Dear readers,

Thanks for the opportunity to share this work in progress. This is a true early draft with lots still left to develop and deepen. I plan to further flesh out each of the three parts of the paper and engage more fully with the enormous body of scholarly literature on Rule 10b-5 securities fraud. I very much look forward to hearing your questions and feedback. I’d be especially appreciative to hear any ideas about data and/or empirical studies that could be used to enrich this project and points that could sharpen the analysis in Part III on potential responses. Many thanks! – Elizabeth

PRIVATE COMPANY LIES

Elizabeth Pollman

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 increasingly large 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. Further, this Article identifies potential responses to this underappreciated problem, including increasing SEC enforcement, adjusting the public-private line, and implementing alternative mechanisms for accountability. It ultimately concludes that although some arguments exist for continuing the status quo, potential harm to vulnerable stakeholders warrants additional oversight and enforcement at minimum and perhaps bolder action.
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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.”

Edison himself was sometimes known to skate around the truth, discussing his work as a success while there was still more left to be figured out. In 1878, the New York Sun printed Edison’s claim that he had perfected the incandescent lightbulb, but it was not true at the time. He faked demonstrations for investors and gave stock in his company to journalists, while clandestinely trying to solve the technical challenge—which he ultimately succeeded in doing.

Nearly a century and a half 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 was as reliable as 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

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3 Id.
4 Id.
5 Id.
6 Id.
8 Id.; see also John Carreyrou, BAD BLOOD: SECRETS AND LIES IN A SILICON VALLEY STARTUP (2018).
9 Carreyrou, supra note 7.
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, Sunny Balwani, 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 year. These revelations spurred the spectacular fall of the company, going from a $9 billion valuation to zero, and Holmes settled fraud charges with the SEC in 2018. The harm was notably not confined to wealthy investors—customers were exposed to faulty blood testing results and employees lost their jobs and the value of their stock options. Holmes agreed to pay a $500,000 penalty, accepted a ban on serving as a director or officer of a public company for 10 years, returned her shares obtained during the fraud, and relinquished her voting control. Criminal charges are currently pending against Holmes and she could face up to twenty years in prison.

The Theranos case raises the question of how much securities fraud exists in the private markets. Is the case an outlier or a bellwether? There is no way to know the full extent of securities fraud in private companies, but the answer may be a bit of both.

Consider another example from the recent batch of “unicorn” startups reaching a private valuation of $1 billion or more—Hampton Creek. For a time, the company’s Facebook page said that a jar of its signature Just Mayo vegan mayonnaise saved 80 gallons of water—a full bathtub’s worth. The first “sustainable-food” unicorn developed a cult-like following from customers by touting its environmental credentials, from the water saved with its Just Mayo to its vegan cookie which it claimed saved 35 grams of carbon emissions and 7

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10 CARREYROU, supra note 8, at 20, 33.
11 Id. at 36, 50-51.
12 Carreyrou, supra note 7. In addition, the SEC found that Holmes and Balwani had falsely claimed that Theranos’ products were deployed by the U.S. Department of Defense on the battlefield in Afghanistan. Id.
13 Id.
14 For a discussion of harm to nonshareholders from securities fraud, see Urska Velikonja, The Cost of Securities Fraud, 54 WM. & MARY L. REV. 1887 (2013).
16 Peter J. Henning, What’s Next for Elizabeth Holmes in the Theranos Fraud Case?, N.Y. TIMES (June 18, 2018), https://www.nytimes.com/2018/06/18/business/dealbook/theranos-fraud-case.html. Sunny Balwani did not agree to the civil settlement with the SEC and will simultaneously fight civil and criminal fraud charges. Id.
17 [Could instead use WeWork or Zenefits examples. Input welcome.]
gallons of water compared to a conventional cookie. A consulting firm’s audit of its products, however, revealed that the true numbers on environmental impact were significantly different—and the company received a FDA warning letter about misleading labeling and health claims.

An even bigger scandal at Hampton Creek came to light when a Bloomberg article revealed that the company had secretly been buying back its vegan mayonnaise from grocery store shelves, expensing over a million dollars in “internal testing” costs. The company had been using its environmental claims and supermarket sales figures to raise venture capital—almost $220 million—from high-profile billionaires and investors including Salesforce’s CEO-founder Marc Benioff, tech investor Vinod Khosla, and PayPal co-founder Peter Thiel.

In a media interview, Hampton Creek CEO-founder Josh Tetrick said the most important lesson he had learned as an entrepreneur was that “every single rule that you think exists, is probably wrong and was probably created by people no smarter than you and no smarter than me. We can look at all those rules and totally ignore them and do whatever we want.” This statement might have revealed more than intended—when an angel investor joined the team shortly after and dug into the company’s financials, the investor uncovered information that led him to quit after just nine days and alert board members that he believed the company was misleading investors and risking potential fraud lawsuits. The board launched no formal investigation and decided to support the CEO-founder, with one investor noting, “Frankly, Josh is the company.”

These examples reflect the pervasiveness of startup hype and “fake it till you make it” culture, creating a slippery starting point that can ultimately lead startup founders and executives to cross the line into conduct constituting securities fraud. On one side of the line is harmless puffery and optimism. For example, the

