# Private Company Fraud

*Verity Winship*[*]

*Fewer companies are going public in the United States, but public companies are still the focus of securities law and enforcement. A major exception is that anti-fraud provisions apply to all companies, public or private. Theranos is a prominent example. The Securities and Exchange Commission ("SEC") sued this private company for securities fraud. This Article examines one societal cost of the decline of public companies: the loss of information needed to detect and punish fraud. It analyzes the SEC's securities fraud enforcements against private companies and assesses the information costs of moving to an anti-fraud-only regime. It concludes by identifying ways to incentivize information disclosure in the newly private universe of corporations, including a proposal to expand whistleblower protection for employees of private companies.*

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## INTRODUCTION

"Garbage to gold." That was the promise of Indiana-based plastics manufacturer, Lucent Polymers, Inc.[1] The company's one product was plastic generated from recycled and scrap material. Corporate officers promoted the plastic as cheap to produce but able to meet tough standards for flame resistance and strength.[2] Lucent Polymers was a success. The company was sold twice, and the former Chief Executive Officer ("CEO") and Chief Operations Officer ("COO") reportedly made millions of dollars between them.

Despite the company's apparent success, its underlying product was flawed. "I am having some ethical/conscience issues here," wrote Lucent Polymer's technical director in an internal email.[3] "There is a level of dishonesty going on (which I am part of) which is troubling me greatly."[4] Subsequent correspondence expressed fears about what the buyer's due diligence might uncover, and also — belatedly — suggested that communicating by email was a bad idea.[5]

In 2019, the SEC brought an enforcement action against Lucent Polymer's CEO and COO for securities fraud.[6] "Like a modern-day Rumpelstiltskin," the SEC alleged, the company promised remarkable — and unrealistic — transformation.[7]

"One tiny drop changes everything."[8] This is the now-infamous promise of Theranos: that a single drop of blood could replace needles and blood draws for most blood tests. At the heart of the company was Elizabeth Holmes, the founder, inventor, charmer and — some say — sociopath.[9] The Theranos board was full of heavy hitters like Henry

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[1] Complaint at 1, SEC v. Kuhnash, No. 19-CV-00028 (S.D. Ind. Feb. 12, 2019) [hereinafter Complaint, Kuhnash].

[2] *Id.*

[3] *Id.* at 13.

[4] *Id.*

[5] *See id.* at 14.

[6] SEC Charges Former Executives of Plastics Manufacturer with Fraud, SEC Litigation Release No. 24397, 2019 WL 554227 (Feb. 12, 2019).

[7] *See* Complaint, Kuhnash, *supra* note 1, at 1.

[8] JOHN CARREYROU, BAD BLOOD: SECRETS AND LIES IN A SILICON VALLEY STARTUP 153 (2018) (noting two Theranos slogans, "One tiny drop changes everything" and "The lab test, reinvented").

[9] *See, e.g.*, Jia Tolentino, *The Story of a Generation in Seven Scams*, *in* TRICK MIRROR: REFLECTIONS ON SELF-DELUSION 157, 184 (2019) (describing "Holmes's belief in her own significance" as "appear[ing] to border on sociopathic zealotry"); *cf.* CARREYROU, *supra* note 8, at 299 ("A sociopath is often described as someone with little or no conscience. I'll leave it to the psychologists to decide whether Holmes fits the clinical profile, but there's no question that her moral compass was badly askew.").

Kissinger and former Secretary of State, George Shultz.[10] Media and investors became caught up in the story of the intrepid and apparently altruistic young female entrepreneur.[11] Walgreens struck a deal to have Theranos blood testing in its stores.[12] Theranos was widely declared a "unicorn," a company valued at more than a billion dollars.[13]

Media and investors were equally riveted by the story of Elizabeth Holmes' fall from grace. It gradually became clear that a single drop of blood is *not* enough, and Theranos insiders scrambled to cover up the failure of the blood testing machine to provide reliable information.[14] Criminal and civil authorities, government and private citizens, the U.S. Food and Drug Administration ("FDA") — all wanted a piece of the Theranos action.[15] News headlines about Theranos had been full of puns about blood; now they were about vampires.[16] In 2018, the SEC

[10] *See* Ken Auletta, *Blood, Simpler: One Woman's Drive to Upend Medical Testing*, NEW YORKER (Dec. 8, 2014), https://www.newyorker.com/magazine/2014/12/15/blood-simpler [https://perma.cc/D737-SJWL] (noting that the Theranos board was "stocked with prominent former government officials, including George P. Shultz, Henry Kissinger, Sam Nunn, and William H. Foege, the former director of the Centers for Disease Control and Prevention"); Roger Parloff, *A Singular Board at Theranos*, FORTUNE (June 12, 2014, 4:40 AM PDT), https://fortune.com/2014/06/12/theranos-board-directors/ [https://perma.cc/N4PT-9HMN] [hereinafter *A Singular Board*] ("Little known and privately held, Theranos has assembled what may be, in terms of public service, the most illustrious board in U.S. corporate history.").

[11] *See* Roger Parloff, *This CEO Is Out for Blood*, FORTUNE (June 12, 2014, 4:37 AM PDT), https://fortune.com/2014/06/12/theranos-blood-holmes/ [https://perma.cc/NKR6-C5HT] [hereinafter *This CEO Is Out for Blood*] (lauding Holmes and helping bring her to prominence).

[12] Christopher Weaver & John Carreyrou, *Craving Growth, Walgreens Dismissed Its Doubts About Theranos*, WALL ST. J. (May 25, 2016, 5:14 PM ET), https://www.wsj.com/articles/craving-growth-walgreens-dismissed-its-doubts-about-theranos-1464207285 [https://perma.cc/673J-77H8].

[13] CARREYROU, *supra* note 8, at 174; Aileen Lee, *Welcome to the Unicorn Club: Learning from Billion-Dollar Startups*, TECHCRUNCH (Nov. 2, 2013, 11:00 AM PDT), https://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/ [https://perma.cc/YL2U-RYEL] (introducing the term "unicorn" for companies valued over a billion dollars).

[14] *See generally* CARREYROU, *supra* note 8, at ch. 19-22 (detailing how Carreyrou, a WSJ journalist, uncovered the truth about Theranos's blood testing capabilities).

[15] *See, e.g.*, Ludmila Leiva, *Here Are All of Elizabeth Holmes's Criminal Charges*, REFINERY29 (Mar. 11, 2019, 12:14 PM), https://www.refinery29.com/en-us/elizabeth-holmes-trial-criminal-charges-theranos-case-sec [https://perma.cc/ZM9P-WSYY] (outlining the criminal charges against Holmes).

[16] *See, e.g.*, Warren, *HBO Theranos Doc to Focus on Holmes as Blood-Stealing Vampire*, BOREDROOM NEWS (Feb. 1, 2019), https://boredroomnews.com/2019/02/01/hbo-theranos-doc-to-focus-on-holmes-as-blood-stealing-vampire/ [https://perma.cc/Q48W-A3A3] (discussing an HBO film that portrays Holmes as a "centuries-old vampire").

brought an anti-fraud action against Theranos, Elizabeth Holmes, and her partner Ramesh "Sunny" Balwani.[17]

What Lucent Polymers and Theranos have in common — besides fundamental flaws in the technology at the center of their businesses — is that these are not public companies. Lucent Polymers and Theranos were both private. The definition of private company has nuances, which are taken up below, but the key characteristics are that the companies' stock is not traded on a public exchange and the companies are not subject to mandatory periodic disclosure.[18] The events at Lucent Polymers and Theranos are examples of private company fraud and the SEC enforcement actions designed to address it.

According to the SEC's co-head of enforcement, the action against Theranos, Holmes, and Balwani sent a message that "there is no exemption from the anti-fraud provisions of the federal securities laws simply because a company is non-public, development-stage, or the subject of exuberant media attention."[19] This echoed the SEC's 2016 declaration that it is "axiomatic" that "all private and public securities transactions . . . must be free from fraud."[20]

Indeed, the key securities fraud provisions apply broadly to all companies, whether private or public.[21] In particular, Section 10(b) of the Exchange Act and SEC Rule 10b-5 contain a broad prohibition on the use of any "manipulative or deceptive devices . . . in connection with the purchase or sale of *any security*."[22]

How effective are these anti-fraud measures in meeting the aims of U.S. securities regulation: "to protect investors, ensure fair and efficient

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[17] Complaint at 1, SEC v. Holmes, No. 18-cv-01602 (N.D. Cal. Mar. 14, 2018) [hereinafter Complaint, Holmes]; Complaint at 1, SEC v. Balwani, No. 18-cv-01603 (N.D. Cal. Mar. 14, 2018) [hereinafter Complaint, Balwani].

[18] *See infra* Part I.A.

[19] *Theranos, CEO Holmes, and Former President Balwani Charged with Massive Fraud*, U.S. SEC. AND EXCHANGE COMMISSION (Mar. 14, 2018), https://www.sec.gov/news/press-release/2018-41 [https://perma.cc/K4F3-795Z] (quoting Steven Peikin, Co-Director of the SEC's Enforcement Division).

[20] Mary Jo White, Chair, U.S. Sec. and Exch. Comm'n, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html [https://perma.cc/ZQD8-4PCE] [hereinafter *SEC Silicon Valley Initiative Speech*].

[21] *See infra* Part II.A.

