Drowning Unicorns: The Case Against More Disclosure in Private Markets

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ABSTRACT

This Note traces the economic and legal factors that led to the proliferation of unicorn companies—private, venture-backed startups valued over one billion dollars—over the past decade and argues that unicorn companies should be subject to fewer security disclosures. A lighter disclosure regime fosters greater private-market illiquidity, which, in turn, better aligns an investor’s profit motive with prudential corporate management. Because they cannot flee at the first sign of trouble, shareholders are incentivized to play a more active role in overseeing management and eschew risky decisions that threaten the well-being of a company to avoid losing their investments. Given the dynamic between market illiquidity and increased shareholder oversight, this Note advocates for the adoption of a regulatory stance that disfavors onerous disclosure requirements on private companies but prefers startup companies to go public earlier in their lifecycles. To pressure companies to IPO sooner, the shareholders of record threshold in Section 12(g) of the Securities Exchange Act should be restored to its pre-JOBS Act level of 500 from its current level of 2000.

INTRODUCTION

Unicorn companies—private, venture-backed tech startups with valuations exceeding a billion dollars—have become a fixture in Silicon Valley over the past decade.1 As private companies, unicorns lack the rigorous disclosure requirements their public counterparts are subjected to and present a blind spot for regulators.2 As evidenced by numerous high-profile tech scandals occurring over the past few years, it is increasingly apparent that unicorn companies operate with a cavalier attitude toward the law. This presents a serious problem as many of these companies now control vast swathes of the digital economy.3

There are two ways to analyze the unicorn phenomenon: macroeconomically and legally. On the macroeconomic side, one could say this problem is a result of low interest rates born out of the 2007–2008 Great Financial Crisis (GFC).4 Cheap money has stunted unicorns’ development

2. Id. at 1207.
and encouraged founders to delay going public; with abundant financing opportunities, intransigent entrepreneurs feel less pressure to conduct an Initial Public Offering (IPO), grow up, and subject their companies to the scrutiny of public markets. On the legal side, government policies favoring deregulation in securities markets have enabled unicorns to operate with wide latitude under the cover of regulatory darkness. In either case, it is clear that unicorns are growing increasingly powerful, and something must be done to reign in these companies.

Much of the literature proposing solutions to this problem focuses on increasing government oversight by imposing greater disclosure requirements upon private companies. In effect, many of these proposed solutions attempt to import the regulatory features of public markets into the private sphere. This Note presents an argument to reject greater transparency and instead asks policymakers to do the opposite: impose less disclosure and foster market illiquidity in the private space. While unconventional, this position is informed by the view that market illiquidity better engages shareholders to hold corporate management accountable and invested in their company’s success. This argument proceeds in five parts: Part I provides background on the growth of private markets and traces the macroeconomic drivers of unicorn development; Part II describes the other half of the unicorn equation—deregulation of securities markets—and discusses the specific features of the 2012 Jumpstart our Business Startups (JOBS) Act that has allowed unicorns to proliferate; Part III elaborates on the relationship between less disclosure, market illiquidity, and good corporate governance; Part IV advances a simple solution based upon the connection articulated in Part III and addresses a potential counterpoint; finally, Part V summarizes the Note’s position and provides some prognostications about the future of unicorns in America.

1. THE MACROECONOMIC BACKGROUND

A. PRIVATE MARKETS ARE THE NEW PUBLIC MARKETS

The growth of private markets over the past decade has been nothing short of incredible. In the first half of 2021, global private assets under management (AUM) reached a record high of $11.7 trillion, and total private market fundraising expanded threefold from $380 billion in 2011 to $1.2 trillion in 2022. Since the GFC, institutional investors have steadily

5. See id.
increased their holdings of private assets. Among U.S. pension funds in 2019, alternative investments, including private equity and private debt, comprised 27 percent of total AUM, up from 18 percent in 2009. Representative of industry headwinds, CALPERS, the largest public pension fund in the United States, announced in 2021 that it would increase the allocation of private equity investments in its portfolio from 8 percent to 13 percent. Outside of institutional money, retail investors have also been looking towards the private sphere for investment opportunities, and new fintech platforms have arisen to facilitate this. In June 2022, investing startup Titan announced that it would offer its customers the option to buy into Cathie Wood’s new ARK Venture Fund through their Roth IRAs. In Washington, D.C., there have been recent legislative efforts to eliminate the long-standing prohibition on private investments within employee 401K plans. Taken together, these developments collectively underscore the growing influence of private market investing in asset management space.

What has fueled this growth in private market investment? In answering this question, one cannot deny the role of “ultra-loose monetary policy.” A common explanation is as follows: In the wake of the GFC, central banks around the world dropped interest rates and printed money to spur economic growth. This flood of “cheap debt” reduced the attractiveness of safer, lower-yielding assets and pushed investors to explore riskier corners of the investment landscape. In addition, the regulatory reforms of the GFC forced bulge-bracket banks to scale back their proprietary trading activity, creating a vacuum for aggressive fund managers to fill. Flush with cash and hungry for returns, investors and their financial advisors began allocating ever-

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14. See id.

15. Id.; Kyle Wiggers & Alex Wilhelm, As Interest Rates Rise, Startups and VCs are Playing a New Game, TECHCRUNCH (May 7, 2022), https://techcrunch.com/2022/05/07/as-interest-rates-rise-startups-and-vcs-are-playing-a-new-game/.

increasing amounts of capital to risky alternative assets that promised higher yields.\textsuperscript{17} As a result, investment in private markets boomed.\textsuperscript{18}

Two clear winners of this macroeconomic trend have been venture capital (VC) and the technology industry. In 2011, global VC AUM stood at $720 billion and grew at a compound annual growth rate (CAGR) of 24 percent to reach the over $6.3 trillion figure it stands at today (for comparison, the CAGR of traditional private equity “buyout” funds’ AUM was only 11 percent over the same period).\textsuperscript{19} The majority of this new VC money has gone into the coffers of the technology industry, particularly in North America (North American companies captured approximately 55 percent of VC deal value over the past decade).\textsuperscript{20} Deal size has steadily increased, and the amount of VC investment in global technology firms more than doubled between 2010 and 2020.\textsuperscript{21} In 2016, the average value of a late-stage venture deal was $25 million; by 2021, that figure grew to $56 million.\textsuperscript{22} This explosion of VC money has disrupted the traditional model of venture investing practiced for years on Sand Hill Road.\textsuperscript{23} Enter the late-stage growth equity fund.