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19 Id.
21 Zaleski et al., supra note 18.
22 Id. While the secret buyback program was underway, CEO-founder Josh Tetrick tweeted: “Wow! Some @WholeFoods are selling 100+ jars of #justmayo/day.” Id. A former employee, speaking anonymously to reporters, later said: “Everyone knew about the buybacks. . . I drove all over one night buying the entire shelf of every store I passed. I felt ridiculous, but it was so culty I couldn’t push back.” Id.
23 Id.
24 Id. (noting that he personally felt “duped” and warned the CEO-founder to revise the sales forecast, as “the company was on pace to have less than $4 million in sales in 2014, not the $28 million projected in the pitch deck”).
25 Id.; see also Mikey Tom, Hampton Creek about to join unicorn club despite questionable ethics, PITCHBOOK (Aug. 16, 2016), https://pitchbook.com/news/articles/hampton-creek-about-to-join-unicorn-club-despite-questionable-ethics (noting that the company was closing a round of financing that valued the company at $1.1 billion in 2016, despite the “ethically dubious” buyback program and “flimsy science behind their innovations and dishonest labeling of products”).
26 [string cite]
founder-CEO of AngelList, a platform for early-stage investing, said “all startups exaggerate a bit” and this likely rings true to anyone who has spent time in fast-moving, innovative companies. Similarly, the founding partner of 500 Startups, a well-known tech accelerator, explained that misrepresentations do not prevent his firm from investing, noting that “[y]ou might even find a correlation between ‘interesting’ behavior and successful entrepreneurship.” Hype and gray areas notwithstanding, a line exists all the same and it is possible that a significant number of startup founders, executives, and other participants may transgress it and veer into misconduct. 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.

This Article provides an in-depth exploration of the issue of securities fraud in private companies. Notably, the federal antifraud catch-all of Rule 10b-5 applies to both public and private company securities. This provision, promulgated under the Securities and 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


28 Id. (quoting Dave McClure additionally stating, “You know the saying ‘There’s a fine line between genius and insanity? There’s probably a fine line between entrepreneurship and criminality.”).

29 Id.


31 17 C.F.R. § 240.10b-5 (“in connection with the purchase or sale of any security”).

32 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”).

33 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.”).
heavily judicially created bodies of federal law”—but, as this Article observes, this voluminous case law has focused primarily on public corporations and markets.

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 securities fraud case law that enabled aggregate litigation seeking compensatory damages. Private placements were generally composed of sophisticated investors and there was little secondary trading of private company stock. 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, however.

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. Companies have stayed private longer on average, fewer companies have gone public, and those that do tend to be larger in size. The debate regarding this development has been largely framed by the competing goals of capital formation and investor protection, with the key issue of regulatory and scholarly focus being the access of investors to growth companies and the health of the public markets.

34 Buell, __ note 32, 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.”).

35 See infra Section I.B.

36 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.”).


38 See infra Section II.A.

39 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”); [add SEC concept release; Clayton speech]; but see Jeff Schwartz, Should Mutual Funds Invest in
While providing Main Street investors access to private investments takes precedence, little attention has been paid to the rapidly growing space in the U.S. capital markets that receives relatively light scrutiny and enforcement of securities fraud. The driving force in securities fraud enforcement against public companies is private class actions—which have been absent in private capital markets due to a variety of obstacles and economic realities.40

Given the presence in the private capital market of key factors that can foster securities fraud, and the potential for nonshareholder stakeholders to be harmed, this Article argues it is time to explore potential responses to these dramatic developments. The possibilities include increasing SEC enforcement, adjusting the public-private line to return to a regulatory approach that forces large corporations to go public, and exploring alternative mechanisms to increase accountability such as giving startup employees voice in governance matters. Balancing each of these potential responses against the option of maintaining the status quo, this Article argues that potential harm to vulnerable stakeholders warrants at minimum additional oversight and enforcement by the SEC and perhaps bolder action.

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 in the workplace, 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 the future of policing securities fraud in private markets, arguing that the greater potential for harm merits additional oversight.

I. The Development of Rule 10b-5 Securities Fraud in a Public Market Paradigm

Although Rule 10b-5 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.41

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”).

40 See infra Section II.C.

41 See Glater, supra note 30, at 53 (“Litigation between buyers and sellers in private placements has received less scholarly attention than shareholder class actions; post-private placement litigation clearly benefits the successful plaintiff but less obviously helps anyone else.”).
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.”42 The securities acts that Congress passed in the wake of the stock market crash and the Great Depression that followed “were primarily concerned with preventing a recurrence.”43 Together, the two key securities acts put in place a system of mandatory public disclosure and sanctions for disclosure violations and fraud.44

First, after a series of hearings that revealed shocking financial abuses,45 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.”46 The 1933 Act replaced the existing *caveat emptor* philosophy with one of issuer disclosure—an idea that suggested that the stock market crash had sharpened public and congressional

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42 Thel, *supra* note 34, at 409.
43 Id.
44 See, e.g., LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION (4th ed. 2006); Velikonja, *supra* note 14, 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.”).
45 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 34, at 394-424 (discussing the historical background of the 1934 Act); LOSS ET AL., *supra* note 44, at 254-57, 300-305 (describing the events of 1929-1933).
46 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 it allows under Section 17(a)(2) and (a)(3) may be based on negligent conduct, and narrower in that it does not reach the “purchase” of securities or allow for private rights of action. 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. Domínguez, 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).
attention on the importance of informational transparency and stock prices.47 Further, the 1933 Act includes section 17(a), prohibiting fraud and misrepresentations in the offer or sale of securities.48

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).49 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.50 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.”51 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.52

In an oft-recounted anecdote, a former 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 in the coming year.53 Upon learning of this incident, the staff attorney and a SEC director promptly drafted a rule, putting together language from section 17 of the 1933 Act and the congressional grant of authority from section 10(b) of the 1934 Act.54

49 See LOSS ET AL., supra note 44, 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.”).
51 See LOSS ET AL., supra note 44, 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.”).
54 Id.
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.”55 As the telling goes, upon submitting the draft language to the commissioners, they passed it around the table and immediately approved it without controversy.56 The only comment made was by Commissioner Sumner Pike who said, “Well . . . we are against fraud, aren’t we?”57 Shortly after Rule 10b-5’s adoption, federal courts began to recognize a private right to sue for securities fraud, and, as consensus was forming, the Supreme Court affirmed this implied right.58 Early cases brought under Rule 10b-5 resembled common law fraud claims, both with respect to the elements and the factual allegations.59 Plaintiffs were required to prove actual reliance on a defendant’s misrepresentations and typical cases involved face-to-face dealings and privity of contract.60

B. Evolution

By the 1960s, two developments began to take root that would ultimately shape our modern landscape: the drawing of the public-private line between corporations and the emergence of the “fraud-on-the-market” class action that pervades modern Rule 10b-5 litigation.