[22] Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2018) (emphasis added) (making unlawful manipulative or deceptive devices "in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered"); U.S. Sec. and Exch. Comm'n Rule 10b-5, 17 C.F.R. § 240.10b-5(c) (2020) (making unlawful deception "in connection with the purchase or sale of any security").

markets, and encourage capital formation"?[23] Anti-fraud is important to these articulated aims. There is the straightforward goal of protecting investors from fraud. In addition, without some assurance that there is no fraud, investors would impose a "fraud discount," impounding the risk of fraud into the price and increasing the costs of capital.[24]

The question of anti-fraud's effect is urgent. The move towards "going private," — or "going dark" — has been well documented.[25] Journalists have called U.S. publicly listed companies "a dying breed."[26] SEC commissioners have pointed to Initial Public Offerings' ("IPO") "precipitous decline."[27]

And yet private companies, even big private companies, may commit fraud.[28] As fewer companies go public at all, or go public later in their

[23] SEC, DIVISION OF ENFORCEMENT: 2019 ANNUAL REPORT 1 (2019), https://www.sec.gov/files/enforcement-annual-report-2019.pdf [https://perma.cc/5824-QU3J] (describing "to protect investors, ensure fair and efficient markets, and encourage capital formation" as the Commission's "mandate"); SEC, AGENCY FINANCIAL REPORT: FISCAL YEAR 2018, at 4 (2018), https://www.sec.gov/files/sec-2018-agency-financial-report.pdf [https://perma.cc/E7VE-XRLB] (describing the SEC's mission as "[t]o protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation").

[24] Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1893 (2013) (noting that "investors demand a fraud discount").

[25] *See, e.g.*, Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445 (2017) (arguing that the decline of public companies hurts private companies by reducing available information); Renee M. Jones, *The Unicorn Governance Trap,* 166 U. PA. L. REV. ONLINE 165 (2017) (identifying costs to investors and society because of unicorns' founder-focused governance structure); Amy Deen Westbrook & David A. Westbrook, *Unicorns, Guardians, and the Concentration of the U.S. Equity Markets*, 96 NEB. L. REV. 688 (2018) (discussing how the rise in private equity has changed the meaning and role of the stock market in the United States).

[26] Andrew Ross Sorkin, *C.E.O.s Meet in Secret Over the Sorry State of Public Companies*, N.Y. TIMES (July 21, 2016), https://www.nytimes.com/2016/07/21/business/dealbook/ceos-meet-in-secret-over-sorry-state-of-public-companies.html [https://perma.cc/R89K-4KWR]; *see also* Maureen Farrell, *America's Roster of Public Companies Is Shrinking Before Our Eyes*, WALL ST. J, https://www.wsj.com/articles/americas-roster-of-public-companies-is-shrinking-before-our-eyes-1483545879 (last updated Jan. 6, 2017, 12:59 PM ET) [https://perma.cc/U4YQ-RQXT].

[27] Michael S. Piwowar, Comm'r, Opening Remarks at SEC-NYU Dialogue on Securities Market Regulation: Reviving the U.S. IPO Market (May 10, 2017), https://www.sec.gov/news/speech/opening-remarks-sec-nyu-dialogue-securities-market-regulation-reviving-us-ipo-market [https://perma.cc/9BU2-2BTR].

[28] *See generally* Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. (forthcoming 2020), https://ssrn.com/abstract=3551565 [https://perma.cc/SV7B-6F4Z] [hereinafter *Private Company Lies*] (describing incentives to commit fraud for actors within private companies and outlining alternative mechanisms to "increase accountability" and address securities fraud in the startup context); *cf.* E-mail from

life cycle, one of the potential costs is to detection of and enforcement against fraud. Much of the apparatus of U.S. securities law is designed to force disclosure. But some large companies are not subject to this mandatory disclosure. They do not offer securities publicly in a way that triggers transactional disclosures; nor do they fall into the categories of firms subject to periodic disclosure — what we generally think of as "public companies."

This Article examines one particular societal cost of going private: the loss of the information needed to detect and punish fraud. It analyzes the costs of moving from a disclosure ecosystem with a range of regulatory tools to a low-information regime where the only tool is anti-fraud. It does so by examining the SEC's securities fraud enforcements against private companies. It looks at what the SEC has done in a world — our world — where the balance between public companies and private companies has shifted.

The Article's proposals respond to the current trajectory towards an increasingly private marketplace, arguing that an anti-fraud-only regulatory regime needs enhanced information incentives to make up for the lack of information about private companies. The need is particularly clear when these now-private companies share characteristics such as size and investor base that are traditionally associated with public companies and that led to securities regulation in the first place.

Part One lays the groundwork, defining the private company, describing the decline in the number and percentage of U.S. public companies, and outlining the reasons for the SEC to intervene on the private side. Part Two examines what the SEC has done in this context, analyzing its power to enforce its anti-fraud provisions against private companies, and how it has used this power to police private companies and their officers and directors. (Yes, Theranos and Elizabeth Holmes, but also the action against Lucent Polymer officers and others that got less press.)

Part Three examines what SEC anti-fraud enforcement is able to do and what is lost in the move to private companies. It assesses what it is like to be in a regime where the only regulatory tool is anti-fraud, and that tool is unaccompanied by disclosure and the information from the

Christopher Gerold, President, Nat'l American Sec. Adms Ass'n, Inc., to Vanessa Countryman, Sec'y, U.S. Sec. and Exch. Comm'n (Mar. 16, 2020), https://www.nasaa.org/wp-content/uploads/2020/03/NASAA-Accredited-Investor-Comment-Letter.pdf [https://perma.cc/8FQ6-FY9A] (noting that "private offerings are often characterized by opaque disclosures, related party transactions, illiquidity, minimal financial information and, unfortunately, fraud").

market and the price. It argues that anti-fraud actions — even high-profile actions — are not a substitute for the full suite of mandatory disclosure and regulatory tools.

Part Four looks at potential substitutes for public company information. It develops one particular tool that is used in anti-fraud actions and whose scope varies depending on whether the company is public or private: corporate whistleblowers. And it suggests expansion of whistleblower protections and prizes that would generate information in the newly private universe of corporations.

## I. THE SHRINKING PUBLIC MARKET

> [W]hy are companies staying more private or staying private longer[?] And, you know, not to be flip, but the kind of short answer we've come up with is because we can . . . .
>
> — Participant in the SEC's Small and Emerging Companies Advisory Committee (2017)[29]

The division between public and private companies is an organizing principle of the U.S. law that governs the way businesses raise money. Much of the apparatus of U.S. securities law is designed to force disclosure when securities are offered publicly or to force periodic disclosure for certain registered companies.[30] What companies get in return is access to large amounts of money. In fact, historically, participation in the public markets was a necessary step in growth. The public-private divide sorted companies so that smaller companies stayed private while large corporations were on the public side, providing information and drawing on a wide investor base. The trade was clear: mandatory disclosure was the price for access to large amounts of capital.[31]

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[29] SEC, TRANSCRIPT: SMALL AND EMERGING COMPANIES ADVISORY COMMITTEE 48 (Feb. 15, 2017), https://www.sec.gov/info/smallbus/acsec/acsec-transcript-021517.txt [https://perma.cc/W3ZZ-MAMN] [hereinafter TRANSCRIPT].

[30] Companies that have securities listed on a national securities exchange and companies that have offered securities in an offering where the Securities Act requires registration both must make periodic disclosures. *See* Securities Exchange Act of 1934 §§ 12(a)-(b), 15(d), 15 U.S.C. §§ 78l(a)-(b), 78o(d) (2018). Companies that reach a certain size in terms of number of investors and amount of assets are also Exchange Act reporting companies. *See* Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l(g).

[31] *See* de Fontenay, *supra* note 25, at 448 (calling this the "disclosure bargain" and reporting that it "has largely been revoked"); George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation*, 64 UCLA L. REV. 602, 605 (2017) (pointing to the "implicit bargain" made by public companies: "access to large

Over the past few decades, however, the balance between public and private has shifted, with the public company in decline both in the sheer number of public companies and in the amount of capital raised in the public market. The discussion below begins with definitions, with a particular focus on the private company that is at the heart of any discussion of "private company fraud." It then outlines evidence of the shift away from the public company and discusses the main identified causes for it. Together these sections lay the groundwork for understanding how anti-fraud tools function in this new private-public balance.

### *A. Defining the Private Company*

Lurking in the background is a definitional problem. What is a private company? The most straightforward way to define private companies is in opposition to the public counterpart. Private companies do not have publicly traded stock and are not subject to periodic reporting obligations (10-Ks, etc.).[32]

Companies with stock listed on a national stock exchange are clearly in the "public" category,[33] as are companies that register public offerings with the SEC.[34] These categories were put in place when the securities

and highly liquid pools of capital" in return for "provid[ing] investors and the [SEC] with information").

[32] de Fontenay, *supra* note 25, at 448 n.6 (defining private companies as "businesses that are not subject to periodic reporting requirements under the securities laws and whose stock is not publicly traded"); *cf.* SEC, *Public Companies*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/basics/how-market-works/public-companies (last visited Sept. 8, 2020) [https://perma.cc/SF6N-KTRS] ("There are two commonly understood ways in which a company is considered public: first, the company's securities trade on public markets; and second, the company discloses certain business and financial information regularly to the public.").

