Private Company Lies

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PRIVATE COMPANY LIES

Elizabeth Pollman*

Forthcoming GEO. L.J. 2020

Rule 10b-5’s antifraud catch-all is one of the most consequential pieces of American administrative law and 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.

* Professor of Law, University of Pennsylvania Law School. For helpful conversations and comments, thanks to Yifat Aran, Miriam Baer, Carlos Berdejó, Ryan Bubb, Elisabeth de Fontenay, Jill Fisch, Jeff Gordon, Zack Gubler, Dave Hoffman, Kate Judge, Ann Lipton, Dorothy Lund, Frank Partnoy, Ed Rock, Eric Talley, Urska Velikonja, 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, and the Law & Economics Workshop at Columbia Law School and NYU School of Law.
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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 catchpenny, a sensation, a mechanism for swindling the public 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 dollars 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 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.

Reporting by the 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. 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. The small number of blood tests being run on Theranos devices were unreliable and posed a public health threat to consumers. Under Holmes’ leadership, the company operated in a highly secretive manner, with “information compartmentalized so that only she had the full picture of the system’s development.” As a matter of corporate governance, she had super-majority voting stock that allowed her to maintain control of the company.

The 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, but in fact had barely $100,000 of revenue that

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3 Id.
4 Id.
5 Id.
6 Id.
8 Id. at 36, 50-51.
year. These revelations spurred the spectacular fall of the company, going from a $9 billion valuation to virtually zero, and Holmes settled fraud charges with the SEC in 2018. Criminal charges are currently pending against Holmes and she could face up to twenty years in prison.

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, of course, and dates back to before Edison’s time. 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. 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 a stake 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. Moreover, the relative dearth of enforcement in the private market, which is surging in size and may have rampant 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 $60 to $90 billion valuation for its initial public offering (IPO) to teetering on the brink of bankruptcy within just 33 days. Upon releasing information for the planned offering, public market investors responded with scathing criticism of the company’s losses and corporate governance—WeWork shelved the IPO plans and its private valuation of $47 billion plummeted by 70% almost immediately. The CEO-founder parachuted out of the company

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9 Carreyrou, supra note 2. In addition, the SEC found that Holmes had falsely claimed that Theranos’ products were deployed by the U.S. Department of Defense on the battlefield in Afghanistan. Id.


12 EDWARD J. BALLEISEN, FRAUD: AN AMERICAN HISTORY FROM BARNUM TO MADOFF 9 (2017) (discussing the history of policing business fraud).


15 Campbell, supra note 14.
with a $1.7 billion payout, while various investors faced steep losses—as did over ten thousand employees whose stock options went to zero. Reverberations may be felt in markets around the world as property owners take losses on improvements made for WeWork and other startups struggle to get out of the gate in a tarnished IPO market. 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.

Notably, the federal antifraud catch-all of Rule 10b-5 applies to both public and private company securities. This provision, promulgated under the Securities Exchange Act of 1934, 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.” 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.” Indeed, securities fraud is “one of the most heavily judicially created

18 See Matt Robinson, Robert Schmidt & Ellen Huet, WeWork Is Facing SEC Inquiry Into Possible Rule Violations, BLOOMBERG (Nov. 15, 2019), https://www.bloomberg.com/news/articles/2019-11-15/weework-is-said-to-face-sec-inquiry-into-possible-rule-violations (noting the SEC observed that the irregular financing reporting of WeWork might have been “misleading”). WeWork shareholders have already brought a breach of fiduciary duty suit and the possibility of a Rule 10b-5 securities fraud suit 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. Rey Mashayekhi, WeWork’s Legal Floodgates May Have Just Opened, FORTUNE (Nov. 19, 2019), https://fortune.com/2019/11/19/weework-softbank-takeover-lawsuits/.
19 17 C.F.R. § 240.10b-5 (“in connection with the purchase or sale of any security”).
20 See Samuel W. Buell, What Is Securities Fraud?, 61 DUKE L.J. 511, 540, n.84 (2011) (noting “[t]he rule has sparked thousands of lawsuits, causing billions of dollars to change hands”, “routinely spawned headlines in the nation’s leading papers”, and has “sent hundreds of people to prison, some for decades”).
21 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975); see also LOSS, SELIGMAN & PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 1285-86 (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.”).
bodies of federal law”—but this voluminous case law, and the related scholarly literature, has focused primarily on public corporations and markets.23

This state of the world, with Rule 10b-5 actions generally 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.24 By contrast, private placements were generally composed of sophisticated investors and there was little secondary trading of private company stock.25 Startups were on an average 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. Non-registered securities offerings totaled more than $3 trillion in 2017—far outpacing public offerings for stocks and bonds.26 Companies have stayed private longer on average, fewer companies have gone public, and those that do tend to be larger in size.27 In simple terms, this means that a significant part of the lifecycle of a growth company is typically occurring on the private rather than the public market. For example, if Amazon, Google, and Salesforce had stayed private for the “new normal”—an average of 12 years—an additional $197 billion in

22 Buell, supra note 20, at 545; see also Steven 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.”).


24 See infra Section I.B.

25 See 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.’”); 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.”).


27 See infra Section II.A.
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 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 democratizing retail investors’ opportunities to fund high-risk and potentially high-growth private companies.

As the SEC considers dramatically expanding Main Street 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 private 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

29 Id.
30 See infra Section II.A.
31 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 (2017) (arguing “that the [mutual funds]’ new interest in venture investing poses several potential investor-protection concerns”).
32 See Press Release 2019-97, SEC Seeks Public Comment on Ways to Harmonize Private Securities Offering Exemptions (June 18, 2019), https://www.sec.gov/news/press-release/2019-97 (stating 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); Jay Clayton, SEC Chairman, Testimony on “Oversight of the Securities and Exchange Commission,” U.S. Senate Comm. on Banking, Housing, and Urban Affairs, Dec. 10, 2019, https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%2012-10-191.pdf (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”); 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 the SEC granted certain individuals in the investment sector access to the private markets even though not meeting accredited investor status and expects to further open access to private markets in the future).
33 See infra Section I.B.
34 See infra Section II.C.
pressure, opportunity, and rationalizing culture that can foster misconduct and deception.\textsuperscript{35}

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 a response is due. The path forward should aim to protect the integrity 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.\textsuperscript{36} To date this literature has focused primarily on the need for the sunlight of public disclosure—by contrast, this Article contributes the securities fraud piece of the argument, rooted in our federal framework that envisioned both as key mechanisms for the protection of 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 the development of Rule 10b-5 securities fraud in a public market paradigm. Part II describes the growth of the private capital market, including discussion of both primary issuances and secondary trading. Further, the Part examines governance and cultural factors 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 and 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.

