting expertise—both of which are commonplace in private companies.

3. Rationalization

Startup and tech company culture have become known for the concept of “disruption” and slogans such as “move fast and break things.” Innovative companies often bump up against, disregard, or even intentionally disobey laws in their quests to develop new technology. Recent research finds that people who
become entrepreneurs are more likely than others to have had high self-esteem, to have scored highly on learning aptitude tests, and to have engaged in more disruptive, illicit activities in their youth. This kind of rule-breaking spirit and conduct has become normalized and even celebrated—from Steve Jobs flying the pirate flag at Apple to Uber’s early mantra “always be hustlin’” which became “[w]e do the right thing” once the company prepared to go public. Entrepreneurs may rationalize their behavior and business strategies through a process psychologists call “moral disengagement”—for example, thinking certain regulations are unnecessary and thus that it is not bad to violate them. There are various ways this process of moral disengagement or rationalizing mentality might play out in the context of securities fraud in private companies.

The path to corporate fraud may start out with innocent confidence and optimism. Managers are known to be optimistic in their appraisals. Because startup founders in particular are often optimistic by nature and situationally encouraged by their venture capital investors to aim for home runs, their estimates may be favorably high. When performance falls short, managers and founders might interpret this as a temporary setback that can be overcome and deny the bad news.

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187. See Ross Levine & Yona Rubinstein, Smart and Illicit: Who Becomes an Entrepreneur and Do They Earn More?, 132 Q.J. ECON. 963, 963 (2017) (“The combination of ‘smart’ and ‘illicit’ tendencies as youths accounts for both entry into entrepreneurship and the comparative earnings of entrepreneurs.”); see also Griffith, supra note 100, at 76 (quoting a startup industry insider that there is “a fine line between entrepreneurship and criminality”).


190. Noam Scheiber, The Shkreli Syndrome: Youthful Trouble, Tech Success, Then a Fall, N.Y. TIMES (Sept. 14, 2017), https://www.nytimes.com/2017/09/14/business/entrepreneur-young-trouble.html (citing psychologist Laurence Steinberg); see also Langevoort, supra note 37, at 42 (“Cultures enable beliefs about the law’s legitimacy that can be either positive or negative relative to other values, and when the latter, compliance falls.”).


192. See Anwer S. Ahmed & Scott Duellman, Managerial Overconfidence and Accounting Conservatism, 51 J. ACCT. RES. 1, 2–4 (2013).

193. See Noam Wasserman, How an Entrepreneur’s Passion Can Destroy a Startup: Founders Need to Believe in Their Ideas and Their Business; but They Can Believe Too Much, WALL. ST. J. (Aug. 25, 2014), https://www.wsj.com/articles/how-an-entrepreneur-s-passion-can-destroy-a-startup-140891204 (analyzing 16,000 startup founders, and finding the “consistent theme” among them is their “passion” and “contagious enthusiasm”).

194. See Langevoort, supra note 37, at 35.
developments may fall into mental blind spots or be rationalized by self-serving wishful thinking.

From this point, innocent optimism might evolve into deliberate deception. Managers or founders might deflect the truth to buy time. They might choose to follow down this slippery slope of deception, particularly as founders or managers realize that the company and its stakeholders, including employees and customers, would be hurt if the deception were revealed.

The cognitive pressure to justify deception grows, particularly as the actor has already committed to a rosier narrative. As Donald Langevoort has observed, “The more leaders believe in group goals, the more they think of themselves as justified in taking unethical actions on behalf of the group.” Research also indicates that trying to meet “frustratingly high performance goals” depletes ethicality and can make eventual dishonesty more likely. If the situation does not improve and the company is truly in trouble, the genuine optimism from the outset might be replaced with fear about survival and the possibility that the managers or founders will be viewed as having lied all along.

Many frauds go through stages of awareness that end with a guilty state of mind. In private companies, without public disclosures of quarterly earnings and analysts, this “optimism-commitment” pattern could fester for longer periods of time or manifest in particularly pernicious forms of pressure for risk-taking activity to achieve or maintain high valuations. Startups often lack internal controls and outside auditing that could detect problems before they evolve into the stage of intentional deception. And once detected, insiders and investors might choose to bury the fraud rather than expose it and risk being associated with the misconduct. Private companies often offer the opportunity for more active engagement, which might both facilitate detection but also risk complicity.

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196. LANGEVOORT, supra note 37, at 36.
197. Id. (“Psychology research shows that people are more willing to cheat when the benefit will go to a family member or colleague rather than only to themselves.”).
198. Id. (citing Crystal L. Hoyt, Terry L. Price & Alyson E. Emrick, Leadership and the More-Important-than-Average Effect: Overestimation of Group Goals and the Justification of Unethical Behavior, 6 LEADERSHIP 391, 391–93 (2010)).
200. Id.
201. Id. at 43.
Research suggests “that dysfunctional corporate cultures are a main reason that frauds occur.”203

Furthermore, the rationalization of fraud seems to spread through business culture or competitive pressures. One study found that the incidence of financial fraud by one company makes it more likely that others, even in different industries, will commit fraud too.204 Social norms and business culture affect a wide range of misbehaviors, including fraud and other financial misconduct.205 This research calls to mind the stock option backdating scandal that spread through Silicon Valley in the early 2000s, perhaps through directors serving on interlocking boards of directors and sharing knowledge about manipulating option grants.206 In sum, all of the contextual factors or elements that can give rise to fraud not only exist but also may be relatively commonplace in the private market, particularly in venture-backed startups.