[33] *See* Securities Exchange Act of 1934 § 15(d), 15 U.S.C. § 78o(d); *see* Kevin LaCroix, *Executive Protection: Private Company D&O Insurance*, D&O DIARY (Sept. 21, 2010), https://www.dandodiary.com/2010/09/articles/d-o-insurance/executive-protection-private-company-do-insurance/ [https://perma.cc/6469-MQ58] [hereinafter *Executive Protection*] ("The critical distinction between private and public companies is that public companies have publicly traded securities and private companies do not."). Although note the question of whether companies with other types of publicly traded securities count as "private." *See* ADVISEN, THE PRIVATE EYE: SPOTLIGHT ON THE US PRIVATE D&O MARKET 3 (2013), https://www.advisenltd.com/wp-content/uploads/us-private-d-o-market-spotlight-aig-2013-08.pdf [https://perma.cc/WL3D-34XL] (listing "Private Companies with public debt" as one form private companies can take).

[34] 15 U.S.C. § 78l(a) (requiring registration by companies that list securities on a national securities exchange); *id.* § 78o(d) (requiring registration by companies that have filed a Securities Act registration statement that has become effective).

statutes were initially passed in the 1930s and have remained a stable part of what is generally considered a public company.[35]

Even without listing shares or registering a public offering, however, some companies are required to report to the SEC — becoming "public" — because they reach a certain size in terms of the number of investors and amount of assets.[36] Exchange Act § 12(g) is the key provision that defines this route to the public reporting system. Statutory and rule changes to the thresholds determine how big a company can become and how many investors a company can have before triggering public reporting requirements. Tweaks to the underlying definitions by the Jumpstart Our Business Startups Act (the "JOBS Act"), other legislation, and SEC rules are thus an important part of the story about the shift to raising capital privately.[37]

Private companies are those that do not fall into any of these public categories. To think about the role of the SEC in policing these private firms, however, it makes sense to break down the description further. One important division in the category of private companies, particularly when thinking about SEC supervision and enforcement, is between those companies that grow big without becoming public and those that have been or will be a public company (companies in transition).[38]

For companies in transition, the idea is that echoes of public company institutional and governance knowledge likely persist if they once were public (the companies that have gone private). And companies have incentives to get their ducks in order if they plan, someday, to go public.[39]

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[35] *See* 15 U.S.C. §§ 78m(a), 78n(a) (2018).

[36] *See* 15 U.S.C. § 78l(g) (triggering reporting status when a company has a minimum number of investors (for non-financial issuers the limit is 2,000 persons or 500 persons who are not accredited investors) and a minimum level of total assets ($10 million)).

[37] *See infra* Part I.B. *See generally* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013) (highlighting section 12(g) as a key mechanism in defining the public-private divide); Usha R. Rodrigues, *The Once and Future Irrelevancy of Section 12*(g), 2015 U. ILL. L. REV. 1529, 1532 (tracing the history of 12(g)).

[38] A nuanced list of categories of private companies developed in the context of D&O insurance pointed to companies in transition, separately identifying "Private with a filed, pending, postponed, or withdrawn IPO" and "Private Companies that were formerly public." ADVISEN, *supra* note 33, at 3. Also on the list were "Private Companies with public debt; Private Companies with public subsidiaries; Venture Backed private companies; [and] Partnerships." *Id.*

[39] *See, e.g.*, Philip Oettinger & Andrew Ellis, *Preparing a Successful IPO in 2018*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 30, 2018), https://corpgov.law.harvard.edu/

The difficulty is that the easy assumption that all growing private companies will eventually go public no longer holds. When the SEC publicly announced its pursuit of private company fraud in 2016, the SEC Chair described unicorns like Theranos as "pre-IPO."[40] In contrast, this Article does not assume that going public is always the companies' ultimate goal. One reason to move away from this assumption lies in the decline in the number of U.S. public companies overall and the increased ability of companies to go public later in their growth or not at all. The economic shift towards raising capital privately is the topic of the next section.

### *B. Public Company Decline*

The decline in the number of U.S. public companies is well documented. World Bank figures show that the number of listed U.S. companies dropped by almost 50% from 1996 to 2018.[41] This total can be broken down further. Between 1997 and 2017, the number of IPOs declined and the number of acquisitions and leveraged buyouts (a mode of "going private") increased.[42] Although the number of delistings also

2018/01/30/preparing-a-successful-ipo-in-2018/ [https://perma.cc/LXJ5-G786] (advising pre-IPO companies to build up their financial team and "Create Public Company Infrastructure"). Renee Jones helpfully notes signs of planning and restructuring as a private company contemplates going public: she points to Google's hiring of Eric Schmidt as CEO three years before its IPO and Facebook's hiring of Sheryl Sandberg as COO four years before its IPO. Jones, *supra* note 25, at 178.

[40] *SEC Silicon Valley Initiative Speech*, *supra* note 20.

[41] The World Bank reported data on U.S. listed companies from 1980 to 2018. The high was 8,090 U.S. domestic listed companies in 1996. The low in this period was in 2012 with 4,102 companies. The number has crept up only slightly since then, reaching 4,397 in 2018. *See* WORLD FED'N OF EXCHS., *Listed Domestic Companies, Total — United States*, WORLD BANK, https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?end=2018&locations=US&start=2008&view=bar (last visited Sept. 8, 2020) [https://perma.cc/8JVK-Y3VZ]. World Bank data shows an increase in the same period in the market capitalization of US listed companies from $8.48 trillion in 1996 to $30.436 trillion in 2018. *See* WORLD FED'N OF EXCHS., *Market Capitalization of Listed Domestic Companies (Current US$) — United States*, WORLD BANK, https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?end=2018&locations=US&start=1980&view=chart (last visited Sept. 8, 2020) [https://perma.cc/Q3PP-4U8D] (comparing these two charts results in a mean of $1,048,207 per listed company in 1996, with a mean of $6,921,992 in 2018).

[42] PETE WITTE & GREG BROWN, A NEW EQUILIBRIUM: PRIVATE EQUITY'S GROWING ROLE IN CAPITAL FORMATION AND THE CRITICAL IMPLICATIONS FOR INVESTORS 7 (2019), https://www.kenaninstitute.unc.edu/index.php/publication/awp-content/uploads/2019/10/A-new-equilibrium-report.FINAL_.v2-1.pdf [https://perma.cc/9UB3-8SV9] (reporting statistics from the Center for Research in Security Prices); Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANTITATIVE ANALYSIS

fell in that period, the overall result is that new listings in the U.S. have fallen below the replacement rate.[43]

Historically, access to large amounts of capital was on the public side, sorting large companies into the public markets. However, the amount of capital raised in the private market versus the public market has shifted. In 2016, the SEC chair noted that some private companies have higher valuations than their public counterparts, something that would have been impossible in earlier years when accessing the public market was the main way to raise large amounts of capital.[44] Reportedly companies raised more new capital in the private market than the public for the first time in 2017.[45]

One sign that private companies have ballooned is that unicorns are not as rare as they once were. According to a 2020 snapshot, more than two hundred U.S.-based private companies were reportedly worth a billion dollars or more.[46] Tellingly, terms have been coined for even larger private companies: the decacorn (private company valued ten billion dollars or more) may be the new unicorn.[47] And hectocorns — private companies valued at over one hundred billion dollars — may be on the horizon.[48]

The reasons for this shift to private capital-raising matter to analyzing private company fraud. In part they help identify the kinds of companies that are now private rather than public, and the availability of their securities to retail investors. Both are important considerations in evaluating an appropriate level of regulatory scrutiny.

The decline in the number of public companies in the last decades has been tracked to several potential causes, including the amount and cost of regulation on the public side, deregulation of private capital, and the availability of money seeking a good return, particularly in an environment of low interest rates.[49] The ability to exit an investment

1663, 1663 (2013) (noting that the average was 310 U.S. IPOs per year from 1980–2000, whereas the average was 99 U.S. IPOs per year for 2001–2012).

[43] WITTE & BROWN, *supra* note 42, at 7.

[44] *See SEC Silicon Valley Initiative Speech*, *supra* note 20.

[45] WITTE & BROWN, *supra* note 42, at 1.

[46] *The Global Unicorn Club: Current Private Companies Valued at $1B+*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies (last visited Sept. 8, 2020) [https://perma.cc/TQ8A-HYS3] [hereinafter *The Global Unicorn Club*].

[47] *See id.*

[48] *See id.*

[49] *See* CREDIT SUISSE, THE INCREDIBLE SHRINKING UNIVERSE OF STOCKS: THE CAUSES AND CONSEQUENCES OF FEWER U.S. EQUITIES 5 (2017), https://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf [https://perma.cc/VP5E-9P9G]; *Looking Behind the Declining Number of Public Companies*, FEI DAILY (June 12, 2017),

through merger rather than IPO also disincentivizes founders from taking companies public.[50] The discussion below begins with the market context, then turns to the regulation and deregulation that affect the public-private divide.

The appetite to invest privately is driven in part by market conditions. Low interest rates mean that money is looking for investments with a higher return.[51] Some participants in private equity have also suggested that the structure of investors has changed, introducing new "deep pools of capital" that invest directly in private companies.[52] For example, venture capital funds that once focused on early stage startup investing have both become larger and "their mandates" have changed so that they are "across the spectrum, from early stage to late stage."[53] Traditional private equity funds became willing to take minority positions rather than seek control, and the shifting interest of hedge funds, sovereign wealth funds, mutual funds, and family offices (e.g., of big tech company founders) seem to have contributed to the availability of private money.[54]

Regulation too may play a part. The debate over the balance between private and public markets sometimes translates into the usual debate about the optimal level, and pros and cons, of market regulation. The U.S. Chamber of Commerce, for instance, argues that costly disclosure has pushed companies out of the public markets.[55] U.S. regulation costs

https://www.financialexecutives.org/FEI-Daily/June-2017/looking-behind-declining-number-public-companies.aspx [https://perma.cc/23LP-8K4Z].