55 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 32, at 545 (internal quotation marks and footnotes omitted). The first element is in fact broader and encompasses “schemes to defraud or acts or practices that ‘operate as’ fraud.” Id. at 545-46.
56 Blue Chip Stamps, 421 U.S. at 767 (Blackmun, J., dissenting).
57 Id.
59 Rose, supra note 52, at _.
60 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.”).
Regarding the first, both securities acts reflect a public-private divide, although they take different approaches. The 1933 Act governs “public offerings,” but does not define the term. 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. In 1953, the Supreme Court handed down its decision in SEC v. Ralston Purina Co., ruling that offerees who could “fend for themselves” did not need the protections of the Act. This interpretation focused the 1933 Act’s public-private line on notions of investor qualification based on investor wealth and sophistication, as well as access.

By contrast, the 1934 Act tied the periodic disclosure obligations to voluntarily listing on a national securities exchange. In the decades that followed, extensive SEC studies of firms not subject to the mandatory disclosure system led to the Securities Acts Amendments of 1964 which added section 12(g) to the 1934 Act and set a threshold for public status based on features of the issuer—assets and number of shareholders of record. The effect of section 12(g) was to bring securities trading over the counter within the purview of SEC reporting requirements. The SEC later explained that “the registration requirement of

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61 A.C. Pritchard, Revisiting “Truth in Securities” Revisited: Abolishing IPOs and Harnecing 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, “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).

62 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 61, at 343, n.14 (noting the intrastate exemption and exemptions for small dollar offerings).


64 346 U.S. 119, 125 (1953).


66 Id. at 344; 15 U.S.C. §§ 78m(a), 78n(a) (1934).

67 Richard M. Phillips & Morgan Shipman, An Analysis of the Securities Acts Amendments of 1964, 1964 DUKE L.J. 706 (1964); see also Langevoort & Thompson, supra note 61, 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 44, 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, 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).

68 Usha Rodrigues, The Once and Future Irrelevancy of Section 12(g), 2015 U. ILL. L. REV. 1529, 1534 (2015) (discussing the origins of section 12(g) of the 1934 Act).
Section 12(g) was aimed at issuers that had ‘sufficiently active trading markets and public interest and consequently were in need of mandatory disclosure to ensure the protection of investors.’ 69

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.” 70

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.” 71 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.

The first notable doctrinal step was the abandonment of privity as a requirement for liability. In SEC v. Texas Gulf Sulphur Co., the Second Circuit held that a defendant need not be either a counterparty nor a contemporaneous trader to violate section 10(b) or Rule 10b-5. 72 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.” 73

Subsequently, investors began filing actions that became known as “fraud-on-the-market” cases, claiming the marketplace had been deceived by false representations. 74 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. 75

The next important doctrinal development was the Supreme Court’s recognition in Basic v. Levinson of a presumption of reliance in private Rule 10b-5 cases involving securities widely traded in “efficient” markets. 76 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{77}

The fraud-on-the-market theory was based on the efficient capital market
hypothesis, which maintained that “the market price of shares traded on well-
developed markets reflects all publicly available information, and, hence, any
material misrepresentations.”\textsuperscript{78} Thus, \textit{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.\textsuperscript{79}

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.\textsuperscript{80} As Amanda Rose has observed, these developments added up to
the birth of the modern “Rule 10b-5 class action brought on behalf of secondary
market traders against a non-transacting public company defendant for alleged
misstatements or omissions by corporate agents, upon which the plaintiff class did
not directly rely.”\textsuperscript{81}

These class actions grew to predominate the universe of securities fraud
litigation and dramatically departed from earlier case law and traditional common
law fraud cases. Not only do the modern fraud-on-the-market class actions
involve an “expanded set of plaintiffs and defendants, an altered set of elements,
and the aggregation of claims,” but they also “involve defendants with different
motives, raise different stakes, and create different incentives to sue and settle

\textsuperscript{77} \textit{Basic}, 485 U.S. at 241-47; \textit{Rose, supra note 52, at \_}.

\textsuperscript{78} \textit{Basic}, 485 U.S. 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 could not be accurately predicted based on prior prices (i.e., a ”random
walk”). The ECMH “explains” the random walk by hypothesizing that price changes in
response to information about a particular company’s stock. The ECMH comes in three forms
reflecting theoretical levels of informational efficiency of the market: strong (reflecting all
information including private), semi-strong (reflecting all publicly available information), and
weak (reflecting all information about past stock prices). See Eugene F. Fama, \textit{Efficient Capital
literature on the ECMH); Lawrence A. Cunningham, \textit{From Random Walks to Chaotic Crashes: The
(summarizing the history of the ECMH and the random walk model of public capital market
behavior); \textit{see also Ronald J. Gilson & Reinier H. Kraakman, \textit{The Mechanisms of Market Efficiency},
costs”).

\textsuperscript{79} \textit{Basic}, 485 U.S. at 246-47. For a discussion of the Supreme Court’s decision in \textit{Halliburton Co. v. Erica P. John Fund, Inc.}, 573 U.S. 258 (2014), which re-affirmed the fraud-on-the-market
presumption, see Allen Ferrell & Andrew Roper, \textit{Price Impact, Materiality, and Halliburton II}, 93

\textsuperscript{80} \textit{Rose, supra note 52, at \_}.

\textsuperscript{81} \textit{Id.}
than existed in the early years of 10b-5 enforcement." 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 very strong incentive to bring these suits—and they indeed exploded by the 1990s, prompting regulation attempting to re-calibrate the level of private litigation.