C. OBSTACLES TO RULE 10B–5 CLASS ACTIONS IN PRIVATE MARKETS

The previous Sections examine the growth of the private capital market and the potential for securities fraud. This Section analyzes the differences between the private and public market that prevent securities fraud class actions from playing a similar role in the private market as in the public. Although contested, private class actions are understood to serve a monitoring and deterrence function207—something that the private capital market needs. A variety of factors

203. LANGEVOORT, supra note 37, at 41; see also Donald C. Langevoort, Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms), 146 U. PA. L. REV. 101, 107–08 (1997) (providing “a robust set of explanations for why managers of a public corporation would mislead stock market investors either in their filings or in ongoing publicity efforts,” including an institutional theory of “corporate cultural biases, particularly optimistic ones” that serve as “adaptive mechanisms for encouraging trust and cooperation”). 204. Christopher A. Parsons, Johan Sulaeman & Sheridan Titman, The Geography of Financial Misconduct, 73 J. FIN. 2087, 2090 (2018) (finding that “firms are more likely to commit [financial misconduct] when their industry (nonlocal) peers do so, as well as when the [financial misconduct] rate for local (nonindustry) peers is higher than average”). 205. Id. at 2089. 206. See John Bizjak, Michael Lemmon & Ryan Whitby, Option Backdating and Board Interlocks, 22 REV. FIN. STUD. 4821, 4822–23 (2009). 207. See William W. Bratton & Michael L. Wachter, The Political Economy of Fraud on the Market, 160 U. PA. L. REV. 69, 70 (2011) (arguing that “a superior enforcement outcome” would require private plaintiffs “to meet an actual-reliance standard” and because this would diminish private litigation, “a compensating increase in public-enforcement capability” is due); Jill E. Fisch, Federal Securities Fraud Litigation as a Lawmaking Partnership, 93 WASH. U. L. REV. 453, 453, 467 (2015) (arguing that the collaboration between Congress and the Supreme Court to develop the private class action for federal securities fraud is a “lawmaking partnership” that offers the advantages of “efficiency, political insulation, and comparative institutional competence”); Rose, supra note 53, at 50 (arguing that “[f]raud-on-the-market (FOTM) suits might be thought of as a way for shareholders to outsource the monitoring of corporate agents [because] . . . the class action bar—lured by the prospect of large attorneys’ fees—is delegated the job of detecting FOTM; once the discovered fraud is revealed through the filing of a class action complaint, shareholders may in turn impose punishment as appropriate”).
may explain why securities class actions have not played a significant role to date in the private capital market: the lack of fluid pricing to identify potential suits, impediments to aggregate litigation, and the different economics of the lawsuit.

As to the first, the private capital market is no longer entirely opaque regarding pricing, but even with significant increases in secondary trading, it is a semi-illiquid market lacking informational efficiency and transparency. Because venture-backed startups typically issue preferred stock to investors such as VCs and other institutional investors, the price of a particular series of stock reflects a specific set of contractual features that varies from other series issued by the same company.208 Significant amounts of time often pass in between rounds of stock issuances, and there may be no trading in between, all while new material information is developing for the company. Valuations reflect the views of the company’s enthusiasts; it is not possible to short sell private company stock.209 Moreover, views about valuation can vary widely and can change dramatically with little notice or transparency.210 All of these factors contribute to the lack of available information about stock price that would allow attorneys to monitor for stock drops followed by corrective disclosures—a typical technique for identifying potential securities fraud suits.211

As a related point, there might be significant frictions to bringing aggregate litigation in the private company context. The fraud-on-the-market theory would not apply given the lack of an efficient market as the Supreme Court described in Basic v. Levinson212 and reaffirmed in Halliburton Co. v. Erica P. John Fund,

208. See Gornall & Streubelav, supra note 94, at 120; Pollman, supra note 99, at 172–74.
210. For example, Morgan Stanley’s mutual funds valued Palantir at $4.4 billion at the same time that several other Palantir investors appraised it higher, and Morgan Stanley’s own bankers predicted that the company could price nine times as much in an IPO. See Lizette Chapman & Sonali Basak, Palantir Tried Buying Morgan Stanley’s Stake in Value Feud, BLOOMBERG (Nov. 15, 2018, 10:22 AM), https://www.bloomberg.com/news/articles/2018-11-14/palantir-said-to-try-buying-morgan-stanley-s-stake-in-value-feud.
211. See supra note 88 and accompanying text; see also Park, supra note 123, at 141 (“Securities law targets a particular kind of investor injury that is triggered by the purchase or sale of securities at a distorted price.”). This point highlights that public market stock prices are a public good. See de Fontenay, supra note 103, at 449 (“[P]ublic companies’ mandatory disclosure and stock trading prices provide a major information subsidy to private companies. . . .”); Clayton, 2019 Remarks, supra note 92 (“Prices for stocks, bonds, and other assets, generated by markets that are transparent, information rich and fair, are of immense value to our economy. They are . . . ‘public goods[,]’ [and generally, once prices are published, we can all use them.’].”)
212. See supra notes 78–81 and accompanying text. For arguments that the fraud-on-the-market theory should not be limited by the concept of the efficient market hypothesis, see Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities Regulation, 55 DUKE L.J. 711, 712, 719 (2006) (arguing for “the use of the fraud-on-the-market presumption in all fraud cases even when markets are inefficient”) and Donald C. Langevoort, Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation, 97 NW. U. L. REV. 135, 176 (2002) (arguing that “the [efficient market hypothesis] is unnecessary to justify the Court’s approach” to fraud-on-the-market reliance and
Inc. (Halliburton II). The individual reliance of each shareholder would have to be shown. The shareholders might be positioned differently such that a class could not be easily maintained. Shareholders in startups often vary in the amounts of different classes and series of stock that they hold on different terms.

Furthermore, there could be difficulty in actually building a class of shareholders who want to be included in the lawsuit. Traditional VC and private equity investors have been assumed to be sophisticated players who understand and manage these risks. They perform their own due diligence and place bets in a portfolio of companies, knowing that many may fail for various reasons, including for misconduct or mismanagement. In particular, the portfolio approach of VC investing that seeks a small number of mega hits allows for a buffer for some amount of loss from fraud. There may be little to gain from pursuing private action against bad actors in these situations—no deep pockets to seek recompense, and it could be bad for a VC’s reputation. Further, some VCs actively manage their investments by sitting on company boards, and they might have failed to catch the fraud and could be exposed to litigation risk in their own right.