[50] *E.g.*, Gao et al., *supra* note 42, at 1663-92.

[51] de Fontenay, *supra* note 25, at 448 n.7.

[52] SEC, TRANSCRIPT, *supra* note 29, at 50. At the committee meeting, James ("Jamie") Hutchinson, a partner in Goodwin's private equity and technology practices, described his role as follows: "We do a lot of work representing emerging stage companies and the folks that invest in them. And we've actually kind of had a front row seat over about the past decade to what we kind of call the large cap growth equity. So a lot of the very big rounds into the high-profile tech companies, sort of the unicorn set." *Id.* at 49-50 (noting that "the capital is coming from different places than maybe was historically the case").

[53] *Id.*; *see also* Miles Kruppa, *Investors Race to Tech Start-Ups Despite SoftBank Stumbles*, FIN. TIMES (Nov. 13, 2019), https://www.ft.com/content/35df8336-05a4-11ea-9afa-d9e2401fa7ca [https://perma.cc/KF4T-63CZ] (reporting that "Blackstone, Tiger Global, Lightspeed and Founders Fund are all raising huge funds for late-stage companies").

[54] SEC, TRANSCRIPT, *supra* note 29, at 50; *see, e.g.*, MIKE ISAAC, SUPER PUMPED: THE BATTLE FOR UBER 96 (2019). Another private equity participant suggested that "FOMO" — fear of missing out — drives private company investors. *See id.*

[55] U.S. CHAMBER OF COMMERCE CTR. FOR CAPITAL MKTS., ESSENTIAL INFORMATION: MODERNIZING OUR CORPORATE DISCLOSURE SYSTEM 17 (2017), http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/U.S.-Chamber-

have been of particular concern in the context of global competition for listings. Over time these concerns have motivated some relaxation of regulation on the public side, particularly through the JOBS Act.[56]

The other side of the equation is increased access to capital before, or even without ever, going public. In other words, deregulation on the private side. The Council of Institutional Investors has argued that the ability to raise private capital, and not the amount of U.S. regulation, has pushed the decline in the number of public companies.[57] The former chair of the SEC, Mary Jo White, pointed to particular SEC rule changes that made private capital more available: crowdfunding, Reg A+, and the elimination of some prohibitions on solicitation in private offerings.[58]

Not only do regulatory changes make money on the private side more available, but they also allow private companies to get much bigger without triggering mandatory public reporting. The mechanism for this private growth is changes to the amount of assets and investors that trigger public company status under Exchange Act § 12(g). As noted above, in addition to companies that are public because their shares are listed on an exchange or they have made public offerings, some companies must enter the public reporting system because of their size. The thresholds have changed over time, allowing private companies to grow bigger without triggering mandatory disclosure requirements.[59]

Essential-Information_Materiality-Report-W_FINAL.pdf?x48633 [https://perma.cc/P7VG-639N] ("Left unchecked, ineffective disclosure will further hasten the steady decline in the number of private companies seeking public listings in the U.S., which over the longer term impairs economic growth."); *see also* Editorial, *Where Are the IPOs?*, WALL ST. J., Dec. 31, 2016, at A10.

[56] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 102, 126 Stat. 306, 310 (2012) [hereinafter JOBS Act]; IPO TASK FORCE, REBUILDING THE IPO ON-RAMP: PUTTING EMERGING COMPANIES AND THE JOB MARKET BACK ON THE ROAD TO GROWTH 6-8 (2011), https://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf [https://perma.cc/56WP-4QRV].

[57] *See* Letter from Jeffrey P. Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Craig S. Phillips, Counselor to the Sec'y, U.S. Dep't of Treasury 2, 3 (Aug. 23, 2017), https://www.cii.org/files/August%2023%202017%20Letter%20to%20Treasury%20v3.pdf [https://perma.cc/3T7X-7NC5].

[58] *SEC Silicon Valley Initiative Speech*, *supra* note 20.

[59] The JOBS Act increased the triggering asset amount to $10 million, increased the number of investors permitted to 2000 (as long as no more than 499 of them were not accredited investors) and excluded employee-investors from the investor count. JOBS Act § 102.

### *C. Reasons to Regulate Private Companies*

The shift towards staying private, or staying private longer, upsets some of the assumptions underlying regulation and monitoring of private companies. Relaxed regulation on the private side results in private companies that have some of the characteristics of traditional public companies that led to regulation and disclosure in the first place.[60]

The rationale for keeping private capital-raising relatively unregulated has long been that sophisticated (wealthy) investors and institutions do not need the protections of the securities laws, including mandatory disclosure.[61] These investors had access to information, the ability to absorb it, and the capacity to sustain losses.[62] In the Supreme Court's words, they could "fend for themselves."[63] These were the investors on the private side.[64]

As more capital is raised on the private side, however, there is a regulatory push to give "Main Street investors" access to private investments.[65] The loosening of restrictions on private capital includes initiatives that, as the SEC has acknowledged, reach retail investors, the core subject of investor protection.[66] And SEC Chair Jay Clayton has

[60] *See* ADVISEN, *supra* note 33, at 5 (pointing to "large private companies that share many traits of a public firm, while maintaining private ownership, including Cargill, Hearst Corporation and Mars").

[61] *See, e.g.*, Regulation D Revisions, 52 Fed. Reg. 3015, 3016-17 (proposed Jan. 30, 1987) (codified at 17 C.F.R. pt. 230 & 239) (identifying accredited investors as "those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary"); *SEC Silicon Valley Initiative Speech*, *supra* note 20 ("From a securities law perspective, the theory behind the private markets is that sophisticated investors do not need the protections offered by the robust mandatory disclosure provisions of the 1933 Securities Act.").

[62] *See SEC Silicon Valley Initiative Speech*, *supra* note 20.

[63] *See* SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953) (defining what counts as a private offering).

[64] *See* SEC Rule 506, 17 C.F.R. § 230.506 (2020) (limiting some private placements to "accredited investors" and requiring sophistication from additional investors).

[65] For reasons to favor equalizing access, see Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3390 (2013) (pointing to unequal access to the private markets as the "dirty little secret of U.S. securities law": the ability of the rich to access "types of wealth-generating investments not available, by law, to the average investor").

[66] *SEC Silicon Valley Initiative Speech*, *supra* note 20 (indicating that former SEC Chair Mary Jo White noted that some "capital formation tools" could "be used to, and in certain cases are expected to, raise money from retail investors").

spoken repeatedly about connecting retail investors with "expanded investment opportunities" in the context of a declining public market.[67]

One of the ways in which the law sorts between private company investments limited to wealthy and sophisticated investors and public investments broadly open to retail investors is through the definition of "accredited investor."[68] The SEC has called it "one of the principal tests for determining who is eligible to participate in our private capital markets."[69] A large number of accredited investors can invest in private companies without making the company subject to public reporting requirements.[70] Because the definition is not indexed to inflation, over time it has included a greater swath of the U.S. population.[71] In other

[67] *See* Jay Clayton, Chairman, SEC, Remarks on Capital Formation at the Nashville 36|86 Entrepreneurship Festival (Aug. 29, 2018), https://www.sec.gov/news/speech/speech-clayton-082918 [https://perma.cc/49V3-9RSK]; *see also* Jay Clayton, Chairman, SEC, Testimony on "Oversight of the Securities and Exchange Commission" Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Dec. 10, 2019) [hereinafter *Testimony*] ("I believe it is our obligation to explore whether we can increase opportunities for Main Street investors in the private markets while maintaining strong and appropriate investor protections."); Dave Michaels, *SEC Chairman Wants to Let More Main Street Investors in on Private Deals: Jay Clayton Outlines Overhaul Plans in Interview, Says Changes Could Happen 'Pretty Quickly*,' WALL ST. J. (Aug. 30, 2018), https://www.wsj.com/articles/sec-chairman-wants-to-let-more-main-street-investors-in-on-private-deals-1535648208 [https://perma.cc/5K2A-N2F7].

[68] *See* Amending the "Accredited Investor" Definition, Final Rule (amending 17 C.F.R. pt. 230 & 240), Release No. 33-10824, 34 SEC Docket S7-25-19 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10824.pdf [https://perma.cc/M4QM-BTFW] ("Qualifying as an accredited investor, as an individual or an institution, is significant because accredited investors may, under Commission rules, participate in investment opportunities that are generally not available to non-accredited investors, including certain investments in private companies . . . ."); *see also* U.S. Sec. and Exch. Comm'n Rule 501, 17 C.F.R. § 230.501; SEC, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 5 (2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf [https://perma.cc/88YB-NTUE] [hereinafter DEFINITION OF "ACCREDITED INVESTOR"] ("The accredited investor definition attempts to identify those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary.").

[69] Press Release, SEC, SEC Modernizes the Accredited Investor Definition (Aug. 26, 2020), https://www.sec.gov/news/press-release/2020-191 [https://perma.cc/YW6D-AJBJ].

[70] *See* Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l(g) (2018).