The key point here is that regulatory and doctrinal developments converged to create a world in which securities fraud litigation is largely framed as monitoring for agency costs through class actions aimed at public company defendants. The corporate agents responsible for material misrepresentations and omissions are typically understood to be hiding poor performance, gaming incentive compensation, or otherwise seeking to avoid shareholder discipline. To be sure, on the government side, the SEC and DOJ play a critical role in enforcement and they can go after public and private companies. But the nature of 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 (or semi-efficient) market.

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82 Id.
83 See Buell, supra note 32, 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).
84 See, e.g., Jennifer Arlen & William Carney, Vicarious Liability for Fraud on the Securities Markets: Theory and Evidence, 1992 U. ILL. L. REV. 691 (finding that in 111 fraud-on-the-market cases from 1975 to 1990, nearly 70% involved attempts to conceal earnings declines or other bad news and 20% involved falsely optimistic statements); see also Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. CHI. L. REV. 1047, 1085 (1995) (“One might view financial reporting as principally a form of monitoring for the benefit of shareholders, creditors, and other interested parties.”); Pritchard, supra note 83, 930-31 (discussing how “fraud on the market usually reflects the human frailties of those agents: fear, greed, and pollyannaism”).
85 Rose, supra note 52, at _.
87 See Buell, supra note 32, at 550 (“the class action dominates the modern industry of private securities litigation, and almost no cases go to trial”). As late as the 1970s, commentators observed the opposite. See Steinberg, supra note 30, at 735 (“Most rule 10b-5 cases involve close corporations.”); 1 A. BROMBERG, SECURITIES LAW: FRAUD § 4.2 (1975) (“The archetypal
Beyond the presumption of reliance that plaintiffs can obtain through fraud on the market, other elements of a private 10b-5 suit also reflect the public company paradigm. For example, “materiality” is satisfied when there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” In setting out this standard, the Supreme Court noted it was “careful not to set too low a standard of materiality” out of concern that management would “bury the shareholders in an avalanche of trivial information.” Putting aside the improbability of an “avalanche” of information being shared in the private company context, the notion of a “reasonable investor” is not clearly connected to the separate concept of the “sophisticated investor” typically involved in private placements of securities and secondary trading in private company stock.

Moreover, courts have allowed the market itself to stand-in for the reasonable investor when securities are traded in an “efficient” market. 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.” And, in an efficient market, the “total mix of information” is understood as the information available to the public market.

The element of loss causation similarly has developed through the public company lens. The Supreme Court has held that a plaintiff must prove “that the defendant’s misrepresentation (or other fraudulent conduct) proximately caused the plaintiff’s economic loss.” In illustrating this requirement, the Court noted that loss causation can be established by showing that public disclosure of a fact was followed by a stock price decline. A number of questions still remain open,

90 See Tom C.W. Lin, Reasonable Investor(s), 95 B.U. L. REV. 461 (2015) (discussing the diversity of investors that stands in contrast to the concept of a monolithic “reasonable investor”).
92 No. 84 Employer-Teamster JT Council Pension Trust Fund v. Am. West Holding Co., 320 F.3d 920, 950 (9th Cir. 2003); see also In re Merck & Co., Inc. Sec. Litig., 432 F.3d 261, 274 (3d Cir. 2005) (material information changes the market price in an efficient market).
93 See, e.g., In re Pfizer, Inc. Sec. Litig., 538 F. Supp. 2d 621 (S.D.N.Y. 2008); In re Convergent Techs. Sec. Litig., 948 F.2d 507 (9th Cir. 1991).
94 The PSLRA codified the common law requirement of proximate cause in fraud actions: “In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.” 15 U.S.C. § 78u-4(b)(4) (2012).
96 Id. at 344-45 (citing the Restatement of Torts § 548A, Comment b, 107); see also James C. Spindler, Why Shareholders Want Their CEO to Lie More After Dura Pharmaceuticals, 95 GEO.
such as regarding the proper use of event studies to establish recoverable damages and what types of disclosure should count as a corrective disclosure and if one is required.97 But what is clear is that “for public firms, share-price drops can trigger class action lawsuits alleging that glowing public disclosures released prior to a collapse were fraudulent.”98

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 by plaintiffs’ class action lawyers and the prospect of large compensatory damages incentivizes such monitoring. In 2018 alone, seventy-eight securities class actions against public companies settled for over $5 billion in total.99 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.100 As the next Part explains, while these settlement amounts and corporate defendants are large, the doctrinal evolution of securities litigation toward a public company model significantly narrows the realm of capital markets being actively monitored once one takes into account the rise of the private capital market.

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.101 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’ 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. Further, it explores 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

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104 [string cite].
105 McKinsey, supra note 103.
106 Clayton, 2019 Remarks, supra note 102.
dominated the private markets in virtually every measure. Today, in many measures, the private markets outpace the public markets, including in aggregate size.\textsuperscript{107} 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.\textsuperscript{108} Public companies have declined in number by nearly half in the past two decades and they are significantly larger on average.\textsuperscript{109} 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) lifecycle starts with the creation of funds that raise capital from institutional and accredited investors interested in private growth assets.\textsuperscript{110} The VC deploys the funds into a portfolio of startup companies, typically also playing a role in governance or otherwise supporting these innovative companies.\textsuperscript{111} 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.\textsuperscript{112} 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.\textsuperscript{113} While M&A exits are more common, industry experts and academics have long viewed IPOs as essential for sustaining a robust venture capital market.


\textsuperscript{108} Id.

\textsuperscript{109} Id.