This point has its limits, however. Although the rationale of risk spreading through a portfolio of investments may work for venture capitalists and private equity investors, it does not eliminate the potential impact of a massive business failure on other shareholders (and stakeholders). Furthermore, with private companies reaching high valuations and staying private longer, the potential impact is greater in terms of financial magnitude and number and type of participants affected. Even venture capitalists may not fare well with spreading risk through a portfolio approach when valuations are skyrocketing.

“[o]ne can readily justify the presumption as the only workable way to facilitate private litigation in this area, substituting causation in place of reliance”.


214. This might be an impediment to maintaining suit as a class or may add cost to doing so, but it might still be possible to show reliance through transaction-specific documents. See Glater, supra note 29, at 50–51 (“An investor who files a lawsuit alleging fraud after purchasing securities through a private placement (a transaction available essentially by invitation only) can draw on transaction-specific information that is more detailed and relevant than disclosures in an annual report, for example.”) (footnotes omitted).

215. See Pollman, supra note 99, at 179–99 (explaining that differences in shareholder positions in startups and terms can give rise to conflicts among shareholders of all types).


217. See Johnson, supra note 31, at 197–98 (“Such antifraud-only markets may be acceptable for institutional players, but they are not designed for individual investors.”).
The economics of the lawsuit, however, might be problematic for plaintiffs’ attorneys. Attorneys’ fees are mainly driven by recoveries. Therefore, “the larger the potential payout, the more willing a rational plaintiffs’ lawyer is to pursue a case with a smaller likelihood of success.” This dynamic likely attracts attorneys toward large public corporation cases even if there are meritorious cases against private companies. Furthermore, the number of shareholders affected to join a private class action will nearly always be fewer than in the public company context because private companies must avoid the 2,000 holders-of-record threshold under Section 12(g) in order to stay private. The availability (or lack) of directors and officers (D&O) insurance in the private company context, and limits in coverage, might also affect the prospect of suit from the attorneys’ perspectives. In addition, given the potentially smaller scale of lawsuit, the expense of hiring experts could also make bringing suit less attractive as a matter of economics.

Finally, the likely gains from compensatory money damages differ in public and private contexts. In the public company setting, one of the key criticisms of securities class actions is that because corporate defendants tend to fund settlements, it is the public company shareholders who ultimately pay, giving rise to a “circularity” of the money flows. As some class members will continue to hold shares, some portion of the class will fund a portion of their own recovery, and on

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219. Rose, supra note 53, at 47; see also Berdejó, supra note 29, at 581 (“The structure of attorney compensation in class actions renders these ineffective in the context of small-scale fraud, which results in a skewed composition of securities fraud class actions favoring cases involving large-scale fraud.”); James D. Cox, Randall S. Thomas & Dana Kiku, SEC Enforcement Heuristics: An Empirical Inquiry, 53 DUKE L.J. 737, 744 (2003) (“In many cases, the loss suffered by the plaintiff or even a group of plaintiffs may not rise to a sufficient level to attract the interest of the entrepreneurial plaintiffs’ attorney.”).

220. See 15 U.S.C. § 78l(g)(1)(A) (2018). Employees with stock options do not count toward this threshold and may not have standing to sue for securities fraud. See In re Cendant Corp. Sec. Litig., 81 F. Supp. 2d 550, 555–58 (D.N.J. 2000) (holding that employees were not “purchasers or sellers” of any securities, as required for a Section 10(b) and Rule 10b–5 action); In re Cendant Corp. Sec. Litig., 76 F. Supp. 2d 539, 544, 550 (D.N.J. 1999) (holding that former employee lacked standing to bring private action under Section 10(b) and Rule 10b–5 because employee had not purchased or sold any of the stock options received under employee stock option plan); Aran, supra note 130, at 892 n.98 (noting that the JOBS Act of 2012 “allow[ed] companies to exclude securities held by Rule 701 offerees when counting” shareholders of record); Matthew T. Bodie, Aligning Incentives with Equity: Employee Stock Options and Rule 10b–5, 88 IOWA L. REV. 539, 542–43 (2003) (discussing case law ruling that employee stock option holders lack standing to bring Rule 10b–5 actions); Cable, supra note 130, at 625 (“The JOBS Act . . . significantly relaxed the 12(g) threshold by exempting shares that traced back to Rule 701.”).


a macro level, over time they will be on the paying side as often as on the receiving side. Diversified investors in public company stock may not, therefore, ultimately benefit on a net basis from fraud-on-the-market settlements—they may simply “produce wealth transfers among shareholders that neither compensate nor deter.”

Private company shareholders do not have the same circularity problem on a macro level because they are often not truly diversified. However, private company shareholders have a different potential problem that is more likely: the company may not have funds available for a settlement or to pay damages, the individuals responsible may not have deep pockets, and any payout might effectively be the shareholder’s own money. For example, the SEC levied a variety of fines and penalties against Theranos and Elizabeth Holmes, but only a relatively small sum of money might be recovered from Holmes, and the shares she returned had little value because the company was already defaulting on credit agreements with few assets.

On the whole, for the reasons explained, plaintiffs’ attorneys face obstacles to bringing securities fraud class actions in the private company context, and in many circumstances, investors may have little incentive to sue. Sophisticated investors might price this reality into their investments and instead invest in ex ante monitoring mechanisms—which could work reasonably well on an individual level for some investors but represent significant deadweight costs in the aggregate that skew the efficient allocation of capital in this increasingly important sector of the economy.

III. The Future of Policing Fraud in Private Markets

The previous Parts have illuminated the development of Rule 10b-5 in the public market paradigm and the lack of fit of this jurisprudence to the private markets, despite the potential for widespread misconduct. The dominant mode of securities fraud enforcement in the public company context is through class action suits brought by plaintiff lawyers. This mechanism is lacking in the private market context and unlikely to develop in a similar fashion.