[71] *See, e.g.*, 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 [https://perma.cc/W6GZ-DZ5K] (reporting that "$200,000 in annual income requirement set in 1982 would translate into roughly $538,000 today, while the $1 million net-worth threshold is now equal to $2.7 million" and that the 1.6% of US households that qualified as accredited investors in 1982 climbed to approximately 13% in 2019); Allison Herren Lee & Caroline Crenshaw,

words, some retail investors may already have access to these private companies, and some reports suggest that private equity firms are increasingly interested in accessing this population.[72]

Moreover, more recently, the SEC has taken steps to increase access through changes to the definition of "accredited investor." After signaling changes to come,[73] the SEC finalized a rule in August 2020 that adds new categories of people and entities to the definition, expanding those who qualify.[74]

In addition to concerns about the entry of retail investors into private investments, regulation and enforcement may be justified by the sheer size of some of these new private companies. Even when sophisticated investors are involved, the concentration of money on the private side means that any failure may have broad societal consequences.[75] This justification has roots in existing U.S. securities regulation, especially the size triggers in Exchange Act § 12(g).[76] The focus of some securities regulation on company size has led some prominent scholars to suggest that "some portion of what we call securities regulation follows from an

Comm'rs, Joint Statement on the Failure to Modernize the Accredited Investor Definition (Aug. 26, 2020), https://www.sec.gov/news/public-statement/lee-crenshaw-accredited-investor-2020-08-26#_ftnref20 [https://perma.cc/G7BB-33VU] (lamenting the failure of the SEC's final rule to index amounts to inflation because it will contribute to the rise in qualified households, and noting that the "failure to update the thresholds thus far has resulted in an increase of 550% in qualifying households since 1983").

[72] *See* Miriam Gottfried, *Mom and Pop Millionaires Are Driving Blackstone's Growth; Private-equity Giant Joins a Gaggle of Firms Looking to a Segment of the Market It Once Ignored*, WALL ST. J. (Feb. 14, 2020), https://www.wsj.com/articles/mom-and-pop-millionaires-are-driving-blackstones-growth-11581676203 [https://perma.cc/UV2G-X98G].

[73] SEC, DEFINITION OF "ACCREDITED INVESTOR," *supra* note 68, at 2-5; *see* Bernard, *supra* note 71 (reporting that SEC Chair Clayton said to "expect more in this space").

[74] Amending the "Accredited Investor" Definition, *supra* note 68 (noting that the SEC Commissioners are not unanimous in their support for this expansion); *see* Lee & Crenshaw, *supra* note 71 ("With its actions today [finalizing the rule expanding the accredited investor definition], the Commission continues a steady expansion of the private market, affording issuers of unregistered securities access to more and more investors without due regard for the risks they face . . . .").

[75] *See, e.g.*, Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583 (2016) (examining case studies including Uber and Airbnb, and arguing that "although unicorns are technically private companies, their size and influence render their effect in the marketplace much more like that of a publicly held corporation").

[76] *See* Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l (2018) (triggering reporting status when a company has a minimum number of investors (2,000 total or 500 non-accredited investors) and a minimum level of total assets ($10 million)).

effort to create more accountability of large, economically powerful business institutions."[77]

At times, the SEC has made the argument that anti-fraud protections should apply even when the investors are sophisticated.[78] This argument could be justified by general concerns about confidence in the market's integrity. The SEC's 2019 enforcement report declared that enforcement actions "removing bad actors from the markets, . . . and acting quickly to stop frauds and prevent losses . . . sent clear and important messages to market participants, and enhanced confidence in the integrity and fairness of our markets."[79]

In sum, the fundamental shift in how U.S. companies access capital unsettles existing regulatory structures and actors. One way in which the existing regime addresses problems at private companies is through broadly applicable securities fraud prohibitions. The SEC's securities fraud enforcement actions against private companies are the subject of the next Part.

## II. SEC ENFORCEMENT AGAINST PRIVATE COMPANIES

> It is axiomatic that all private and public securities transactions, no matter the sophistication of the parties, must be free from fraud. Exchange Act Section 10(b) and Rule 10b-5 apply to all companies and we must be vigorous in ferreting out and punishing wrongdoers wherever they operate.
>
> — Mary Jo White, then-Chair of the SEC (2016)[80]

Though U.S. securities regulation is focused on public corporations and public offerings, the SEC has a key tool to address problems at private companies. Even private companies can be pursued for securities fraud.

What the SEC has done with this anti-fraud power is the subject of this Part. It begins with the statutory provisions, providing the legislative underpinnings for the uncontroversial, but also underexamined, ability of the SEC to pursue fraud at private companies. It then examines the SEC's self-declared intervention into the universe of private company fraud, made overt in 2016 with the SEC's so-called Silicon Valley Initiative.

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[77] Langevoort & Thompson, *supra* note 37, at 340.

[78] *SEC Silicon Valley Initiative Speech*, *supra* note 20.

[79] SEC, DIVISION OF ENFORCEMENT: 2019 ANNUAL REPORT, *supra* note 23, at 1.

[80] *SEC Silicon Valley Initiative Speech*, *supra* note 20.

The Part concludes by analyzing the SEC's securities fraud enforcement actions against private companies, focusing on the years after the SEC's announced initiative (FY 2016 through FY 2019). The actions are few enough that they resist systematic quantification, but key elements can nonetheless be identified. This Part uses case studies to provide a framework for the categories of enforcement, as well as to make more granular points about the type of investors and information involved.

### *A. Scope of Anti-Fraud Provisions*

Although for a long time underemphasized, the consensus is that key anti-fraud provisions — Exchange Act section 10(b), Rule 10b-5, and Securities Act section 17(a) — cover private as well as public companies. Whereas other securities law requirements are limited to public companies or public offerings, the securities fraud provisions are not so limited.[81]

The most widely used of these provisions is Section 10(b), accompanied by SEC Rule 10b-5. The plain language of Section 10(b) prohibits manipulation or deception "in connection with the purchase or sale" of securities listed on national exchanges, but also explicitly includes "any security not so registered."[82] Rule 10b-5 similarly contains a broad prohibition on the use of "any manipulative or deceptive device . . . in connection with the purchase or sale of any security."[83]

There is notoriously a dearth of legislative history on 10(b), but it was reportedly uncontroversial.[84] The legislative history of section 10(b) also shows an evolution from proposals limited to listed securities to the broad final language. The proposed bill that contained the precursor to section 10(b) did not reach private companies. Although much of its language was similar to section 10(b), it reached only "any security

[81] Some anti-fraud provisions in the securities laws are directed at misstatements or omissions in the registration statement filed with the SEC, Securities Act of 1933 § 11, 15 U.S.C. § 77k (2018); or in the prospectus that accompanies the public offering of securities, Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l (2018). These particular provisions of the securities statutes that cover fraud in the primary market/securities offerings by issuers are limited to companies that are making public offerings, so are outside this Article's definition of private company.

[82] Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2018).

[83] U.S. Sec. and Exch. Comm'n Rule 10b-5, 17 C.F.R. § 240.10b-5 (2020).

[84] *See, e.g.*, Steven Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990) (recounting the legislative history of section 10(b)).

registered on a national securities exchange."[85] This was ultimately revised to include securities "not so registered" as well.[86] This often amounts to the short hand "in connection with the purchase or sale of any security."[87]

When the SEC drafted Rule 10b-5 to effectuate the statutory provision, that drafting was apparently uncontroversial as well. SEC lawyer Milton Freeman later described this process like this: "We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, 'Well,' he said, 'we are against fraud, aren't we?'"[88]

The other anti-fraud provision with broad reach, including private as well as public companies, is Securities Act § 17(a).[89] The text of the provision is very similar to 10(b). Indeed, reportedly the Exchange Act's 10(b) was modeled on the earlier Securities Act provision.[90] Section 17(a) is narrower than 10(b) in that it is enforced only by the SEC rather than by private litigants as well.[91] It is also broader in the sense that it does not require any showing of scienter.[92]

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[85] H.R. 7852, 73d Cong. § 9 (1934) ("It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange . . . . [t]o use or employ in connection with the purchase or sale of *any security registered on a national securities exchange* any device or contrivance which, or any device or contrivance in a way or manner which the [regulating agency] may by its rules and regulations find detrimental to the public interest or to the proper protection of investors.") (emphasis added); Thel, *supra* note 84, at 429 (canvassing the legislative history of § 10(b)).

[86] H.R. 8720, 73d Cong. § 8(a)(1)-(8), (e) (1934).

[87] *See, e.g.*, SEC v. Zandford, 535 U.S. 813, 815 (2002) ("The question presented is whether the alleged fraudulent conduct was 'in connection with the purchase or sale of any security' within the meaning of the statute and the rule.").

[88] Milton V. Freeman, *Administrative Procedures*, 22 BUS. LAW. 891, 922 (1967) (describing "what actually happened when 10b-5 was adopted").

[89] Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a)(2) (2018) ("It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly . . . to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."); Wendy Gerwick Couture, *Prosecuting Securities Fraud Under Section 17(a)(2)*, 50 LOY. U. CHI. L.J. 669, 672 (2019).

[90] Couture, *supra* note 89, at 672 & n.16.

[91] Aaron v. SEC, 446 U.S. 680, 702 (1980); Maldonado v. Dominguez, 137 F.3d 1, 7 (1st Cir. 1998).

[92] *Aaron*, 446 U.S. at 702. For analysis of the other textual and contextual differences between the provisions, see Couture, *supra* note 89, at 672.