\textsuperscript{35} See infra Section II.B.  
\textsuperscript{36} See infra Section III.C.
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 dwarfed the latter. The story of Rule 10b-5 has been told many times, but what has not been the focus of the tale is the distinctly public lens through which the jurisprudence and practice has developed. 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 over time, 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. At the time of passage, there was “widespread consensus that excessive stock market speculation and the collapse of the stock market had brought down the economy.”37 The securities acts that Congress passed in the Great Depression that followed “were primarily concerned with preventing a recurrence.”38 Together, the two key securities acts put in place a system of mandatory public disclosure and sanctions for disclosure violations and fraud.39

First, after a series of hearings that revealed shocking financial abuses,40 Congress passed the Securities Act of 1933 (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.”41 The 1933 Act replaced the existing caveat

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37 Thel, supra note 22, at 409.
38 Id.
39 See, e.g., LOSS ET AL., supra note 21; Velikonja, supra note 13, 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.”).
40 See generally MICHAEL PERINO, THE HELLHOUND OF WALL STREET: HOW FERDINAND PECORA’S INVESTIGATION OF THE GREAT CRASH FOREVER CHANGED AMERICAN FINANCE (2010) (discussing the Pecora hearings that brought to light a freewheeling banking industry in which officials had sold worthless bonds, manipulated stock prices, and garnered excessive compensation and bonuses); see also Thel, supra note 22, at 394-424 (discussing the historical background of the 1934 Act); LOSS ET AL., supra note 21, at 254-57, 300-305 (describing the events of 1929-1933).
41 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976). 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
emptor philosophy with one of issuer disclosure.42 Further, the 1933 Act includes section 17(a), prohibiting fraud and misrepresentations in the offer or sale of securities.43

Second, in light of the apparent need for additional regulation beyond primary securities offerings from issuers, Congress passed the Securities Exchange Act of 1934 (the 1934 Act), which provides for periodic reporting requirements and a broad catch-all prohibition against securities fraud in section 10(b).44 This provision makes it unlawful to “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.45 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.”46 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.47

In an oft-recounted anecdote, a staff attorney described how the SEC’s rule was created several years later, in 1942, in response to a specific incident of fraud—an executive was buying up stock in his own company, telling shareholders that the company was doing very badly, while knowing that earnings would in fact quadruple or allow for private rights of action. Touche Ross & Co. v. Redington, 442 U.S. 560, 568-71 (1979); Finkel v. Stratton Corp., 962 F.2d 169, 174-75 (2d Cir. 1992) (discussing difference between Section 17 and Rule 10b-5); Maldonado v. Dominguez, 137 F.3d 1, 3 (1st Cir. 1998) (Section 17 actions can be brought in civil regulatory actions by the SEC and criminal prosecutions by the DOJ, but not plaintiffs in private lawsuits); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 859 (2d Cir. 1968) (noting Section 10(b) was intended as a broad “catch-all” enforcement provision aimed at both buyers and sellers of securities).


44 See LOSS ET AL., supra note 21, at 263-66, 328-30 (describing the perceived need for the 1934 Act and its main provisions) (“The 1934 Act, as initially enacted, had four basic purposes: to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and manipulation of the markets; to regulate the securities markets; and to control the amount of the Nation’s credit that goes into those markets.”); see also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 859 (2d Cir. 1968) (“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.”).


46 See LOSS ET AL., supra note 21, at 290-91, 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 staunching 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.”).

in the coming year. Upon learning of this incident, the staff attorney and a 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 light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.” As the telling goes, upon submitting the draft language to the commissioners, they passed it around the table and immediately approved it without controversy. The only comment made was by Commissioner Sumner Pike who said, “Well. . . we are against fraud, aren’t we?”

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

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

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48 Blue Chip Stamps, 421 U.S. at 767 (Blackmun, J., dissenting).
49 Id.
50 17 C.F.R. § 240.10b-5. The Supreme Court has established a private cause of action 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 (5) loss causation, i.e., a causal connection between the material misrepresentation and the loss.” Buell, supra note 20, at 545 (internal quotation marks and footnotes omitted).
51 Blue Chip Stamps, 421 U.S. at 767 (Blackmun, J., dissenting).
52 Id.
54 Rose, supra note 47, at 40-41.
55 Id. (noting that in the early years of securities fraud jurisprudence “there was little difference between Rule 1b-5 and common law fraud claims”); 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, “[p]rivate 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.”); I. A. BROMBERG, SECURITIES LAW: FRAUD § 4.2 (1975) (“The archetypal 10b-5 case is the purchase by one group in a closed corporation of the interest of another . . .”).
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 largely 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.\(^{56}\) The 1933 Act governs “public offerings,” but does not define the term.\(^{57}\) An early SEC release provided guidance for exempt transactions, noting as relevant factors various indicia of a small offering size and close relationship between the issuer and offerees.\(^{58}\) In 1953, the Supreme Court handed down its decision in \emph{SEC v. Ralston Purina Co.}, ruling that offerees who could “fend for themselves” did not need the protections of the Act.\(^{59}\) This interpretation focused the 1933 Act’s public-private line on notions of qualification for private investments based on investor wealth and sophistication.\(^{60}\)

By contrast, the 1934 Act tied the periodic public disclosure obligations to voluntarily listing on a national securities exchange,\(^{61}\) 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.\(^{62}\) 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

\(^{56}\) A.C. Pritchard, \emph{Revisiting “Truth in Securities” Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good}, 36 SEATTLE U. L. REV. 999, 1000-1001 (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); Donald C. Langevoort & Robert B. Thompson, \emph{Publicness in Contemporary Securities Regulation After the JOBS Act}, 101 GEO. L.J. 337, 339-40 (noting the “gross inconsistency” in how the securities acts approach the public-private divide).

\(^{57}\) See 15 U.S.C. § 77d(2) (stating the Section 5 registration requirement shall not apply to “transactions by an issuer not involving any public offering”); Langevoort & Thompson, supra note 56, at 343, n.14 (noting the intrastate exemption and exemptions for small dollar offerings).


\(^{59}\) 346 U.S. 119, 125 (1953).


\(^{61}\) Id. at 344; 15 U.S.C. §§ 78m(a), 78n(a) (1934).

\(^{62}\) Richard M. Phillips & Morgan Shipman, \emph{An Analysis of the Securities Acts Amendments of 1964}, 1964 DUKE L.J. 706 (1964); see also Langevoort & Thompson, supra note 56, at 345 (noting the lack of theoretical consensus on how to define publicness for purposes of section 12(g) at the time of adoption); LOSS ET AL., supra note 39, 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. Guttentag, \emph{Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures}, 88 IND. L.J. 151, 166-68 (2013) (discussing congressional debate of the 1964 amendments).
disclosure regime.\textsuperscript{63} 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) size 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 growing businesses for both capital and liquidity.”\textsuperscript{64}

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.”\textsuperscript{65} 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 \textit{SEC v. Texas Gulf Sulphur Co.}, the Second Circuit held that a defendant need not be either a counterparty nor a contemporaneous trader to violate section 10(b) or Rule 10b-5.\textsuperscript{66} The requirement that the fraud be “in connection with the purchase or sale of [a] security” was met by victims who were purchasers or sellers; the violator could be anyone who made a material misrepresentation or omission in a manner “reasonably calculated to influence the investing public.”\textsuperscript{67} Subsequently, investors began filing actions that became known as “fraud-on-the-market” cases, claiming the marketplace had been deceived by false representations.\textsuperscript{68} Furthermore, 1966 revisions to the Federal Rules of Civil Procedure enabled plaintiffs to aggregate claims in an opt-out class action under Rule 23(b)(3), provided common issues predominate over individualized ones.\textsuperscript{69}

The next important doctrinal development was the Supreme Court’s recognition in \textit{Basic v. Levinson} of a presumption of reliance in private Rule 10b-5 cases involving securities widely traded in “efficient” markets.\textsuperscript{70} 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.\textsuperscript{71} The fraud-on-the-market theory was based on the

\begin{footnotesize}
\begin{enumerate}
\item Langevoort & Thompson, \textit{supra} note 56, at 346.
\item Rose, \textit{supra} note 47, at 39.
\item 401 F.2d 833, 860 (2d Cir. 1968) (en banc).
\item Id. at 862.
\item Langevoort, \textit{supra} note 55, at 2149.
\item Rose, \textit{supra} note 47, at 45.
\item \textit{Basic}, 485 U.S. at 241-47.
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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 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 compensatory damages available in Rule 10b-5 class actions, such that plaintiffs can recover their full out-of-pocket losses attributable to the fraud, attorneys have strong incentive to bring these suits against public company defendants.