\textsuperscript{112} See Bernard S. Black & Ronald J. Gilson, \textit{Does Venture Capital Require an Active Stock Market?}, J. APPLIED CORP. FIN., Winter 1999, at 36, 41 (explaining the standard limited partnership agreement).

capital industry because they provide a mechanism for obtaining high investor returns and liquidity.\textsuperscript{114} VCs are based on a business model that aims for having a few “home runs” that account for much of the fund returns.\textsuperscript{115}

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.\textsuperscript{116} Companies raised capital from public markets to fuel growth and access liquidity for VC investors and startup employees who had received stock options.\textsuperscript{117} The world’s largest companies by market capitalization—Microsoft, Amazon, Apple, and Google—all followed this path as venture-backed startups.\textsuperscript{118}

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.\textsuperscript{119} One of the most notable regulatory changes facilitating staying private longer was the JOBS Act of 2012, in which Congress raised the section 12(g) threshold of the 1934 Act from 500 to 2,000

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\item[{\textsuperscript{114}}] Black & Gilson, supra note 112, at _ (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 36, at 11 (“IPOs are the gold standard in VC success.”).
\item[{\textsuperscript{115}}] See Peter Thiel, \textit{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, \textit{How Venture Capital Works}, HARV. BUS. REV., Nov.-Dec. 1999, 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.”).
\item[{\textsuperscript{117}}] See, e.g., Smith, supra note 113, 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.”).
\item[{\textsuperscript{118}}] Pollman, \textit{Startup Governance}, supra note 111; Stephen Grocer, Biggest Public Company? Microsoft. Wait, Apple Again. Amazon? No, Back to Microsoft., N.Y. TIMES (Feb. 5, 2019), https://www.nytimes.com/2019/02/05/business/dealbook/apple-amazon-microsoft-marketvalue.html. 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 would have to become publicly reporting—thus, the company decided to file for an IPO and it raised $2.7 billion. See Rodrigues, supra note 68, at 1537.
\item[{\textsuperscript{119}}] See Pollman, \textit{Startup Governance}, supra note 111 (add parenthetical). Bloomberg columnist Matt Levine has referred to this phenomenon with the pithy phrase, “private markets are the new public markets.” Matt Levine, \textit{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.”).
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shareholders of record, of which no more than 499 can be unaccredited investors. Employee stock optionholders and shareholders are not counted in this tally—and, in 2018, the SEC raised the Rule 701 threshold to require financial disclosures to stock optionholders only once a company grants more than $10 million in options during a twelve-month period.

The upshot of these changes is that significant amounts of capital are tied up for long periods in essentially illiquid or semi-illiquid markets with little transparency. The average time to M&A and IPO exits have nearly tripled since the late 1990s and, as noted, fewer companies have gone public. Going public has become a choice 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 have 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


121 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 Governance Trap, 166 U. PA. L. REV. ONLINE 165, 175-76 (2017) (discussing amendments to Rules 144 and 506).

122 NVCA Yearbook; Jay Ritter IPO database.

123 See Rodrigues, supra note 68, at 1530 (finding that the previous threshold of 500 shareholders of record may have affected only three percent of those going public); cf. William K. Sjostrom, Jr., Questioning the 500 Equity Holders Trigger, 1 HARV. BUS. L. REV. ONLINE 43, 45 (2011) (explaining that under the 500 shareholder threshold “the practical effect of the rule is to force certain types of firms into public markets earlier than is desirable.”).


125 [string cite]
offices, hedge funds, mutual funds, pension funds, and sovereign wealth funds. These newcomers 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.

126 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, Information Issues on Wall Street 2.0, supra note 30, (discussing secondary trading in private company stock).

127 For example, a notable recent study of 116 unicorn companies found that the average unicorn has eight share classes, indicating many rounds of financings. Will Gornall & Ilya A. Strebulaev, Squaring Venture Capital Valuations with Reality, J. FIN. ECON. (forthcoming).

128 [statutes; accredited investor definition]; 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’”); see also Mark S. Bergman & Sofia D. Martos, Of Unicorns, Private Companies and Public Scrutiny, BLOOMBERG (Oct. 4, 2017), https://www.paulweiss.com/media/3977419/bergmanmartos_bna_5oct2017.pdf (discussing private placements); Jennifer S. Fan, Regulating Unicorns: Disclosure and the New Private Economy, 57 B.C. L. REV. 583, 592-93 (2016) (same); 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.”).

129 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,
Employees generally are not financially sophisticated and typically do not qualify as accredited investors who would be permitted to participate in a private placement of their employers’ securities. Rule 701 exempts grants of share-based compensation to employees.130 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.131 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.132 Scholars have criticized these disclosure requirements as inadequate and poorly tailored to employees’ needs, particularly in unicorn companies that have reached large valuations and may have large numbers of employees with little access to information.133

While the changing private market landscape has impacted primary issuances, the bigger transformation has been the rise of secondary trading in private company stock.134 A decade ago, the private secondary market had been notably illiquid and ad hoc, with occasional transfers done as carefully negotiated affairs.135 An opportunity arose for intermediaries to facilitate such trading, however, with two developments—internet platform technology and a 2007 rule change in which the SEC shortened the holding period for the transfer of private company stock to one year with no conditions.136 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 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.

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137 Pollman, Information Issues on Wall Street 2.0, supra note 30.


139 Pollman, Information Issues on Wall Street 2.0, supra note 30, at 205-21 (discussing information issues in secondary trading of private company stock and the potential for insider trading); Rodrigues, supra note 68, 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.”).


142 David F. Larcker, Brian Tayan & Edward M. Watts, Cashing It In: Private-Company Exchanges and Employee Stock Sales Prior to IPO, Stanford Univ. Graduate School of Business Research.
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.

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. In light of the lack of mandated disclosure, however, it is

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143 Id.


145 [string cite]; Douglas MacMillan, In Silicon Valley Frenzy, VCs Create New Inside Track, WALL ST. J. (Apr. 2, 2015), https://www.wsj.com/articles/in-silicon-valley-frenzy-vc-create-new-inside-track-1427992176 (“With the connections already in place, these deals happen quickly and further narrow the exclusive club that gets access to prime startups. But these funds pose financial risks. A venture capitalist gets a detailed look into a startup's revenue, costs and financial projections before they make a decision to invest. Buyers of SPVs are usually only offered a high-level view into the potential performance, not detailed financial metrics, according to both investors who have arranged these funds and firms and individuals who have considered investing in them.”).