The textual hook for including private companies in section 17(a)'s prohibition is its application to "any" securities.[93] Courts have also tended to interpret the section's language more broadly than 10(b), in part because it has no private right of action.[94] Some courts have considered the fact that securities are publicly traded to be enough to satisfy the "in connection with" requirement, but these opinions do not preclude other connection.[95]

Finally, the notion of "security" does not limit the type of company covered by the anti-fraud provisions. Indeed, Theranos undisputedly issued securities. However, these qualified for exemptions that made them a private rather than a public offering (which would have triggered associated registration requirements).[96]

### *B. Private Company Enforcement and the Silicon Valley Initiative*

Against the backdrop of the declining number of public companies and the shrinking of the available regulatory and enforcement tools to the anti-fraud provisions, the SEC declared its intention to police these private companies. In 2016, then-SEC Chair, Mary Jo White, gave a keynote address at an event called the "Silicon Valley Initiative."[97] Regulators, lawyers, corporate directors, and academics gathered at Stanford to discuss "key regulatory issues relating to private and pre-

[93] Securities Act of 1933 § 17(a), 15 U.S.C. § 77q ("Use of interstate commerce for purpose of fraud or deceit. It shall be unlawful for any person in the offer or sale of *any* securities . . . .") (emphasis added).

[94] For example, courts have not limited the scope to the '33 Act primary market context despite the reference to "in the offer or sale." United States v. Naftalin, 441 U.S. 768, 773 n.4 (1979). *But see* Couture, *supra* note 89, at 678 (arguing that this language should be interpreted more narrowly).

[95] SEC v. RPM Int'l, Inc., 282 F. Supp. 3d 1, 29 (D.D.C. 2017) ("Many courts have concluded that an allegation that the company's stock was publicly traded is sufficient to plead this element under Section 17(a)(2).").

[96] *See, e.g.*, Theranos Inc., Notice of Exempt Offering of Securities (Form D) (July 8, 2010), https://sec.report/Document/0001313697-10-000004/ [https://perma.cc/2P8E-GCS3] [hereinafter Form D] (claiming a Reg D exemption under Rule 506).

[97] *SEC Silicon Valley Initiative Speech*, *supra* note 20; *see* STANFORD ROCK CTR. FOR CORP. GOVERNANCE, *The Silicon Valley Initiative: Protecting Investments in Pre-IPO Issuers*, YOUTUBE (Mar. 11, 2016), https://www.youtube.com/watch?v=cKwn62p2Tu0 [https://perma.cc/Y7SU-46LV].

IPO companies."[98] What the SEC Chair said there soon became known as the "SEC's Silicon Valley Initiative."[99]

In her speech, the SEC Chair recognized changes in the market, especially the tendency of companies to stay private longer.[100] She reminded listeners of the reach of securities fraud prohibitions, pointing out in particular that 10(b) and 10b-5 apply to all companies, public or private.[101] The speech detailed some of the SEC's concerns about startups, including pressure to reach sky high valuations that were analogous, according to White, to the pressures to meet earnings in the public context.[102] The absence of "robust internal controls and governance procedures" in even "quite mature" startup companies even "amplified . . . the risk of distortion and inaccuracy."[103]

The speech announced a few themes related to investor protection, noting the entry of retail investors into private investments and the need to prevent fraud even when investors are sophisticated.[104] It also acknowledged the connection between federal securities law and the state corporate law and fiduciary duties that have traditionally regulated purely private companies, pointing to an obligation of "candor and fair dealing" that is "fundamentally the same."[105]

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[98] *See The Rock Center and the SEC's San Francisco Regional Office Present, "The Silicon Valley Initiative: Protecting Investments in Pre-IPO Issuers*," STAN. L. SCH. (Mar. 31, 2016, 5:00 PM), https://law.stanford.edu/event/rock-center-evening-speaker-series/ [https://perma.cc/T9TF-NVRU].

[99] *See, e.g.*, FENWICK & WEST LLP, *The SEC's Silicon Valley Initiative: What You Need to Know About the SEC's Increasing Scrutiny of Private Companies and Secondary Market Trading in Pre-IPO Shares*, FENWICK (Apr. 26, 2016), https://www.fenwick.com/Events/Pages/The-SECs-Silicon-Valley-Initiative-MV.aspx [https://perma.cc/5U7Z-2CZE] (using the phrase "SEC's Silicon Valley Initiative" in the event title).

[100] *SEC Silicon Valley Initiative Speech*, *supra* note 20 ("New models for how these companies are funded and how investors unlock their value are changing the landscape of private start-up financing and the IPO market . . . . All of these factors are contributing to the decision made by more and more companies to stay private longer.").

[101] *Id.*

[102] *Id.* ("[O]ne must wonder whether the publicity and pressure to achieve the unicorn benchmark is analogous to that felt by public companies to meet projections they make to the market with the attendant risk of financial reporting problems.").

[103] *Id.*; *see* Pollman, *Private Company Lies*, *supra* note 28, at 5 (describing incentives for fraud in startups); *see also* Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 159 (2019) [hereinafter *Startup Governance*] (noting that startup governance issues such as overlapping roles and prioritization of growth are sometimes exacerbated with growth).

[104] *See SEC Silicon Valley Initiative Speech*, *supra* note 20.

[105] *Id.*

Following the 2016 speech, law firms offered advice on "What You Need to Know About the SEC's Increasing Scrutiny of Private Companies and Secondary Market Trading in Pre-IPO Shares."[106] They warned clients that "unicorns [were] in [the] SEC's line of sight."[107]

### *C. SEC Securities Fraud Enforcement Against Private Companies*

The 2016 SEC Silicon Valley Initiative may have been an inflection point, an overt announcement of the SEC's intention to police some of the most extreme misbehavior in the growing private universe. This Part examines what actions the SEC Enforcement Division took against private company fraud after this initiative.

The first category is enforcement against private companies that have many of the characteristics of public companies that led to regulation and mandatory disclosure in the first place, especially size, investor type, and/or the existence of a (private) secondary market.[108]

This subpart, however, provides a broader picture of private company fraud and the SEC's actions to police it. The SEC has also pursued securities fraud allegations against private companies when companies have used the (false) promise of access to the public markets to commit a fraud. A few examples illustrate these situations where the private company fraud implicates the integrity of the public securities markets in this way.

Though enforcement actions against unicorns and Silicon Valley startups are few,[109] SEC securities fraud allegations against private companies are quite common and likely uncontroversial in another large category of cases. These are classic frauds where an individual moves money around corporate and other business entities, some or all of which are private.[110]

These classic anti-fraud actions are often characterized by allegations that some of the investments offered should have been *public* offerings, but failed to comply with the registration requirements. The discussion

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106 FENWICK & WEST LLP, *supra* note 99.

107 *The Silicon Valley Initiative — Unicorns in SEC's Line of Sight: Action Items*, DLA PIPER (May 26, 2016), https://www.dlapiper.com/en/us/insights/publications/2016/05/quarterly-governance-review-may-2016/the-silicon-valley-initiative/ [https://perma.cc/8NKX-5P54].

108 *See supra* notes 59–64 and accompanying text.

109 *See infra* Chart 1.

110 *See, e.g.*, SEC Files Charges to Stop Fraudulent Misuse of Cancer-Fighting Investments to Fund Restaurant Businesses, SEC Litigation Release No. 23893, 117 SEC Docket 1214, 2017 WL 3278183 (July 31, 2017). *See generally infra* Appendix: SEC Securities Fraud Enforcement Actions Against Private Companies, FY2016-FY2019.

below provides a few illustrations — the Fyre Festival and the "Frack Master" — of this borderline category where the SEC has routinely used 10(b)/10b-5 and 17(a) to bring securities fraud allegations against private companies.

Finally, this Part examines several of the SEC's actions against companies in transition between being public and private, or vice versa. The aim, in part, is to provide a foil for the unicorn enforcements, isolating the types of information that are available in these transitional cases. This category also serves as another example that complicates the borders between private and public companies, introducing change over time as another element.

### 1. Unicorns and Other Private Companies with "Public" Characteristics

Are unicorns like Theranos really in the SEC's "line of sight"?[111] This category is an important one. The decline of the number of public companies and IPOs will impact this area, shifting more business activity to these large privately held companies. To get a sense of the number of companies in this category, consider that 238 U.S.-based private companies were reportedly worth a billion dollars or more as of September 2020.[112]

The following chart reports SEC securities fraud cases brought against unicorns and Silicon Valley startups — the subject of the SEC's 2016 announcement — after the SEC's Silicon Valley speech. It covers SEC fiscal years 2016 through 2019 (Oct. 1, 2015 to Sept. 30, 2019).

[111] *See DLA PIPER*, *supra* note 107.

[112] *See The Global Unicorn Club*, *supra* note 46.

Chart 1. SEC Securities Fraud Actions Against Unicorns and Silicon Valley Startups SEC FY 2016 — FY 2019

| Private Company | Company Target | Indiv. Target | Date of SEC Action | SEC Release[113] | Alleged Violations[114] |
|---|---|---|---|---|---|
| Zenefits, Inc. | X | X | 26-Oct-17 | SEC Admin. Pro. No. 33-10429 | Sec. Act 17(a) |
| Theranos, Inc. | X | X | 19-Mar-18 | SEC Lit. Rel. No. 24069 | Sec. Act 17(a)<br>Exch. Act 10(b)<br>Rule 10b-5 |
| Mozido | X | X | 30-Mar-18 | SEC Lit. Rel. No. 24092 | Sec. Act 17(a)<br>Exch. Act 10(b)<br>Rule 10b-5<br>Sec. Act 5(a) & 5(c) |
| Jumio, Inc. | | X | 2-Apr-19 | SEC Pr. Rel. 2019-50 | Sec. Act 17(a)<br>Exch. Act 10(b)<br>Rule 10b-5 |

Although too few to be systematically quantified, a few themes emerge from actions against large private companies and their officers and directors, which are the focus of the discussion below: the unicorn-plus size of some of the companies; actions that protect employee-investors; and the presence in some cases of a private secondary market.