\section*{B. Growth Equity: Venture Capital Disruptors}

In the traditional venture investing model, VCs assume the role of the experienced shepherd herding young portfolio companies along the path to an eventual IPO.\textsuperscript{24} The process begins with fund formation. VC sponsors (called general partners) raise capital by soliciting various institutional investors and high-net-worth individuals (called limited partners).\textsuperscript{25} The sponsors then deploy small amounts of capital across a wide range of fledgling, moonshot businesses with the understanding that many of their bets will fail and lose money.\textsuperscript{26} The hope is that a few portfolio companies will grow to become robust businesses, go public, and generate windfall returns to offset the losses

\begin{itemize}
\item\textsuperscript{18} See \textit{Private Markets Have Grown Exponentially}, supra note 4.
\item\textsuperscript{20} Sheth et al., supra note 19.
\item\textsuperscript{22} Id.
\item\textsuperscript{23} Renee M. Jones, \textit{The Unicorn Governance Trap}, 166 U. PA. L. REV. ONLINE 165, 173 (2017).
\item\textsuperscript{24} Id. at 172.
\item\textsuperscript{25} Wansley, supra note 1, at 1212.
\item\textsuperscript{26} Id.
from the failed bets. Under this model, VCs invest early in a company’s lifecycle and help to develop a business as it grows. Investment horizons are time-bound; sponsors traditionally aim for a public offering within five to seven years post-investment. Most importantly, VCs provide guidance as a company scales—counseling founders on strategy and holding the company to various growth milestones along an IPO timeline. In effect, under this traditional VC model, venture investors are not merely sources of capital—they are similar to business advisors, providing support for company management to lean on as their startup matures. This was the paradigmatic model of venture investing that dominated Silicon Valley for the greater part of the past two decades.

In the years following the GFC, with more idle money searching for returns, VC sponsors started raising larger and larger funds. As these funds grew, large financial sponsors, traditionally known for leveraged buyouts and public equity investing, started to flock to the space. Many of these firms—Softbank, Tiger Global, Dragoneer Investment Group, and Coatue Management—were new to venture investing and competed with smaller, traditional VC sponsors for deals. This new class of investors became known as “growth equity”: a hybrid venture-capital-buyout model that dealt with bigger sums of capital invested at a faster pace. Unlike traditional VCs, these growth equity investors were less engaged in the active supervision of their portfolio companies.

The investing strategy of Tiger Global (Tiger) exemplified the modus operandi of these new growth equity investors. Originally a hedge fund focused on public equities, Tiger began participating in private VC deals in the early 2010s. Believing the value proposition of venture investment was to exclusively provide financing, Tiger’s portfolio managers eschewed the “slow and steady” mentoring approach of traditional VCs and focused instead on the speed of capital deployment. Indeed, by the first half of 2021, Tiger

27. Id.
29. Id. at 172.
30. Id.
31. Id.
33. Sheth et al., supra note 19.
34. Private Markets Have Grown Exponentially, supra note 4.
35. Sheth et al., supra note 19.
36. Id.
40. Salmon, supra note 38.
was closing a venture deal every two days and had fully deployed its multibillion-dollar venture fund within a year (for comparison, traditional venture funds typically took two to four years to be fully deployed).\footnote{Miles Krupa, Stampede for Silicon Valley Start-ups Sees VCs Invest at Fast Pace, FIN. TIMES (Mar. 10, 2021), https://www.ft.com/content/9e6b7543-3000-45e5-ace8-e8ccc95f0661; Everett Randle, Playing Different Games, THE VALLEY OF DUNNING-KRUGER (Apr. 12, 2021), https://randle.substack.com/p/playing-different-games.} Furthermore, as opposed to traditional VCs that invested early in a company’s lifecycle, Tiger invested at a later stage—often before a mature startup contemplated an IPO—and was willing to pay a premium for popular companies while conducting cursory due diligence.\footnote{Id. (The pace of capital deployment and investment returns are the primary two ‘levers’ that make up a venture fund’s eventual profits. Faster velocity of capital deployment despite lower investment returns can generate higher net returns on an IRR basis, which is the main way private investments are valued).} The rationale behind this strategy was that Tiger could rely on the deal research completed by the more cautious VCs that had invested at earlier rounds while taking advantage of the higher internal rate of return (IRR) generated by the swift deployment of capital.\footnote{Salmon, supra note 38.} Essentially, Tiger became a follow-on, “free-ride” investor signing huge checks to any buzzy Silicon Valley startup with few strings attached.\footnote{Id.} This approach made the firm very popular among startup founders searching for financing and allowed it to secure the highest-profile deals with Silicon Valley’s most successful private companies.\footnote{Id.} The emergence of growth equity investors like Tiger dramatically increased competition for venture deals and caused a decline in the bargaining power of financiers relative to the startups they wanted to fund.\footnote{Jones, supra note 23, at 172–73.} All VCs—growth equity and traditional venture funds alike—began offering money to founders on increasingly advantageous terms, and the supervisory role that venture investors traditionally provided, often resented by recalcitrant founders, slowly eroded.\footnote{Id.} As a result, startup CEOs gained greater autonomy to manage their companies with limited oversight, ushering in the “founder friendly” golden era of Silicon Valley.\footnote{April Joyner et al., How Tiger Global Is Beating Other VCs, According to 6 Startup Founders Who Took Its Deals, BUS. INSIDER (Aug. 30, 2021), https://www.businessinsider.com /startup-founders-tell-why-tiger-global-wins-so-many-deals-2021-8.}

C. ENTER THE UNICORNS

In addition to transforming the paradigm of venture investing, the flood of central-bank-induced capital also changed the startups on the receiving end of the VC money cannon. This past decade has seen hundreds of unicorn
companies debut.\textsuperscript{49} Unlike tech startups of the Dot-Com era, these unicorns have matured into multibillion-dollar businesses entirely within the private realm.\textsuperscript{50} Indeed, the average age of a U.S. technology company that went public in 1999 was four years.\textsuperscript{51} By comparison, the average age of a U.S. technology company that went public in 2014 was eleven years.\textsuperscript{52} Why have these companies remained private for longer? It can mostly be explained by improved access to capital.\textsuperscript{53} Prior to the post-GFC “cheap money” era, a public offering used to be an important vehicle for fledgling startups to attain the capital necessary to reach the next stage of growth.\textsuperscript{54} Now, with abundant financing opportunities in the private sector, Silicon Valley entrepreneurs can secure growth funding without subjecting their companies to the burdens of being publicly traded.\textsuperscript{55} Essentially, an oversupply of venture dollars has created a fundraising market where companies have the upper hand, and entrepreneurs no longer feel the need to pursue an IPO.\textsuperscript{56}

Amidst this environment, unicorns have proliferated in number and influence. Between 2005 and 2010, only fourteen companies in the world reached the vaunted unicorn status.\textsuperscript{57} However, by 2016, this number grew to 165, and by October 2023, this figure had ballooned to an astonishing 1220.\textsuperscript{58} Most of these new businesses attained their unicorn valuations after large investments by growth equity investors, and as of October 2023, global unicorns collectively commanded a private market capitalization of $3.8 trillion.\textsuperscript{59}

Unicorns have come to dominate their respective industries. Uber, for example, commands a substantial 74 percent of the U.S. ridesharing market.\textsuperscript{60} To achieve such a large market presence in a relatively short timeframe, many unicorns have employed a growth strategy centered on accumulating capital


\textsuperscript{52} Id.