This confluence of factors leads to the question of what, if anything, should be done about securities fraud in the private markets. This Part takes up that question by examining a variety of potential responses: maintaining the status quo, increasing public enforcement, adjusting the public–private line, and exploring alternative mechanisms to increase accountability in private companies. Although there is some merit to the status quo approach, a stronger case exists for increasing public enforcement and further considering bolder or more finely tuned regulatory change.

A. MAINTAINING THE STATUS QUO

Debate about the optimal amount of securities fraud enforcement has raged with little regard for private companies. One view upon examination of the issue might be that little, if anything, additional needs to be done. The SEC’s resources are limited.225 To the extent that securities class actions are ineffective in achieving compensation of victims or deterrence of wrongful conduct, critics might urge that this activity not be imported into the private capital market.226

Indeed, some observers might view the relative paucity of securities litigation in private companies as an advantage of staying private.227 Venture capitalists are key victims of securities fraud in the startup context, and they already have an incentive to engage in due diligence and monitoring. In some instances, they self-police by uncovering fraud and addressing the issue internally.228 If liability were to increase, venture-backed startups would likely pay more for insurance, which in turn might increase the cost of investment without creating corresponding gain for investors or—worse yet—chill entrepreneurship and innovation. A similar story can be told about private equity investors and the optimal level of liability and insurance.

Furthermore, reasonable minds might differ regarding how to balance the goals of investor protection and capital formation. The JOBS Act, for example, provides for deregulated forms of capital raising such as crowdfunding based on the notion “that putting more risk on these investors is worth it to enable small-business entrepreneurship and job creation.”229 Similarly, with respect to securities fraud in the private market, one might believe “the social good offset[s] the investor harm suffered.”230 For example, Donald Langevoort explains this viewpoint as one of pursuing the greater good: “Amid all the creative destruction when the [late-1990s] bubble formed and then popped, the Internet was born and

225. Cox et al., supra note 219, at 751–52.
226. See, e.g., Coffee, Jr., supra note 222, at 1535–36 (discussing the “fundamental problem” of securities class action litigation as the failure to compensate victims of fraud and to deter potential wrongdoers); Cox et al., supra note 219, at 741 (“[T]here are two very different perspectives of the role of private suits in the enforcement of the securities laws: one perspective enlists plaintiffs as private attorneys general, and the other perspective paints the same plaintiffs as vexatious litigants.”); Jill E. Fisch, Cause for Concern: Causation and Federal Securities Fraud, 94 IOWA L. REV. 811, 815 (2009) (noting that critics have argued that the class action “is largely ineffective” and have “urged that private litigation be substantially reduced or eliminated”).
227. See, e.g., Jonathan Macey, The SEC’s Facebook Fiasco, WALL ST. J. (Jan. 20, 2011, 12:01 AM), https://www.wsj.com/articles/SB10001424052748703954004576089840802830596 ("In a public offering, shares are bought by representatives of plaintiffs’ law firms, and if the share price goes down significantly after the offering, the issuer and underwriters typically get sued for having misrepresented the merits of the deal. This is far less likely to happen in a private placement.").
229. LANGEVOORT, supra note 37, at 2.
230. Id.
began maturing, with the United States well in the lead in global technology inno-
vation.231 Within bounds, “a moderate excess of investor confidence can enhance capital formation. If so, . . . [t]he law should take a light touch.”232

Another viewpoint in support of the status quo might focus on the nature of innovative technology companies that constitute a significant portion of the private capital market. As valuations of private technology startups are at times subjective or unreliable, one might worry that increased securities litigation and enforcement would have an overdeterrent effect because valuation fluctuations and failures might be confused with misconduct in hindsight.

Along a similar vein, innovative companies may need a long leash during the early part of their life cycle. It may be that “in an economy that values innovation and aggressiveness—creative disruption—transparency doesn’t work well. Private equity-style financing, allowing more confidential forms of governance, may be better.”233 Venture- and private-equity-backed companies may benefit, on average, from being allowed to operate largely in the dark and not to disclose significant amounts of information while they are in their most innovative or transformational phase—for competitive reasons and to give the company space to nimbly adjust and pivot from product ideas or business models. Furthermore, from the perspective of VCs, early stage investing is anyway speculative and investment decisions are made on intuitions about the promise of the team and market opportunity.234 Enforcing representations about early-stage investments makes little sense if the parties involved understood, despite the hype, that the company was high-risk and the bet was on future performance. In addition, for a VC it might make little difference if a loss in the portfolio comes from a company that made material misstatements or one that simply failed to successfully execute the business plan or develop technology—in fact, on the whole they might prefer to invest in teams and companies that push boundaries even if that means that some will cross the line.235

Most fundamentally, one might argue that investors in private capital markets are typically sophisticated or accredited investors such that they can bear the loss and are not a vulnerable class.236 Private equity and venture-backed governance

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231. Id. at 17.
232. Id.
234. See KUPOR, supra note 164, at 42–52 (explaining that early-stage VCs decide to invest based on people and team, the process the founder used to get to the current product idea, and market size).
235. See, e.g., Polina Marinova, Why VC Tim Draper Keeps Defending Theranos CEO Elizabeth Holmes, FORTUNE (May 11, 2018, 10:52 AM), https://fortune.com/2018/05/11/tim-draper-theranos-elizabeth-holmes (“Look, when I’m an investor in a startup, I assume that 60% of them are going to go out of business . . . I make my money on a few extraordinary companies. Theranos was one of those extraordinary companies that could’ve been one of those big, huge winners.” (quoting a venture capitalist)).
236. See, e.g., Leo E. Strine, Jr., Response, Poor Pitiful or Potently Powerful Preferred?, 161 U. PA. L. REV. 2025, 2029 (2013) (observing that investors who buy preferred stock in startups are “quite sophisticated”).
are often assumed to have fewer agency costs because ownership and control are not entirely separated, and investors play a monitoring role.\footnote{237} As the next Section explores, however, this view does not account for potential harms to other shareholders and stakeholders.