*a. Zenefits*

Zenefits (derived from Zen + Benefits) is a private software company based in San Francisco that promises "All-In-One" and "Automagically integrated" human resources.[115] Part of its business has been the

[113] Because some of these actions involve multiple targets and multiple stages, the SEC may have issued several public releases. The listed release reports the action against the private company (if any) or the earliest within the set of releases.

[114] Unless otherwise indicated, this lists all of the violations alleged in the complaint, including some that were brought against a subset of the defendants. It excludes allegations against relief defendants.

[115] ZENEFITS, https://www.zenefits.com/hr/?utm_source=Bing&utm_medium=Zenefits-Platform&lc=PPC&ls=Bing&cm1=Sitelink&cm2=what-is-zenefits&cm3=%5Bzenefits%5D&cm4=e&cm5=&adgroup_id=1210562309569683&campaign_id=276066989&msclkid=576d407d4f8e145dca331d947125befe&utm_campaign=B_S_Brand_Alpha&

purchase of employee health policies.[116] In fact, at one time this business accounted for most of its revenues.[117]

Zenefits raised money privately. Lots of money. Two private placements raised $565 million each from accredited investors.[118] The latter impliedly valued the company at $4.5 billion dollars, making Zenefits another private Silicon Valley unicorn.[119]

Alas for Zenefits, state insurance enforcement agencies were concerned that the company stepped into the insurance broker business without the required licensing. In particular, in 2015 the Washington state insurance enforcement agency started inquiring, and Buzzfeed quickly picked up on potential problems.[120] Around the same time, Zenefits self-reported potential violations to state insurance regulators across the country.[121] Ultimately state insurance regulators from forty-nine states brought an enforcement action, which the company settled for eleven million dollars.[122]

Zenefits' securities fraud trouble came from the positive statements it made about its insurance business in the context of its private placements. In 2017, the SEC brought and settled a securities fraud action against the company and its CEO.[123]

The resolution was relatively mild, in part reflecting the company's acknowledged cooperation with government authorities. The settlement was in administrative rather than court proceedings, acknowledged Zenefits' remedial acts and cooperation, and alleged only Section 17(a)(2) violations, which is significant because the provision

utm_term=%5Bzenefits%5D&utm_content=zenefits-ALL [https://perma.cc/9CDD-KFHA] (last visited Dec. 5, 2019) ("Minimize HR headaches so you can get back to business.").

116 YourPeople, Inc., SEC Release No. 10429, 2017 WL 4863857, at *2 (Oct. 26, 2017) [hereinafter Zenefits Settlement] (order instituting cease-and-desist proceedings).

117 *Id.* at 3.

118 *Id.* at 2.

119 *Id.*

120 William Alden, *Startup Zenefits Under Scrutiny for Flouting Insurance Laws*, BUZZFEED NEWS (Nov. 25, 2015, 11:39 AM ET), https://www.buzzfeednews.com/article/williamalden/zenefits-under-scrutiny-for-flouting-insurance-laws [https://perma.cc/B532-36U3].

121 Zenefits Settlement, *supra* note 116, at 8.

122 William Alden, *The SEC Just Fined a Unicorn Startup for the First Time: Penalties Against Zenefits and Its Former CEO for Misleading Investors Show the SEC's Aggressive New Stance in Silicon Valley*, BUZZFEED NEWS (Oct. 26, 2017, 5:41 PM ET), https://www.buzzfeednews.com/article/williamalden/the-sec-just-fined-a-unicorn-startup-for-the-first-time [https://perma.cc/X5PZ-HMCA] [hereinafter *The SEC Just Fined*].

123 Zenefits Settlement, *supra* note 116, at 2; Alden, *The SEC Just Fined*, *supra* note 122.

does not require scienter. As is the custom, Zenefits neither admitted or denied the included law or facts. In addition to agreeing to cease and desist, Zenefits agreed to pay a $450,000 money penalty, and the former CEO agreed to pay a money penalty of $160,000 and disgorgement of another $350,000.[124]

Zenefits is squarely within the target category of the SEC's Silicon Valley Initiative. Although "investors primarily consist[ed] of investment companies, venture capital firms, private equity funds and accredited individual investors," it was of unicorn size and "[s]ome of its shares also trade on secondary markets."[125]

*b. Theranos*

Before it all collapsed, Elizabeth Holmes' Stanford chemistry professor said: "I wish I wasn't 70 years old. I wish I was her age and could be in on this. Because this is going to be a long, exciting, fascinating, exhilarating ride."[126] He was prescient, but not in a good way. The exhilarating ride up and then down has now been recounted

[124] Zenefits Settlement, *supra* note 116, at 11.

[125] *Id.* at 2.

[126] Parloff, *This CEO Is Out for Blood*, *supra* note 11.

by articles and books,[127] movies,[128] a TV series,[129] a podcast,[130] comedy sketch,[131] and reportedly Halloween costumes.[132]

The SEC brought a securities fraud action against Theranos, Holmes, and Balwani in 2018.[133] One might question the amount of new information it needed to do so, and how much its action added to the mix given the press attention and the parallel criminal charges and the various other government actions. At the same time, Theranos illustrates both limits and promise of whistleblowers as an information source for detecting private company fraud.[134]

Theranos is also a clear example of unicorn enforcement and the SEC's pursuit of private company fraud. First, Theranos is clearly private. Theranos had filed with the SEC, but only to explain why its offerings of securities were not public offerings and fit into an

[127] *E.g.*, CARREYROU, *supra* note 8. The articles are too numerous to list, but include, for example, Auletta, *supra* note 10; Nick Bilton, *"She Never Looks Back": Inside Elizabeth Holmes's Chilling Final Months at Theranos*, VANITY FAIR (Feb. 21, 2019), https://www.vanityfair.com/news/2019/02/inside-elizabeth-holmess-final-months-at-theranos [https://perma.cc/CF8X-69A3] ("At the end, Theranos was overrun by a dog defecating in the boardroom, nearly a dozen law firms on retainer, and a C.E.O. grinning through her teeth about an implausible turnaround."); Parloff, *This CEO Is Out for Blood*, *supra* note 11; Weaver & Carreyrou, *supra* note 12.

[128] *E.g.*, THE INVENTOR: OUT FOR BLOOD IN SILICON VALLEY (HBO 2019).

[129] Nellie Andreeva, *Hulu Orders 'The Dropout' Limited Series Starring Kate McKinnon as Elizabeth Holmes from Fox Searchlight TV*, DEADLINE (Apr. 10, 2019, 2:20 PM), https://deadline.com/2019/04/the-dropout-hulu-limited-series-kate-mckinnon-star-elizabeth-holmes-fox-searchlight-television-abc-news-1202593032/ [https://perma.cc/FWK9-FM3U].

[130] Rebecca Jarvis, *The Dropout*, ABC AUDIO (2019), https://abcaudio.com/podcasts/the-dropout/ [https://perma.cc/RBY7-7Y7L] ("Money. Romance. Tragedy. Deception. The story of Elizabeth Holmes and Theranos is an unbelievable tale of ambition and fame gone terribly wrong.").

[131] Ryan Reed, *James Corden Mocks Elizabeth Holmes, Theranos With 'Poo' Company Sketch*, ROLLING STONE (Mar. 28, 2019, 9:47 AM ET), https://www.rollingstone.com/tv/tv-news/james-corden-elizabeth-holmes-theranos-the-inventor-814385/ [https://perma.cc/QWP5-36YU] ("The clip looks back at Corden's fake, 'multi-billion-dollar health company' that aimed to 'transform the landscape of modern medicine as we know it — 'no more disease, no more doctors, no more death.'").

[132] Eric Hegedus, *Black Turtleneck Shortage Linked to Elizabeth Holmes Halloween Costumes*, N.Y. POST (Oct. 29, 2019, 4:36 PM), https://nypost.com/2019/10/29/black-turtleneck-shortage-linked-to-elizabeth-holmes-halloween-costumes/ [https://perma.cc/H7JU-N89B]; Rose Minutaglio, *How to Dress Like Elizabeth Holmes This Halloween*, ELLE MAG. (Oct. 8, 2019), https://www.elle.com/fashion/trend-reports/a29341871/elizabeth-holmes-halloween-costume/ [https://perma.cc/SM6D-9RFJ].

[133] Complaint, Balwani, *supra* note 17, at 1; Complaint, Holmes, *supra* note 17, at 1.

[134] *See infra* Part IV.

exemption.[135] Second, Theranos grew large without going public. Early investors were a hodge-podge of family, friends and "aging venture capitalists," but later rounds drew in a broader range of Silicon Valley investors.[136] As its unicorn moniker suggests, its implicit claimed value reached more than $1 billion.