\textsuperscript{53} Id. at 3.

\textsuperscript{54} See As Companies Stay Private Longer, Advisors Need Access to Private Markets, supra note 50.

\textsuperscript{55} Jones, supra note 23, at 179.

\textsuperscript{56} Id. at 178.

\textsuperscript{57} Eckert, supra note 49.


\textsuperscript{60} Michal Kaczmarski, Uber vs. Lyft: Who’s Tops in the Battle of U.S. Rideshare Companies, BLOOMBERG SECOND MEASURE (Sept. 7, 2023), https://secondmeasure.com/datapoints/rideshare-industry-overview/.
and tactically deploying it to kill off competition. Under this strategy, unicorns fundraise aggressively to amass substantial cash reserves, which they use to price their services below cost. This drives consumer adoption and increases product use. Smaller players lacking the same access to VC financing cannot match the unicorn’s prices, often incurring losses and eventually exiting the market. Essentially, through this approach, unicorns employ VC cash to gain pricing power and distort the unit economics of the market in their favor. By growing in this manner, many unicorns have lost massive amounts of money and cannot find a path to profitability—VC money has basically subsidized these companies’ loss-generating business models. Indeed, a 2019 report showed that 64 percent of VC-backed unicorns that went public since 2010 were unprofitable, and only six of the seventy-three unicorn startups that announced an IPO in 2019 were profitable. Uber, the unicorn exemplar, has never incurred non-adjusted annual GAAP operating profit in its thirteen years of existence.

While some see the growing unicorn phenomenon as a positive force due to its creation of jobs and promotion of technological innovation, there is a rising chorus of voices advocating for tighter regulation and increased oversight of unicorns. As non-public companies, unicorns operate under the opacity of private markets. Recent high-profile scandals involving unicorns have led many to question the wisdom of allowing these companies to remain hidden from the consortium of public and private actors that collectively regulate securities markets. One of the biggest and most publicized scandals

63. Id.
64. Horan, supra note 61; see also Peter Thiel, Competition Is for Losers, WALL ST. J. (Sept. 12, 2014), https://www.wsj.com/articles/peter-thiel-competition-is-for-losers-1410535536.
65. Horan, supra note 61.
66. Roose, supra note 62.
69. Private Markets Have Grown Exponentially, supra note 4.
involved the unicorn health startup Theranos. The story of Theranos exemplifies the damage unicorns can inflict and demonstrates the risks associated with allowing these companies to operate with minimal oversight in the age of the empowered founder.\textsuperscript{70}

\section*{D. THERANOS: A CASE STUDY INTO UNICORN MISBEHAVIOR}

Theranos demonstrates the ease with which an unscrupulous founder can sustain a massive, multi-year corporate fraud. The company was founded in 2004 by Elizabeth Holmes, a Stanford University dropout with ambitions to make blood testing cheaper, faster, and more accessible.\textsuperscript{71} Holmes’s company initially gained traction after receiving an early investment from venture capitalist Tim Draper of the established VC firm Draper Fisher Jurvetson.\textsuperscript{72} The product Holmes envisioned was a portable machine—initially named the Edison but later rebranded as the Minilab—that could produce a wide range of health data using a small amount of blood drawn from a single finger prick.\textsuperscript{73} From the company’s inception, there were issues with the Minilab’s proof of concept. In 2006, Holmes presented fake test results to a group of Novartis executives, concealing the fact that her prototype had malfunctioned.\textsuperscript{74} Despite this incident, Theranos continued to grow and attract funding. It entered the unicorn club in 2010 after receiving a $45 million investment, and by 2013, the company announced a major partnership with Walgreens.\textsuperscript{75} Four years later, Theranos’s valuation had climbed to $9 billion.\textsuperscript{76} Unfortunately, throughout this period, the startup had not yet built a properly functioning product—the Minilab could not replicate the broad range of test results produced by commercial laboratories, so Holmes outsourced various tests to external blood labs while pretending that her machines were doing all the work.\textsuperscript{77} In reality, Theranos’s product was a dud that relied upon other companies to produce its data, but Holmes

\begin{thebibliography}{9}
\bibitem{Wansley2016} Wansley, \textit{supra} note 1, at 1216.
\bibitem{Wansley2019} Wansley, \textit{supra} note 1, at 1216.
\bibitem{Wansley2018} Wansley, \textit{supra} note 1, at 1216.
\end{thebibliography}
represented the Minilab to investors and the press as a fully functional, all-in-one device.\textsuperscript{78}

Real people were harmed by Theranos’s defective machine. Throughout the life of its Walgreens contract, Theranos conducted 1.5 million tests for 176,000 patients; one out of every ten test results was either voided or corrected.\textsuperscript{79} A number of patients were misdiagnosed and underwent treatments for illnesses they did not have.\textsuperscript{80} Paradoxically, as medical experts began to question the validity of Theranos’s product, Holmes’s celebrity soared; in June 2014, she was featured on the cover of Fortune Magazine, and by the end of that year, she had earned a spot on Forbes’s List of American billionaires.\textsuperscript{81} But by the following year, the company’s fortunes began to change. The first indication of Holmes’s deception came to light in October 2015 after Wall Street Journal reporter John Carreyrou published an article that revealed Theranos had outsourced some of its blood tests to external parties.\textsuperscript{82} Then, in 2016, the national laboratory testing regulator, the Center for Medicare and Medicaid Services (CMS), threatened to revoke Theranos’s testing license due to its lab facilities’ non-compliance with industry standards.\textsuperscript{83} Two years later, the jig was up. Holmes’s fraudulent misrepresentation was exposed, and shareholders who lost millions on their early investments initiated a series of lawsuits against Theranos.\textsuperscript{84} In March 2018, the SEC brought a Rule 10-b civil action against Holmes for securities fraud.\textsuperscript{85} Two months later, the Department of Justice indicted Holmes on criminal charges.\textsuperscript{86} Holmes settled the SEC’s civil action in 2018, paying a $500,000 fine and agreeing not to serve as a director or officer of a public company for ten years.\textsuperscript{87} In 2022, Holmes was found guilty on four of the eleven criminal charges and was sentenced to over ten years in prison.\textsuperscript{88}


\textsuperscript{80} Id.

\textsuperscript{81} Roger Parloff, \textit{This CEO Is out for Blood}, \textbf{FORTUNE} (June 12, 2014), https://fortune.com/2014/06/12/theranos-blood-holmes/; O’Brien, supra note 71.

\textsuperscript{82} Wansley, \textit{supra} note 1, at 1218.

\textsuperscript{83} Id.

\textsuperscript{84} O’Brien, \textit{supra} note 71.

