

Private Company Lies

ELIZABETH POLLMAN*

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

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

TABLE OF CONTENTS

INTRODUCTION	354
I. THE DEVELOPMENT OF RULE 10B-5 IN A PUBLIC MARKET PARADIGM . .	360
A. ORIGINS	361
B. EVOLUTION	363

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

II. THE GROWTH OF PRIVATE MARKETS AND THE POTENTIAL FOR PRIVATE COMPANY LIES	368
A. THE NEW PRIVATE LANDSCAPE.	370
B. THE POTENTIAL FOR SECURITIES FRAUD IN PRIVATE COMPANIES . . .	377
1. Pressure	379
2. Opportunity	380
3. Rationalization	383
C. OBSTACLES TO RULE 10B-5 CLASS ACTIONS IN PRIVATE MARKETS . .	386
III. THE FUTURE OF POLICING FRAUD IN PRIVATE MARKETS	390
A. MAINTAINING THE STATUS QUO	391
B. INCREASING PUBLIC ENFORCEMENT	393
C. ADJUSTING THE PUBLIC-PRIVATE LINE	396
D. EXPLORING ALTERNATIVE MECHANISMS TO INCREASE ACCOUNTABILITY IN PRIVATE COMPANIES	398
CONCLUSION	402

INTRODUCTION

One of the world’s great inventors, Thomas Edison, bemoaned the propensity of technologists to lie about an exciting new invention of the late-nineteenth century, the storage battery. In Edison’s words: “The storage battery is, in my opinion, a catch-penny, a sensation, a mechanism for swindling by stock[] companies. . . . Just as soon as a man gets working on the secondary battery it brings out his latent capacity for lying.”¹

More than a century later, CEO-founder Elizabeth Holmes of blood-testing startup Theranos found inspiration in Edison—but rather than making the world a better place, she created a company valued at over \$9 billion that was nothing more than a dangerous house of cards.² At age nineteen, Holmes dropped out of Stanford University to develop groundbreaking blood-testing technology that could use just a drop of blood.³ Over the next dozen years, Holmes became a

1. Interview by the *New York Sunday Herald* with Thomas Edison, in 10 THE ELECTRICIAN: A WEEKLY JOURNAL OF THEORETICAL AND APPLIED ELECTRICITY AND CHEMICAL PHYSICS., 329, 329–31 (1883).

2. See John Carreyrou, *SEC Charges Theranos CEO Elizabeth Holmes with Fraud*, WALL ST. J. (Mar. 14, 2018, 10:21 PM), <https://www.wsj.com/articles/sec-charges-theranos-and-founder-elizabeth-holmes-with-fraud-1521045648>.

3. *Id.*

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

Reporting by the *Wall Street Journal* exposed a devastatingly different story told by employees who suggested that Theranos had falsified lab records to make it look like its blood-testing technology met the industry standard.⁵ According to employees, the vast majority of tests that Theranos offered to consumers were actually being run on commercial devices made by third-party manufacturers.⁶ The small number of blood tests being run on Theranos devices were unreliable and posed a public health threat to consumers.⁷ Under Holmes’s leadership, the company operated in a high-pressure and secretive environment,⁸ with “information compartmentalized so that only she had the full picture of the system’s development.”⁹ Many venture capitalists declined the opportunity to invest in Theranos when Holmes refused to provide specific information about the technology for due diligence—but that did not stop her from raising millions of dollars from an assortment of wealthy investors.¹⁰ As a matter of corporate governance, Holmes allegedly misled the board¹¹ and had supermajority voting stock that gave her the opportunity to override any controls that might otherwise be put in place.¹²

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

4. *Id.*

5. *See id.*

6. *Id.*

7. *Id.*

8. JOHN CARREYROU, *BAD BLOOD: SECRETS AND LIES IN A SILICON VALLEY STARTUP* 33 (2018).

9. *Id.* at 20.

10. *See id.* at 16.

11. *Id.* at 50.

12. *Id.* at 298.

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

14. *See id.*

15. Press Release, U.S. Sec. & Exch. Comm’n, Theranos, CEO Holmes, and Former President Balwani Charged with Massive Fraud (Mar. 14, 2018), <https://www.sec.gov/news/press-release/2018-41> [<https://perma.cc/Q7AF-LXRT>]; *see also* Mary McNamara, Opinion, *The Elizabeth Holmes Story Is Not About the Black and the Blinks*, L.A. TIMES (Mar. 25, 2019, 1:45 PM), <https://www.latimes.com/entertainment/la-et-elizabeth-holmes-con-artist-20190325-story.html> (noting that several people who knew Holmes reported that Holmes believed that she was on a “noble mission,” which justified “fudg[ing] the truth” and that she would eventually succeed).

Subsequently, the Department of Justice (DOJ) brought criminal charges against Holmes.¹⁶

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

Consider another example. WeWork, a shared workspace startup, went from having Goldman Sachs publicize a \$63 to \$96 billion valuation for its initial public offering (IPO) to teetering on the brink of bankruptcy within just thirty-three days.²⁰ Upon releasing information for the planned offering, public market investors responded with scathing criticism of the company's losses and corporate governance—WeWork shelved the IPO plans, and its private valuation of \$47 billion plummeted by seventy percent almost immediately.²¹ The CEO—

16. See Dorothy Atkins, *Ex-Theranos CEO's Criminal Trial Moved to 2021 Due to Virus*, LAW360 (Aug. 11, 2020, 4:14 PM), <https://www.law360.com/articles/1300212/ex-theranos-ceo-s-criminal-trial-moved-to-2021-due-to-virus>. As of fall 2020, Holmes awaits trial on criminal charges and faces up to twenty years in prison if she is convicted. See 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/holmes-theranos-fraud-case.html>.

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

18. See *infra* Section I.B.

19. For a discussion of harm from securities fraud to nonshareholders, see generally Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887 (2013).

20. See, e.g., Dakin Campbell, *How WeWork Spiraled from a \$47 Billion Valuation to Talk of Bankruptcy in Just 6 Weeks*, BUS. INSIDER (Sept. 28, 2019, 10:29 AM), <https://www.businessinsider.com/weworks-nightmare-ipo>; Peter Eavis & Michael J. de la Merced, *WeWork I.P.O. Is Withdrawn as Investors Grow Wary*, N.Y. TIMES (Sept. 30, 2019), <https://www.nytimes.com/2019/09/30/business/wework-ipo.html>.

21. Campbell, *supra* note 20. Several years earlier, a former WeWork employee shared an internal document with reporters that showed the company was falling significantly short of its financial goals. Herbert Lash, *WeWork Sues Ex-Employee for Disclosing Information to Reporters*, REUTERS (July 16, 2016, 6:57 PM), <https://www.reuters.com/article/us-usa-property-wework-lawsuit/wework-sues-ex-employee-for-disclosing-information-to-reporters-idUSKCN0ZW162> [<https://perma.cc/LP8V-TG4S>]. WeWork reported the employee's unauthorized disclosure to the U.S. Attorney's Office, claimed that the information did not reflect its "operating momentum," and then sued the former employee. *Id.*

founder attempted to parachute out of the company with a billion-dollar payout, while various investors faced steep losses—as did thousands of employees whose stock options went to zero.²² The SEC is currently investigating WeWork for rule violations in its abandoned public stock issuance—and it remains to be seen whether the extensive conflicts and irregular financial reporting that have come to light might portend possible securities fraud violations going back to the decade-long period in which the company raised money privately in relative darkness without the regulator’s scrutiny.²³

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

22. See Eliot Brown, *WeWork Employee Options Underwater as Ex-CEO Reaps*, WALL ST. J. (Oct. 23, 2019, 6:33 PM), <https://www.wsj.com/articles/wework-employees-feel-sting-as-ex-ceo-stands-to-reap-11571870011?mod=searchresults&page=1&pos=2>. WeWork’s largest investor, SoftBank, later withdrew the offer to provide a payout to the CEO–founder, resulting in litigation. Peter Eavis, *Adam Neumann, WeWork’s Former Chief, Sues SoftBank*, N.Y. TIMES (May 5, 2020), <https://www.nytimes.com/2020/05/05/business/adam-neumann-softbank-lawsuit.html>.

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

24. See 17 C.F.R. § 240.10b–5(c) (2020).

25. *Id.* § 240.10b–5.

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

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

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

this voluminous case law, and the related scholarly literature, has focused primarily on public corporations and markets.²⁹

This state of the world, with Rule 10b–5 actions aimed at public corporations and little regard given to private corporations, sufficed for a time. Most corporations of significant size were publicly reporting and traded on national securities exchanges, exposed to the threat of class action lawsuits brought by plaintiffs’ attorneys using case law that enabled aggregate litigation seeking compensatory damages.³⁰ By contrast, private placements were composed of sophisticated investors and there was little secondary trading of private company stock.³¹ Startups on average were on a timeline to be acquired or go public within a few years, and valuations did not surpass, or even approach, a billion dollars.

This twentieth-century model of a dominant public capital market has been transformed. Capital formation through private placements has exploded in the past decade. Nonregistered securities offerings totaled more than \$3 trillion in 2017—far outpacing public offerings for stocks and bonds.³² Companies have stayed private longer on average, fewer companies have gone public, and those that do tend to be larger in size.³³ In simple terms, this means that a significant part of the life cycle of a growth company is typically occurring in the private rather than the public market. For example, if Amazon, Google, and Salesforce had stayed private for the “new normal”—an average of twelve years—an additional \$197 billion in growth would have occurred in the private market.³⁴ Venture capitalists now refer to the mega rounds of financings in late-stage startups as “private-IPOs.”³⁵ Marketplaces for trading private company stock have

29. The vast scholarly literature on Rule 10b–5 securities fraud focuses on issues related to public companies, and the literature discussing private companies and Rule 10b–5 is comparatively scarce: see, for example, Carlos Berdejó, *Small Investments, Big Losses: The States’ Role in Protecting Local Investors from Securities Fraud*, 92 WASH. L. REV. 567, 570–73 (2017); Jonathan D. Glater, *Hurdles of Different Heights for Securities Fraud Litigants of Different Types*, 2014 COLUM. BUS. L. REV. 47, 53; Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 216–21 (2012); Kenneth J. Black, Note, *Private Equity & Private Suits: Using 10b-5 Antifraud Suits to Discipline a Transforming Industry*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 271, 271–72 (2013); Robert E. Steinberg, Note, *A New Approach to Rule 10b-5: Distinguishing the Close Corporation*, 1978 WASH. U. L.Q. 733, 735–76.

30. See *infra* Section I.B.

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

32. SCOTT BAUGUESS, RACHITA GULLAPALLI & VLADIMIR IVANOV, SEC, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009–2017, at 7 (2018), https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf?mod=article_inline [<https://perma.cc/K9YB-XS4P>].

33. See *infra* Section II.A.

34. MARK SUSTER & CHANG XU, UPFRONT VENTURES, IS VC STILL A THING? 25 (2019), <https://www.slideshare.net/msuster/is-vc-still-a-thing-final> [<https://perma.cc/7ZA5-7HUQ>].

35. *Id.* at 26.

become part of the ecosystem.³⁶ The rise of the private market has consequently sharpened scholarly and regulatory focus on the health of the public market and on democratizing retail investors' opportunities to fund high-risk and potentially high-growth private companies.³⁷

As the SEC considers dramatically expanding retail investor access to private investments,³⁸ this Article argues that it is time to examine in-depth the issue of securities fraud in private companies. Federal securities law and doctrine has oriented our system around a public–private divide with class actions serving as the driving force in securities fraud enforcement—but only against public companies.³⁹ Due to a variety of obstacles and economic realities, securities fraud class actions have been absent in the private market.⁴⁰ Although public enforcement plays an important role in policing securities fraud, there is no sign that it has kept pace with recent developments. Meanwhile, significant information asymmetries characterize stock issuances and trading in the private market, as well as the kind of pressure, opportunity, and rationalizing culture that can foster misconduct and deception.⁴¹

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

36. See *infra* Section II.A.

37. See, e.g., DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION 165 (2016) (“Also alarming for the SEC is whether economic forces are leading to an eclipse of the public corporation, so that public equity gradually becomes less available as an investment opportunity.”); Usha Rodrigues, *Securities Law’s Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3389–90 (2013) (arguing for general public participation in the private market via mutual fund investment because inequality of investor access “lets the rich get richer, while the poor get left behind”); Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund’s Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1341 (2017) (arguing “that the [mutual funds’] new interest in venture investing poses several potential investor-protection concerns”).

38. See *Oversight of the Securities and Exchange Commission: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 116th Cong. 11 (2019) (statement of Jay Clayton, Chairman, U.S. Sec. & Exch. Comm’n), <https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%2012-10-191.pdf> [<https://perma.cc/HZK9-U75A>] (noting the SEC has an “obligation to explore whether we can increase opportunities for Main Street investors in the private markets while maintaining strong and appropriate investor protections”); Press Release, U.S. Sec. & Exch. Comm’n, *SEC Seeks Public Comment on Ways to Harmonize Private Securities Offering Exemptions* (June 18, 2019), <https://www.sec.gov/news/press-release/2019-97> [<https://perma.cc/WL2W-FAGY>] (stating that the SEC is considering whether to allow retail investors greater exposure to growth-stage companies and whether to revise the limitations on who can invest in exempt offerings); see also Tara Siegel Bernard, *Opening the Door to Unicorns Invites Risk for Average Investors*, N.Y. TIMES (Jan. 4, 2020), <https://www.nytimes.com/2020/01/04/your-money/investing-private-market-startups.html> (noting that the SEC granted certain individuals in the investment sector access to the private markets and expects to further open access to private markets in the future).