147 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 to differing liquidity expectations of the buyers and sellers, and the subsequent wide spread between the bid and ask of these private stock offerings”).

148 Although different, the public and private market may act as substitutes for certain purposes. See Gubler, supra note 120, at 752 (“The two securities markets—the public and the
clear that far less information is available 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.\textsuperscript{149} 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 Theranos and Hampton Creek 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;\textsuperscript{150} human resources startup Zenefits admitted that its employees cheated on mandatory compliance training;\textsuperscript{151} WrkRiot’s CEO-founder plead guilty to defrauding employees by forging wire-transfer documents;\textsuperscript{152} Skully’s founders faced a lawsuit alleging they engaged in fraudulent bookkeeping and widespread misuse of funds.\textsuperscript{153}

Perhaps the most high-profile recent startup scandal arose from WeWork’s failed IPO which revealed questionable financial dealings between the company and its CEO-founder, among other concerns.\textsuperscript{154} WeWork shareholders have

\textsuperscript{149} See, e.g., Michael D. Guttentag, Protection From What? Investor Protection and the JOBS Act, 13 U.C. DAVIS BUS. L.J. 207, 254 (2013) (“The JOBS Act [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.”). [Question for readers: Any available data on number of private company securities fraud cases? Enforcement actions? Currently looking into whether can add data to paper.]


already brought a breach of fiduciary duty suit and the possibility of a Rule 10-b5 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.\textsuperscript{155}

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 framing, from the Association of Certified Fraud examiners, identifies three main factors behind workplace fraud: (1) pressure, (2) opportunity, and (3) rationalization.\textsuperscript{156} Each are present in venture-backed startups.

\textit{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 significantly less than the intense demands for hyper-growth that is common in startups.\textsuperscript{157}

By its nature, the venture-backed governance model tends to push toward risk-taking and potentially unattainable goals.\textsuperscript{158} [Explain VC model is to take big bets for a few home runs; VCs sit on and sometimes control the board; startups are typically unprofitable for long periods of time and “burning” money, which means many startups are frequently operating on the verge of bankruptcy; 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; employees are also invested in the company. It is not uncommon for founders to go days without sleeping and to suffer from depression or other mental health issues.\textsuperscript{159}]

[Further, startups are clustered in technology and at growth-stages of the life cycle—both of which add to challenges, the uncertainty of outcome, and the

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\textsuperscript{157} [May also explore link between fraud and equity compensation for executives (e.g., Burns & Kedia (2006); Goldman & Slezak (2006); Efendi, Srivastava & Swanson (2007); Peng & Röell (2008); Armstrong, Jagolinzer & Larcker (2009); Johnson, Ryan & Tian (2009)).]

\textsuperscript{158} Pollman, \textit{Startup Governance}, supra note 111, at \_ (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”). [Connect discussion with research on corporate financial fraud post-2000s era, focusing on the role of executive compensation and corporate governance structure.]

potential of failure, which contribute to perceived pressure. Note statistics on rate of failure of startups.]

**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,\(^{160}\) and disclosures to investors are negotiated as part of this transaction. Standard financing documents include a stock purchase agreement that includes representations and warranties, with a schedule of exceptions that acts as an information-forcing device.\(^{161}\) In the past, these documents were 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. However, these representations can be a minefield for companies that operate in heavily regulated areas or have legal issues such as compliance failures or sexual harassment in the workplace that are not disclosed and later come to light.\(^{162}\) Startups frequently bump up against regulatory issues, sometimes even purposely operating in legal gray areas or in violation of legal requirements.\(^{163}\)

In recent years, some high-profile startups have had leverage to keep information confidential—providing an opportunity to 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.\(^{164}\) 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

\(^{160}\) Gornall & Strebulaev, *supra* note 127, at 3. [Shareholders may also have negotiated for information rights or a board observer seat.]


\(^{162}\) Representations that a corporation is in legal compliance are common. 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”).


\(^{164}\) Griffith, *supra* note 27.
still received so much skepticism the public offering failed to get out of the gate.\textsuperscript{165}

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 and omissions. 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 affect. 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 optionholders will be in neither position and may be more easily mislead 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.\textsuperscript{166} They might promise employees liquidity events such as a planned IPO or buybacks.

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.\textsuperscript{167} The letter noted: “Although the values in the table below are hypothetical and inherently uncertain, we want to emphasize our


\textsuperscript{166} See Joseph Bankman, \textit{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, \textit{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, \textit{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”).

belief in Palantir’s potential to become a $100 billion company.” The potential for mischief is apparent.168

Finally, the governance structure of venture-backed startups might present opportunity for carrying out securities fraud. [Describe lack of independent monitoring; founder-friendly structures;169 literature linking fraud to corporate boards lacking independence or financial and accounting expertise.170]

**Rationalization.** Startup and tech company culture have become known for the concept of “disruption” and slogans such as “move fast and break things.”171 Innovative companies often bump up against, disregard, or even intentionally disobey laws in their quests to develop new technology.172 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.173 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.174 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.175

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168 Employees might be easily mislead regarding the valuation of the company based on a preferred stock financing round versus their common stock. See Gornall & Strebulaev, supra note 127.
171 [cite]
172 Pollman, *Corporate Disobedience*, supra note _, at 735.
174 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-rightThing-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”).
175 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?ref=dailydeal&k=undefined&auth=login-email&_r=1 (quoting psychologist Laurence Steinberg); see also LANGEVOORT, supra note 39, 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.”).
There are various ways this process of moral disengagement or rationalizing mentality might play out in the context of securities fraud in private companies.

The path to corporate fraud may start out with innocent confidence and optimism. Managers are known to be optimistic in their appraisals. Startup founders are even more so. Because founders are often optimistic by nature and situationally 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 once more to buy time. They might choose to follow further down this slippery slope of deception particularly as founders or managers realize that the company and its stakeholders, including employees and customers, would be hurt if the deception were revealed.