\textsuperscript{85} Id.; Pollman, \textit{supra} note 70, at 355.

\textsuperscript{86} Pollman, \textit{supra} note 70, at 356.


Three key factors enabled Theranos to sustain its fraud: (1) the ability to continually raise large funding rounds that extended the company’s operational runway; (2) compliant investors and a subservient board of directors that were reticent to challenge Holmes’s decision-making; and (3) Holmes’s strong reputation within the close-knit world of Silicon Valley—a place where “fake-it-until-you-make-it” culture creates an environment of acceptable misrepresentation.99 While some may contend that the Theranos affair was a Silicon Valley anomaly, the numerous tech scandals that have occurred over the past decade suggest a troubling pattern.90 Regulators are beginning to realize that the growing prevalence of unicorn misbehavior needs to be addressed.

II. THE LEGAL CONTEXT

A. HOW WE GOT HERE: THE LEGAL DRIVERS

Ultra-loose monetary policy only explains half of the unicorn phenomenon; the other half concerns an evolving legal regime that saw a concerted push for deregulation in securities markets with the passage of the 2012 JOBS Act.91 To fully explain the impact of this law on the rise of unicorns, we must first examine the history and legal framework of American securities regulation.

The structure of modern American securities regulation was conceived during the Great Depression in response to the economic devastation that followed the “Roaring Twenties.”92 In 1933, Franklin Delano Roosevelt (FDR) assumed the presidency at a time when thirteen million Americans were unemployed, and countless others had lost their life savings in the massive stock market crash of 1929.93 Prior to FDR’s reforms, investing in securities was a risky endeavor; the growth of industrial capitalism in the late nineteenth century drew many unsophisticated investors to securities markets and sparked a proliferation of speculative investment opportunities.94 Investor protection was minimal, and the prevailing attitude towards securities regulation was caveat emptor—victims of fraud had little recourse and often had to shoulder the financial consequences of their poor investment

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91. Georgiev, supra note 6, at 265.
93. Id. at 1.
decisions. Stock markets were regulated at the state level by a fragmented network of “Blue Sky” laws—specialized state statutes that imposed varying degrees of information disclosure requirements on companies seeking to promote their securities. These conditions of lax regulation and market exuberance fueled the investing craze of the 1920s, culminating in the catastrophic events of “Black Tuesday” in 1929. Upon assuming office in the wake of the crash, FDR assigned Felix Frankfurter the task of reforming securities markets. Frankfurter sought to establish federal oversight of the securities industry and produced two statutes that were eventually passed into law: the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act). As the bedrock of American securities regulation, these two pieces of legislation persist today in the same general form as their original drafts.

Together, the Securities Act and the Exchange Act created a regulatory regime centered around the belief that greater transparency into a company’s operations would mitigate instances of corporate misbehavior. The Securities Act established the practice of information disclosure for companies seeking to access capital from the public: Businesses meeting certain requirements looking to sell their securities on a public exchange must register with the SEC and abide by a set of disclosure requirements before the offering can be consummated. Disclosure takes the form of a registration statement—a detailed prospectus outlining critical information about the business’s financial position, governance, and operations made available to investors and corroborated by the SEC’s examiners. The Exchange Act further expanded upon the Securities Act, requiring every “member, broker, or dealer” transacting on a national securities exchange to ensure listed businesses continually publish information reports at set intervals after an initial disclosure. In effect, the legislative design of these two acts created a “self-trusting” system wherein companies and

97. Poser, supra note 92.
98. Frankfurter was later nominated to and confirmed as a Justice of the United States Supreme Court.
100. id.
101. id. at 3.
104. 15 U.S.C. § 78(a); Lee, supra note 102.
intermediary brokers regulated themselves through a continuous cycle of self-disclosure.\textsuperscript{105} A critical feature of this regulatory regime is the distinction in disclosure requirements between public and private companies.\textsuperscript{106} This divide was intentional and contemplated at the inception of the Securities Act when Congress observed that the bill should not apply to situations “where the public benefits are too remote.”\textsuperscript{107} Section 4 of the Securities Act codifies this perspective with a list of transactions exempt from SEC registration; Section 4(a)(2) notably excludes “transactions by an issuer not involving any public offering.”\textsuperscript{108} Unfortunately, the Act does not define a “public offering” but instead leaves it up to the SEC to determine the term’s definitional contours.\textsuperscript{109} Early on, the agency employed a multi-factor test to determine a company’s “publicness,” but this all changed in 1953 when the Supreme Court heard \textit{SEC v. Ralston Purina Company}.\textsuperscript{110} In this case, the Court opined that Section 4 of the Securities Act was meant to “protect investors by promoting full disclosure of information thought necessary to [make] informed investment decisions.”\textsuperscript{111} It then concluded that an offering is not considered “public” when the offering’s recipients possess the ability to “fend for themselves.”\textsuperscript{112} Essentially, the Court drew a distinction between sophisticated and unsophisticated investors; offerings made to unsophisticated investors (those who cannot “fend for themselves”) must meet a higher threshold of regulatory disclosure, while offerings made to sophisticated investors (those who can “fend for themselves”) are exempt from most disclosure requirements.\textsuperscript{113}

Later, in 1982, the SEC crystallized the public-private divide with the promulgation of Regulation D.\textsuperscript{114} This regulation specified what it meant for investors to “fend for themselves” and outlined the rules governing private securities sales.\textsuperscript{115} A notable facet of this regulation was the agency’s elucidation of the “accredited investor” concept: An entity deemed sophisticated enough to purchase private securities by virtue of its net worth, expertise, or position.\textsuperscript{116} The “accredited investor” concept also appears in Section 12(g) of the Exchange Act—another critical provision that codifies

\begin{footnotesize}
\begin{enumerate}
\item[105.] Lee, supra note 102.
\item[106.] Georgiev, supra note 6, at 235.
\item[109.] Georgiev, supra note 6, at 237.
\item[110.] Ralston Purina Co., 346 U.S. at 119.
\item[111.] Id. at 124.
\item[112.] Id.
\item[113.] Georgiev, supra note 6, at 237.
\item[114.] Id.; 17 C.F.R. § 230.500.
\item[115.] Georgiev, supra note 6, at 237.
\item[116.] See 17 C.F.R. § 230.501 (2023).
\end{enumerate}
\end{footnotesize}
the public-private divide.\textsuperscript{117} This section lists exemptions from the Act’s registration requirements, excluding companies under certain thresholds from SEC registration.\textsuperscript{118} The thresholds are specified by the number of shareholders or accredited investors that own a company’s securities.\textsuperscript{119} Most critically, these thresholds were modified in the deregulatory push of the 2010s that paved the way for unicorn growth.\textsuperscript{120}