39. See *infra* Section I.B.

40. See *infra* Section II.C.

41. See *infra* Section II.B.

of the private market and those affected by securities fraud, while carefully avoiding chilling the flow of funding for innovation and new business.

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

Finally, the Article explores two additional responses to securities fraud in the private market—one bold and one unconventional—both reinforcing the argument for increasing public enforcement and presenting opportunity for future regulatory change. First, the Article contributes to a growing literature that imagines redrawing the public–private line to better capture the public footprint of large corporations and possible gradations or tiers of publicness.⁴² To date, this literature has focused primarily on the need for the sunlight of public disclosure for large private corporations—by contrast, this Article highlights that securities fraud enforcement is another important consideration for redrawing the public–private line, as it represents another key mechanism for protecting investors and the general public. Second, this Article highlights that the response to securities fraud need not look the same in the private as in the public market. Alternative mechanisms to increase accountability, such as giving startup employees additional information and empowering gatekeepers to play a stronger role in monitoring, could provide finely tuned responses to information problems that could supplement increased public enforcement.

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

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

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

42. See *infra* Section III.C.

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

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

A. ORIGINS

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

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

43. Thel, *supra* note 28, at 409.

44. *Id.*

45. *See, e.g.*, 1 LOSS ET AL., *supra* note 27, at 46, 57–59; Velikonja, *supra* note 19, at 1897 (“Modern American securities regulation has two prongs: regulation of securities markets and the securities industry; and regulation of corporate issuers, including mandatory disclosure, the prohibition of fraud, and, more recently, corporate governance.”).

46. *See, e.g.*, Thel, *supra* note 28, at 394–424 (discussing the historical background of the 1934 Act); *cf.* 1 LOSS ET AL., *supra* note 27, at 44–45 (describing the economic losses in 1929–1934). *See generally* MICHAEL PERINO, *THE HELLHOUND OF WALL STREET: HOW FERDINAND PECORA’S INVESTIGATION OF THE GREAT CRASH FOREVER CHANGED AMERICAN FINANCE* (2010) (discussing how the Pecora hearings brought to light a freewheeling banking industry in which officials had sold worthless bonds, manipulated stock prices, and garnered excessive compensation and bonuses).

47. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

48. Thel, *supra* note 28, at 409. For a discussion of the purposes served by accurate stock prices, see generally Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977 (1992).

49. 15 U.S.C. § 77q (2018). Section 17(a) is similar in many respects to Rule 10b–5 but is broader in that claims under Section 17(a)(2) and (a)(3) may be based on negligent conduct, and narrower in that it does not reach the “purchase” of securities or allow for private rights of action. *See, e.g.*, Touche Ross & Co. v. Redington, 442 U.S. 560, 568–71 (1979); Maldonado v. Dominguez, 137 F.3d 1, 6 (1st Cir. 1998)

Second, in light of the apparent need for additional regulation beyond primary securities offerings from issuers, Congress passed the 1934 Act, which provides for periodic reporting requirements and a broad catchall prohibition against securities fraud in Section 10(b).⁵⁰ This provision makes it unlawful “[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance” that contravenes any rule promulgated by the SEC.⁵¹ 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.”⁵² 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.⁵³

In an oft-recounted anecdote, a staff attorney described how Rule 10b–5, which implemented Section 10(b) of the 1934 Act, was created in 1943 in response to a specific incident of fraud—an executive was buying up stock in his own company by telling shareholders that the company was doing badly, all while knowing that earnings would in fact quadruple in the coming year.⁵⁴ Upon learning of this incident, the staff attorney and an SEC director promptly drafted a rule, combining language from Section 17 of the 1933 Act and the congressional grant of authority from Section 10(b) of the 1934 Act.⁵⁵

In relevant part, Rule 10b–5 makes it unlawful for any person “to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of

(explaining that Section 17 actions can be brought in civil regulatory actions by the SEC and criminal prosecutions by the DOJ, but not by plaintiffs in private lawsuits); *Finkel v. Stratton Corp.*, 962 F.2d 169, 174–75 (2d Cir. 1992) (discussing difference between Section 17 and Rule 10b–5); *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 859 (2d Cir. 1968) (en banc) (noting that Section 10(b) was intended as a broad “catchall[]” enforcement provision aimed at both buyers and sellers of securities).

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

51. 15 U.S.C. § 78j(b) (2018).

52. 1 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, *SECURITIES REGULATION* 289–90 (4th ed. 2006); *see id.* at 298 (“By the end of the 1917–1920 securities fraud wave, it was obvious that state blue sky enforcement alone could have only limited success in 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.”).

53. Amanda Marie Rose, *The Shifting Raison D’Être of the Rule 10b-5 Private Right of Action*, in *RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION* 39, 40 (Sean Griffith et al. eds., 2018) (citing Exchange Act Release No. 3230, 7 Fed. Reg. 3804, 3804 (May 21, 1942)).

54. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 767 (1975) (Blackmun, J., dissenting) (quoting Milton V. Freeman, *Administrative Procedures, Address Before the Conference on Codification of the Federal Securities Laws*, in 22 *BUS. LAW.* 793, 922 (1967)).

55. *See id.*

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

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

B. EVOLUTION

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

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

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

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

58. *Id.*

59. See, e.g., *Kardon v. Nat’l Gypsum Co.*, 69 F. Supp. 512, 513–14 (E.D. Pa. 1946) (recognizing a private right of action under Rule 10b–5).

60. See, e.g., *Alexander v. Sandoval*, 532 U.S. 275, 286–88 (2001) (discussing evolution of Supreme Court jurisprudence on implied private rights of action in other contexts); *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 & n.9 (1971) (citing *Shell v. Hensley*, 430 F.2d 819, 827 (1970)) (affirming federal district court in recognizing private right of action under Rule 10b–5); *Rose, supra* note 53 (discussing the development of the private right of action under Rule 10b–5 and the consensus developed by the federal courts leading up to Supreme Court recognition).

61. *Rose, supra* note 53, at 40–41.

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

63. See, e.g., Donald C. Langevoort & Robert B. Thompson, “Publicness” in *Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 339–40 (2013) (noting the “gross inconsistency” in how the securities acts approach the public–private divide); A.C. Pritchard, *Revisiting*

1933 Act governs “public offering[s],” but does not define the term.⁶⁴ An early SEC release provided guidance for what qualified as exempt transactions, noting as relevant factors a small offering size and close relationship between the issuer and offerees.⁶⁵ 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.⁶⁶ This interpretation focused the 1933 Act’s public–private line on notions of qualification for private investments based on investor wealth and sophistication.⁶⁷

By contrast, the 1934 Act tied the periodic public-disclosure obligations to voluntarily listing on a national securities exchange⁶⁸ and was amended in 1964 to add Section 12(g), which set a threshold for public status based on features of the issuer company—assets and number of shareholders of record.⁶⁹ The effect of Section 12(g) was to bring over-the-counter securities trading, with “sufficiently active trading markets and public interest,” within the purview of the SEC’s public-disclosure regime.⁷⁰ Thus, by the 1960s there were three triggers for public status: making a “public offering,” listing on a national securities exchange, and reaching the Section 12(g) threshold. As Donald Langevoort and Robert Thompson have observed: “For a time, at least, the 1964 amendments created a strong bias in favor of public status, precisely given the practical needs of most

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

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

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

66. 346 U.S. 119, 125 (1953).

67. Langevoort & Thompson, *supra* note 63, at 340; see also C. Edward Fletcher III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1083–85 (examining treatment of investor sophistication).

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

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

70. Reporting by Small Issuers, Exchange Act Release No. 34-23407, 1986 WL 703825, at *2 (July 8, 1986); see also Usha R. Rodrigues, *The Once and Future Irrelevance of Section 12(g)*, 2015 U. ILL. L. REV. 1529, 1534 (2015) (discussing the origins of Section 12(g) of the 1934 Act).

growing businesses for both capital and liquidity.”⁷¹

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.”⁷² As a result of a series of rulings, the fraud-on-the-market class action emerged and became the dominant force of modern securities fraud litigation.

An early step on this path was the abandonment of privity as a requirement for liability. In *SEC v. Texas Gulf Sulphur Co.*, the Second Circuit held that a defendant need not be a counterparty or a contemporaneous trader to violate Section 10(b) or Rule 10b-5.⁷³ The requirement that the fraud be “in connection with the purchase or sale of [a] security”⁷⁴ was fulfilled by victims who were purchasers or sellers, whereas the violator could be anyone who made a material misrepresentation or omission in a manner “reasonably calculated to influence the investing public.”⁷⁵ Subsequently, investors began filing actions that became known as fraud-on-the-market cases, claiming the marketplace had been deceived by false representations.⁷⁶ Furthermore, 1966 revisions to the Federal Rules of Civil Procedure enabled plaintiffs to aggregate claims in a class action under Rule 23(b)(3), provided that common issues predominated over individualized ones.⁷⁷

The next important doctrinal development was the Supreme Court’s recognition in *Basic Inc. v. Levinson* of a presumption of reliance in private Rule 10b-5 cases involving securities widely traded in “efficient” markets.⁷⁸ 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

71. Langevoort & Thompson, *supra* note 63, at 346.

72. Rose, *supra* note 53, at 44.

73. 401 F.2d 833, 860–61 (2d Cir. 1968) (en banc) (“Congress intended to protect the investing public . . . [from] misleading statements promulgated for or on behalf of corporations irrespective of whether the insiders contemporaneously trade . . . [or] the corporation or its management have an ulterior purpose or purposes in making an official public release.”).

74. 17 C.F.R. § 240.10b-5 (2020).

75. *Tex. Gulf Sulphur Co.*, 401 F.2d at 862; *see id.* at 857–62 (discussing the SEC’s argument that, after newspaper reports of Texas Gulf Sulphur’s discovery of mineral deposits, the “corporate defendant” violated 10b-5 by issuing a press release that denied the reports and “painted a misleading and deceptive picture of the drilling progress at the time of its issuance”).

76. Langevoort, *supra* note 62.

77. Rose, *supra* note 53, at 45.

78. 485 U.S. 224, 227–28, 250 (1988) (affirming a presumption of reliance existed in a class action of former Basic shareholders who sold stock after the corporation’s first public denial of merger activity but before the suspension of its stock trading just prior to merger announcement); *see* Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 158–62. Prior to this decision, the Supreme Court had dispensed with the requirement of reliance in material omission cases under the efficient market theory. *See* *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152 (1972). For a critical examination of the weaknesses of the efficient market theory, *see* generally Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985) (casting “doubt on the wisdom of reliance on the efficient market hypothesis”); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2003) (discussing the weaknesses of the efficient market theory).

when the truth was revealed.⁷⁹ 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.”⁸⁰ Thus, *Basic* freed public company shareholders from showing that they actually relied on the alleged misrepresentation. Instead, such plaintiffs have a presumption that they relied on the integrity of the stock’s market price.⁸¹

Together, the abandonment of the privity requirement and the acceptance of the fraud-on-the-market theory transformed Rule 10b–5 litigation. Corporations that had not bought or sold stock could be defendants, despite being neither a counterparty nor contemporaneous trader. Eliminating the requirement to prove individualized reliance expanded the universe of potential plaintiffs and facilitated class actions.⁸² These class actions grew to predominate securities fraud litigation and dramatically departed from earlier case law and traditional common law fraud cases.⁸³ With the availability of compensatory damages in Rule 10b–5 class actions—which allow plaintiffs to recover their full out-of-pocket losses attributable to the fraud—attorneys have a strong incentive to bring these suits against public company defendants.⁸⁴

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

79. See *Basic*, 485 U.S. at 241–47.

80. *Id.* at 246. Economists developed the efficient capital market hypothesis (ECMH) in the mid-1960s as a way to explain several empirical studies that found that future changes in stock prices were a “random walk” that could not be accurately predicted based on prior prices. The ECMH “explains” the random walk by hypothesizing that prices change in response to information about a particular company’s stock. See Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546, 551–66 (1994) (summarizing the history of the ECMH and the random walk model of public capital market behavior); see also Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 609 (1984) (observing “relative efficiency is a function of information costs”). See generally Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (reviewing economics literature on the ECMH).

81. See *Basic*, 485 U.S. at 246–47.

82. See Rose, *supra* note 53, at 45–46 (noting that modern fraud-on-the-market class actions not only involve an “expanded set of plaintiffs and defendants, an altered set of elements, and the aggregation of claims” but also “involve defendants with different motives, raise different stakes, and create different incentives to sue and settle than existed in the early years of private Rule 10b-5 enforcement”).