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72 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 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 price changes in response to information about a particular company’s stock. See Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. FIN. 383 (1970) (reviewing economics literature on the ECMH); Lawrence A. Cunningham, From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis, 62 GEO. WASH. L. REV. 546 (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”).


74 Rose, supra note 47, at 45-46.

75 Id. (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 10b-5 enforcement”).

76 Securities fraud class actions against public companies exploded by the 1990s, prompting regulation attempting to re-calibrate the level of private litigation. See Buell, supra note 20, 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.”); 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 “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).
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 efficient market.  

From the fraud-on-the-market presumption of reliance to “materiality” defined in terms of a “reasonable investor,” the very elements of a 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 2018, 374 of the 403 securities class actions involved public companies with stock traded on the New York Stock Exchange or Nasdaq. The trend is toward larger company defendants—those involved in cases settled in 2018 were approximately 50 percent larger than those in the previous year, as measured by median total assets—seventy-eight securities class actions against public companies settled for over $5 billion in total. As the next Part explains, while these settlement amounts and corporate defendants are large, the doctrinal evolution of securities litigation toward a public

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77 See Buell, supra note 20, at 550 (“the class action dominates the modern industry of private securities litigation”).

78 Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 38 (2011) (discussing “materiality”); No. 84 Employer-Teamster JT Council Pension Trust Fund v. Am. West Holding Co., 320 F.3d 920, 950 (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 (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 (2012) (noting courts have allowed the market itself to stand-in for the reasonable investor when securities are traded in an “efficient” market).

79 To be sure, on the government side, the SEC and DOJ also play a critical role in enforcement and can go after the full spectrum of public and private companies. See James J. Park, Rules, Principles, and the Competition to Enforce the Securities Laws, 100 CALIF. L. REV. 115, 145-62 (2012) (discussing securities fraud enforcement by the SEC, federal prosecutors, state attorneys general, and private class action attorneys); Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 313 (2007) (noting that private actions are an “essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)”).

80 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 Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 344-46 (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”).


82 Id.
company model significantly narrows the realm of capital markets being actively monitored once one takes into account the rise of the private capital market.

II. The Growth of Private Markets and the Potential for Private Company Lies

The era of one dominant capital market in the United States is over. 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 contribut[ing] to the competitiveness of U.S. firms.”

Research indicates that private equity and venture capital investments have grown at twice the rate of their public counterparts in recent years. 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. Private company returns have also outperformed public market-growth—global private equity net asset value grew by 18% in 2018, and overall it has grown by 7.5 times in the twenty-first century—twice as fast as public-market capitalization.

The rising private capital market not only delivers growth and innovation that is the envy of the world, however—it also poses enormous 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 increasing the attractiveness of public capital markets while also expanding Main Street investors’

87 McKinsey, supra note 85.
access to private investments. 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. While the SEC prioritizes opening up access to the private capital market, little debate has focused on the potential for harm through securities fraud in this increasingly large section of the overall capital markets.

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. 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. While 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 homermuns and writing off failures. This Part therefore gives special attention to exploring the information asymmetries, pressure for growth, and freewheeling culture in startups that give rise to the potential for securities fraud that could significantly impact investors and stakeholders. 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 Chairman 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 have declined in number by nearly

88 Clayton, 2019 Remarks, supra note 84.
90 See Erin Griffith, The Ugly Unethical Underside of Silicon Valley, FORTUNE (Dec. 28, 2016), 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 ‘till you make it’ for a successful, disruptive startup. Some companies just push their luck a little too far.”).
91 Id.
92 Id.
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 lifecycle 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. VC funds generally 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 this period through an M&A sale or IPO that makes a significant return on investment. While 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. VCs are based on a business model that aims for having a few “home runs” that account for much of the fund returns.

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95 Gilson, supra note 94, at 1071; Pollman, supra note 89, at 164, 170.


98 Black & Gilson, supra note 96, 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 25, at 11 (“IPOs are the gold standard in VC success.”).

99 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.”); Bob Zider, How Venture Capital Works, HARV. BUS. REV., Nov.-Dec. 1998,
In previous times, a startup company that survived to exit would typically be acquired within its first two years or go public within five and a half years on average. Companies raised capital from public markets to fuel growth and access liquidity for VC investors and startup employees who had received stock options. The world’s largest companies by market capitalization—Microsoft, Amazon, Apple, and Google—all followed this 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 decade 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 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—and, in 2018, the SEC 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.

at 131, 136 (“Given the portfolio approach and the deal structure VCs use, 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.”).


101 See, e.g., Smith, supra note 97, 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.”).


Google had been profitable pre-IPO and was able to finance its operations but hit up against the section 12(g) threshold of 500 shareholders of record and thus decided to file for an IPO. See Rodrigues, supra note 63, at 1537.

103 See Pollman, supra note 89, at 209-16. Bloomberg columnist Matt Levine has referred to this phenomenon with the pithy phrase, “private markets are the new public markets.” Matt Levine, Something Is Lost When Companies Stay Private, BLOOMBERG (April 3, 2018), 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.”).


105 Additionally, the SEC shortened the Rule 144 holding period to allow resales of private company stock after one year with no conditions, and exempted Rule 506 private placements with accredited investors from the ban on general solicitation. See Renee M. Jones, The Unicorn
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 has nearly tripled 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 limit of 2,000 shareholders of record is sufficiently high 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 in their past as a private company. With record-breaking amounts of private capital available, and a competitive market to invest in the most buzzworthy startups, private valuations have been high—leading to speculation of a tech bubble and “overpriced” IPOs.

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. These newcomers expose retail investors to the private markets and, as institutional


106 NVCA 2019 Yearbook, supra note 86; Ritter, supra note 86.

107 See William K. Sjostrom, Jr., Questioning the 500 Equity Holders Trigger, 1 HARV. BUS. L. REV. ONLINE 43, 45 (2011) (explaining that the practical effect of the previous threshold was “to force certain types of firms into public markets”); cf. Rodrigues, supra note 63, at 1530 (finding that the previous threshold of 500 shareholders of record may have affected only three percent of those going public).


109 See Gornall & Strebulaev, supra note 86, at 1 (finding that after adjusting for valuation-inflating terms in preferred stock financings, almost half of “unicorns” lose their status as billion-plus valued companies); David Trainer, The Unicorn Bubble is Bursting, FORBES (Oct. 7, 2019), https://www.forbes.com/sites/greatspeculations/2019/10/07/the-unicorn-bubble-is-bursting/#c3ef34388198 (“There does not appear to be any appreciation for risk of bidding up the price of unicorns too high.”); Matt Phillips et al., 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 “the verdict from the stock market is that it’s the private investment binge that has gone too far”).