\textbf{B. THE JOBS ACT: A UNICORN ENabler}

From a legal perspective, the passing of the JOBS Act was a critical link in the chain of events that has led to today’s explosion of unicorn companies.\textsuperscript{121} When the bill passed in 2012, the anemic U.S. economy was struggling to recover, and the JOBS Act represented an experiment in using deregulation as a catalyst for economic growth.\textsuperscript{122} The Act generally endeavored to streamline regulations around capital raising, and pursuant to this goal, two of the Act’s key initiatives facilitated the growth of tech unicorns: (1) the IPO on-ramp and (2) the adjustment of securities registration thresholds.\textsuperscript{123}

\textit{i. The IPO On-Ramp}

Several provisions in the JOBS Act were drafted with the intention to relax the regulations that burdened companies seeking to IPO—effectively creating an “on-ramp” to simplify the process of going public.\textsuperscript{124} Title I of the Act created a new classification of businesses called Emerging Growth Companies (EGCs).\textsuperscript{125} To qualify as an EGC, a company must have “total annual gross revenues of less than $1,000,000,000 . . . during its most recently completed fiscal year” (this gross revenue threshold is adjusted for inflation every five years, and the most recent adjustment set the revenue trigger to $1,235,000,000).\textsuperscript{126} A company remains an EGC until the earliest date of either (1) surpassing the gross revenue threshold, (2) existing for five fiscal years after the date of an initial offering of common equity securities,

\textsuperscript{117} 15 U.S.C. § 78l(g)(1)(A).
\textsuperscript{118} Id.
\textsuperscript{119} Id.
\textsuperscript{120} Georgiev, supra note 6, at 238.
\textsuperscript{121} See Wansley, supra note 1, at 1215.
\textsuperscript{122} Erik F. Gerding, Against Regulatory Stimulus, 83 L. & CONTEMP. PROBS. 49 (2020).
\textsuperscript{124} See Skelton, supra note 123, at 456.
\textsuperscript{125} See id.
(3) issuing more than $1 billion in non-convertible debt over a three-year period, or (4) meeting the conditions of a “large accelerated filer” under Rule 12b-2 of the Exchange Act.\textsuperscript{127}

Once a company attains EGC status, it is entitled to various special privileges.\textsuperscript{128} Confidently filing for SEC registration and prematurely soliciting investors for a securities offering are two of the most significant privileges EGCs are entitled to under the IPO on-ramp.\textsuperscript{129} A carve-out within Section 5 of the Securities Act allows EGCs to begin the IPO process without disclosing their business information to the public.\textsuperscript{130} This is advantageous for startups that want to keep their sensitive data confidential from competitors and short-sellers in the lead-up to an IPO.\textsuperscript{131} In addition, the Act modified Section 502(c) of Regulation D: a long-standing prohibition on the solicitation and advertisement of a securities offering to potential investors before a company has filed its SEC registration.\textsuperscript{132} Prior to the JOBS Act, companies seeking to IPO could only solicit investors with whom they had pre-existing relationships or use intermediary parties connected to qualified investors to secure buy orders for a future listing.\textsuperscript{133} There was also a blanket prohibition on using the internet to solicit investors.\textsuperscript{134} The JOBS Act changed these rules, removing the internet ban and allowing the solicitation


\textsuperscript{128} See Skelton, supra note 123, at 456–57.

\textsuperscript{129} See id. at 456–65.

\textsuperscript{130} Id.


\textsuperscript{132} Jones, supra note 23, at 176; Skelton, supra note 123, at 456–67.

\textsuperscript{133} Jones, supra note 23, at 176; Skelton, supra note 123, at 465–66.

\textsuperscript{134} Jones, supra note 23, at 176; BLOOMENTHAL & WOLFF, supra note 126; 17 C.F.R. § 230.502(c).
of “accredited investors”135 in the lead-up to an IPO.136 As a result, pre-IPO companies were given the ability to “jump the gun” and gauge investor interest to test market demand for a prospective offering.137 The removal of the internet ban allowed startups to advertise to a larger pool of investors, potentially increasing the amount of capital raised.138

Lastly, the IPO on-ramp exempted EGCs from the many burdensome disclosure requirements by which their non-EGC peers had to abide.139 Unlike typical public companies that needed to present three years of audited financial statements in preparation for an initial SEC registration, EGCs only had to provide two years of audited financials.140 Additionally, post-IPO, EGCs had fewer periodic reporting requirements—they did not have to provide select financial data “for any period prior to the earliest audited periods presented in connection with [the] first registration statement that became effective.”141 Burdens on auditing quality were also relaxed. If new or revised accounting standards were released, EGCs could choose whether to comply with the new standards until the rules were made mandatory for all private companies.142 EGCs were also exempted from Section 404(b) of the Sarbanes-Oxley Act (the attestation of internal controls requirement) and had the ability to avoid other Public Company Accounting Oversight Board rules when publishing their financials.143

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135. “Accredited investor” is a term defined by SEC Rule 144 and requires the investor to have either:

(1) a net worth over $1 million, excluding primary residence (individually or with spouse or partner); or (2) income over $200,000 (individually) or $300,000 (with spouse or partner) in each of the prior two years, and reasonably expects the same for the current year; or (3) the investor is an investment professional in good standing holding the general securities representative license (Series 7), the investment adviser representative license (Series 65), or the private securities offerings representative license (Series 82); or (4) the investor is a director, executive officer, or general partner (GP) of the company selling the securities (or of a GP of that company); or (5) the investor is any ‘family client’ of a ‘family office’ that qualifies as an accredited investor; or (6) the investor is a ‘knowledgeable employee’ of a private fund and is investing in the fund that employs him or her.


139. Skelton, supra note 123, at 456–65.

140. Skelton, supra note 123, at 459; BLOOMENTHAL & WOLFF, supra note 126.


142. Skelton, supra note 123, at 459–60; BLOOMENTHAL & WOLFF, supra note 126.

143. Skelton, supra note 123, at 456–62; BLOOMENTHAL & WOLFF, supra note 126.
ii. The Adjustment of Registration Thresholds

The modification of Section 12(g) in the Exchange Act is arguably the most impactful provision of the JOBS Act that contributed to the rise of unicorns. Section 12(g) of the Exchange Act behaves as an IPO forcing function; it compels companies to go public once they surpass certain size thresholds. Prior to the JOBS Act, Section 12(g) required private companies with (1) over $10 million in assets and (2) over 500 nonbank “shareholders of record” possessing any “class of company equity security” to register with the SEC and subject themselves to the agency’s reporting requirements. While this rule did not mandate companies over this threshold to IPO, virtually all companies would go public upon reaching these milestones. The JOBS Act elevated this threshold, increasing the “shareholder of record” number from 500 to (1) 2000 nonbank shareholders or (2) 500 nonbank shareholders who are not accredited investors. This modification virtually eliminated the IPO forcing mechanism of Section 12(g); according to an SEC study conducted around the time of the JOBS Act’s passing, 87 percent of existing, publicly traded companies would have been excluded from SEC registration under these new thresholds. In effect, these provisions extended the runway for companies that wanted to stay private and delay an IPO.