83. See *id.* at 45.

84. Securities fraud class actions against public companies exploded by the 1990s, prompting regulation attempting to recalibrate the level of private litigation. See Buell, *supra* note 26, at 550 (“Seeking to reduce the expenses arising out of weak or meritless cases, Congress updated the ‘34 Act with the Private Securities Litigation Reform Act of 1995 (PSLRA). Under the PSLRA, private plaintiffs must satisfy a heightened pleading standard with respect to the element of scienter.” (footnote omitted)); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 927–28 (1999) (noting that “the damages recoverable in such suits can be a substantial percentage of the corporation’s total capitalization, reaching the tens or even hundreds of millions of dollars” and that corporations’ complaints about their prevalence led to the Private Securities Litigation Reform Act of 1995).

efficient market.⁸⁵ From the fraud-on-the-market presumption of reliance to “materiality” defined in terms of a “reasonable investor,” the elements of a Rule 10b–5 suit reflect the prevalence of public company cases.⁸⁶

And although courts certainly have not required the markers of the public company paradigm for a securities fraud action,⁸⁷ the availability of stock price movements on a public market facilitates discovery of suits, and the prospect of large compensatory damages incentivizes such monitoring.⁸⁸ In 2019, 382 of the 428 securities class actions involved public companies with stock traded on the New York Stock Exchange or Nasdaq.⁸⁹ Securities class actions are trending toward larger company defendants—companies involved in cases that settled in 2019 were fifty-nine percent larger than those in the previous year, as measured by total assets—and the median settlement amount was thirty-four percent higher than the nine-year median.⁹⁰ As the next Part explains, although these settlement amounts and corporate defendants are large, the doctrinal evolution of securities litigation toward a public company model significantly narrows the realm of capital markets being actively monitored once one takes into account the rise of the private capital market.

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

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

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

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

89. CORNERSTONE RESEARCH, *SECURITIES CLASS ACTION FILINGS: 2019 YEAR IN REVIEW* 1, 49 (2020), <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2019-Year-in-Review> [https://perma.cc/JQF3-DFXN].

90. See LAARNI T. BULAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, *SECURITIES CLASS ACTION SETTLEMENTS: 2019 REVIEW AND ANALYSIS* 2–3 (2020), <https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Settlements-2019-Review-and-Analysis> [https://perma.cc/BZ2W-X5EC].

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

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

The rising private capital market not only delivers growth and innovation, however—it also poses new challenges and concerns that policymakers, academics, and market participants have only begun to address. For its part, the SEC has announced twin goals of making public capital markets more attractive while also expanding retail investors’ access to private investments.⁹⁶ This policy

91. See, e.g., Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339, 340–53 (2008) (describing “the global proliferation of viable private and public markets, the trend of investment intermediation and deretailization, and the accelerated pace of financial innovation”); Amy Deen Westbrook & David A. Westbrook, *Unicorns, Guardians, and the Concentration of the U.S. Equity Markets*, 96 NEB. L. REV. 688, 716–27 (2017) (discussing the rise of the private equity market and the relative decline of the IPO market).

92. Jay Clayton, Chairman, U.S. Sec. & Exch. Comm’n, Remarks to the Economic Club of New York (Sept. 9, 2019) [hereinafter Clayton, 2019 Remarks], (transcript available at <https://www.sec.gov/news/speech/speech-clayton-2019-09-09> [<https://perma.cc/Z37B-QJRG>]).

93. See *id.*; see also MCKINSEY & CO., MCKINSEY’S PRIVATE MARKETS ANNUAL REVIEW 4 (2019), <https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review> [<https://perma.cc/QF74-GYRB>] (noting that \$778 billion of new capital flowed into the private capital market in 2018).

94. See, e.g., NAT’L VENTURE CAPITAL ASS’N, 2019 YEARBOOK 5, 32 (2019), <https://nvca.org/wp-content/uploads/2019/08/NVCA-2019-Yearbook.pdf> [<https://perma.cc/6S3K-9CXW>]; Clayton, 2019 Remarks, *supra* note 92. See generally Jay R. Ritter, Initial Public Offerings: Median Age of IPOs Through 2019 (Jan. 14, 2020) (unpublished tabular data) (available at <https://site.warrington.ufl.edu/ritter/files/2020/02/IPOs2019Age.pdf> [<https://perma.cc/J2MA-Q7TH>]) (providing year-by-year documentation of the median age and proceeds for VC-backed and technology IPOs). For a discussion of venture-backed company valuations, see generally Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, 135 J. FIN. ECON. 120 (2019).

95. MCKINSEY & CO., *supra* note 93. The economic downturn spurred by the COVID-19 pandemic has impacted the private market, but private equity and venture capital have proven resilient to date. See HUGH MACARTHUR, BAIN & CO., PRIVATE EQUITY TAKES A MIDYEAR BOUNCE OFF THE BOTTOM 1–2 (2020), <https://www.bain.com/insights/private-equity-takes-a-midyear-bounce-off-the-bottom/> [<https://perma.cc/3S3H-GPK9>]; PITCHBOOK, NAT’L VENTURE CAPITAL ASS’N, SILICON VALLEY BANK & CERTENT, VENTURE MONITOR: Q2 2020, at 3, 11 (2020), <https://pitchbook.com/news/reports/q2-2020-pitchbook-nvca-venture-monitor> (complete form and download report).

96. Clayton, 2019 Remarks, *supra* note 92.

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.⁹⁷ As the SEC has prioritized opening up access to the private capital market and harmonizing securities offering exemptions, little debate has focused on the potential for harm through securities fraud in this increasingly large section of the overall capital markets.⁹⁸

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

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

97. *See id.*

98. *See, e.g.*, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 33-10844, at 268 (Nov. 2, 2020), <https://www.sec.gov/rules/final/2020/33-10844.pdf> [<https://perma.cc/F48U-HXQV>] (“The amendments may increase aggregate potential investor losses [and] [i]ncreased offering limits under Regulation A Tier 2, Regulation Crowdfunding, and Rule 504 may make it easier for smaller, higher-risk issuers to access capital through these exemptions.” (footnote omitted)); Caroline A. Crenshaw, Comm’r, Statement on Harmonization of Securities Offering Exemptions (Nov. 2, 2020), <https://www.sec.gov/news/public-statement/crenshaw-harmonization-2020-11-02> [<https://perma.cc/2T5B-JGQ9>] (“Today’s rule significantly expands private market access to investors without first putting in place appropriate investor protections. . . . The solutions this rule presents are to allow private companies to raise capital by selling more risky offerings, in greater dollar amounts, with less information, and fewer rights to unprepared and unprotected investors.”); Allison Herren Lee, Comm’r, Statement on Amendments to the Exempt Offering Framework (Nov. 2, 2020), <https://www.sec.gov/news/public-statement/lee-harmonization-2020-11-02> [<https://perma.cc/3FGW-537F>] (“In recent years . . . the exception (or exemptions from registration) have swallowed the rule, with statutory and regulatory changes steadily chipping away at restrictions on private offerings and exposing more and more retail investors to their risks.”).

99. *See* Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 163–65 (2019).

100. *See* Erin Griffith, *The Ugly Unethical Underside of Silicon Valley*, FORTUNE, Jan. 2017, at 72, 75, <https://fortune.com/longform/silicon-valley-startups-fraud-venture-capital/> (“Faking it, from marketing exaggerations to outright fraud, feels more prevalent than ever—so much so that it’s time to ask whether startup culture itself is becoming a problem.”); *see also* 16 of the *Biggest Alleged Startup Frauds of All Time*, CB INSIGHTS (May 23, 2019), <https://www.cbinsights.com/research/biggest-startup-frauds> (“There’s almost always an element of ‘fake it ‘till you make it’ for a successful, disruptive startup. Some companies just push their luck a little too far.”).

Finally, it examines the obstacles for traditional securities class actions to play a monitoring role in the private capital market.

A. THE NEW PRIVATE LANDSCAPE

In a recent speech, SEC Chair Jay Clayton acknowledged: “We now have two segments in our capital markets. . . . Twenty five years ago, the public markets dominated the private markets in virtually every measure. Today, in many measures, the private markets outpace the public markets, including in aggregate size.”¹⁰¹ 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.¹⁰² Public companies listed on U.S. stock exchanges have declined in number by nearly half in the past two decades, and they are significantly larger on average.¹⁰³ These figures reflect the dramatic transformation of U.S. markets in the twenty-first century.

Venture-backed startups constitute a large portion of the private capital market and their life cycle has changed significantly. The venture capital (VC) life cycle starts with the creation of funds that raise capital from institutional and accredited investors interested in private-growth assets.¹⁰⁴ The VC deploys the funds into a portfolio of startup companies,¹⁰⁵ typically also playing a role in governance or otherwise supporting these innovative companies.¹⁰⁶ Venture capital funds have a defined term of ten years and detailed rules about how limited partner investors can liquidate their assets at the end of that period.¹⁰⁷ The goal is for the startup companies in the portfolio to grow quickly and achieve successful “exits” during

101. Clayton, 2019 Remarks, *supra* note 92.

102. *Id.* at n.9 (citing a 2018 analysis by the SEC’s Division of Economic and Risk Analysis).

103. *See, e.g.*, Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 455 (2017) (“From 2001 through 2012, there were an average of only 99 IPOs per year, compared to 310 IPOs per year between 1980 and 2000.”); Craig Doidge, G. Andrew Karolyi & René M. Stulz, *The U.S. Listing Gap*, 123 J. FIN. ECON. 464, 467 (2017) (discussing how the number of U.S. listings fell from 8,025 in 1996 to 4,102 in 2012); Brian R. Cheffins, *Rumours of the Death of the American Public Company Are Greatly Exaggerated* 23 (European Corp. Governance Inst., Law Working Paper No. 444, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3225889 [<https://perma.cc/T2GA-N8F6>] (observing that the number of U.S. public companies has declined and “those companies which are publicly traded are now considerably bigger”); Kathleen M. Kahle & René M. Stulz, *Is the U.S. Public Corporation in Trouble?* 2 (European Corp. Governance Inst., Finance Working Paper No. 495, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2869301 [<https://perma.cc/D8NL-EBSV>] (“The steady decrease in the number of listed firms since 1997 has resulted from both low numbers of newly listed firms and high numbers of delists. . . . [T]he average yearly number of IPOs after 2000 is roughly one-third of the average from 1980 to 2000.”).

104. *See, e.g.*, PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 6–8 (2d ed. 2004); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070 (2003).

105. *See* Gilson, *supra* note 104, at 1071; Pollman, *supra* note 99, at 170, 172.

106. *See* Pollman, *supra* note 99, at 173.

107. *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 256 (1998); Gilson, *supra* note 104, at 1070–76 (explaining the standard limited partnership agreement).

this period through a mergers and acquisitions (M&A) sale or IPO that makes a significant return on investment.¹⁰⁸ Although M&A exits are more common, industry experts and academics have long viewed IPOs as essential for sustaining a robust venture capital industry because they provide a mechanism for obtaining high investor returns and liquidity.¹⁰⁹ Venture capital is based on a business model that aims to have a few “home runs” that account for much of the fund returns.¹¹⁰

In previous times, a startup company that survived to exit would typically be acquired or go public within about five years.¹¹¹ Companies raised capital from public markets to fuel growth and access liquidity for VC investors and startup employees who had received stock options.¹¹² Several of the world’s largest companies by market capitalization—Microsoft, Amazon, Apple, and Google—followed this exit path as venture-backed startups.¹¹³

But with regulatory changes and an unprecedented influx of private capital, companies have increasingly stayed longer in the private market and tend to go to the public markets only when governance complexity builds over a period and private investors are ready to cash out.¹¹⁴ 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

108. See D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 317 (2005).

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

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

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

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

113. Pollman, *supra* note 99, at 156; see 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-market-value.html>. Google, now organized under parent company Alphabet, had been profitable pre-IPO and was able to finance its operations while remaining private but hit up against the Section 12(g) threshold and thus decided to file for an IPO. Rodrigues, *supra* note 70, at 1536–37; Grocer, *supra*.

114. See Pollman, *supra* note 99, at 209–16; see also Matt Levine, *Something Is Lost when Companies Stay Private*, BLOOMBERG (Apr. 4, 2018, 1:00 AM), <https://www.bloomberg.com/opinion/articles/2018-04-04/something-is-lost-when-companies-stay-private> (“Private markets are the new public markets. That’s a thing that I say a lot. . . . You stay private to raise money and build your business and grow; you go public to allow your investors to cash out.”).

shareholders of record, of which no more than 499 can be unaccredited investors.¹¹⁵ Employee stock option holders and shareholders are not counted in this tally.¹¹⁶ In 2018, the SEC also raised the Rule 701 threshold to require financial disclosures to stock option holders only once a company grants more than \$10 million in options during a twelve-month period.¹¹⁷

The upshot of these changes is that significant amounts of capital are tied up for long periods in essentially illiquid or semi-illiquid markets with little transparency. The average time to M&A and IPO exits have doubled since the late 1990s, and as noted, fewer companies have gone public.¹¹⁸ Going public has become a choice rather than an inevitability even for large corporations as the Section 12(g) threshold no longer “forces” any companies over the line.¹¹⁹ The 2,000 holders-of-record limit is sufficiently high such that a shareholder base can be managed to stay below it—particularly as “special purpose vehicles” (SPVs) and other planning tools are used to aggregate holdings.¹²⁰

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

115. Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, sec. 501, § 12(g)(1)(A), 126 Stat. 306, 325 (2012) (codified as amended at 15 U.S.C. § 781(g)(1)(A) (2018)). In 2020, the SEC adopted amendments to the definition of “accredited investor,” adding new categories of qualifying persons and entities. Press Release, U.S. Sec. & Exch. Comm’n, SEC Modernizes the Accredited Investor Definition (Aug. 26, 2020), <https://www.sec.gov/news/press-release/2020-191> [<https://perma.cc/2R58-2YCC>].