B. INCREASING PUBLIC ENFORCEMENT

The threat of SEC engagement has hung over Silicon Valley and the world of technology startups as the private capital market grows. In 2016, then-SEC Chair, Mary Jo White, gave a speech at Stanford Law School, encouraging startups to concern themselves with transparent disclosure, financial controls, and good corporate governance.\footnote{238} She noted that the SEC was watching the secondary market for trading pre-IPO shares.\footnote{239} The previous year, the SEC brought its first enforcement action under the Dodd-Frank Act’s rules that require registering security-based swaps or limiting them to “eligible contract participant[s].”\footnote{240} Specifically, the SEC detected violations by a Silicon Valley-based startup, Sand Hill Exchange, which illegally offered and sold derivative contracts based on the value of pre-IPO shares.\footnote{241} The platform was quickly shut down.\footnote{242} Further, not long after Chair White’s speech, the SEC launched its investigation of Theranos, which eventually resulted in a settlement with CEO–founder Elizabeth Holmes, as discussed above.\footnote{243}

Yet, despite these warnings, the relative infrequency of actions has given an empty tone to the SEC threat.\footnote{244} Until startups prepare to go public, they are

\footnote{237. See Ronald J. Gilson & Jeffrey N. Gordon, Board 3.0: An Introduction, 74 Bus. Law. 351, 359 (2019) (describing the private equity board model as “thickly informed, well-resourced, and highly motivated” and includes members with deal and operations experience as well as an outside director with industry-specific experience); Pollman, supra note 99, at 200–09 (explaining and critiquing the conventional view that VCs are strong monitors).


239. See id.


241. See id.

242. Id.


244. Before Chair White’s 2016 speech in Silicon Valley, one of the few private company enforcement actions dated to 2011, in a case alleging that Stiefel Labs, a family-owned business, had undervalued employee stock for buybacks, while the CEO was aware that the equity valuation was low and misleading because the company was in negotiations for a sale to GlaxoSmithKline. See Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges GlaxoSmithKline Subsidiary and Former CEO with
under no obligation to follow advice for better governance and may be unlikely to take heed without a greater possibility of SEC activity in the space. Some observers were quick to criticize the lack of clarity from the SEC, noting that vague threats regarding SEC interest in frothy valuations only adds uncertainty.\footnote{245} Some enforcement actions have followed in subsequent years but have not illuminated a clear picture that enforcement against private company frauds is a priority on the agency’s agenda.\footnote{246}

A variety of arguments weigh in favor of increasing SEC enforcement through clear and consistent action. Above all, the sheer size of the private company market and of certain late-stage startups means that if the SEC maintains the longstanding allocation of enforcement between public and private markets, it is giving considerably fewer proportional resources than in times past to the private side of the line.\footnote{247} Higher enforcement might encourage allocational efficiency and the quality of private company offerings.\footnote{248}

Furthermore, VCs are not always the strong monitors they are assumed to be because they not only serve in overlapping roles as board members and shareholders but also are repeat institutional players in a reputation-based market for investments.\footnote{249} The “fire-the-founder” era of the twentieth century gave way to a “founder-friendly” era of the twenty-first century with competitive pressures on VCs.\footnote{250} Startup governance may not sufficiently constrain the social costs of high-growth, innovative startups.\footnote{251}


\footnote{247. The SEC also has certain advantages over private litigants. See Buell, supra note 26, at 546 (“When it charges securities fraud, the SEC is not a victim seeking damages, so it need not show that it did anything, much less that it acted in reliance on anything the defendant did. Nor does the SEC need to show that it suffered any loss.”).}

\footnote{248. See John C. Coffee, Jr., Law and the Market: The Impact of Enforcement, 156 U. PA. L. REV. 229, 230 (2007) (arguing that “higher enforcement intensity gives the U.S. economy a lower cost of capital and higher securities valuations”); Hillary A. Sale, Disclosure’s Purpose, 107 GEO. L.J. 1045, 1065 (2019) (“When coupled with enforcement and litigation, the system is designed to increase the odds of a strong and healthy market system—where fraud is policed and punished and capital is allocated efficiently.”).}

\footnote{249. See Pollman, supra note 99 (explaining why some startup boards have monitoring failures).}

\footnote{250. See Steve Blank, When Founders Go Too Far, HARV. BUS. REV., Nov.–Dec. 2017, at 94.}

\footnote{251. See id.}
Additionally, VCs can spread their risk through a portfolio of investments, but this does not eliminate the potential impact of securities fraud on other shareholders and stakeholders. Accredited investor status does not necessarily reflect true sophistication.\(^{252}\) Retail investors are exposed to securities fraud in private companies through their investments in mutual funds and pension funds. Employees often receive a significant portion of their compensation in stock or stock options, and they cannot easily diversify their risk—they can only work full-time for one company at a time, and they are usually not in a position to invest in other private companies. And, critically, the harm to employees, consumers, and others from large business failures can be significant. As Urska Velikonja has argued, empirical evidence suggests that “harm to nonshareholders dwarfs that suffered by defrauded shareholders,” and these “other market participants cannot easily self-insure.”\(^{253}\) Given the large footprint of some private companies, the impact on the public can be meaningful.\(^{254}\)

Protective devices that sophisticated investors contract for in VC deals such as IPO ratchets in some way counteract harm from fraud—but that only protects the holder of the right, typically the last money invested in a company, and other investors and stakeholders might suffer. Employees typically hold common stock or options, not preferred stock with contractual mechanisms.\(^{255}\) Their stock or options are based on valuations that employees typically do not have the ability.

\(^{252}\) Rodrigues, supra note 70, at 1558–59 (noting that trading even among accredited investors “raises serious questions about investor protection—at least if one believes, as many scholars do—that accredited investor status does not equate to sophistication”); see Howard M. Friedman, On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation, 47 OKLA. L. REV. 291, 293 (1994); Felicia Smith, Madoff Ponzi Scheme Exposes “The Myth of the Sophisticated Investor,” 40 U. BALTIMORE L. REV. 215, 253, 262–63 (2010). The SEC’s recently expanded definition of accredited investor allows individuals to qualify for this status based on certain professional certifications or credentials. See Press Release, U.S. Sec. & Exch. Comm’n, supra note 115. Although this change may alleviate concern regarding the sophistication of at least some accredited investors, the SEC has opened the door to investing in private company stock to a greater number of investors, and individuals may still qualify based on their income or assets.