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. At core, companies staying private longer and reaching higher valuations means that there is a greater volume of transactions and dollars invested—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 Supreme Court in *Ralston Purina*.

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 generally are not financially sophisticated and typically do not qualify as accredited investors who would be permitted to participate in a private

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111 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 form the issuer to an investor.”); Pollman, *supra* note 23 (discussing secondary trading in private company stock).

112 For example, a notable recent study of 116 unicorn companies found that the average unicorn has eight share classes, indicating many rounds of financings. *Gornall & Strebulaev, supra* note 86, at 3.

113 See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (holding application of the exemption “should turn on whether the particular class of persons affected need the protection of the [Securities] Act. An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering’”); TERESE H. MAYNARD, DANA M. WARREN & SHANNON TREVIÑO, *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.”).

114 If non-accredited investors are included in a Regulation D offering, the issuer would have to comply with Regulation 502(b) which requires financial statements and other information similar to a registration statement for an IPO. See 17 C.F.R. § 230.502(b). For this reason, issuers typically structure private placements to include only accredited investors to avoid the requirements of Rule 502(b).
placement of their employers’ securities. Rule 701 exempts grants of share-based compensation to employees.\textsuperscript{115} Most companies will satisfy the minimal disclosure requirement of Rule 701 by merely providing the employee recipients with a copy of the relevant stock option plan.\textsuperscript{116} Companies that issue more than $10 million worth of securities under the exemption in a 12-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.\textsuperscript{117} 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.\textsuperscript{118}

While the changing private market landscape has impacted primary issuances, the bigger transformation has been the rise of secondary trading in private company stock.\textsuperscript{119} A decade ago, the private secondary market had been notably illiquid and ad hoc, with occasional transfers done as carefully negotiated affairs.\textsuperscript{120} 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.\textsuperscript{121} The agency further provided a regulatory exemption for resales to “qualified institutional

\textsuperscript{115} 17 C.F.R. § 230.701 (2019).
\textsuperscript{116} See id.
\textsuperscript{117} Id.
\textsuperscript{119} Pollman, supra note 23; Darian M. Ibrahim, The New Exit in Venture Capital, 65 VAND. L. REV. 1 (2012). Earlier periods noted a lack of secondary trading in private company stock as a limiting factor on securities fraud litigation. See Steinberg, supra note 23, 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.”).
\textsuperscript{121} 17 C.F.R. § 230.144 (2017); see also Pollman, supra note 23, 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); Jones, supra note 105, at 175 (describing the SEC’s series of reforms shortening the Rule 144 holding periods).
buyers”—allowing unlimited transactions with no holding period. In 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—and quickly the platforms were 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 valuation and information issues that 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 and repositioned itself as the private parallel to its public exchange counterpart. It works with companies to facilitate “structured sales 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 122 17 C.F.R. § 230.144A (2017). Qualified institutional buyers are companies that invest at least $100 million in securities of non-affiliated issuers and registered broker-dealers with over $100 million in assets. Id. § 230.144A(a).
123 Pollman, supra note 23.
125 Pollman, supra note 23, at 205-21 (discussing information issues in secondary trading of private company stock and the potential for insider trading); Rodrigues, supra note 63, 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.”).
fund. Additional private-company marketplaces arose such as Equidate and EquityZen, each with their variations on facilitating private company secondary deals and liquidity for private company employees.

Finally, the level of secondary activity and complexity of the transactions is 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, resulting 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 employees. Companies are often therefore 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.

131 Id.
135 Companies may be exposed to risk to the extent 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. SECURITIES LAWYER BLOG (Mar. 15, 2017), https://www.newyorksecuritieslawyerblog.com.tech-unicorns-engaging-stock-buybacks-securities-law-experts-worried/ (noting “Uber appear[ed] to be profiting off of a] buyback, due
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.\(^{136}\) In light of the lack of mandated disclosure, however, it is clear that 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.\(^{137}\) State enforcement actions provide one indication of significance—private offerings have been the most common source of such actions.\(^{138}\) And, anecdotally, numerous startup stories have made headlines that reveal alleged misconduct that could potentially have touched upon stock purchases or sales. In addition to the examples already highlighted, the past few years have revealed a host of issues: Lending Club falsified loan transactions and failed to disclose the CEO-founder’s conflict of interest;\(^ {139}\) human resources startup Zenefits admitted that its employees cheated on mandatory compliance training central to its business model;\(^ {140}\) WrkRiot’s CEO-founder plead guilty to defrauding to differing liquidity expectations of the buyers and sellers, and the subsequent wide spread between the bid and ask of these private stock offerings.

\(^{136}\) Although different, the public and private markets may act as substitutes for certain purposes. See Gubler, supra note 104, 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).”).

\(^{137}\) 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 [provisions] 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.”).

\(^{138}\) Bernard, supra note 32.


employees by forging wire-transfer documents; Skully’s founders faced a lawsuit alleging they engaged in fraudulent bookkeeping and widespread misuse of funds; mobile payments identification company Jumio allegedly overstated its revenues to investors before going bankrupt; and “sustainable-food” unicorn Hampton Creek 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.

As the potential for securities fraud is thus significant, it is worth exploring the factors that might contribute to its prevalence and the differences that exist from the public company paradigm. One widely adopted framework, from the Association of Certified Fraud examiners, identifies three main factors behind workplace fraud: (1) pressure, (2) opportunity, and (3) rationalization. Each are present in venture-backed startups.

**Pressure.** While 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 or perhaps even less than commonly experienced by startup managers pushed for survival and growth.

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146 Accordingly, 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.

Startups are typically unprofitable for long periods of time and “burning” money, which means many startups are frequently operating on the verge of bankruptcy. Moreover, by its nature, the venture-backed governance model tends to encourage risk-taking and aiming for potentially unattainable goals. Given the high rate of startup failures, each investment in a VC’s portfolio needs to potentially account for the entire return of the fund. Venture capitalists—with these incentives to push for mega hits—sit on and sometimes control the 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 technology and at 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 “skin in the game” that adds to the urgency of survival and growth.

Opportunity. Free from mandatory reporting requirements, private companies have enormous ability to take advantage of information asymmetries—they can publicize unaudited financials and 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 12-24 months, and

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99, at 87 (discussing the importance to venture capitalists of investing only in startups that have “the potential to succeed at vast scale”); Prayag Narula, It’s Time to Talk About Stress At Venture-Backed Tech Startups, FORBES (Apr. 20, 2018), https://www.forbes.com/sites/forbestechcouncil/2018/04/20/its-time-to-talk-about-stress-at-venture-backed-tech-startups/#1250284857ac (discussing the “[s]tress-induced mental health challenges” that affect founders of venture-backed startup, including lack of sleep and depression).

147 Pollman, supra note 89, 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”); Griffith, supra note 90 (“The nature of technology requires a degree of magical thinking to function. . . . Even the most well-intentioned startup founders have to persuade investors, engineers, and customers to believe in a future where their totally made-up idea will be real. . . .”)

148 THIEL, supra note 99, at 86-87 (noting that the typical pattern in a venture fund is that “a small handful of companies radically outperform all others”); Zider, supra note 99, at 131, 136 (discussing the VC business model searching for mega hits).