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

\[176\] 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).

\[177\] Anwer S. Ahmed & Scott Duellman, Managerial Overconfidence and Accounting Conservatism, 51 J. ACCT. RES. 1, 2-4 (2013).

\[178\] [cite]

\[179\] LANGEVOORT, supra note 39, at 19.


\[181\] LANGEVOORT, supra note 39, at 36.

\[182\] 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.”).

\[183\] 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)).

\[184\] Id. (citing David T. Welsh & Lisa D. Ordoñez, 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)).

\[185\] Id. at 35.
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.

Another common pattern of fraud that rings familiar in the startup setting is
that of the dysfunctional corporate culture. In this story, the corporate fraud is not
pulled off by a lone CEO or founder, but rather the corporate fraud occurs
through the work of a group of individuals, any one of whom might bend their
moral compass to the will of the group or blow the whistle. Again, this dynamic
might be a classic slippery slope that starts off innocently enough, such as where
“the company creates a representation of its current situation that is ‘true’ in its
own rosy view of reality, even if it doesn’t necessarily follow the financial
reporting rules religiously.” Research suggests “that dysfunctional corporate
cultures are a main reason that frauds occur.”

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. The stock option backdating scandal
in the early 2000s spread through Silicon Valley, perhaps through directors serving
on interlocking boards of directors, learning to play accounting games.

**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 inquires into the differences
that prevent securities fraud class actions from playing a similar role in the private

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186 Id. at 43.
188 LANGEVOORT, supra note 39, at 41.
189 Id.; 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”).
market as in the public. Although contested, private class actions are understood to serve a monitoring and deterrence function—something that the private capital market needs. A variety of factors may be at play in 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. 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. Moreover, views can vary widely about valuation and can change dramatically with little notice or transparency. All of these factors contribute to the lack of available information about stock price that would allow attorneys to monitor for stock

192 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 52, at _ (arguing that “[fraud-on-the-market (FOTM)] suits might be thought of as a way for 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. . .”).

193 Pollman, Startup Governance, supra note 111, at _; Gornall & Strebulaev, supra note 127, at _


drops followed by corrective disclosures—a typical technique for identifying potential securities fraud suits.196

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 Supreme Court in Basic v. Levinson, and affirmed in Halliburton II.197 The individual reliance of each shareholder would have to be shown.198 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.199

Furthermore, there could be difficulty in actually building a class of shareholders who wanted to be included in the lawsuit. Traditional VC 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. The portfolio approach of VC investing that seeks a small number of mega-hits allows for a buffer for some amount of loss from fraud. There may be little to gain from pursuing private action against bad actors in these situations—no deep pockets to seek recompense and it could be bad for a VC’s reputation. Further, some VCs actively manage their investments by sitting on

196 See supra n.95; see also Park, supra note 126, 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 102 (“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 109, at 449 (“[P]ublic companies’ mandatory disclosure and stock trading prices provide a major information subsidy to private companies . . .”).

197 See supra nn.76-79 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”).

198 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 30, 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.”).

199 Pollman, Startup Governance, supra note 111, at _ (explaining that differences in shareholder positions in startups and terms can give rise to conflicts among shareholders of all types).
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, it does not eliminate the potential impact of a massive business failure on other shareholders (and stakeholders). Furthermore, with private companies reaching very high valuations and staying private longer, the potential impact is greater in terms of financial magnitude and number and type of participants affected. Even venture capitalists may not fare well with 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, “a rational plaintiffs’ lawyer is more willing to pursue a case with a smaller likelihood of success the larger the potential payout.” 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 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 be on the paying side as often as 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


201 Rose, supra note 52, at _.

202 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).

neither compensate nor deter.”

Private company shareholders generally do not have the same circularity problem on a macro level because they are usually 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, from the introduction—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.

III. The Future of Policing Fraud in Private Markets

There is no way to know the amount of securities fraud in private markets. Particularly as these markets are characterized by relative darkness, there is little research or means of accurately accessing the empirical question. Judging simply by sheer numbers, however, we can be relatively certain that with the growth of private markets and the lack of an increase in enforcement or other changes in approach to combatting fraud, there is likely more fraud or potential impacts from fraud than in earlier time periods.

The previous Parts have highlighted 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 rampant 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 for reasons explained, 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: continuing with the status quo approach to private market activity, increasing SEC enforcement, adjusting the public-private line, and exploring alternative mechanisms to increase accountability.

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. To the extent that securities class actions are ineffective in achieving compensation of victims or deterrence of wrongful conduct, critics might urge

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204 Id. at 1536; see also Frank Easterbrook & Daniel Fischel, Optimal Damages in Securities Cases, 52 U. CHI. L. REV. 611, 626 (1985).
that this activity not be imported into the private capital market.\textsuperscript{206} Indeed, some observers might view the relative paucity of securities litigation in private companies as an advantage of staying private.\textsuperscript{207}

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{208} Similarly with respect to securities fraud in private markets, one might believe “the social good offset[s] the investor harm suffered.”\textsuperscript{209} 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{210} Within bounds, “a moderate excess of investor confidence can enhance capital formation. If so, . . . [t]he law should take a light touch. . .”\textsuperscript{211}

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 would have an overdeterrent effect because valuation fluctuations and failures might be confused with misconduct in hindsight. Along a similar vein, disruptive growth 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.”\textsuperscript{212}

Finally, 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

\textsuperscript{206} See, e.g., Jill E. Fisch, \textit{Cause for Concern: Causation and Federal Securities Fraud}, 94 IOWA L. REV. 811, 815 (2009) (noting that critics have argued that the class action “is largely ineffective” and have “urged that private litigation be substantially reduced or eliminated”); Coffee, \textit{supra} note 203, at 1536 (discussing the “fundamental problem” of securities class action litigation as the failure to compensate victims of fraud and to deter potential wrongdoers).