\(^{253}\) Velikonja, supra note 19, at 1887–88; see id. at 1916–29, 1937–38 (discussing harms to creditors, employees, the government, and communities); see also Ann M. Lipton, Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure, 37 YALE J. ON REG. 499, 572 (2020) (“Massive, socially impactful companies may do very well by their shareholders, but by operating out of the public eye, they can do significant harm to their employees, customers, and competitors.”).

\(^{254}\) See Langevoort & Thompson, supra note 63, at 339–42; Sale, supra note 248, at 1046 (“Disclosure’s purpose, then, is to diminish asymmetries and the space for fraud, both for those within the entity and for the public affected by the entity.”); Sale & Thompson, supra note 207, at 487–88, 526–31 (arguing that securities litigation encompasses a broader set of goals related to publicness, including market protection, innovation, growth, stability, and systemic considerations). See generally Hillary A. Sale, The Corporate Purpose of Social License (Feb. 19, 2020) (unpublished manuscript) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3403706 [https://perma.cc/5KZ2-RPEC]) (exploring how failure to account for the public nature of corporate actions can result in the loss of social license).

\(^{255}\) See MAYNARD ET AL., supra note 125, at 337–39.
or leverage to negotiate. Particularly where there is a vulnerable or harmed class of employees, the SEC may be better positioned to take action as the harmed individuals may not have the means to pursue action, and courts might find that employees who are only option holders lack standing.

Finally, one study explored the factors that correlate with higher or lower levels of fraud around the time of an IPO, finding that firms’ incentives to commit fraud interact with investors’ beliefs and monitoring incentives. The study found that “voluntary monitoring by institutional investors or venture capitalists is less effective at reducing fraud when investors are optimistic about an industry’s prospects.” Thus, “[i]f regulators want to reduce fraud in order to avoid [the] externalities and negative consequences of fraud, more regulatory vigilance in good times may be needed.” This research suggests that as the private capital market grows, the SEC should proportionately scale or otherwise increase its enforcement efforts and remain engaged even during periods of growth and enthusiasm. Federal prosecutors and state regulators may also have an increased role to play to effectuate an optimal quantity and quality of enforcement.

C. ADJUSTING THE PUBLIC–PRIVATE LINE

The debate engaged thus far operates on the existing regulatory framework and considers how greater public oversight and enforcement are warranted given the growth of the private capital market and the weakness of private securities litigation. The discussion has also highlighted a concern that some of the shareholders and option holders in the private market will not be wealthy, sophisticated, or have access to information and may be more easily misled or kept in the dark. Further, retail investors are now exposed to the private market through mutual and pension funds, just as they are to the public market—and more broadly, other stakeholders such as consumers may also be impacted by private companies that are not subjected to the discipline that securities fraud class actions can impose.


257. See Bodie, supra note 220 (discussing case law that dismissed claims under Rule 10b–5 brought by employees who held stock options for lack of standing); Cable, supra note 130, at 622–28 (discussing vulnerability of unicorn employees); Fan, supra note 130, at 585, 603–05 (same).

258. See Tracy Yue Wang, Andrew Winton & Xiaoyun Yu, Corporate Fraud and Business Conditions: Evidence from IPOs, 65 J. FIN. 2255, 2256, 2287 (2010).

259. Id. at 2257; see also id. at 2256–57 (“[W]hen venture capitalists are present or when venture capitalists enjoy a high level of industry expertise, fraud is less likely for low investor beliefs but more likely for high investor beliefs.”).

260. Id. at 2257.

261. See id. at 2287.

262. See Berdejó, supra note 29, at 572–73; Park, supra note 123, at 117–22; Andrew K. Jennings, State Securities Enforcement 12–30 (June 8, 2020) (unpublished manuscript) (on file with author) (surveying state securities enforcers); cf. Johnson, supra note 31, at 198 (arguing that “Congress or the SEC should return to the states the power to enforce private placement standards” to “allow states some meaningful measure of authority to protect investors in the more dangerous private markets”).
The observations highlighted in this Article, therefore, not only raise the possible need for greater public oversight and enforcement in the private market but also point to a larger issue and potential policy response—a redrawing of the public–private line. A growing scholarly debate has generated a variety of proposals to this end, but it has focused on the need for disclosure as the rationale rather than the problem of securities fraud. The motivating philosophy of our securities law framework, however, envisions both disclosure and enforcement against fraud as reinforcing mechanisms for protection of investors and the general public. This Article may therefore bolster the rising voices pushing for reexamination of the public–private divide.

The literature, for example, includes scholarship that champions redrawing the public–private line with a tiered approach by reference either to market capitalization or trading volume.263 One such proposal would require companies that hit the public threshold to go through a seasoning period, during which they would make periodic disclosures, before making public offerings.264 Supporting this view is the promise that it might promote efficient capital formation, eliminate waste currently associated with IPOs, and more vigorously protect unsophisticated investors in the public markets.265 More broadly, the proposals for a tiered approach, particularly by trading volume, harken back to the original idea that gave rise to Section 12(g) and cohere with the logic of needing public disclosure.266

Other scholars have proposed a system of scaled disclosure that would account for the social footprint or “publicness” of large companies.267 These arguments recognize that theoretical justifications for mandatory disclosure are grounded in benefits to all citizens, not only investors.268 Further, a graduated approach to

263. See, e.g., Pritchard, supra note 63, at 1002 (proposing “a two-tier market for both primary and secondary transactions keyed to investor sophistication” using “[a]n easily measured quantitative benchmark—market capitalization or trading volume”); Rodrigues, supra note 70, at 1561 (discussing proposals to require mandatory disclosure based on active trading of a company’s shares or size of public float).