149 Pollman, supra note 89, at 202-03.

disclosures to investors are negotiated as part of this transaction.\textsuperscript{151} Standard financing documents include a stock purchase agreement that includes representations and warranties, with a schedule of exceptions that acts as an information-forcing device.\textsuperscript{152} These documents have tended to be relatively lightly negotiated in an effort to keep transaction costs down, particularly as VCs take a portfolio approach to investments and many startups ultimately fail.\textsuperscript{153} One consultant who helps investors conduct due diligence on startups estimates that three-quarters of the 150 early-stage startups he has investigated have pitched investors with misleading or purposely incomplete information.\textsuperscript{154}

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 got no financial information beyond a set of risk factors.\textsuperscript{155} Shareholders in WeWork claim 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 valuation was adjusted down from its last private valuation of $47 billion to a suggested $20 billion—a number which still received so much skepticism the public offering failed to get out of the gate.\textsuperscript{156}


\textsuperscript{153} 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., NVCA Model Legal Documents, § 2.9 Stock Purchase Agreement (including representation “The 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”); Elizabeth Pollman, Corporate Disobedience, 68 Duke L.J. 709, 731-39 (2019) (discussing corporate disobedience related to innovation and entrepreneurship); Elizabeth Pollman, The Rise of Regulatory Affairs in Innovative Startups, in The Handbook on Law and Entrepreneurship in the United States (D. Gordon Smith, Christine Hurt & Brian Broughman eds., forthcoming 2020) (identifying developments contributing to the rise of regulatory affairs in startups); Elizabeth Pollman & Jordan M. Barry, Regulatory Entrepreneurship, 90 S. Cal. L. Rev. 383, 398-402 (2017) (discussing regulatory entrepreneurship and breaking the law or taking advantage of legal gray areas).

\textsuperscript{154} Griffith, supra note 90.

\textsuperscript{155} Id.

A number of other transactions such as share buybacks, tender offers, and M&A deals, similarly pose issues concerning the information that is disclosed by the company and provide an opportunity for material misrepresentations. For example, when Good Technology sold to BlackBerry, employees learned that while company executives had assured them not to worry and that the company had pathways to success including an IPO, in reality the company was lowering financial forecasts in investor documents and sliding toward a sale that demolished the value of the employees’ stock options. 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.”

Furthermore, without periodic reporting and stock analysts, the mix of information available on the private capital market may be spotty at best, and a company’s “hype” to the media could have 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.

While 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. They might promise employees liquidity events such as a planned IPO or buybacks.


158 Id.

159 See Pollman, supra note 23, at 216-21 (discussing the potential for insider trading in private company stock).

160 See Joseph Bankman, The Structure of Silicon Valley Start-Ups, 41 UCLA L. REV. 1737, 1750 (1994) (explaining that because startups provide “contingent compensation” in the form of equity, “employees sacrifice the higher cash salary” they might obtain at “more established companies”); Yifat Aran, Note, Beyond Covenants Not to Compete, 70 STAN. L. REV. 1235, 1263-75 (2018) (describing the ability of stock options to “handcuff” employees to startups; see also Nicholas Iovino, Uber Accused of Luring Talent With False Promises, COURTHOUSE NEWS (Dec. 20, 2016), https://www.courthousenews.com/uber-accused-of-luring-talent-with-false-promises/ (discussing class action lawsuit against Uber alleging it “lured hundreds of high-tech workers with false promises of more valuable stock options before quickly breaking that pledge for its own financial benefit”).

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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 a scenario in which Palantir’s valuation were to grow to $50, $100, or even $200 billion. The letter noted: “Although the values in the 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.

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162 Employees might be easily misled regarding the valuation of the company based on a preferred stock financing round versus their common stock. See Gornall & Strebulae, supra note 86, at 7 (noting that employees’ lack of knowledge of Square’s complex capital structure would lead to a 262% overvaluation of their stock options).

163 See Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 462 (discussing the composition of startup boards and independent directors); Pollman, supra note 89, at 200-09 (discussing lack of board independence and startup monitoring failures).

164 See Renee M. Jones, *The Unicorn Governance Tarp*, 166 U. PA. L. REV. ONLINE 165, 169 (2017) (arguing that “recent market trends and deregulatory reforms have weakened or eliminated the principal mechanisms that imposed discipline on start-up company founders”); Pollman, supra note 89, at 205 (discussing founder-friendly governance structures in startups and oversight weakness); see also Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 577-79, 589-90 (2016) (discussing dual-class structures and observing the value of entrepreneurs controlling management decisions to pursue their “idiosyncratic vision” under conditions of information asymmetry or differences of opinion).

165 See, e.g., Mark S. Beasley, *An Empirical Analysis of the Relation between the Board of Director Composition and Financial Statement Fraud*, 71 ACCT. REV. 443-45 (1996) (finding that companies have boards with significantly higher percentages of outside members than fraud firms’); Patricia M. Dechow, Richard G. Sloan & Amy P. Sweeney, *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 CONTEMP. ACCT. RES. 1, 1-2 (1996) (finding “an important motivation for earnings manipulation is the desire to attract external financing at low costs” and firms that manipulate earnings are more likely to have boards dominated by management and a CEO who is also the firm’s founder); Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J. L. ECON. 371 (2005) (finding “that the probability of restatement is lower in companies whose boards or audit committees have an independent director with financial expertise; it is higher in companies in which the chief executive officer belongs to the founding family”).
Rationalization. Startup and tech company culture have become known for the concept of “disruption” and slogans such as “move fast and break things.”\(^\text{166}\) Innovative companies often bump up against, disregard, or even intentionally disobey laws in their quests to develop new technology.\(^\text{167}\) 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.\(^\text{168}\) 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 “we do the right thing” once the company prepared to go public.\(^\text{169}\) 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.\(^\text{170}\) 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.\(^\text{171}\) Managers are known to be optimistic in their appraisals.\(^\text{172}\) Because startup founders in particular are often optimistic by nature and situationally


\(^\text{167}\) Pollman, supra note 153, at 735.

\(^\text{168}\) Ross Levine & Yona Rubinstein, Smart and Illicit: Who Becomes An Entrepreneur and Do They Earn More?, 132 QUARTERLY 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 90 (quoting a startup industry insider that there is “a fine line between entrepreneurship and criminality”).

\(^\text{169}\) Sarah Todd, The Steve Jobs Speech That Made Silicon Valley Obsessed With Pirates, QUARTZ (Oct. 22, 2019) (noting that Steve Jobs had famously motivated Apple’s developers in 1983 by telling them “It’s better to be a pirate than join the navy” and explaining how the pirate flag came to embody “a certain willingness to plunder”); Jena McGregor, ‘Hustlin’ is out. Doing ‘the right thing’ is in. Uber has rewritten its notorious list of core values, WASH. POST (Nov. 8, 2017), https://www.washingtonpost.com/news/on-leadership/wp/2017/11/08/hustlin-is-out-doing-the-right-thing-is-in-uber-has-rewritten-its-notorious-list-of-core-values/ (quoting Dara Khosrowshahi, who replaced the CEO-founder, stating: “the culture and approach that got Uber where it is today is not what will get us to the next level”).

\(^\text{170}\) 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 (quoting psychologist Laurence Steinberg); see also Langevoort, supra note 31, at 42 (“Culture enables beliefs about the law’s legitimacy that can be either positive or negative relative to other values, and when the latter, compliance falls.”).

\(^\text{171}\) Survey evidence indicates that financial managers believe excessive optimism is common among their peers. See Robert Libby & Kristina Rennekamp, Self-Serving Attribution Bias, Overconfidence and the Issuance of Management Forecasts, 50 J. ACCT. RES. 197, 198-200 (2012).