\textsuperscript{207} See, e.g., Jonathan Macey, \textit{The SEC’s Facebook Fiasco}, 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.”).

\textsuperscript{208} LANGEVOORT, \textit{supra} note 39, at 2.

\textsuperscript{209} Id.

\textsuperscript{210} Id.

\textsuperscript{211} Id.

\textsuperscript{212} Id. at 165; Jerold L. Zimmerman, \textit{The Role of Accounting in the 21st Century Firm}, 45 ACCOUNTING AND BUSINESS RESEARCH 485 (2015).
vulnerable class. Venture-backed governance is often assumed to have fewer agency costs because ownership and control are not entirely separated and VCs play a monitoring role. As the next section explores, however, this view misses the bigger picture of potential harms to other shareholders and stakeholders.

B. Increasing SEC 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, former 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 for 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 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, such as billionaire investor Mark Cuban, were quick to criticize the lack

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”).
214 Pollman, Startup Governance, supra note 111 (explaining and refuting the conventional view that VCs are strong monitors).
216 Id.
218 Id.
219 Id.
220 See supra n.15 and accompanying text.
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 located in Florida, had undervalued employee stock for buybacks despite the CEO’s awareness that the equity valuation was low and misleading, in part because the company was in negotiations for a sale to GlaxoSmithKline. See U.S. Securities and Exchange Commission, SEC Charges GlaxoSmithKline Subsidiary and Former CEO with Defrauding Employees in Stock Plan, Dec. 12, 2011, https://www.sec.gov/news/press/2011/2011-261.htm.
of clarity from the SEC, noting that vague threats regarding SEC interest in frothy valuations only adds uncertainty. 222

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 vastly fewer proportional resources than in times past to the private side of the line. 223 Higher enforcement might encourage allocational efficiency and the quality of private company offerings. 224

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. 225 The “fire-the-founder” era of the twentieth century gave way to a “founder-friendly” era of the twenty-first century with competitive pressures. 226 As I have argued elsewhere, startup governance may not sufficiently constrain the social costs of high-growth, innovative startups. 227

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 mean sophistication. 228 Retail investors are exposed to securities fraud in private companies through their investments in mutual funds and pension funds. 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

\[\text{References}\]


223 The SEC also has certain advantages over private litigants. See Buell, supra note 32, 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, Startup Governance, supra note 111 (explaining why some startup boards have monitoring failures).


227 Id.

shareholders” and these “other market participants cannot easily self-insure.”229 Given the large footprint of some “startup” 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. Particularly where there is a vulnerable or harmed class of employees, the SEC may be better positioned to take action as courts might deem employees who are only optionholders to lack standing.231

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.232 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.”233 This finding suggests “that voluntary monitoring by institutional investors or venture capitalists is less effective at reducing fraud when investors are optimistic about an industry’s prospects.”234 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 needed.”235 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.236

C. Adjusting the Public-Private Line

The debate engaged thus far operates on the existing regulatory framework and argues that given the growth of the private capital market and the weakness of

229 Velikonja, supra note 14, at 1887-88, 1916-37 (discussing harms to creditors, employees, the government and communities); see also Sale & Thompson, supra note 192, 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).


231 See Bodie, supra note 30, 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 133 (discussing vulnerability of unicorn employees); Fan, supra note 133 (same).

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

233 Id. at 2256.

234 Id.

235 Id.

236 Federal prosecutors and state attorneys general may also have an increased role to play to effectuate an optimal quantity and quality of enforcement. See Park, supra note 86, at 117-20.
private securities litigation, greater SEC oversight and enforcement is warranted. The observations highlighted in this Article, however, point to a larger issue and potential policy path—a redrawing of the public-private line.

The presence of a larger market space relatively free from securities fraud scrutiny presents a new argument in favor of reverting to an approach like the previous section 12(g) threshold, scaled disclosure, or disclosure on the basis of an active trading market, as proposed by other scholars. Political economy forces could have lead 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. [Discuss line-drawing debate; SEC concept release]

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. The Theranos case, for example, highlights the role that an employee whistleblower can play in bringing alleged fraud to light. Employees reached out to the media, which then attracted the attention of the SEC and the DOJ. With the obstacles to private securities class actions, the non-traditional players (employees, media, and industry regulators) may take on greater importance as monitors.

Because employees in startups frequently hold stock options or shares of common stock, they may have more incentive to take on this monitoring role. [The flip side is that stock options in some circumstances might have the opposite effect—refuse to expose fraud or even encourage participation in it? Creates a potential conflict of interest. Also consider going further into analysis of proposals to incorporate employee voice into governance through board or worker council,

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237 See, e.g., Langevoort & Thompson, supra note 61, at (379) (proposing to “separate out the largest issuers (public issuers) for full publicness treatment rather than just exempting the smallest”); Pritchard, supra note 61, at 1002 (proposing a two-tier market for both primary an secondary transactions keyed to investor sophistication”); Rodrigues, supra note 68, at 1561 (arguing that once a company’s shares are actively it should be subject to mandatory disclosure); Schwartz, supra note 98, at 531 (proposing a “lifecycle model” in which “regulations would adapt to firms as they age”).

238 See Gubler, supra note 120, 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”).

239 Dyck et al., supra note _ (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”).

240 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”).
etc., and how that might impact fraud detection because of lowering cost of identifying and gathering fraud-relevant information.

Conclusion

In a relatively short amount of time, our U.S. capital markets have bifurcated from a dominant public realm to a new reality of two markets—public and private. The explosive growth of the private market 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. Significant information asymmetries characterize trading in the private capital market, as well as the kind of pressure, opportunity, and rationalizing culture that can foster misconduct and deception.

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 SEC enforcement, adjusting the public-private line, and implementing alternative mechanisms for accountability such as giving greater voice to employees. 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 warrants additional oversight and enforcement. 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.