264. Pritchard, supra note 63, at 1002.

265. See, e.g., id.


267. See Langevoort & Thompson, supra note 63, at 342; see also Sale, supra note 248, at 1046 (arguing the purposes of disclosure extend beyond investors to the public).

268. See Coffee, Jr., supra note 266, at 722 (explaining the social interest in an allocatively efficient capital market and arguing that mandatory disclosure provides a public good); de Fontenay, supra note 103, at 487 (discussing mandatory disclosure as a public good); Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment, 85 VA. L. REV. 1335, 1415
public disclosure might better reflect the different types of corporations and their societal impacts.269

Without further study of the frequency and magnitude of fraud in the private market, it is far from clear that a bold redrawing of the public–private line would be justified on that basis alone. The growth of the private market relatively free from securities fraud scrutiny does, however, present a new argument in favor of at least taking a hard look at the issue. Political economy forces could have led the SEC to allow for private capital market growth beyond its optimal size, or the expansion might be the unintended consequence of a series of smaller regulatory and market changes.270

As the SEC expands access to the private market and liberalizes restrictions on capital formation, it is particularly important to reflect on whether these goals are appropriate and whether they could be achieved while lessening the harms of fraud in the private market.271 The public–private line could be redrawn to create a larger public sphere or smaller measures along that path could be considered, such as fixing easily manipulated metrics such as “record” shareholders or allowing for some measure of short selling in the private market to create a mechanism for downward price pressure and signaling.

D. EXPLORING ALTERNATIVE MECHANISMS TO INCREASE ACCOUNTABILITY IN PRIVATE COMPANIES

Another broader implication of the developments discussed in this Article is that securities fraud might operate somewhat differently in the private company context. Some of the conventional “gatekeepers,” such as securities analysts and credit rating agencies are absent from the private market.272 Without a public market and active trading, there are no stock price drops for plaintiffs’ attorneys to find potential class actions with low search costs.

With these differences in mechanisms to identify and enforce securities fraud, the nontraditional players (employees, media, and industry regulators) may take

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269. See Langevoort & Thompson, supra note 63, at 379 (proposing to “separate out the largest issuers (public issuers) for full publicness treatment rather than just exempting the smallest”); see also Fan, supra note 130, at 583 (arguing for “enhanced disclosure requirements that will alleviate the risks of unicorns”); Schwartz, supra note 88, at 531 (proposing a “lifecycle model” in which “regulations would adapt to firms as they age”).


271. See Pritchard, supra note 63, at 1024 (“[W]e should funnel transactions to the venues that make it most difficult to get away with fraud.”).

on greater importance as monitors in the private market.\textsuperscript{273} The Theranos case, for example, highlights the role that an employee–whistleblower can play in bringing alleged fraud to light.\textsuperscript{274} Employees reached out to the media, which then investigated and reported to the public, attracting the attention of the SEC and the DOJ.\textsuperscript{275} Other regulators, such as the Food and Drug Administration, also took action to protect the public interest.\textsuperscript{276}

Two types of actors hold notable promise: employees and trading marketplaces. Each offers a different potential avenue for increasing accountability in private companies—one internal and one external.

First, employees are particularly well positioned to serve as monitors in private companies because they are some of the only individuals with access to information. Rank-and-file employees are typically not privy to financing documents, but they may be involved in technology development, creating marketing materials and pitch decks, and producing information for the due diligence process. Red flags can appear in any of these information-producing activities and might alert employees to potential securities fraud and allow them to gather relevant information that could be brought to light.

Further, because employees in startups frequently hold stock options or shares of common stock, they may have more incentive to take on this monitoring role or serve as whistleblowers.\textsuperscript{277} Not only are they equity holders, they may in some sense be understood as the residual claimants to the value of the firm.\textsuperscript{278} The flip side of this point is that stock options might in some circumstances have the opposite effect of encouraging employees to hide fraud or participate in it as they may believe exposure could affect their own financial reward or result in retaliation. Whistleblower protections and rewards can provide important incentives for employees to come forward, but they can also be gamed or manipulated by employees.\textsuperscript{279} For these reasons, relying on employees for fraud detection is

\textsuperscript{273} Alexander Dyck, Adair Morse & Luigi Zingales, \textit{Who Blows the Whistle on Corporate Fraud?}, 65 J. Fin. 2213, 2213, 2251 (2010) (finding that fraud detection “takes a village, including several nontraditional players [such as] employees, media, and industry regulators” and that having access to information or monetary rewards has a significant impact on the probability a stakeholder becomes a whistleblower).

\textsuperscript{274} See \textit{Carreyrou}, supra note 8, at 186–200 (describing the role of the employee–whistleblower).

\textsuperscript{275} Id. at 296.

\textsuperscript{276} Id. at 274–75.

\textsuperscript{277} See Sharon Hannes, \textit{Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation}, 105 Mich. L. Rev. 1421, 1421 (2007) (proposing that “recipient employees be viewed as potential monitors of other employees and . . . stock options (or similar types of compensation) motivate them to fulfill this task”).


\textsuperscript{279} See, e.g., Lynne Bernabei, Alan Kabat, Richard Levine & Kristen Sinisi, \textit{Navigating the Nuances of Sarbanes-Oxley and Dodd-Frank Whistleblower Claims}, 65 Pract. Law. 42, 42–44 (2019) (providing overview of Sarbanes-Oxley and Dodd-Frank whistleblower provisions); Matt A. Vega,
likely insufficient but could be given a better chance of success by exploring new mechanisms to provide employees with greater incentives to serve as early whistleblowers or increase their voice in governance, such as through board access or work councils.  

Relatedly, another approach would not rely on employees as a resource but rather would recognize that they are the key group to protect from securities fraud harm in the private market. To the extent that private equity and venture capital investors are sophisticated and do not need protection, the greatest concern is for the class of working investors in private companies—the employees with equity-based compensation.