116. JOBS Act of 2012 sec. 502. For a discussion of agency capture and public choice theory with regard to the JOBS Act, see Zachary J. Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. REV. 745, 786–96 (2013) and Rodrigues, *supra* note 70, at 1552–54.

117. Exempt Offerings Pursuant to Compensatory Arrangements, Securities Act Release No. 33-10520, 83 Fed. Reg. 34,940, 34,941 (July 18, 2018) (to be codified at 17 C.F.R. pt. 230), <https://www.sec.gov/rules/final/2018/33-10520.pdf> [<https://perma.cc/J9NR-8WSK>]. 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).

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

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

120. See Langevoort & Thompson, *supra* note 63, at 355–59 (discussing the “record ownership” and the SEC’s anticircumvention rule, Rule 12g5-1, in the private company context); cf. Alistair Barr, *One Theory Why Lyft, Uber IPOs Flopped: Special Purpose Vehicles*, BLOOMBERG (May 17, 2019, 5:00 AM), <https://www.bloomberg.com/news/articles/2019-05-17/one-theory-why-lyft-uber-ipos-flopped-special-purpose-vehicles> (“SPVs are often set up to invest in fast-growing startups, especially those like Uber that stay private for many years.”); Douglas MacMillan, *In Silicon Valley Frenzy, VCs Create New Inside Track*, WALL ST. J. (Apr. 2, 2015, 8:12 PM), <https://www.wsj.com/articles/in-silicon-valley-frenzy-vc-create-new-inside-track-1427992176> (discussing the increasing use of special purpose vehicles to invest in venture-backed startups).

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

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

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

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

121. See Gornall & Strebulaev, *supra* note 94, at 120, 135, 136 tbl.7 (finding that after adjusting for valuation-inflating terms in preferred stock financings, almost half of “unicorns” lose their status as billion-plus valued companies); Matt Phillips, Stephen Grocer & Erin Griffith, *Wall Street Deflates America’s Favorite Start-Ups*, N.Y. TIMES (Sept. 30, 2019), <https://www.nytimes.com/2019/09/26/business/tech-ipo-market.html> (discussing fear of a bubble and that “the verdict from the stock market is that it’s the private investment binge that has gone too far”); David Trainer, *The Unicorn Bubble Is Bursting*, FORBES (Oct. 7, 2019, 9:21 AM), <https://www.forbes.com/sites/greatspeculations/2019/10/07/the-unicorn-bubble-is-bursting/#e3f34f388198> (“There does not appear to be any appreciation for risk of bidding up the price of unicorns too high.”).

122. See, e.g., Gornall & Strebulaev, *supra* note 94, at 121; Pollman, *supra* note 99, at 175; Sergey Chernenko, Josh Lerner & Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns 2* (Nat’l Bureau of Econ. Research, Working Paper No. 23981, 2017), <https://www.nber.org/papers/w23981.pdf> [<https://perma.cc/AA4Q-5ART>].

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

124. For example, a notable recent study of 135 unicorn companies found that the average unicorn has eight share classes, indicating many rounds of financings. Gornall & Strebulaev, *supra* note 94, at 121.

Supreme Court in *SEC v. Ralston Purina Co.*¹²⁵ There are no specific disclosure requirements for private placements under Section 4(a)(2) or Regulation D offerings to accredited investors,¹²⁶ creating the possibility of negotiations for limited disclosures and extreme divergences in the information known about the company.

Employees are typically not financially sophisticated and do not qualify as accredited investors who would be permitted to participate in a private placement of their employers' securities. Rule 701 exempts grants of share-based compensation to employees.¹²⁷ 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.¹²⁸ Companies that issue more than \$10 million worth of securities under the exemption in a twelve-month period are required to provide a summary of the material terms of the compensatory plan, a list of risk factors associated with investing in the company's securities, and financial statements.¹²⁹ Scholars have criticized these disclosure requirements as inadequate and poorly tailored to employees' needs, particularly in unicorn companies that have reached sizeable valuations and may have large numbers of employees with little access to information.¹³⁰

Although the changing private market landscape has impacted primary issuances, the bigger transformation has been the rise of secondary trading in private company stock.¹³¹ A decade ago, the private secondary market had been notably illiquid and ad hoc, with occasional transfers done as carefully negotiated

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

126. See 17 C.F.R. § 230.502(b) (2020).

127. *Id.* § 230.701(c).

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

129. 17 C.F.R. § 230.701(e).

130. See, e.g., Alon-Beck, *supra* note 128, at 182–83; Yifat Aran, *Making Disclosure Work for Start-up Employees*, 2019 COLUM. BUS. L. REV. 867, 870–72 (2019); Abraham J.B. Cable, *Fool's Gold? Equity Compensation & the Mature Startup*, 11 VA. L. & BUS. REV. 613, 616 (2017); Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 585, 604–05 (2016).

131. See Ibrahim, *supra* note 31, at 3; Pollman, *supra* note 29, at 181–82. Earlier periods noted a lack of secondary trading in private company stock as a limiting factor on securities fraud litigation. See Steinberg, *supra* note 29, at 762 ("The application of rule 10b-5 to close corporations, where lawsuits typically relate less directly to the purchase or sale of a security, has been a major cause of uncertainty over the rule's scope. Because there is no secondary trading of [private company] securities, the rule 10b-5 close corporation lawsuit is more likely to contain corporate law issues.").

affairs.¹³² An opportunity arose for intermediaries to facilitate such trading, however, with two developments—internet-platform technology and rule changes that eased resale restrictions. Specifically, in 2007, the SEC shortened the holding period for the transfer of private company stock to one year with no conditions.¹³³ The agency further provided a regulatory exemption for resales to “qualified institutional buyers”—allowing unlimited transactions with no holding period.¹³⁴ By 2009, two platforms, SecondMarket and SharesPost, launched as online intermediaries, taking a small fee while reducing the search and transaction costs for secondary trading.¹³⁵ With companies staying private longer and using stock and stock options as incentive-based compensation, the possibility for secondary trading to liquidate some stock ownership became increasingly important to startup participants. Employees, former employees, angel investors, and VCs used these sites to identify accredited buyers willing to buy their private company stock. The platforms were quickly doing large amounts of transactions.¹³⁶

In turn, many startups responded by putting in place contractual trading restrictions on their stock in order to manage their shareholder base and the valuation and information issues that can arise with an active secondary trading market for private company stock.¹³⁷ 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.¹³⁸ In 2014, Nasdaq launched a private market initiative as a competitor and by the following year had acquired SecondMarket

132. See Pollman, *supra* note 29, at 203; Brad Stone, *Silicon Valley Cashes Out Selling Private Shares*, BLOOMBERG BUSINESSWEEK (Apr. 21, 2011, 5:00 PM), <https://www.bloomberg.com/news/articles/2011-04-21/silicon-valley-cashes-out-selling-private-shares>.

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

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

135. Pollman, *supra* note 29, at 195–97, 199–201.

136. See Evelyn M. Rusli & Peter Lattman, *Losing a Goose That Laid the Golden Egg*, N.Y. TIMES: DEALBOOK (Feb. 2, 2012, 9:26 PM), <https://dealbook.nytimes.com/2012/02/02/losing-the-goose-that-laid-the-golden-egg> (noting that in 2011 SharesPost facilitated \$625 million in transactions and SecondMarket almost \$600 million, with pre-IPO Facebook stock constituting about a third of the trading volume).

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

138. See *A Brief History of Secondary Stock Sales: From One-Offs to Employee Tender Offers*, FOUNDERS CIRCLE CAP., <https://www.founderscircle.com/history-of-secondary-sale-shares> [<https://perma.cc/P3K9-NMJE>] (last visited Oct. 8, 2020).

and repositioned itself as the private parallel to its public exchange counterpart.¹³⁹ Nasdaq works with companies to facilitate “liquidity programs” that allow a company to impose guidelines, limitations, or restrictions around the sale of stock.¹⁴⁰

The rest of the secondary market evolved as well. SharesPost continues to function as an over-the-counter marketplace and has added an offering to invest in late-stage, venture-backed companies through a proprietary, closed-end interval fund.¹⁴¹ Additional private company marketplaces have sprung up to compete, each with their own variations on facilitating private company secondary deals and liquidity for private company employees.¹⁴²

Finally, the level of secondary activity and complexity of the transactions are noteworthy. The overall size of these secondary markets is significant and the trend is increasing—over \$4 billion in transaction volume was executed in 2017 by the four main players.¹⁴³ 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.¹⁴⁴ Moreover, the combinations of company buybacks, third-party tender offers, and intermediated purchases, such as through SPVs, has grown and resulted in new norms as well as different information flows and pricing.¹⁴⁵ 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

139. See Press Release, Nasdaq, NASDAQ Private Market Acquires SecondMarket (Oct. 22, 2015), <http://ir.nasdaq.com/news-releases/news-release-details/nasdaq-private-market-acquires-secondmarket> [<https://perma.cc/HP5R-L4CQ>]; Tess Stynes & Bradley Hope, *Nasdaq Acquires SecondMarket, Profit Rises 12%*, WALL ST. J. (Oct. 22, 2015, 9:04 AM), <https://www.wsj.com/articles/nasdaq-acquires-secondmarket-profit-rises-12-1445511644>.

140. See NASDAQ PRIVATE MKT., SECONDARY MARKET 2019 RETROSPECTIVE 3, 5 (2020).

141. See *FAQs*, SHARESPOST, <https://sharespost.com/marketplace/individual-investors/buying-private-assets/sharespost-100-fund/faqs> [<https://perma.cc/GVE9-7QF2>] (last visited Oct. 9, 2020).

142. See DAVID F. LARCKER, BRIAN TAYAN & EDWARD WATTS, CASHING IT IN: PRIVATE-COMPANY EXCHANGES AND EMPLOYEE STOCK SALES PRIOR TO IPO 1–2 (2018), <https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-73-private-company-exchanges.pdf> [<https://perma.cc/F879-YEZC>]; Miles Kruppa, *Carta Plans Private Share Trading Platform to Rival Nasdaq*, FIN. TIMES (May 10, 2020), <https://www.ft.com/content/d52b0487-b13c-4bae-bf27-770518ff083d>.

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

144. See Press Release, Nasdaq Private Mkt., Secondary Market Performance 2018 Retrospective (Jan. 29, 2019), <https://www.globenewswire.com/news-release/2019/01/29/1706864/0/en/Nasdaq-Private-Market-Facilitates-a-Record-12-Billion-in-Transaction-Volume-in-2018.html> [<https://perma.cc/R7S9-BDA6>].

145. See DAWN BELT, FENWICK & WEST LLP, LEXIS PRACTICE ADVISOR PRACTICE NOTE: PRE-IPO LIQUIDITY FOR LATE STAGE START-UPS 2–4 (2018), <https://www.fenwick.com/FenwickDocuments/Pre-IPO-Liquidity-for-Late-Stage-Start-Up.pdf> [<https://perma.cc/8L7W-QVYM>] (discussing secondary sales, company buybacks, and information asymmetry considerations); LARCKER ET AL., *supra* note 142, at 2 (describing the impact of private marketplaces on companies and employees); NASDAQ PRIVATE MKT., *supra* note 140, at 2–4 (describing the variety of secondary activity in private company stock and the growth of transaction sizes); Douglas MacMillan, *In Silicon Valley Frenzy, VCs Create New Inside Track*, WALL ST. J. (Apr. 2, 2015, 8:12 PM), <https://www.wsj.com/articles/in-silicon-valley-frenzy-vc-create-new-inside-track-1427992176> (“[T]hese 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.”).

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

B. THE POTENTIAL FOR SECURITIES FRAUD IN PRIVATE COMPANIES

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

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

146. See NASDAQ PRIVATE MKT., *supra* note 140, at 5. Some investors, such as the Softbank Vision Fund, have simultaneously participated in both primary and secondary transactions. See Dana Olsen, *Vision Fund 101: Inside SoftBank's \$98B Vehicle*, PITCHBOOK (Aug. 2, 2017), <https://pitchbook.com/news/articles/vision-fund-101-inside-softbanks-93b-vehicle> [<https://perma.cc/8JSC-3ABC>].