In sum, the JOBS Act created a carve-out within the framework of U.S. securities regulation that provided greater flexibility to companies that met the EGC qualifications. By allowing companies to remain hidden from regulators and the public, the Section 12(g) threshold adjustments created a fertile and private breeding ground for unicorns to grow, thereby decreasing accountability and increasing the risk of corporate misbehavior. By relaxing the disclosure requirements and solicitation restrictions on companies looking to go public, the IPO on-ramp provisions weakened the public-private design of securities markets. In a 2012 study conducted by a leading law firm, 90 percent of the companies that went public between 2007 and 2011 would have been classified as EGCs. Another study found that EGCs comprised over 80 percent of all U.S. IPOs between 2012 and 2017, and the number of EGCs disclosing only two years of selected financial

144. See Skelton, supra note 123, at 463; see also Jones, supra note 23, at 177–78.
145. 15 U.S.C. § 78l(g); see also Jones, supra note 23, at 177.
146. Jones, supra note 23, at 177; Skelton, supra note 123, at 463.
147. Jones, supra note 23, at 177, n.72.
148. 15 U.S.C. § 78l(g); Jones, supra note 23, at 177; Skelton, supra note 123, at 463.
149. Jones, supra note 23, at 177 (citing JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 149, 583 (8th ed. 2017)).
150. See Georgiev, supra note 6, at 258–77.
information increased from 21 percent in 2012 to 70 percent in 2017. These statistics demonstrate that the JOBS Act excluded many companies from the exacting standards of the United States securities laws, creating a “blind spot” for regulators and the investing public. Ultimately, the deregulatory spirit of the JOBS Act stands in stark opposition to the fraud-mitigation-through-transparency principle of Justice Frankfurter’s original legislative design.

III. THE CASE FOR LESS DISCLOSURE IN PRIVATE MARKETS

In summary, there are two central drivers of the unicorn phenomenon: (1) ultra-loose monetary policy set by the Federal Reserve and (2) the effect of securities markets deregulation brought about primarily by Congress’s passage of the 2012 JOBS Act. Ultra-loose monetary policy changed the VC ecosystem, introducing hands-off, diligence-light models of venture investing that provided entrepreneurs with greater negotiating leverage over their financial backers. On the legal side, the relaxed regulatory regime following the JOBS Act afforded entrepreneurs greater optionality over the direction of their companies—founders had more autonomy to decide whether to keep their companies private. Ultimately, the combined effect of these two factors removed many of the previous checks and balances on entrepreneurs; as such, corporate misbehavior flourished, evidenced by the multitude of unicorn tech scandals occurring over the past decade, like Theranos. These conditions remain in place today, and the specter of corporate misbehavior by private companies has not abated. What is the solution?

Much of the scholarship addressing this problem emphasizes a restoration of disclosure; many proposed solutions recommend applying a more stringent reporting regime upon private companies. Indeed, a leading scholar on this issue, Matthew Wansley, recently published an article suggesting the imposition of “limited public disclosures” on private market actors to reduce the propensity of corporate fraud. The SEC seems to tacitly endorse this approach based on a 2021 speech by retired commissioner Allison Heren Lee. On the surface, this increased disclosure strategy

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154. Wansley, supra note 1.
155. Lee, supra note 102 (“The foundational statutory language made clear that the securities laws were intended to protect the ‘general welfare.’ The principal remedy was disclosure. . . . But the Commission can and should act now within our existing authority to restore transparency in
seems to make sense given that it channels the founding “transparency” principle of Justice Frankfurter’s original 1933 Securities Act. However, this Note argues that a different tack should be pursued instead: Securities regulation should endeavor to keep private markets opaque. This view is informed by two observations: (1) increased disclosure facilitates market liquidity, and (2) greater market liquidity incentivizes “arms-length” investment behavior that leads to deficient corporate governance. This Note contends that fostering illiquidity in the private market can actually create salutary incentives on shareholders that work to reduce corporate misbehavior. The solution advanced in this paper is simple and prosaic yet offers a contrarian perspective not commonly considered among securities regulators. Ultimately, I believe regulatory architects are negligent in not considering the moral hazard investing behavior that their “more disclosure” policies create within market actors, and this point is often lost in the prevailing discourse.

A. MORE DISCLOSURE?

Supreme Court Justice Louis Brandeis once famously stated that “sunlight is said to be the best of disinfectants”—this quote encapsulates the rationale underpinning the argument for imposing more stringent disclosure requirements upon private companies in the pursuit of reducing corporate fraud. On the surface, the “more disclosure” argument appears compelling, as lax reporting played a role in several recent unicorn scandals, enabling companies to engage in illegal activities undetected for years. A 2009 study into patterns of corporate fraud revealed that the regulatory mechanism for policing businesses in America is comprised of a number of private and public actors working alongside each other to expose illegality. It follows that increasing the exposure of unicorn companies’ operations to a greater number of regulators would raise the likelihood that corporate misbehavior gets noticed. This critical assumption underscores the conventional argument

capital markets. That means, at a minimum, it’s time to revisit how we define shareholders of record under 12(g). And more broadly, it means recalling the fundamental importance of transparency in capital markets.”).

156. Id.

157. Market liquidity is the degree to which one can sell an asset or investment. A liquid market would mean one could sell something easily: buyers are plentiful, and assets can be sold quickly. Conversely, an illiquid market is one in which there is great difficulty in selling something: buyers are hesitant to purchase, and assets take a long time to be sold. See Adam Hayes, Understanding Liquidity and How to Measure It, INVESTOPEDIA (Mar. 14, 2023), https://www.investopedia.com/terms/l/liquidity.asp.

158. Bhide, supra note 95.

159. Poser, supra note 92, at 2.


presented by most scholars on this issue: the legal regime of securities markets should prioritize maximum disclosure of company information to disincentivize misconduct and accelerate the detection of illegality.\textsuperscript{162} In his 2021 article entitled “Taming Unicorns,” Professor Matthew Wansley presents a three-point plan to “solve” the problem of unicorn misbehavior—a solution that aligns with the typical approach of the “more disclosure” strategy.\textsuperscript{163} The two central pillars of his plan call for (1) removing the Exchange Act’s Section 12(g) investor threshold to create a “liberalized” market for trading private securities among accredited investors and (2) imposing a “limited disclosure mandate” upon private companies participating in the newly formed market governed by the SEC.\textsuperscript{164} Wansley asserts that the “[increased] disclosures combined with [private securities] trading [would] deter misconduct” because private actors that regulate securities markets (short sellers, analysts, and financial journalists) would have the financial incentive and means (access to greater company information) to root-out corporate fraud.\textsuperscript{165} In addition, SEC oversight of private company disclosures would enhance transparency and add accountability within the system.\textsuperscript{166} Essentially, Wansley’s plan attempts to import the enforcement mechanisms, economic incentives, and increased liquidity of public markets into the private sphere, albeit to a somewhat lesser extent, to achieve the same fraud-sleuthing capabilities that public markets provide. In doing so, Wansley states that private companies could “no longer evade the accountability that robust trading delivers,” and, therefore, the prevalence of corporate misbehavior would be reduced.\textsuperscript{167}