For years, federal securities law has magnified the importance of private exemptions and accredited investor status while turning a blind eye to concerns about startup employees. A fresh evaluation of Rule 701 on compensatory offerings is warranted, with an understanding that startup employees make important, firm-specific investments. Rather than easing disclosure requirements by raising the Rule 701 threshold, the SEC could take an approach that looks at the changing informational needs of working investors and better recognizes their particular needs and vulnerabilities. The response to securities fraud in the

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**Beyond Incentives: Making Corporate Whistleblowing Moral in the New Era of Dodd-Frank Act “Bounty Hunting,”** 45 *Conn. L. Rev.* 483, 509–13 (2012) (discussing how the SEC’s “bounty program” sends a message that whistleblowers “respond only to radical financial incentives” and could “suppress[] ‘real’ whistleblowing by over incentivizing external whistleblowing”).


281. See *Aran*, supra note 130, at 870 (“Employee recipients of equity compensation are generally not financially sophisticated, and, typically, they do not qualify as accredited investors who would be permitted to participate in a private placement of their employers’ securities.”); Lynn A. Stout, *On the Nature of Corporations*, 2005 *U. Ill. L. Rev.* 253, 265 (“By locking in capital, board governance also attracts firm-specific investments and commitments from a variety of other groups. . . . Employees from the shop floor to the corner office may be more willing to acquire firm-specific skills and to contribute extra hours and extra effort.” (footnote omitted)).


283. *See Aran, supra* note 130, at 875–76 (proposing that Rule 701 be amended to disclose waterfall analysis describing “employee’s personalized expected payout in various exit scenarios” with “appropriate caveats about risk”; *see also* Alon-Beck, *supra* note 128, at 186 (noting that “[r]ank-and-file employees might be naïve,” and suggesting that “[p]erhaps the approach should go even further, and require that unicorns adhere to the same financial disclosure requirements as public companies”); Cable,
private market might thus look quite different from the public market paradigm of securities class actions while responding to the vulnerabilities of those most affected.

Second, a different potential avenue for increasing accountability in private companies could look to the trading marketplaces to play a stronger role as gatekeepers.\textsuperscript{284} Aided by deregulatory efforts, such as new exemptions for private resales of securities,\textsuperscript{285} these intermediaries have been allowed to follow client preferences in facilitating liquidity events.\textsuperscript{286} The marketplaces are presumably motivated by the fees that they earn for providing services, and the incentive of their client companies is to create a liquidity opportunity for certain investors, founders, and employees while maintaining control over their shareholder base to avoid hitting the Section 12(g) threshold for public reporting.

With a hot market of willing buyers, this dynamic may give rise to a market failure for information to be produced.\textsuperscript{287} The lack of mandatory, standardized disclosures could allow for some private companies to engage in issuances or facilitate trading without providing basic information such as audited financial statements that are fundamental building blocks in the public market for accurate pricing. The least sophisticated investors in the marketplace may be either subsidizing the smart money or victims of fraud.\textsuperscript{288}

A range of oversight and regulatory initiatives related to these trading marketplaces could strengthen private company accountability. The SEC could require them to collect and report data regarding the trading of private companies,
including trading volume, participants, and the type of information disclosed. Consistent oversight of this trading data could better position the SEC to detect potential instances of securities fraud and launch further investigations. This pool of data would primarily capture larger, more mature private companies, which would be underinclusive by nature but a clear starting point involving little cost.

Furthermore, the SEC could require a minimum level of disclosure for private secondary trading in order to fit within a registration exemption. The trading marketplaces would then be enlisted in the role of regulator along the lines that exchanges have played for over a century.

These regulatory changes would not only enrich the informational environment of private company stock trading but would also incorporate the monitoring function of another set of gatekeepers—auditors. A variation on this concept could require that executives such as the CEO and CFO provide a certification attesting to the accuracy and fair representation in all material respects of certain information provided to investors, such as financial reports. Although private market participants might prefer the relatively lax status quo, strengthening controls and improving information is an alternative to forcing public company status while still ultimately promoting the integrity of the private market. On the whole, these alternative mechanisms could significantly bolster efforts to increase public enforcement.

CONCLUSION

In a relatively short amount of time, our U.S. capital markets have bifurcated from a dominant public realm to a new reality of two markets—public and private. The explosive growth of the private market rivals the public in terms of aggregate size. With companies staying private longer, much of their growth occurs outside the public market and subject to relatively light securities fraud scrutiny and enforcement. Without the discipline that mandatory disclosure can impose, information asymmetries abound fostering the characteristic ingredients for fraud.

The primary mechanism for policing securities fraud in the public market—securities class actions—has not played a significant role in the private capital market. Rule 10b–5 jurisprudence and practice has developed over decades

289. See Pollman, supra note 29, at 222–26 (arguing for minimum disclosures in private company stock trading).
290. See Paul G. Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1453, 1455 (1997) (arguing that the benefits of securities exchanges provide rules and enforcement mechanisms to protect investors and increase their returns).
291. See COFFEE, JR., supra note 272, at 108–91 (examining the role of auditors as gatekeepers).
through a public company paradigm. In the private company context, the lack of information, rich and transparent pricing, the presence of impediments to aggregate litigation, and different economics for bringing suit create friction for plaintiffs’ attorneys.

It is therefore more pressing than ever to consider how and whether the private capital market is policed for securities fraud, and more broadly, the implications of allowing this market to grow relatively unfettered. This Article identifies several potential responses, including increasing public enforcement, adjusting the public–private line, and implementing alternative mechanisms for accountability such as giving more information to employees and regulating trading marketplaces. Although caution is needed to avoid impinging upon the engine of growth and innovation that our private capital market represents, the potential harm to shareholders and vulnerable stakeholders likely warrants some mix of response that increases oversight, enforcement, and accountability. Looking further ahead, the policymaking imperative to take action raises deeper questions about the ongoing tenability of maintaining the health and integrity of these bifurcated markets. The past twenty-five years of opening the private market and relaxing its rules has fueled an alternate universe to its public parallel, which becomes harder to distinguish yet offers few of the same protections and disciplining mechanisms.