147. Companies may be exposed to risk, like employee lawsuits, to the extent that they reap significant premiums from the “spread” between what employees are willing to sell for and what investors are willing to pay. See Lax & Neville LLP, *Tech Unicorns Engaging in Stock Buybacks Has Some Securities Law Experts Worried*, N.Y. SEC. LAW. BLOG (Mar. 15, 2017), <https://www.newyorksecuritieslawyerblog.com/tech-unicorns-engaging-stock-buybacks-securities-law-experts-worried> [<https://perma.cc/GCR4-US75>] (“Uber appear[ed] to be profiting off of [a] buyback, due to differing liquidity expectations of the buyers and sellers, and the subsequent wide spread between the bid and ask of these private stock offerings.”).

148. See Gubler, *supra* note 116, at 758–61. Although different, the public and private markets may act as substitutes for certain purposes. See *id.* at 752 (“The two securities markets—the public and the private—serve many of the same functions (capital raising, liquidity generation, and price creation) and therefore act as substitutes (albeit imperfect ones).”).

149. See, e.g., Michael D. Guttentag, *Protection from What? Investor Protection and the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 207, 254 (2013) (“The JOBS Act . . . [p]rovisions will make it possible for many more firms to have freely traded securities without any affirmative federal periodic disclosure obligations. The impact of this change on the extent to which investors will be harmed by an increase in fraudulent activity is uncertain. The main reason for this uncertainty is our limited understanding of what causes fraud.”).

150. See Bernard, *supra* note 38.

151. David Jeans, *\$150 Million to Bankrupt: Fraud Startup Tells Court It Had Just \$25,000 Left After CEO Arrest*, FORBES (Oct. 29, 2020, 1:20 PM), <https://www.forbes.com/sites/davidjeans/2020/10/29/fraud-software-company-ns8-files-bankruptcy-after-ceo-arrest/?sh=4033b90f382e>.

LendingClub falsified loan transactions and failed to disclose the CEO–founder’s conflict of interest;¹⁵² Zenefits, a human resources startup, admitted that its employees cheated on mandatory compliance training central to its business model;¹⁵³ WrkRiot’s CEO–founder pleaded guilty to defrauding employees by forging wire transfer documents;¹⁵⁴ Skully’s founders faced a lawsuit alleging that they engaged in fraudulent bookkeeping and widespread misuse of funds;¹⁵⁵ Jumio, a mobile payments identification company, allegedly overstated its revenues to investors before going bankrupt;¹⁵⁶ and Hampton Creek, a “sustainable food” unicorn, raised venture capital using sales figures that reflected the company’s practice of secretly buying back huge amounts of its own products from supermarket shelves.¹⁵⁷

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

152. See Max Chafkin & Noah Buhayar, *How LendingClub’s Biggest Fanboy Uncovered Shady Loans*, BLOOMBERG BUSINESSWEEK (Aug. 18, 2016, 4:00 AM), <https://www.bloomberg.com/news/features/2016-08-18/how-lending-club-s-biggest-fanboy-uncovered-shady-loans>; Peter Rudegair, *LendingClub CEO Fired Over Faulty Loans*, WALL ST. J. (May 9, 2016, 7:45 PM), <https://www.wsj.com/articles/lendingclub-ceo-resigns-over-sales-review-1462795070>.

153. See Griffith, *supra* note 100, at 74–75; Katie Benner & Mike Isaac, *Zenefits Compensates Investors Over Past Misconduct*, N.Y. TIMES (June 30, 2016), <https://www.nytimes.com/2016/07/01/technology/zenefits-compensates-investors-over-past-misconduct.html>. In 2017, Zenefits settled SEC charges alleging that it misled investors in private offerings by making false statements about the license qualifications of its employees to sell insurance. SEC, FILE NO. 3-18263, SEC: SAN FRANCISCO SOFTWARE COMPANY AND FOUNDER SETTLE CHARGES OF MISLEADING INVESTORS ABOUT BUSINESS (2017), <https://www.sec.gov/litigation/admin/2017/33-10429-s.pdf> [<https://perma.cc/BLQ7-WR32>].

154. Jason Green, *Silicon Valley Startup Founder Pleads Guilty to Defrauding Employees*, MERCURY NEWS (Feb. 6, 2018, 2:27 PM), <https://www.mercurynews.com/2018/02/05/silicon-valley-startup-founder-pleads-guilty-to-defrauding-employees> [<https://perma.cc/PF9G-G5FL>]; Press Release, U.S. Dep’t of Justice, Former Silicon Valley CEO Pleads Guilty to Defrauding Employees of Tech Company Start-Up (Feb. 5, 2018), <https://www.justice.gov/opa/pr/former-silicon-valley-ceo-pleads-guilty-defrauding-employees-tech-company-start> [<https://perma.cc/L6PH-SJQ5>].

155. David Z. Morris, *Suit Alleges Rampant Fraud at Collapsed HUD Helmet Maker Skully*, FORTUNE (Aug. 14, 2016, 1:22 PM), <https://fortune.com/2016/08/14/fraud-allegations-hud-skully>.

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

157. See Olivia Zaleski, Peter Waldman & Ellen Huet, *How Hampton Creek Sold Silicon Valley on a Fake-Mayo Miracle*, BLOOMBERG BUSINESSWEEK (Sept. 22, 2016), <https://www.bloomberg.com/features/2016-hampton-creek-just-mayo>.

158. Joe McGrath, *Why Do Good People Do Bad Things? A Multi-Level Analysis of Individual, Organizational, and Structural Causes of White-Collar Crime*, 43 SEATTLE U. L. REV. 525, 540 (2020) (describing the fraud triangle, Donald Cressey’s “internationally prominent model”); see also EUGENE SOLTES, WHY THEY DO IT: INSIDE THE MIND OF THE WHITE-COLLAR CRIMINAL 83–85 (2016) (describing Cressey’s fraud triangle as “one of the most widely cited theories to explain managerial deviance in the twenty-first century,” and noting its use by fraud examiners, securities regulators, and academics); *The Fraud Triangle*, ASS’N CERTIFIED FRAUD EXAMINERS, <https://www.acfe.com/fraud-triangle.aspx>

highlights, each may be present in venture-backed startups.¹⁵⁹

1. Pressure

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

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

[<https://perma.cc/YMW6-KCMV>] (last visited Oct. 9, 2020) (discussing three components based on Cressey’s book, *Other People’s Money*: “[p]erceived unshareable financial need,” “[p]erceived opportunity,” and “[r]ationalization”).

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

160. See, e.g., THIEL, *supra* note 110, at 87 (discussing importance to venture capitalists of investing only in startups that have “*the potential to succeed at vast scale*”); Ranjay Gulati, *The Soul of a Startup*, HARV. BUS. REV., July–Aug. 2019, at 84 (describing how “[t]he urgent need for survival and then pressures to scale up the business” can crush “the start-up spirit”); Prayag Narula, *It’s Time to Talk About Stress at Venture-Backed Tech Startups*, FORBES (Apr. 20, 2018, 9:00 AM), <https://www.forbes.com/sites/forbestechcouncil/2018/04/20/its-time-to-talk-about-stress-at-venture-backed-tech-startups/#1250284857ac> (discussing the “[s]tress-induced mental health challenges,” including lack of sleep and depression, which affect founders of venture-backed startups); *Startup = Growth*, PAUL GRAHAM (Sept. 2012), <http://www.paulgraham.com/growth.html> [<https://perma.cc/5HHU-KX3W>] (“A startup is a company designed to grow fast.”).

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

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

163. See Robert Glazer, *The Spectacular Downfall of Elizabeth Holmes and Theranos Is the Best Startup Cautionary Tale in Years. Here’s What You Should Learn*, INC. (Mar. 20, 2018), <https://www.inc.com/robert-glazer/4-critical-leadership-lessons-from-elizabeth-holmes-theranos-spectacular-downfall.html> [<https://perma.cc/7SM9-NUKN>].

164. See SCOTT KUPOR, *SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT* 37–38 (2019) (explaining how the distribution of deals in a fund follow the “power-law curve” in which a small number of investments drive its success and “VCs are completely wrong about half the time and lose most or all of the money that their investors entrusted to them as a result”); THIEL, *supra* note 110, at 87 (noting that “*every single company in a good venture portfolio must have the potential to succeed*”).

capitalist from the prominent firm Andreessen Horowitz explained, “all we really care about is the at bats per home run”—meaning “the frequency with which the VC gets a return of more than ten times her investment.”¹⁶⁵ Venture capitalists—with these incentives to push for mega hits for their own survival, profit, and ability to raise successive funds—sit on and sometimes control the startup’s board.¹⁶⁶

CEO-founders often have invested seed money of their own or have relationships with investors, some of whom may be friends and family, which adds to stress about losing investor money and raising new money to keep the company going.¹⁶⁷ Employees are also invested in the company through equity-based incentive compensation such that the potential payoff for the whole team, often personally recruited by the CEO-founder or executives, is typically at stake if the company cannot continue to show enough promise to raise successive financing. Further, startups are clustered in the technology sector and at the growth stages of the life cycle—adding to challenges, the uncertainty of outcome, and the potential of failure.

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

2. Opportunity

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

Because VCs stage their investments to deal with the uncertainty inherent in innovative startups, rounds of financing typically occur every twelve to twenty-four months,¹⁶⁸ and disclosures to investors are negotiated as part of this transaction.¹⁶⁹ Standard financing documents include a stock purchase agreement that includes representations and warranties, with a schedule of exceptions that acts as

at vast scale”); Zider, *supra* note 110, at 136 (discussing the VC business model searching for mega hits).

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

166. Pollman, *supra* note 99, at 202–03.

167. *Id.* at 167, 170–71.

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

169. See BRAD FELD & JASON MENDELSON, VENTURE DEALS 28 (3d ed. 2016) (discussing due diligence materials and requests for information); BRAD FELD & MAHENDRA RAMSINGHANI, STARTUP BOARDS: GETTING THE MOST OUT OF YOUR BOARD OF DIRECTORS 40–41 (2014) (discussing board observers). Shareholders may also negotiate for information rights or a board observer seat. See NAT’L VENTURE CAPITALIST ASS’N, MODEL LEGAL DOCUMENTS: INVESTOR’S RIGHTS AGREEMENT 1 (2020), <https://perma.cc/S5KP-KZJV> (providing for information and observer rights in model investor rights agreement).

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

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

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

170. See, e.g., NAT’L VENTURE CAPITALIST ASS’N, SERIES A PREFERRED STOCK PURCHASE AGREEMENT 1, 5 (2020), <https://perma.cc/89U3-R9K4> (providing model venture capital financing documents); see also Claire A. Hill, *Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts*, 34 DEL. J. CORP. L. 191, 215 (2009) (discussing how information is communicated through the contracting process).

171. See John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 140 & n.24 (2014). These representations can be a minefield, however. For example, representations that a corporation is in legal compliance are common, but startups frequently bump up against regulatory issues, sometimes even purposely operating in legal gray areas or in violation of legal requirements. See, e.g., Elizabeth Pollman, *Corporate Disobedience*, 68 DUKE L.J. 709, 731–39 (2019) [hereinafter Pollman, *Corporate Disobedience*] (discussing corporate disobedience related to innovation and entrepreneurship); Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 398–403 (2017) (discussing regulatory entrepreneurship and breaking the law or taking advantage of legal gray areas); NAT’L VENTURE CAPITALIST ASS’N, *supra* note 170, at 12 (including representation that “[t]he Company is not in violation or default . . . [to its knowledge,] of any provision of federal or state statute, rule or regulation applicable to the Company, the violation of which would have a Material Adverse Effect”); see also Elizabeth Pollman, *The Rise of Regulatory Affairs in Innovative Startups*, in THE HANDBOOK ON LAW AND ENTREPRENEURSHIP IN THE UNITED STATES (D. Gordon Smith et al. eds.) (forthcoming) (manuscript at 1) (identifying developments contributing to the rise of regulatory affairs in startups).

172. Griffith, *supra* note 100, at 76.

173. *Id.* at 76–77.

174. See Maureen Farrell & Eliot Brown, *WeWork Weighs Slashing Valuation by More than Half Amid IPO Skepticism*, WALL ST. J. (Sept. 5, 2019, 6:45 PM), <https://www.wsj.com/articles/wework-parent-weighs-slashing-its-valuation-roughly-in-half-11567689174>; Liz Hoffman & Maureen Farrell, *WeWork’s Valuation Falls to \$8 Billion Under SoftBank Rescue Offer*, WALL ST. J. (Oct. 21, 2019, 6:45 PM), <https://www.wsj.com/articles/softbank-offers-to-put-6-5b-into-wework-including-5b-loan-11571687872>.

learned that, although company executives had assured them “not to worry” because the company had pathways to success, including an IPO, the company was actually lowering financial forecasts in investor documents and sliding toward a sale that demolished the value of the employees’ stock options.¹⁷⁵ Some employees had exercised their stock options and paid taxes based on a common stock valuation ten times its ultimate worth—resulting in the situation that employees were “essentially . . . paying to work for the company.”¹⁷⁶

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

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

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

175. Katie Benner, *When a Unicorn Start-Up Stumbles, Its Employees Get Hurt*, N.Y. TIMES (Dec. 23, 2015), <https://www.nytimes.com/2015/12/27/technology/when-a-unicorn-start-up-stumbles-its-employees-get-hurt.html>.