Unfortunately, “more-disclosure” arguments like Wansley’s minimize the negative effects that increased disclosure and its corollary of increased market liquidity have on corporate governance. In his article entitled “Efficient Markets, Deficient Governance,” Professor Amar Bhide advances a thesis that postulates increased disclosure brings about greater market liquidity—greater market liquidity then incentivizes “arms-length” shareholding that removes the checks and balances upon company leadership that help prevent corporate fraud.\textsuperscript{168} Bhide’s first assertion is that a robust disclosure regime fosters greater liquidity in securities markets:

The SEC reassures speculators (who make market liquidity a reality) by certifying the integrity of exchanges. Casinos with reputations for rigged games eventually drive patrons away... The SEC’s enforcement of

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\textsuperscript{163} Wansley, \textit{supra} note 1.
\textsuperscript{164} \textit{Id.} at 1252–56.
\textsuperscript{165} \textit{Id.} at 1258.
\textsuperscript{166} See \textit{id.}
\textsuperscript{167} \textit{Id.} at 1253.
\textsuperscript{168} Bhide, \textit{supra} note 95.
accurate and complete disclosure similarly facilitates trading of the stock of companies that neither buyer nor seller has examined from the inside.169

Bhide then argues that increased liquidity through robust disclosure actually inspires shareholders to maintain disinterested and distant relationships with company management:

U.S. rules that protect investors don’t just sustain market liquidity, they also drive a wedge between shareholders and managers. . . . Disclosure requirements . . . encourage arm’s length stockholding. For example, rules that mandate the disclosure of transactions with insiders make a company’s banks, suppliers, and customers less willing to hold large blocks of stock or to serve on boards. Disclosure rules also make anonymous shareholding safe. If companies’ reports were sketchy or unreliable, shareholders would demand an inside role as well as ongoing access to confidential information.170

Next, Bhide claims that decreased levels of liquidity elicit a more active role from shareholders:

Market liquidity itself weakens incentives to play an inside role. All companies with more than one shareholder face what economists call a free-rider problem. The oversight and counsel of any one shareholder benefits all others, with the result that all may shirk their responsibilities. This issue is particularly relevant when a company faces a crisis. In illiquid markets, the shareholders cannot run away easily and are forced to pull together to solve any problem that arises. But a liquid market allows investors to sell out quickly. . . . In economist Albert Hirschman’s terms, investors prefer a cheap “exit” to an expensive “voice.”171

Essentially, Bhide calls attention to the critical role investors play in supervising corporate management. Illiquidity in securities markets better encourages investors to work towards ensuring the success of their portfolio companies because their ability to exit out of their investments is impaired. This makes sense intuitively, especially in the context of reducing corporate fraud. If an investor could not easily liquidate his position and his portfolio company was engaging in fraud that had the potential to destroy the company’s equity value, it would be entirely within the investor’s financial interest to eliminate the fraud and correct the company’s misbehavior. In essence, market illiquidity has a salutary effect on corporate governance: shareholders who cannot exit easily from their positions will do what it takes to prevent corporate misbehavior to achieve the maximum return on their investments. As Lenny Mendonca, a senior partner at McKinsey & Company,172 once stated while commenting on the Uber scandal, “[I]f

169. Id.
170. Id.
171. Id.
investors are worried about returns, they engage [corporate management]. They take control.”

Bhide’s thesis underpins this Note’s argument, which advocates against imposing more extensive disclosure requirements on private companies. Keeping private markets opaque fosters secondary market illiquidity, incentivizing VCs to supervise their portfolio companies more closely and adopt a longer-term outlook that seeks to incubate more resilient private businesses. Alternatively, liquid private markets entice shareholders to pursue risky growth strategies that lead to short-term but unsustainable gains: chase top-line growth to “pump” a company’s equity value, “cash out,” and disappear before the business starts to decline. In this sense, market illiquidity reduces moral hazard on the part of investors. Conversely, regulatory solutions that increase private market liquidity amplify moral hazard and cause unicorns to proliferate. Professor Wansley even admits this fact towards the end of his article when he states his proffered solution of “liberalized [private] markets” would “cause unicorns to multiply faster” because of a reduced “illiquidity discount on [private company] shares” that “diminish[es] the appeal of going public.” More unicorns managed by more disengaged investors is not an outcome for which we should aim. Startup investors need to reclaim their roles as the “adults in the room” and reassert control over founders who stray from the path of responsible and sustainable business growth.

IV. PROPOSED SOLUTION

To mitigate the unicorn problem, this Note advocates for a simple solution that is partly abstract and partly concrete. The abstract part consists of adopting a regulatory stance that disfavors onerous disclosure requirements for private companies and endeavors to keep private markets more illiquid. While this stance would significantly depart from the current orientation of securities regulation, as discussed above, less disclosure would force shareholders to reassert control over corporate management, bringing reckless founders to heel and improving corporate governance. The concrete part of the solution would modify the Exchange Act’s Section 12(g) shareholders of record threshold—the lynchpin of a unicorn’s ability to stay private. Here, I would advocate lowering this threshold to its pre-JOBS Act number (500 shareholders of record).

This modification would trigger Section 12(g)’s IPO forcing function earlier in a company’s lifecycle and remove the broad discretion entrepreneurs currently possess in choosing whether to take their companies public. Ideally, the concurrent effect of these

174. Wansley, supra note 1, at 1253.
175. 15 U.S.C. § 78l(g).
two changes would rebuild the hard, public-private divide in securities markets—an outcome consistent with the original spirit of the Securities and Exchange Acts and the vision outlined by the Court in SEC v. Ralston Purina.\textsuperscript{176}