\(^\text{172}\) Anwer S. Ahmed & Scott Duellman, Managerial Overconfidence and Accounting Conservatism, 51 J. ACCT. RES. 1, 2-4 (2013).
encouraged to aim for home runs for their venture capital investors, estimates may be favorably high. When performance falls short, a manager or founder’s tendency is often to interpret this as a temporary setback that can be overcome and so might deny the bad news. The small step from innocent optimism to denying negative developments may fall into mental blindspots or be rationalized by self-serving wishful thinking.

From this point, innocent optimism might evolve into deliberate deception. The manager or founder 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, “[t]he 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 founder 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.

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173 See Noam Wasserman, How an Entrepreneur’s Passion Can Destroy a Startup, WALL ST. J. (Aug. 25, 2014), https://www.wsj.com/articles/how-an-entrepreneur-s-passion-can-destroy-a-startup-1408912044 (describing research analyzing 16,000 startup founders and finding the “consistent theme” is their “passion” and “contagious enthusiasm”).

174 LANGEVOORT, supra note 31, at 19.


176 LANGEVOORT, supra note 31, at 36.

177 Id. at 36 (“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.”).

178 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)).

179 Id. (citing David T. Welsh & Lisa D. Ordóñez, The Dark Side of Consecutive High Performance Goals: Linking Goal Setting, Depletion, and Unethical Behavior, 123 ORG. BEHAVIOR & HUMAN DECISION PROCESSES 79, 80-81 (2014)).

180 Id. at 35.

181 Id. at 43.

182 See David F. Larcker & Brian Tayan, Scaling Up: The Implementation of Corporate Governance in Pre-IPO Companies, Stanford Closer Look Series, Dec. 2018,
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. Research suggests “that dysfunctional corporate cultures are a main reason that frauds occur.”¹⁸³

Furthermore, the rationalization of fraud seems to spread through contagion of 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.¹⁸⁴ 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, learning to play accounting games.¹⁸⁵ In sum, all of the contextual factors or elements that can give rise to fraud not only exist, but are 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 have examined the growth of the private capital market and the potential for securities fraud. This section analyzes the differences 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 function¹⁸⁶—something that the private capital

¹⁸³ LANGEVOORT, supra note 31, 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 (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”).
¹⁸⁵ John M. Bizjak, Michael L. Lemmon & Ryan J. Whitby, Options Backdating and Board Interlocks, 22 REV. FIN. STUD. 4821, 4822-23 (2009).
¹⁸⁶ See Hillary A. Sale & Robert B. Thompson, Market Intermediation, Publicness, and Securities Class Actions, 93 WASH. U. L. REV. 487 (2015) (“Securities class actions play a crucial, if contested, role in the policing of securities fraud and the protection of securities markets.”); William W. Bratton & Michael L. Wachter, The Political Economy of Fraud on the Market, 160 U. PA. L. REV. 69, 69-71 (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, 453-57 (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 47, at 50 (arguing that “[fraud-on-the-market (FOTM)] suits might be thought of as a way for
market needs. A variety of factors 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.\(^\text{187}\) Significant amounts of time often pass in between rounds of stock issuances and there may be no trading in between, 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.\(^\text{188}\) Moreover, views can vary widely about valuation and can change dramatically with little notice or transparency.\(^\text{189}\) 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.\(^\text{190}\)

As a related point, there might be significant frictions to bringing aggregate litigation in the private company context. Most obviously, the fraud-on-the-market theory would not apply given the lack of an efficient market as described by the shareholders to outsource the monitoring of corporate agents... 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.\

187 Pollman, supra note 89, at 172-74; Gornall & Strebulaev, supra note 86, at 1.
189 For example, Morgan Stanley’s mutual funds valued Palantir at $4.4 billion at the same time as several other Palantir investors appraised it higher and Morgan Stanley’s own bankers predicted the company could price at $36 to $41 billion in an IPO. Lizette Chapman & Sonali Basak, Palantir Tried Buying Morgan Stanley’s Stake in Value Feud, BLOOMBERG (Nov. 14, 2018), https://www.bloomberg.com/news/articles/2018-11-14/palantir-said-to-try-buying-morgan-stanley-s-stake-in-value-feud.
190 See supra note 80; see also Park, supra note 111, at 141 (2017) (“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 Clayton, 2019 Remarks, supra note 84 (“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.' Generally, once prices are published, we can all use them.”); De Fontenay, supra note 93, at 449 (“Public companies' mandatory disclosure and stock trading prices provide a major information subsidy to private companies...”).
Supreme Court in *Basic v. Levinson*, and affirmed in *Halliburton II*.191 The individual reliance of each shareholder would have to be shown.192 More generally, 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.193

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 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.194 Further, some VCs actively manage their investments by sitting on company boards and might have failed to catch the fraud and be exposed to risk of litigation in their own right.

This point has its limits, however. While the rationale of risk spreading through a portfolio of investments may work for venture capitalists and private equity investors more generally, it does not eliminate the potential impact of a massive business failure on other shareholders (and stakeholders).195 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

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191 *See supra* notes 70-73 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 (2006) (arguing for “the use of the fraud-on-the-market presumption in all fraud cases even when markets are inefficient”); 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 “[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”).

192 This might be an impediment to maintaining suit as a class or add cost to doing so, but it might be possible to show reliance through transaction-specific documents. *See Glater, supra* note 23, 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.”).

193 *Pollman, supra* note 89, at 176-99 (explaining that differences in shareholder positions in startups and terms can give rise to conflicts among shareholders of all types).


195 *See Johnson, supra* note 25, at 197-98 (“Such antifraud-only markets may be acceptable for institutional players, but they are not designed for individual investors.”).
participants affected. Even venture capitalists may not fare well with the rationale of spreading risk through a portfolio approach when valuations are skyrocketing.

The economics of the lawsuit, however, might truly be problematic for plaintiffs’ attorneys. Attorneys’ fees are largely driven by recoveries. Therefore, “the larger the potential payout, the more willing a rational plaintiff’s 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 class action will nearly always be fewer than in the public company context—by sheer virtue of the fact that private companies avoid the 2,000 holders of record trigger of section 12(g) of the 1934 Act so that they can stay private. The availability (or lack) of directors and officers (D&O) insurance, depending on the company, in the private company context 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, compensatory money damages do not fit conceptually or practically in the same way as in public company securities class actions. In the public company setting, one of the key criticisms is that because corporate defendants tend to exclusively fund settlements, it is the public company shareholders who ultimately


197 Rose, supra note 47, at 47; see also Berdejó, supra note 23, at 581 (“The structure of attorney compensation in class actions render 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, 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.”).

198 Employees with stock options do not count toward this threshold and may not have standing to sue for securities fraud. See Aran, supra note 118, at n.98 (noting that the JOBS Act of 2012 allows companies to exclude securities held by Rule 701 offerees when counting shareholders of record); Cable, supra note 118, at 625 (noting “[t]he JOBS Act . . . significantly relaxed the 12(g) threshold by exempting shares that traced back to Rule 701”); Bodie, supra note 23, at 543-43 (discussing case law ruling that employee stock option holders lack standing to bring 10b-5 actions); Wyatt v. Cendant Corp., 81 F. Supp. 2d 550, 558 (D.N.J. 2000) (holding employees were not “purchasers or sellers” of any securities, as required for § 10(b) and Rule 10b-5 action); McLaughlin v. Cendant Corp., 76 F. Supp. 2d 539, 550 (D.N.J. 1999) (holding former employee lacked standing to bring private action under § 10(b) and Rule 10b-5 because she had not purchased or sold any of the stock options received under employee stock option plan).