176. *Id.*

177. See Pollman, *supra* note 29, at 216–18 (discussing the potential for insider trading in private company stock).

178. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1750–53 (1994) (explaining that because startups provide “contingent compensation” in the form of equity, “employees sacrifice the higher cash salary” they might obtain at “more established companies”); Yifat Aran, Note, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235, 1263–72 (2018) (describing the ability of stock options to “handcuff” employees to startups); Nicholas Iovino, *Uber Accused of Luring Talent with False Promises*, COURTHOUSE NEWS (Dec. 20, 2016), <https://www.courthousenews.com/uber-accused-of-luring-talent-with-false-promises> [<https://perma.cc/4Y8C-WF3Y>] (discussing a class action lawsuit alleging that Uber “lured hundreds of high-tech workers with false promises of more valuable stock options before quickly breaking that pledge for its own financial benefit”).

179. William Alden, *Ex-Palantir Employees Are Struggling to Sell Their Shares*, BUZZFEED NEWS (Oct. 28, 2016, 2:23 PM), <https://www.buzzfeednews.com/article/williamalden/ex-palantir-employees-are-struggling-to-sell-their-shares> [<https://perma.cc/N2YL-8WDB>].

table below are hypothetical and inherently uncertain, we want to emphasize our belief in Palantir’s potential to become a \$100 billion company.”¹⁸⁰ The potential for mischief is apparent.¹⁸¹

Finally, the governance structure of venture-backed startups might present opportunity for carrying out securities fraud. Startup boards are typically dominated by founders and VCs—they typically allocate only one-quarter or fewer seats to independent directors.¹⁸² Some of the largest startups by valuation have dual-class structures that give control to founders through supervoting shares, further weakening governance mechanisms for oversight and discipline, as illustrated by the Theranos case.¹⁸³ Empirical literature studying public companies has linked financial misconduct to corporate boards lacking independence or financial and accounting expertise¹⁸⁴—both of which are commonplace in private companies.

3. Rationalization

Startup and tech company culture have become known for the concept of “disruption” and slogans such as “move fast and break things.”¹⁸⁵ Innovative companies often bump up against, disregard, or even intentionally disobey laws in their quests to develop new technology.¹⁸⁶ Recent research finds that people who

180. *Id.*

181. Employees might be easily misled regarding the valuation of the company based on a preferred stock financing round versus their common stock. See Gornall & Strebulaev, *supra* note 94, at 123 (noting that employees’ lack of knowledge of Square’s complex capital structure would lead to a 262% overvaluation of their stock options).

182. See Brian J. Broughman, *The Role of Independent Directors in Startup Firms*, 2010 UTAH L. REV. 461, 462 (discussing the composition of startup boards and independent directors); Pollman, *supra* note 99, at 200–09 (discussing a lack of board independence and monitoring in startups).

183. See CARREYROU, *supra* note 8, at 298; Jones, *supra* note 117, at 174; *id.* at 169 (arguing that “recent market trends and deregulatory reforms have weakened or eliminated the principal mechanisms that imposed discipline on start-up company founders”); Pollman, *supra* note 99, at 182, 203–06 (discussing founder-friendly governance structures in startups and oversight weakness); see also Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 580–81, 589–90 (2016) (discussing dual-class structures and observing the value of entrepreneurs controlling management decisions to pursue their “idiosyncratic vision” under conditions of information asymmetry or differences of opinion).

184. See, e.g., Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J.L. & ECON. 371, 371 (2005) (finding “that the probability of restatement is lower in companies whose boards or audit committees have an independent director with financial expertise; it is higher in companies in which the chief executive officer belongs to the founding family”); Mark S. Beasley, *An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud*, 71 ACCT. REV. 443, 443–45 (1996) (finding that “no-fraud firms have boards with significantly higher percentages of outside members than fraud firms”); Patricia M. Dechow, Richard G. Sloan & Amy P. Sweeney, *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 CONTEMP. ACCT. RES. 1, 1–2 (1996) (finding that “an important motivation for earnings manipulation is the desire to attract external financing at low cost” and firms that manipulate earnings are more likely to have boards dominated by management and a CEO who is also the firm’s founder).

185. See THIEL, *supra* note 110, at 56 (“Silicon Valley has become obsessed with ‘disruption.’”); Hemant Taneja, *The Era of “Move Fast and Break Things” Is Over*, HARV. BUS. REV. (Jan. 22, 2019), <https://hbr.org/2019/01/the-era-of-move-fast-and-break-things-is-over> (“Many of today’s entrepreneurs live by Facebook founder Mark Zuckerberg’s now-famous motto: ‘Move fast and break things.’”).

186. Pollman, *Corporate Disobedience*, *supra* note 171, at 735.

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.¹⁸⁷ This kind of rule-breaking spirit and conduct has become normalized and even celebrated—from Steve Jobs flying the pirate flag at Apple¹⁸⁸ to Uber’s early mantra “always be hustlin’” which became “[w]e do the right thing” once the company prepared to go public.¹⁸⁹ 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.¹⁹⁰ 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.¹⁹¹ Managers are known to be optimistic in their appraisals.¹⁹² Because startup founders in particular are often optimistic by nature and situationally encouraged by their venture capital investors to aim for home runs, their estimates may be favorably high.¹⁹³ When performance falls short, managers and founders might interpret this as a temporary setback that can be overcome and deny the bad news.¹⁹⁴ The small step from innocent optimism to denying negative

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

188. Sarah Todd, *The Steve Jobs Speech That Made Silicon Valley Obsessed with Pirates*, QUARTZ (Oct. 22, 2019), <https://qz.com/1719898/steve-jobs-speech-that-made-silicon-valley-obsessed-with-pirates> (noting that Steve Jobs famously motivated Apple’s developers in 1983 by telling them that “[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”).

189. 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, 1:07 PM), <https://www.washingtonpost.com/news/on-leadership/wp/2017/11/08/hustlin-is-out-doing-the-right-thing-is-in-uber-has-rewritten-its-notorious-list-of-core-values> (quoting Dara Khosrowshahi, who replaced the CEO—founder and stated: “[T]he culture and approach that got Uber where it is today is not what will get us to the next level.”).

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

191. Survey evidence indicates that financial managers believe excessive optimism is common among their peers. LANGEVOORT, *supra* note 37, at 35; see Robert Libby & Kristina Rennekamp, *Self-Serving Attribution Bias, Overconfidence, and the Issuance of Management Forecasts*, 50 J. ACCT. RES. 197, 198–200 (2012).

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

193. See Noam Wasserman, *How an Entrepreneur’s Passion Can Destroy a Startup: Founders Need to Believe in Their Ideas and Their Business; but They Can Believe Too Much*, WALL ST. J. (Aug. 25, 2014), <https://www.wsj.com/articles/how-an-entrepreneur-s-passion-can-destroy-a-startup-1408912044> (analyzing 16,000 startup founders, and finding the “consistent theme” among them is their “passion” and “contagious enthusiasm”).

194. See LANGEVOORT, *supra* note 37, at 35.

developments may fall into mental blind spots or be rationalized by self-serving wishful thinking.

From this point, innocent optimism might evolve into deliberate deception.¹⁹⁵ Managers or founders might deflect the truth to buy time.¹⁹⁶ They might choose to follow down this slippery slope of deception, particularly as founders or managers realize that the company and its stakeholders, including employees and customers, would be hurt if the deception were revealed.¹⁹⁷

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.”¹⁹⁸ Research also indicates that trying to meet “frustratingly high performance goals” depletes ethicality and can make eventual dishonesty more likely.¹⁹⁹ If the situation does not improve and the company is truly in trouble, the genuine optimism from the outset might be replaced with fear about survival and the possibility that the managers or founders will be viewed as having lied all along.²⁰⁰

Many frauds go through stages of awareness that end with a guilty state of mind.²⁰¹ 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.²⁰² And once detected, insiders and investors might choose to bury the fraud rather than expose it and risk being associated with the misconduct. Private companies often offer the opportunity for more active engagement, which might both facilitate detection but also risk complicity.

195. See Catherine M. Schrand & Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 J. ACCT. & ECON. 311, 314 (2012).

196. LANGEVOORT, *supra* note 37, at 36.

197. *Id.* (“Psychology research shows that people are more willing to cheat when the benefit will go to a family member or colleague rather than only to themselves.”).

198. *Id.* (citing Crystal L. Hoyt, Terry L. Price & Alyson E. Emrick, *Leadership and the More-Important-than-Average Effect: Overestimation of Group Goals and the Justification of Unethical Behavior*, 6 LEADERSHIP 391, 391–93 (2010)).

199. *Id.* (citing David T. Welsh & Lisa D. Ordóñez, *The Dark Side of Consecutive High Performance Goals: Linking Goal Setting, Depletion, and Unethical Behavior*, 123 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 79, 80–81 (2014)).

200. *Id.*

201. *Id.* at 43.

202. See DAVID F. LARCKER & BRIAN TAYAN, *SCALING UP: THE IMPLEMENTATION OF CORPORATE GOVERNANCE IN PRE-IPO COMPANIES 1* (2018), [https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-2018-scaling-up-the-implementation-of-corporate-governance-in-pre-ipo-companies_0.pdf?pid=\[https://perma.cc/73KT-2CQ2\]](https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-2018-scaling-up-the-implementation-of-corporate-governance-in-pre-ipo-companies_0.pdf?pid=[https://perma.cc/73KT-2CQ2]); Jonny Frank, *Fraud Risk Assessments: Audits Focused on Identifying Fraud-Related Exposures Can Serve as the Cornerstone of an Effective Antifraud Program*, INTERNAL AUDITOR, Apr. 2004, at 40, 40–47 (discussing the role of auditors in preventing and detecting fraud).

Research suggests “that dysfunctional corporate cultures are a main reason that frauds occur.”²⁰³

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

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

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

203. LANGEVOORT, *supra* note 37, at 41; *see also* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 107–08 (1997) (providing “a robust set of explanations for why managers of a public corporation would mislead stock market investors either in their filings or in ongoing publicity efforts,” including an institutional theory of “corporate cultural biases, particularly optimistic ones” that serve as “adaptive mechanisms for encouraging trust and cooperation”).

204. Christopher A. Parsons, Johan Sulaeman & Sheridan Titman, *The Geography of Financial Misconduct*, 73 J. FIN. 2087, 2090 (2018) (finding that “firms are more likely to commit [financial misconduct] when their industry (nonlocal) peers do so, as well as when the [financial misconduct] rate for local (nonindustry) peers is higher than average”).

205. *Id.* at 2089.

206. *See* John Bizjak, Michael Lemmon & Ryan Whitby, *Option Backdating and Board Interlocks*, 22 REV. FIN. STUD. 4821, 4822–23 (2009).

207. *See* William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 70 (2011) (arguing that “a superior enforcement outcome” would require private plaintiffs “to meet an actual-reliance standard” and because this would diminish private litigation, “a compensating increase in public-enforcement capability” is due); Jill E. Fisch, *Federal Securities Fraud Litigation as a Lawmaking Partnership*, 93 WASH. U. L. REV. 453, 453, 467 (2015) (arguing that the collaboration between Congress and the Supreme Court to develop the private class action for federal securities fraud is a “lawmaking partnership” that offers the advantages of “efficiency, political insulation, and comparative institutional competence”); Rose, *supra* note 53, at 50 (arguing that “[fraud-on-the-market (FOTM)] suits might be thought of as a way for shareholders to outsource the monitoring of corporate agents [because] . . . the class action bar—lured by the prospect of large attorneys’ fees—is delegated the job of detecting FOTM; once the discovered fraud is revealed through the filing of a class action complaint, shareholders may in turn impose punishment as appropriate”); Hillary A. Sale & Robert B. Thompson, *Market Intermediation, Publicness, and Securities Class Actions*, 93 WASH. U. L. REV. 487, 487 (2015) (“Securities class actions play a crucial, if contested, role in the policing of securities fraud and the protection of securities markets.”).

may explain why securities class actions have not played a significant role to date in the private capital market: the lack of fluid pricing to identify potential suits, impediments to aggregate litigation, and the different economics of the lawsuit.

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

As a related point, there might be significant frictions to bringing aggregate litigation in the private company context. The fraud-on-the-market theory would not apply given the lack of an efficient market as the Supreme Court described in *Basic v. Levinson*²¹² and reaffirmed in *Halliburton Co. v. Erica P. John Fund*,

208. See Gornall & Strebulaev, *supra* note 94, at 120; Pollman, *supra* note 99, at 172–74.

209. See Matt Levine, Opinion, *The Trades Will Be Free Now*, BLOOMBERG: MONEY STUFF (Oct. 2, 2019, 11:05 AM), <https://www.bloomberg.com/opinion/articles/2019-10-02/the-trades-will-be-free-now> (noting that markets correct pricing through supply principles). For a discussion of how “negative activists can play an important, and indeed helpful, role in financial markets,” see Barbara A. Bliss, Peter Molk & Frank Partnoy, *Negative Activism*, 97 WASH. U. L. REV. 1333, 1376 (2020).