A. POTENTIAL COUNTERPOINT: THE FTX DEBACLE

Those within the “more disclosure” camp might point to the collapse of cryptocurrency exchange FTX as an example of what might happen if securities markets were to adopt a regulatory regime oriented towards less disclosure. On November 11, 2022, FTX filed for bankruptcy in the Chancery Court of Delaware, listing over $8 billion in liabilities.\textsuperscript{177} FTX was a three-year-old private unicorn valued at over $32 billion pre-insolvency, raising $1.8 billion in venture capital and counting the bluest of blue-chip VCs like Sequoia Capital and New Enterprise Associates as its financial backers.\textsuperscript{178} The company was private, headquartered in the Bahamas, and ran its business through myriad global subsidiaries (however, its U.S. subsidiary was an SEC-registered broker-dealer, which meant the SEC had regulatory oversight over its U.S. trading operation).\textsuperscript{179} While the factual record has yet to be developed, the failure of FTX bears an uncanny resemblance to the unicorn frauds that preceded it: a high-profile startup led by an unscrupulous founder that attracted massive sums of venture dollars from laissez-faire investors providing weak oversight.\textsuperscript{180} The company’s collapse happened rapidly—within a week—triggered by a liquidity crisis exacerbated by a compromising news report and a large withdrawal of proprietary tokens from the FTX trading platform.\textsuperscript{181} Reports further indicate that the company’s CEO, Sam Bankman Fried (SBF), engaged in fraudulent behavior and that FTX’s financial statements are wholly unreliable.\textsuperscript{182} FTX’s new CEO, appointed in light of the bankruptcy, attributed the company’s collapse to its “complete failure of corporate controls” with “faulty regulatory oversight” that allowed

\textsuperscript{178} Griffith & Bellany, supra note 177.
\textsuperscript{181} Oliver et al., supra note 177.
“the concentration of control in the hands of a very small group of inexperienced, unsophisticated, and potentially comprised individuals.”

If FTX generally operated under the opacity of private markets, away from the prying eyes of U.S. securities regulators, why did the salutary effect of less disclosure not cause FTX’s VCs backers to demand more stringent corporate controls that could have averted the company’s collapse? This question can be answered by examining the unique market conditions that prevailed in mid-to-late 2021 when FTX raised most of its funding. That year, FTX raised two mega Series B rounds, consisting of forty-two total investors. None of these investors led their respective rounds, and news reports suggest that the size of each VC capital contribution was unusually small (less than 2 percent). Moreover, none of these investors took board seats due to their uniquely small stakes of equity ownership. By VC standards, investing without taking board seats is highly unusual. However, it is essential to recognize that 2021 was an unusual time for private market liquidity and represented the zenith of a tech entrepreneur’s ability to raise capital on favorable terms. The year was a banner year for technology IPOs. Flush with pandemic stimulus money and armed with investing apps like Robinhood, retail investors drove public equity prices to record highs due to speculative trading. In such a unique and overstimulated macroeconomic environment, it stands to reason that the relationship between disclosure and market liquidity broke down—institutional and retail investors were not investing rationally or paying attention to fundamentals. Moral hazard investing was the norm. Demand for equity in top-flight startups like FTX was at its peak, and the company’s VCs knew they could offload their shares to another party at the first sign of trouble. Simply put,

185. “Mega Rounds” consist of deals valued over $100 million.
186. FTX, supra note 184.
188. Id.
189. Id.
FTX’s red flags went unnoticed because the 2021 market was so anomalously liquid, exuberant, and speculative.

There are also reasons to believe that greater levels of securities disclosure would not have averted the FTX disaster. Chief auditor of the SEC, Paul Munter, said the following about FTX’s collapse:

[D]isclosure obligations [are] useful only to market participants that are interested in complying with the securities laws in the first place . . . [some] firms have no interest in serving their investors at all.\(^{193}\)

Essentially, the SEC often faces difficulties in detecting bad actors who do not want to participate in the self-trusting, self-disclosure system of securities regulation. The SEC did not review Enron’s financial statements until the company imploded—private actors generally play a larger role than the agency in detecting securities fraud.\(^{194}\) This is why investors with an inside view of a company’s operations play a critical role in reducing corporate misbehavior. The SEC was even overseeing FTX’s U.S. trading business, but because the company’s collapse originated from liquidity issues at its non-U.S. subsidiaries, American regulators had no advanced warning of the company’s problems.\(^{195}\)

The FTX debacle does not frustrate this Note’s argument but instead reinforces its thesis: conditions of greater market liquidity in private secondary markets increase moral hazard investing and degrade the corporate governance of private startups. Whether market liquidity is brought about by greater disclosure requirements or some other feature, it fundamentally exacerbates the shareholder “free-rider” problem discussed by Professor Amar Bhide, referenced previously in this Note.\(^{196}\) In a more illiquid market, FTX would have probably had fewer investors who made larger contributions and taken board seats. Once on the board, these VC shareholders would have likely noticed the many red flags, raised the alarm, and steered management toward better operating practices, thus preventing FTX’s collapse. Unfortunately, due to extreme market liquidity in 2021, the opposite occurred, and investors took a hands-off approach. The story of FTX should serve as yet another reminder to securities regulators of the dangers of stimulating more liquid trading within private markets.

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\(^{195}\) See Scott Chipolina, *Bahamas Could Not Have Prevented FTX Collapse, Prime Minister Says*, FIN. TIMES (Nov. 16, 2022), https://www.ft.com/content/2b70e9f5-f8d9-455e-8dfb-05d1e8bc638a.

\(^{196}\) Bhide, *supra* note 95.
V. CONCLUSION

This Note fundamentally argues for lower levels of securities disclosure in private markets. There are two causes of the unicorn phenomenon: ultra-loose monetary policy and the implementation of the 2012 JOBS Act. The combined effect of these two drivers weakened the historic public-private design of securities markets by lowering the burdens of an IPO and allowing companies to stay private for longer. Entrepreneurs have been in the driver’s seat for much of the past decade and face few consequences if they engage in illegal behavior. Theranos and FTX are two prominent examples of this phenomenon.

While the regulatory orthodoxy tends to advocate imposing heavier disclosure requirements upon private companies to discourage misbehavior, this perspective ignores the inconvenient byproduct that more disclosure creates—increased market liquidity. Greater market liquidity stimulates moral hazard investing and causes shareholders to adopt short-term strategies that are not conducive to incubating sustainable businesses. Conversely, market illiquidity increases investors’ “skin in the game” and aligns their financial incentives with successful outcomes for their portfolio businesses. Ultimately, this incentivizes shareholders to take a more active role in managing their investments and creates a salutary effect on corporate governance in the startup ecosystem overall.

In closing, with the U.S. Federal Reserve increasing the benchmark interest rate, it seems like the decade-long “free money party” is slated to end. Market liquidity is already being drained from the financial system, and anecdotal reports seem to suggest that VCs are pivoting to longer-term investment strategies that emphasize startup profitability. Essentially, the VC-entrepreneur power balance seems to be swinging back towards VCs. Many industry watchers also predict the number of unicorns will fall as companies look for financing and raise down-rounds. Other watchers suggest many unicorns will die off as continual infusions of VC cash can no longer support their money-losing business models.

layoffs at the largest private tech unicorns seems to support this view. In some ways, the unicorn problem might resolve itself without regulatory intervention. However, regardless of what happens, this past decade should serve as a warning to future securities regulators about the role that onerous disclosure requirements and private market liquidity play in the degradation of corporate governance.

Matthew Whang

201. Tiku & De Vynck, supra note 200.