199 To the extent that D&O insurance is not as prevalent or comprehensive in the private company context, securities litigation might have greater deterrence potential. See Tom Baker & Sean Griffith, The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer, 95 GEO. L.J. 1795, 1821 (2007) (observing that insurance companies are not strong monitors and do not significantly influence fraud prevention efforts).
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 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 generally 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. Taking Theranos, for example, the SEC levied a variety of fines and penalties, but only a relatively small sum of money might be recovered from Elizabeth Holmes and the shares being returned had little value as the company was already in bankruptcy 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 skews 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 private 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. 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.

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201 Id. at 1536; see also Frank Easterbrook & Daniel Fischel, Optimal Damages in Securities Cases, 52 U. CHI. L. REV. 611, 626 (1985).

A. Leaving the Lights Off

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.\textsuperscript{203} 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.\textsuperscript{204}

Indeed, some observers might view the relative paucity of securities litigation in private companies as an advantage of staying private.\textsuperscript{205} Venture capitalists are key victims of securities fraud in the startup context and they already have some incentive to engage in due diligence and monitoring. 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 more generally 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 new 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.”\textsuperscript{206} Similarly with respect to securities fraud in the private market, one might believe “the social good offset[s] the investor harm suffered.”\textsuperscript{207} 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 began maturing, with the United States well in the lead in global technology innovation.”\textsuperscript{208}

\begin{footnotesize}
\begin{enumerate}
\item[203] Cox & Thomas, supra note 197, at 751-52.
\item[204] See, e.g., Jill E. Fisch, \textit{Cause for Concern: Causation and Federal Securities Fraud}, 94 \textit{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”); Coffee, \textit{supra} note 200, at 1536 (discussing the “fundamental problem” of securities class action litigation as the failure to compensate victims of fraud and to deter potential wrongdoers); Cox & Thomas, \textit{supra} note 197, at 741 (“[T]here are two very different perspectives on 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.”).
\item[205] See, e.g., Jonathan Macey, \textit{The SEC’s Facebook Fiasco}, \textit{Wall St. J.} (Jan. 20, 2011), 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.”).
\item[206] Langevoort, \textit{supra} note 31, at 2.
\item[207] \textit{Id}.
\item[208] \textit{Id}.
\end{enumerate}
\end{footnotesize}
bounds, “a moderate excess of investor confidence can enhance capital formation. If so, . . . [t]he law should take a light touch. . .”

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 lifecycle. 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.” 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 largely made on intuitions about the promise of the team and market opportunity. 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 companies that push boundaries even if that means that some will cross the line.

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. Private equity and venture-backed governance is often assumed to have fewer agency costs because ownership and control are not

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209 Id.


211 See SCOTT KUPOR, SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT 42-52 (2019) (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).

212 See, e.g., Polina Marinova, Why VC Tim Draper Keeps Defending Theranos CEO Elizabeth Holmes, FORTUNE (May 11, 2018), 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.”).

213 See, e.g., Leo E. Strine, Jr., 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”).
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. She noted that the SEC was watching the secondary market for trading pre-IPO shares. The previous year, the SEC brought its first enforcement under the Dodd-Frank Act’s rules that require registering security-based swaps or limiting them to “eligible contract participants.” Specifically, the SEC detected violations by a Silicon Valley-based startup, Sand Hill Exchange, that was illegally offering and selling derivative contracts based on the value of pre-IPO shares. The platform was quickly shut down. 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, discussed above.

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

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214 Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Introduction*, 74 Bus. Law. 351, 359 (2019) (describing the private equity board model that is “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 89, at 200-08 (explaining and critiquing the conventional view that VCs are strong monitors).


216 Id.


218 Id.

219 Id.


221 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* U.S. Securities and Exchange Commission, SEC Charges
no obligation to follow advice for better governance and may be unlikely to take
heed without a greater likelihood 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.

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 certain late-stage mature 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. Higher enforcement might encourage allocational efficiency and
the quality of private company offerings.

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

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. Retail investors are exposed to securities fraud in private


223 The SEC also has certain advantages over private litigants. See Buell, supra note 20, at 545 (“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.”).

224 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 design to increase the odds of a strong and healthy market system—where fraud is policed and punished and capital is allocated efficiently.”).

225 Pollman, supra note 89, at 200-08 (explaining why some startup boards have monitoring failures).


227 Id.

companies through their investments in mutual funds and pension funds. Employees often receive a significant portion of their compensation as 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.”229 Given the large footprint of some private companies, the impact on the public can be meaningful.230

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.231 Their stock or options are based on valuations that they typically do not have the ability 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.232

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.233 The study found that “when 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.”234 This finding suggests “that voluntary monitoring by

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229 Velikonja, supra note 13, at 1887-88, 1916-37 (discussing harms to creditors, employees, the government and communities); see also Sale & Thompson, supra note 186, 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); Sale, supra note 224, 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.”); Ann Lipton, Not Everything is About Investors: The Case for Mandatory Stakeholder Disclosure, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3435578, at 69 (forthcoming YALE J. ON REG.) (“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.”).


232 See Bodic, supra note 23, at 542-43 (discussing case law that dismissed claims under Rule 10b-5 brought by employees who held stock options for lack of standing in light of the “in connection with a purchase or sale” of security requirement); see also Cable, supra note 118 (discussing vulnerability of unicorn employees); Fan, supra note 118 (same).

233 Tracy Yue Wang, Andrew Winton & Xiaoyun Yu, Corporate Fraud and Business Conditions: Evidence from IPOs, 65 J. FIN. 2255, 2269 (2010).

234 Id. at 2256.
in institutional investors or venture capitalists is less effective at reducing fraud when investors are optimistic about an industry’s prospects.”235 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.”236 This research suggests that as the private capital market grows, the SEC should proportionately scale or otherwise increase its enforcements efforts and remain engaged even during periods of growth and enthusiasm. Federal prosecutors and state attorneys general may also have an increased role to play to effectuate an optimal quantity and quality of enforcement.237

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.

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 sanction 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 re-examination of the public-private divide.