210. For example, Morgan Stanley's mutual funds valued Palantir at \$4.4 billion at the same time that several other Palantir investors appraised it higher, and Morgan Stanley's own bankers predicted that the company could price nine times as much in an IPO. See Lizette Chapman & Sonali Basak, *Palantir Tried Buying Morgan Stanley's Stake in Value Feud*, BLOOMBERG (Nov. 15, 2018, 10:22 AM), <https://www.bloomberg.com/news/articles/2018-11-14/palantir-said-to-try-buying-morgan-stanley-s-stake-in-value-feud>.

211. See *supra* note 88 and accompanying text; see also Park, *supra* note 123, at 141 (“Securities law targets a particular kind of investor injury that is triggered by the purchase or sale of securities at a distorted price.”). This point highlights that public market stock prices are a public good. See de Fontenay, *supra* note 103, at 449 (“[P]ublic companies’ mandatory disclosure and stock trading prices provide a major information subsidy to private companies. . . .”); Clayton, 2019 Remarks, *supra* note 92 (“Prices for stocks, bonds, and other assets, generated by markets that are transparent, information rich and fair, are of immense value to our economy. They are . . . ‘public goods[.]’ [and] generally, once prices are published, we can all use them.”).

212. See *supra* notes 78–81 and accompanying text. For arguments that the fraud-on-the-market theory should not be limited by the concept of the efficient market hypothesis, see Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 712, 719 (2006) (arguing for “the use of the fraud-on-the-market presumption in all fraud cases even when markets are inefficient”) and Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 176 (2002) (arguing that “the [efficient market hypothesis] is unnecessary to justify the Court’s approach” to fraud-on-the-market reliance and

Inc. (Halliburton II).²¹³ The individual reliance of each shareholder would have to be shown.²¹⁴ 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.²¹⁵

Furthermore, there could be difficulty in actually building a class of shareholders who want to be included in the lawsuit. Traditional VC and private equity investors have been assumed to be sophisticated players who understand and manage these risks. They perform their own due diligence and place bets in a portfolio of companies, knowing that many may fail for various reasons, including for misconduct or mismanagement. In particular, the portfolio approach of VC investing that seeks a small number of mega hits allows for a buffer for some amount of loss from fraud. There may be little to gain from pursuing private action against bad actors in these situations—no deep pockets to seek recompense, and it could be bad for a VC's reputation.²¹⁶ Further, some VCs actively manage their investments by sitting on company boards, and they might have failed to catch the fraud and could be exposed to litigation risk in their own right.

This point has its limits, however. Although the rationale of risk spreading through a portfolio of investments may work for venture capitalists and private equity investors, it does not eliminate the potential impact of a massive business failure on other shareholders (and stakeholders).²¹⁷ Furthermore, with private companies reaching high valuations and staying private longer, the potential impact is greater in terms of financial magnitude and number and type of participants affected. Even venture capitalists may not fare well with spreading risk through a portfolio approach when valuations are skyrocketing.

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

213. 573 U.S. 258, 264, 283–84 (2014) (reaffirming the fraud-on-the-market presumption in a class action against Halliburton and one of its executives for alleged misrepresentations regarding potential liability in asbestos litigation, expected revenue, and anticipated benefits from a merger). For a discussion of the case, see generally Allen Ferrell & Andrew Roper, *Price Impact, Materiality, and Halliburton II*, 93 WASH. U. L. REV. 553 (2015); Donald C. Langevoort, *Judgment Day for Fraud-on-the-Market: Reflections on Amgen and the Second Coming of Halliburton*, 57 ARIZ. L. REV. 37 (2015); and Geoffrey Miller, *The Problem of Reliance in Securities Fraud Class Actions*, 57 ARIZ. L. REV. 61 (2015).

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

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

216. See David Rosenberg, *The Two “Cycles” of Venture Capital*, 28 J. CORP. L. 419, 420–21 (2003) (discussing reputation and high overall fund returns as reasons why there has historically been little litigation in the venture capital ecosystem); cf. Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 293 (2010) (noting historically little litigation in the private equity context between fund managers and investors).

217. See Johnson, *supra* note 31, at 197–98 (“Such antifraud-only markets may be acceptable for institutional players, but they are not designed for individual investors.”).

The economics of the lawsuit, however, might be problematic for plaintiffs' attorneys. Attorneys' fees are mainly driven by recoveries.²¹⁸ Therefore, "the larger the potential payout, the more willing a rational plaintiffs' lawyer is to pursue a case with a smaller likelihood of success."²¹⁹ This dynamic likely attracts attorneys toward large public corporation cases even if there are meritorious cases against private companies. Furthermore, the number of shareholders affected to join a private class action will nearly always be fewer than in the public company context because private companies must avoid the 2,000 holders-of-record threshold under Section 12(g) in order to stay private.²²⁰ The availability (or lack) of directors and officers (D&O) insurance in the private company context, and limits in coverage, might also affect the prospect of suit from the attorneys' perspectives.²²¹ In addition, given the potentially smaller scale of lawsuit, the expense of hiring experts could also make bringing suit less attractive as a matter of economics.

Finally, the likely gains from compensatory money damages differ in public and private contexts. In the public company setting, one of the key criticisms of securities class actions is that because corporate defendants tend to fund settlements, it is the public company shareholders who ultimately pay, giving rise to a "circularity" of the money flows.²²² As some class members will continue to hold shares, some portion of the class will fund a portion of their own recovery, and on

218. For a discussion of how judges set fee and cost awards in securities class actions, see generally Lynn A. Baker, Michael A. Perino & Charles Silver, *Is the Price Right? An Empirical Study of Fee-Setting in Securities Class Actions*, 115 COLUM. L. REV. 1371 (2015).

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

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

221. See Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1801–06 (2007) (discussing D&O insurance and shareholder litigation).

222. See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1535–36, 1536 n.5, 1558 (2006); Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 334.

a macro level, over time they will be on the paying side as often as on the receiving side. Diversified investors in public company stock may not, therefore, ultimately benefit on a net basis from fraud-on-the-market settlements—they may simply “produce wealth transfers among shareholders that neither compensate nor deter.”²²³

Private company shareholders do not have the same circularity problem on a macro level because they are often not truly diversified. However, private company shareholders have a different potential problem that is more likely: the company may not have funds available for a settlement or to pay damages, the individuals responsible may not have deep pockets, and any payout might effectively be the shareholder’s own money. For example, the SEC levied a variety of fines and penalties against Theranos and Elizabeth Holmes, but only a relatively small sum of money might be recovered from Holmes, and the shares she returned had little value because the company was already defaulting on credit agreements with few assets.²²⁴

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

III. THE FUTURE OF POLICING FRAUD IN PRIVATE MARKETS

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

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

223. Coffee, *supra* note 222, at 1536; *see id.* at 1558; Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 641 (1985).

224. *See* Reed Abelson, *Theranos Is Shutting Down*, N.Y. TIMES (Sept. 5, 2018), <https://www.nytimes.com/2018/09/05/health/theranos-shutting-down.html>; Press Release, U.S. Sec. & Exch. Comm’n, *supra* note 15.

A. MAINTAINING THE STATUS QUO

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

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

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

225. Cox et al., *supra* note 219, at 751–52.

226. See, e.g., Coffee, Jr., *supra* note 222, at 1535–36 (discussing the “fundamental problem” of securities class action litigation as the failure to compensate victims of fraud and to deter potential wrongdoers); Cox et al., *supra* note 219, at 741 (“[T]here are two very different perspectives of the role of private suits in the enforcement of the securities laws: one perspective enlists plaintiffs as private attorneys general, and the other perspective paints the same plaintiffs as vexatious litigants.”); Jill E. Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811, 815 (2009) (noting that critics have argued that the class action “is largely ineffective” and have “urged that private litigation be substantially reduced or eliminated”).

227. See, e.g., Jonathan Macey, *The SEC's Facebook Fiasco*, WALL ST. J. (Jan. 20, 2011, 12:01 AM), <https://www.wsj.com/articles/SB10001424052748703954004576089840802830596> (“In a public offering, shares are bought by representatives of plaintiffs’ law firms, and if the share price goes down significantly after the offering, the issuer and underwriters typically get sued for having misrepresented the merits of the deal. This is far less likely to happen in a private placement.”).

228. See, e.g., Robert Freedman, *HeadSpin Said to Be Returning \$95M After Review Finds Irregularities*, CFO DIVE (Aug. 4, 2020), <https://www.cfodive.com/news/headspin-said-to-be-returning-95m-after-review-finds-irregularities/582875> [<https://perma.cc/6SPP-QLAW>] (describing a venture-backed startup in which an internal review of financial irregularities by a special board committee led to firing executives, returning cash to investors, and recapitalizing the company).

229. LANGEVOORT, *supra* note 37, at 2.

230. *Id.*

began maturing, with the United States well in the lead in global technology innovation.”²³¹ Within bounds, “a moderate excess of investor confidence can enhance capital formation. If so, . . . [t]he law should take a light touch.”²³²

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

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

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

231. *Id.* at 17.

232. *Id.*

233. *Id.* at 165; see Jerold L. Zimmerman, *The Role of Accounting in the Twenty-First Century Firm*, 45 ACCT. & BUS. RES. 485, 503 (2015).

234. See KUPOR, *supra* note 164, at 42–52 (explaining that early-stage VCs decide to invest based on people and team, the process the founder used to get to the current product idea, and market size).

235. See, e.g., Polina Marinova, *Why VC Tim Draper Keeps Defending Theranos CEO Elizabeth Holmes*, FORTUNE (May 11, 2018, 10:52 AM), <https://fortune.com/2018/05/11/tim-draper-theranos-elizabeth-holmes> (“Look, when I’m an investor in a startup, I assume that 60% of them are going to go out of business . . . I make my money on a few extraordinary companies. Theranos was one of those extraordinary companies that could’ve been one of those big, huge winners.” (quoting a venture capitalist)).

236. See, e.g., Leo E. Strine, Jr., Response, *Poor Pitiful or Potently Powerful Preferred?*, 161 U. PA. L. REV. 2025, 2029 (2013) (observing that investors who buy preferred stock in startups are “quite sophisticated”).

are often assumed to have fewer agency costs because ownership and control are not entirely separated, and investors play a monitoring role.²³⁷ As the next Section explores, however, this view does not account for potential harms to other shareholders and stakeholders.

B. INCREASING PUBLIC ENFORCEMENT

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

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

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

238. See Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016) (transcript available at <https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html> [<https://perma.cc/NDL4-K9XN>]).

239. See *id.*

240. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Enforcement Action for Illegal Offering of Security-Based Swaps (June 17, 2015), <https://www.sec.gov/news/pressrelease/2015-123.html> [<https://perma.cc/ES5E-UMD5>].

241. See *id.*

242. *Id.*

243. See *supra* note 15 and accompanying text. It also pursued two former executives of Lucent Polymers Inc., a private company that manufactured plastic, for allegedly making false claims about its technology, making deceptive marketing reports, and submitting fraudulent data to auditors. Michael S. Dicke & Vincent Barredo, *SEC and DOJ Charge Former Executives of Private Company for Misrepresenting Company's Technology*, FENWICK (Feb. 20, 2019), <https://www.fenwick.com/Publications/Pages/SEC-and-DOJ-Charge-Former-Executives-of-Private-Company-for-Misrepresenting-the-Companys-Technology.aspx> [<https://perma.cc/HQK7-9CTM>].

244. Before Chair White's 2016 speech in Silicon Valley, one of the few private company enforcement actions dated to 2011, in a case alleging that Stiefel Labs, a family-owned business, had undervalued employee stock for buybacks, while the CEO was aware that the equity valuation was low and misleading because the company was in negotiations for a sale to GlaxoSmithKline. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges GlaxoSmithKline Subsidiary and Former CEO with

under no obligation to follow advice for better governance and may be unlikely to take heed without a greater possibility of SEC activity in the space. Some observers were quick to criticize the lack of clarity from the SEC, noting that vague threats regarding SEC interest in frothy valuations only adds uncertainty.²⁴⁵ Some enforcement actions have followed in subsequent years but have not illuminated a clear picture that enforcement against private company frauds is a priority on the agency's agenda.²⁴⁶

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

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

Defrauding Employees in Stock Plan (Dec. 12, 2011), <https://www.sec.gov/news/press/2011/2011-261.htm> [<https://perma.cc/W2NB-5EW6>].

245. See Jacob Pramuk, *Mark Cuban: Here's the Problem with Regulators*, CNBC (Apr. 22, 2016, 11:14 AM), <https://www.cnbc.com/2016/04/01/mark-cuban-heres-the-problem-with-regulators.html> [<https://perma.cc/S7RN-LMVT>].

246. See, e.g., Matt Levine, Opinion, *You Can Relax Once You're in the Index*, BLOOMBERG (July 28, 2020, 11:59 AM), <https://www.bloomberg.com/opinion/articles/2020-07-28/you-can-relax-once-you-re-in-the-index> (referring to two actions against private companies as a “mini-wave of private fraud enforcement actions”). Recent enforcement actions against private startups and their CEO-founders include those against YouPlus, Inc. and Trustify Inc. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Silicon Valley Start-Up and CEO with Defrauding Investors (July 20, 2020), <https://www.sec.gov/news/press-release/2020-160> [<https://perma.cc/C2WG-VMRP>]; Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Trustify Inc. and Founder in \$18.5 Million Offering Fraud (July 24, 2020), <https://www.sec.gov/news/press-release/2020-162> [<https://perma.cc/YK2S-W97P>].

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

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

249. See Pollman, *supra* note 99 (explaining why some startup boards have monitoring failures).

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

251. See *id.*

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

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

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

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

254. See Langevoort & Thompson, *supra* note 63, at 339–42; Sale, *supra* note 248, at 1046 (“Disclosure’s purpose, then, is to diminish asymmetries and the space for fraud, both for those within the entity and for the public affected by the entity.”); Sale & Thompson, *supra* note 207, at 487–88, 526–31 (arguing that securities litigation encompasses a broader set of goals related to publicness, including market protection, innovation, growth, stability, and systemic considerations). See generally Hillary A. Sale, *The Corporate Purpose of Social License* (Feb. 19, 2020) (unpublished manuscript) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3403706 [<https://perma.cc/SKZ2-RPEC>]) (exploring how failure to account for the public nature of corporate actions can result in the loss of social license).

255. See MAYNARD ET AL., *supra* note 125, at 337–39.

or leverage to negotiate.²⁵⁶ Particularly where there is a vulnerable or harmed class of employees, the SEC may be better positioned to take action as the harmed individuals may not have the means to pursue action, and courts might find that employees who are only option holders lack standing.²⁵⁷

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.²⁵⁸ The study found that "voluntary monitoring by institutional investors or venture capitalists is less effective at reducing fraud when investors are optimistic about an industry's prospects."²⁵⁹ Thus, "[i]f regulators want to reduce fraud in order to avoid [the] externalities and negative consequences of fraud, more regulatory vigilance in good times may be needed."²⁶⁰ This research suggests that as the private capital market grows, the SEC should proportionately scale or otherwise increase its enforcements efforts and remain engaged even during periods of growth and enthusiasm.²⁶¹ Federal prosecutors and state regulators may also have an increased role to play to effectuate an optimal quantity and quality of enforcement.²⁶²

C. ADJUSTING THE PUBLIC-PRIVATE LINE

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

256. See Caroline Moon, *16 Things to Know About the 409A Valuation*, ANDREESSEN HOROWITZ, <https://a16z.com/2020/02/13/16-things-about-the-409a-valuation> [<https://perma.cc/JBL2-RMN7>] (last visited Oct. 10, 2020).

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

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

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

260. *Id.* at 2257.

261. See *id.* at 2287.

262. See Berdejó, *supra* note 29, at 572-73; Park, *supra* note 123, at 117-22; Andrew K. Jennings, *State Securities Enforcement 12-30* (June 8, 2020) (unpublished manuscript) (on file with author) (surveying state securities enforcers); cf. Johnson, *supra* note 31, at 198 (arguing that "Congress or the SEC should return to the states the power to enforce private placement standards" to "allow states some meaningful measure of authority to protect investors in the more dangerous private markets").

The observations highlighted in this Article, therefore, not only raise the possible need for greater public oversight and enforcement in the private market but also point to a larger issue and potential policy response—a redrawing of the public–private line. A growing scholarly debate has generated a variety of proposals to this end, but it has focused on the need for disclosure as the rationale rather than the problem of securities fraud. The motivating philosophy of our securities law framework, however, envisions both disclosure and enforcement against fraud as reinforcing mechanisms for protection of investors and the general public. This Article may therefore bolster the rising voices pushing for reexamination of the public–private divide.

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

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

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

264. Pritchard, *supra* note 63, at 1002.

265. See, e.g., *id.*

266. See Rodrigues, *supra* note 70, at 1561; *Spurring Job Growth Through Capital Formation While Protecting Investors—Part II: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 43 (2012) (prepared statement of Jay R. Ritter, Cordell Professor of Fin., Warrington Coll. of Bus. Admin., Univ. of Fla.); *Spurring Job Growth Through Capital Formation While Protecting Investors—Part I: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 65–66 (2011) (prepared statement of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia Univ. Law Sch.); see also John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722–23 (1984) (explaining policy rationales for mandatory disclosure under securities law); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1436–37 (1989) (same).

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

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

public disclosure might better reflect the different types of corporations and their societal impacts.²⁶⁹

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

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

D. EXPLORING ALTERNATIVE MECHANISMS TO INCREASE ACCOUNTABILITY IN PRIVATE COMPANIES

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

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

(1999) (“[T]he primary function of disclosure is . . . efficiency in the real economy, not investor protection.”); Langevoort & Thompson, *supra* note 63, at 376–78 (discussing how securities regulation reflects efforts to prevent corporate externalities that impact the public and that “transparency, accountability, and openness to external voices are expected of large American corporations”); Lipton, *supra* note 253, at 502–03 (explaining that the U.S. system of disclosure is premised on investor protection but serves broader societal needs of the general public).

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

270. See Gubler, *supra* note 116, at 753; Usha R. Rodrigues, *Dictation and Delegation in Securities Regulation*, 92 IND. L.J. 435, 468–73 (2017) (describing the political context and industry players involved in the passage of the JOBS Act).

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

272. See JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 1–3 (2006) (defining “gatekeepers,” and listing as examples auditors, attorneys, securities analysts, credit-rating agencies, and investment bankers).

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

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

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

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

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

274. See CARREYROU, *supra* note 8, at 186–200 (describing the role of the employee–whistleblower).

275. *Id.* at 296.

276. See *id.* at 274–75.

277. 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 . . . stock options (or similar types of compensation) motivate them to fulfill this task”).

278. See *In re Tradco Inc. S’holder Litig.*, 73 A.3d 17, 36–37 (Del. Ch. 2013) (equating the common shareholders in venture-backed startups to residual claimants). For commentary critiquing an approach to fiduciary duty that fails to maximize aggregate firm value, see Robert P. Bartlett III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE U. L. REV. 255, 259–60 (2015); William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1877 (2013); and Pollman, *supra* note 99, at 216–20.

279. See, e.g., Lynne Bernabei, Alan Kabat, Richard Levine & Kristen Sinisi, *Navigating the Nuances of Sarbanes-Oxley and Dodd-Frank Whistleblower Claims*, 65 PRAC. LAW. 42, 42–44 (2019) (providing overview of Sarbanes-Oxley and Dodd-Frank whistleblower provisions); Matt A. Vega,

likely insufficient but could be given a better chance of success by exploring new mechanisms to provide employees with greater incentives to serve as early whistleblowers or increase their voice in governance, such as through board access or work councils.²⁸⁰

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

For years, federal securities law has magnified the importance of private exemptions and accredited investor status while turning a blind eye to concerns about startup employees. A fresh evaluation of Rule 701 on compensatory offerings is warranted, with an understanding that startup employees make important, firm-specific investments.²⁸¹ Rather than easing disclosure requirements by raising the Rule 701 threshold,²⁸² the SEC could take an approach that looks at the changing informational needs of working investors and better recognizes their particular needs and vulnerabilities.²⁸³ The response to securities fraud in the

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

280. See, e.g., Kent Greenfield, *Debate: Saving the World with Corporate Law?*, 57 EMORY L.J. 948, 961 (2007) (arguing for stakeholder governance); Grant M. Hayden & Matthew T. Bodie, *The Corporation Reborn: From Shareholder Primacy to Shared Governance*, 61 B.C. L. REV. 2419, 2426 (2020) (arguing for increased worker voice in corporate governance); Leo E. Strine, Jr., *Toward Fair and Sustainable Capitalism* 5–6 (Univ. of Pa. Inst. for Law & Econ., Research Paper No. 19-39, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3461924 [<https://perma.cc/E7D4-4C2S>] (proposing rule requiring “boards of large, socially important companies to create workforce committees to address workforce issues at the board level”).

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

282. Exempt Offerings Pursuant to Compensatory Arrangements, Securities Act Release No. 33-10520, 83 Fed. Reg. 34,940, 34,940 (July 18, 2018) (to be codified at 17 C.F.R. pt. 230), <https://www.sec.gov/rules/final/2018/33-10520.pdf> [<https://perma.cc/J9NR-8WSK>] (raising from \$5 million to \$10 million the aggregate sales price or amount of securities sold during any consecutive twelve-month period in excess of which an issuer is required to deliver to employees certain disclosures, including financial statements). The SEC has also issued a concept release soliciting public comment about ways to modernize Rule 701. See Concept Release on Compensatory Securities Offerings and Sales, Securities Act Release No. 33-10521, 83 Fed. Reg. 34,958, 34,958 (July 18, 2018) (to be codified at 17 C.F.R. pt. 230), <https://www.sec.gov/rules/concept/2018/33-10521.pdf> [<https://perma.cc/4JHQ-CC3H>].

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

private market might thus look quite different from the public market paradigm of securities class actions while responding to the vulnerabilities of those most affected.

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

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

A range of oversight and regulatory initiatives related to these trading marketplaces could strengthen private company accountability. The SEC could require them to collect and report data regarding the trading of private companies,

supra note 130, at 613 (“[S]tartup employees may be relatively capable investors in a company’s early stages . . . but poorly equipped to navigate the risks of a mature startup.”); Fan, *supra* note 130 (arguing for enhanced disclosure requirements on unicorn companies).

284. Other gatekeepers, such as attorneys, are present but may be ineffective or conflicted because they sometimes invest in their clients or take equity-based compensation. See COFFEE, JR., *supra* note 272, at 362 (“Law and accounting . . . protect their autonomy; they resist broad duties to the public; and they invest very little in self-policing.”); John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 TEX. L. REV. 405, 408–10 (2002) (observing that “lawyer equity investment in client ventures has become more routine” for law firms representing startups); see also Z. Jill Barclift, *Corporate Responsibility: Ensuring Independent Judgment of the General Counsel—A Look at Stock Options*, 81 N.D. L. REV. 1, 31 (2005) (concluding that boards of public companies should eliminate stock options from compensation for the general counsel to maintain independent judgment and candor).

285. See Fixing America’s Surface Transportation (FAST) Act, Pub. L. No. 114-94, sec. 71003, § 102, 129 Stat. 1312, 1783–84 (2015). The FAST Act incorporated Sections of the Reforming Access for Investments in Startup Enterprises (RAISE) Act of 2015, which amends the 1933 Act by creating a safe harbor in a new Section 4(a)(7) to exempt from registration certain resales of securities to accredited investors. See *id.* sec. 76001, § 4, 129 Stat. at 1787–90; H.R. 1839, 114th Cong. (2015).

286. Several years ago, SharesPost itself came under SEC scrutiny for matching buyers and sellers of private company stock without registering as a broker–dealer. See Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares (Mar. 14, 2012), <https://www.sec.gov/news/press-release/2012-2012-43.htm> [<https://perma.cc/X85B-SDNV>].

287. See Coffee, Jr., *supra* note 266, at 738 (discussing agency costs and conflicts of interest that prevent voluntary disclosure).

288. See KUPOR, *supra* note 164, at 29–32 (“[A] small percentage of [VC] firms capture a large percentage of the returns to the industry.”).

including trading volume, participants, and the type of information disclosed. Consistent oversight of this trading data could better position the SEC to detect potential instances of securities fraud and launch further investigations. This pool of data would primarily capture larger, more mature private companies, which would be underinclusive by nature but a clear starting point involving little cost.

Furthermore, the SEC could require a minimum level of disclosure for private secondary trading in order to fit within a registration exemption.²⁸⁹ The trading marketplaces would then be enlisted in the role of regulator along the lines that exchanges have played for over a century.²⁹⁰

These regulatory changes would not only enrich the informational environment of private company stock trading but would also incorporate the monitoring function of another set of gatekeepers—auditors.²⁹¹ A variation on this concept could require that executives such as the CEO and CFO provide a certification attesting to the accuracy and fair representation in all material respects of certain information provided to investors, such as financial reports.²⁹² Although private market participants might prefer the relatively lax status quo, strengthening controls and improving information is an alternative to forcing public company status while still ultimately promoting the integrity of the private market. On the whole, these alternative mechanisms could significantly bolster efforts to increase public enforcement.

CONCLUSION

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

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

289. See Pollman, *supra* note 29, at 222–26 (arguing for minimum disclosures in private company stock trading).

290. See Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1455 (1997) (arguing that the benefits of securities exchanges provide rules and enforcement mechanisms to protect investors and increase their returns).

291. See COFFEE, JR., *supra* note 272, at 108–91 (examining the role of auditors as gatekeepers).

292. Officer certification requirements from the public corporation context established by the Sarbanes-Oxley Act of 2002 (SOX) could be adapted to the private company context, even without audited financial statements and public disclosures. See Sarbanes-Oxley Act of 2002 § 302(a), 15 U.S.C. § 7241 (2018). An affirmative certification requirement can encourage corporate executives to be actively engaged in the company's financial reporting and to focus their attention on the importance of accurate and complete disclosure. See Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923, 951–52 (2019) (discussing the SOX certification requirement).

through a public company paradigm. In the private company context, the lack of information, rich and transparent pricing, the presence of impediments to aggregate litigation, and different economics for bringing suit create friction for plaintiffs' attorneys.

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