The literature, for example, includes scholarship championing redrawing the public-private line with a tiered approach by reference either to market capitalization or trading volume.238 One such proposal would require companies

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235 Id.
236 Id.
237 See Park, supra note 111, at 117-20; Berdejó, supra note 23, at 572-74; see also Johnson, supra note 25, 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”).
238 Pritchard, supra note 56, 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 of trading volume”); Rodrigues, supra note 63, at 1561
that hit the public threshold to go through a seasoning period during which they would make periodic disclosures before making public offerings.\footnote{Pritchard, supra note 56, at 1002.} 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.\footnote{Id.} 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.\footnote{Rodrigues, supra note 63, at 1561; Spurring Job Growth Through Capital Formation While Protecting Investors-Part I: Hearing Before the Subcomm. on Banking, Hous., \& Urban Affairs, 112th Cong. 15 (2011) (statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School); Testimony of Jay R. Ritter before the S. Comm. on Banking, Hous., \& Urban Affairs, 112th Cong. 10 (2012) (statement of Jay R. Ritter, Cordell Professor of Finance, Warrington College of Business Administration, University of Florida); see also John C. Coffee, Jr., Market Failure and the Economic Case for Mandatory Disclosure, 70 VA. L. REV. 717, 722 (1984) (explaining policy rationales for mandatory disclosure under securities law); Frank H. Easterbrook \& Daniel R. Fischel, The Economic Structure of Corporate Law 286-304 (1991) (same).}

Other scholars have proposed a system of scaled disclosure that would create more than a two-bucket public-private divide and account for the social footprint or “publicness” of large companies.\footnote{See Langevoort \& Thompson, supra note 56, at 375-79 (proposing to “separate out the largest issuers (public issuers) for full publicness treatment rather than just exempting the smallest”); see also Sale, supra note 224, at 1046 (arguing the purposes of disclosure extend beyond investors to the public).} These arguments recognize that theoretical justifications for mandatory disclosure are grounded in benefits to all citizens, not only investors.\footnote{See Langevoort \& Thompson, supra note 56, at 376-78 (discussing how securities regulation reflects efforts to prevent corporate externalities that impact the public and that “transparency, accountability, and openness to external voices are expected of large American corporations”); Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment, 85 VA. L. REV. 1335, 1415 (1999) (noting “the primary function of disclosure is . . . efficiency in the real economy, not investor protection”); Coffee, supra note 241, at 722 (observing the social interest in an allocatively efficient capital market and that mandatory disclosure provides a public good); Lipton, supra note 229, at 4 (explaining that the U.S. system of disclosure is generally premised on investor protection but serves broader societal needs of the general public); De Fontenay, supra note 93, at 487 (discussing mandatory disclosure as a public good).} Further, a graduated approach to public disclosure might better reflect the different types of corporations and their societal impacts.\footnote{See Langevoort \& Thompson, supra note 56, at (379) (proposing to “separate out the largest issuers (public issuers) for full publicness treatment rather than just exempting the smallest”); see also Schwartz, supra note 80, at 531 (proposing a “lifecycle model” in which “regulations would adapt to firms as they age”); Fan, supra note 118, at 583 (arguing for “enhanced disclosure requirements that will alleviate the risks of unicorns”).}

Without further study of the frequency and magnitude of fraud in the private market, it is far from clear that a bold re-drawing 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.245

As the SEC has recently signaled that it is on the precipice of further expanding access to the private market and liberalizing restrictions on capital formation, it is particularly important to reflect on how these goals could be achieved while lessening the harms of fraud in the private market.246 The public-private line could be redrawn 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.247 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 non-traditional players (employees, media, and industry regulators) may take on greater importance as monitors in the private market.248 The Theranos case, for example, highlights the role that an employee whistleblower can play in bringing alleged fraud to light.249 Employees reached out to the media, which then investigated and reported to the public, attracting the attention of the SEC and the

245 See Gubler, supra note 104, at 753 (arguing that “the political economy forces identified here will likely lead the SEC to expand the private securities market beyond its optimal scope”); Usha Rodrigues, Dictation and Delegation in Securities Regulation, 92 IND. L.J. 435, 468-73 (2017) (describing the political context and industry players involved in the passage of the JOBS Act).
246 See Pritchard, supra note 56, at 1024 (noting “we should funnel transactions to the venues that make it most difficult to get way with fraud”).
248 Alexander Dyck, Adair Morse & Luigi Zingales, Who Blows the Whistle on Corporate Fraud?, 65 J. FIN. 2213 (2010) (finding that fraud detection “takes a village of several non-traditional players (employees, media, and industry regulators” and “[h]aving access to information or monetary rewards has a significant impact on the probability a stakeholder becomes a whistleblower”).
249 See CARREYROU, supra note 7, at 185-200 (describing the role of the employee whistleblower).
DOJ.\textsuperscript{250} Subsequently, other regulators such as the FDA also then took action to protect the public interest.\textsuperscript{251}

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.\textsuperscript{252} Not only are they equity holders, they may in some sense be understood as the residual claimants to the value of the firm.\textsuperscript{253} 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. For this reason, relying on employees for fraud detection is likely insufficient, but could be given a better chance of success by exploring new mechanisms to provide employees with greater voice in governance such as through board access or work councils.\textsuperscript{254}

Relatedly, another approach would not rely on employees as a resource, but rather 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

\textsuperscript{250} Id. at 294-96.  
\textsuperscript{251} Id.  
\textsuperscript{252} See Sharon Hannes, 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 that stock options (or similar types of compensation) motivate them to fulfill this task”).  
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 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. Currently these intermediaries such as Nasdaq Private Market and

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255 See Lynn A. Stout, On the Nature of Corporations, 2005 U. ILL. L. REV. 253, 265 (2005) (“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.”); Aran, supra note 118, at 104 (“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 employees’ securities.”).


257 See Aran, supra note 118, at 109-10 (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 Cable, supra note 118, at (arguing that startup employees may be relatively capable investors in a company’s early stages but poorly equipped to navigate risks in mature startups); Fan, supra note 118, at 617-18 (arguing for enhanced disclosure requirements on unicorn companies); Anat Alon-Beck, Unicorn Stock Options: Golden Goose or Trojan Horse?, 2019 COLUM. BUS. L. REV. 107, 186 (noting “[r]ank and file employees might be naïve” and suggesting “[p]erhaps certain private companies, such as unicorns, should adhere to the same financial disclosure requirements as public companies”).

258 Other gatekeepers such as attorneys are present but may be ineffective or conflicted as they sometimes invest in their clients or take equity-based compensation. See COFFEE, supra note 247, at 362 (“Law and accounting . . . protect their autonomy; they resist broad duties to the public; and they invest very little in self-policing.”); John S. Dzienkowski & Robert J. Peroni, The Decline in Lawyer Independence: Lawyer Equity Investments in Clients, 81 TEX. L. REV. 405, 408-10 (2002) (discussing that in venture capital and the technology sector “lawyer equity investment has become more routine”); see also Z. Jill Barclift, Corporate Responsibility: Ensuring Independent Judgment of the General Counsel—A Look at Stock Options, 81 N.D. L. REV. 1, 31 (2005) (concluding
SharesPost are largely free to follow client preferences in facilitating liquidity events. 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. 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.

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 investigation. 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 have the benefit of enriching the informational environment of private company stock trading, but also incorporate the monitoring function of another set of gatekeepers—auditors. 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.

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260 *See* Coffee, *supra* note 241, at 738 (discussing agency costs and conflicts of interests that prevent voluntary disclosure).

261 *See* Pollman, *supra* note 23, at 222-26 (arguing for minimum disclosures in private company stock trading).

262 *See* Paul G. Mahoney, *The Exchange As Regulator*, 83 Va. L. Rev. 1453, 1455 (1997) (arguing the benefits of securities exchanges providing rules and enforcement mechanisms to protect investors and increase their returns).

263 *See* Coffee, *supra* note 247, at 108-91 (examining the role of auditors as gatekeepers).
The explosive growth of the private market has overtaken the public in terms of aggregate size. With companies staying private longer, much of their growth occurs outside the public market, subject to relatively light securities fraud scrutiny and enforcement. Without the discipline that mandatory disclosure can impose, information asymmetries abound as well as the characteristic ingredients for fraud.

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