The action against Theranos was a high-profile signal that the SEC was willing to pursue private tech unicorns. Securities-focused law firms passed this message on to their clients with memos like this: "It's Hunting Season. For Unicorns? Lawsuit Against Theranos Signals Trend In Investors Going After Late-Stage Start-ups."[137]

*c. Jumio*

Jumio, Inc. was a private mobile payments company based in Palo Alto, California. Its founder and (now former) CEO was Daniel Mattes. Mattes also owned many of Jumio's shares. He allegedly told at least one potential Jumio investor that he was not selling his own shares because "there was lots of great stuff coming up" for Jumio and "he'd be stupid to sell at this point."[138] But actually Mattes did sell his own shares, making $14 million dollars. In the process, he provided overstated financial statements to investors and allegedly misled Jumio's board and lawyers so that they would sign off on his sales.[139]

Jumio went bankrupt in 2016, and investors (not Mattes) lost their investment. In April 2019, the SEC charged Mattes with securities fraud in violation of 10(b)/10b-5 and 17(a).[140] Mattes settled with the SEC, agreeing to pay $17 million dollars.[141] As part of the settlement, he was also barred from being the officer or director of a *public* company.[142] He

135 Theranos Inc., Form D, *supra* note 96.

136 CARREYROU, *supra* note 8, at 15-16, 176-78.

137 Christine Hanley, James Thompson & Jim Kramer, *It's Hunting Season. For Unicorns? Lawsuit Against Theranos Signals Trend in Investors Going After Late-Stage Start-Ups*, ORRICK BLOGS (Oct. 20, 2016), https://blogs.orrick.com/securities-litigation/2016/10/20/its-hunting-season-for-unicorns-lawsuit-against-theranos-signals-trend-in-investors-going-after-late-stage-start-ups/ [https://perma.cc/BKK8-45MW].

138 Complaint at 2, SEC v. Mattes, No. 5:19-cv-01689 (N.D. Cal. Apr. 2, 2019).

139 *Id.* at 1-2.

140 *Id.* at 8-9.

141 *SEC Charges Former CEO of Silicon Valley Startup with Defrauding Investors*, SEC (Apr. 2, 2019), https://www.sec.gov/news/press-release/2019-50 [https://perma.cc/9823-5T8V] [hereinafter *SEC Charges Former CEO*].

142 *Id.*

has since returned to Austria, where he is a judge on *2 Minuten 2 Millonen*, the Austrian version of Shark Tank.[143]

The SEC also charged Jumio's CFO with securities fraud.[144] As with Zenefits, the SEC brought administrative proceedings and alleged only § 17(a) (non-scienter) violations.[145] Although in a settlement the CFO agreed to disgorge $450,000 dollars, the SEC did not impose a civil penalty "based on [the CFO's] agreement to cooperate in a related enforcement action."[146]

Two aspects are key here. First that the SEC intervened with a securities fraud action on behalf of employees. These were small investors and may lack informational advantages, perhaps triggering an investor-protection rationale akin to that applicable to retail investors.[147] In some ways, employee-investors may even warrant more protection than ordinary retail investors given their lack of diversification.[148]

Second, the action concerned sales in the *private* secondary market.[149] Some private companies, including those that pay employees in stock, have developed a secondary private market to provide liquidity.[150] Jumio is one example. It was a private company, whose shares were not traded on an exchange. However, Mattes "made arrangements for the employees to sell their Jumio shares through a broker that specialized in private, secondary market transactions (that is, sales of shares from one investor to another, rather than from an issuer to an investor)."[151] The SEC again intervened in the context of a "public-like" private

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143 DANIEL MATTES, https://danielmattes.com/ (last visited Aug. 31, 2019) [https://perma.cc/5U7F-MTDP] (describing Mattes as an "Entrepreneur [sic], Speaker, Author, [and] Visionary").

144 *SEC Charges Former CEO*, *supra* note 141.

145 Chad Starkey, Securities Act of 1933 Release No. 10626, 2019 WL 1452705 (Apr. 2, 2019) (instituting cease and desist proceedings).

146 *Id.* at *7.

147 Not all employees may be in the same position, with early employees having access to relevant information though their employment while later employees do not. *See* Abraham J.B. Cable, *Fool's Gold? Equity Compensation & the Mature Startup*, 11 VA. L. & BUS. REV. 615, 636-37 (2017).

148 *See* Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867, 873 & n.21 (noting that startup employees usually have a large proportion of their wealth concentrated in a single, employer company).

149 *SEC Charges Former CEO*, *supra* note 141.

150 *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 21 (2012); Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 180 (2012) ("Shares in private companies, previously regarded as an illiquid, out-of-reach asset class, are being traded on websites resembling stock markets.").

151 Complaint at 6, SEC v. Mattes, No. 5:19-cv-01689 (N.D. Cal. Apr. 2, 2019).

company, but this time the relevant characteristic was that it had an active secondary market.

Although private secondary markets are relatively new, the SEC's attention to employee-investors is not. Useful context for Jumio is the SEC's 2011 action against Stiefel Labs. This privately held company produced medicinal soap, including over the years Boracic Acid soap, Freckle soap, Oilatum, Zeasorb, and other anti-wart and anti-acne formulations.[152] Throughout its history — in fact until the events that drew the SEC's attention in the early 2000s — the business was privately held and family-run, with the Stiefel family the controlling shareholder.[153]

Starting in the 1970s, company shares were distributed to employees.[154] In a letter to employees from the 1990s, the Stiefel family members then in charge listed this as the first of the company's guiding principles: "We remain a private company. No one on Wall Street tells us what to do."[155] Despite these assurances, in 2009, GlaxoSmithKline acquired Stiefel as a wholly owned subsidiary. GlaxoSmithKline was a UK publicly traded company.[156]

In the run-up to this merger, Stiefel Labs and its chairman and CEO bought shares from employees at a discounted price. The company and its CEO allegedly knew information relevant to valuing these shares. The selling employees did not. The SEC sued the private company and its CEO for securities fraud, alleging violations of 10(b) and 10b-5[157] —

[152] STIEFEL, https://www.stiefel.com/ (last visited Sept. 2, 2020) [https://perma.cc/M8MY-E4VY].

[153] Complaint at 4-5, SEC v. Stiefel Labs. Inc., No. 1:11-cv-24438 (S.D. Fla. Dec. 12, 2011) [hereinafter Complaint, Stiefel Labs].

[154] *Id.* at 5.

[155] Plaintiff's Statement of Undisputed Material Facts, SEC v. Stiefel Labs. Inc., No. 1:11-cv-24438 (S.D. Fla. June 13, 2016), Part 67: Exhibit 412 (Letter from Werner K. Stiefel to "my Friends, Co-Workers and Fellow Owners") (Oct. 2, 1995).

[156] GlaxoSmithKline PLC, Report of Foreign Issuer (Form 6-K) (Oct. 28, 2009); *GlaxoSmithKline PLC*, COMPANIES HOUSE, https://beta.companieshouse.gov.uk/company/03888792 (last visited Sept. 7, 2020) [https://perma.cc/X7FZ-29SM].

[157] Complaint, Stiefel Labs, *supra* note 153, at 19-20. The case was reportedly settled in June 2020 with a multi-million-dollar payment to investors. Investors to Receive $37 Million from SEC Settlement with Stiefel Laboratories and Charles Stiefel., SEC Litigation Release No. 24828, 2020 WL 3034612 (June 5, 2020) ("The Securities and Exchange Commission today announced that it has obtained final judgments that will require a former privately held dermatology products manufacturer and its former chairman and CEO to pay $37 million for the benefit of shareholders whom they defrauded through share buybacks that were improperly undervalued.").

essentially insider trading.[158] As with Jumio, the fraud was of employees who were also investors.

Notably, the SEC's public commentary about the case at the time it was filed presaged the Silicon Valley Initiative. In its press release, the director of the SEC's regional office warned: "Private companies and their officers must understand that they are not immune from the federal securities laws, which protect all shareholders regardless of whether they bought stock in the open market or earned shares through a company's stock plan."[159] And the law firms followed up with warnings of SEC attention to private firms and their officers.[160]

*d. Lucent Polymers*

Lucent Polymers promised "garbage to gold" — a promise its officers knew it could not deliver.[161] The SEC's complaint described the scheme as "simple."[162] The CEO and COO of this private company "aimed to sell the company — including their own substantial equity stake — while hiding from potential buyers the fact that Lucent's core business model was a sham."[163] They (temporarily) succeeded, selling the company twice and making millions between them.[164]

The SEC brought an enforcement action against Lucent Polymer's CEO and COO in 2019.[165] Several private companies were "related parties."[166] Lucent Polymers, Inc., the Matrixx Group, Inc., and Citadel Plastics Holdings, LLC were interrelated "privately held plastics

158 *See* Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693, 1696 n.18 (2020).

159 *SEC Charges GlaxoSmithKline Subsidiary and Former CEO with Defrauding Employees in Stock Plan*, SEC (Dec. 12, 2011), https://www.sec.gov/news/press/2011/2011-261.htm [https://perma.cc/G3GX-3HLR].

160 *See* Molk, *supra* note 158, at 1696 n.18 (citing WINSTON & STRAWN LLP, SEC RENEWS FOCUS ON INSIDER TRADING IN PRIVATE COMPANY STOCK (2011), https://www.winston.com/images/content/1/0/1052.pdf [https://perma.cc/3G5P-HBUM]).

161 *See supra* notes 1–7 and accompanying text.

162 Complaint, Kuhnash, *supra* note 1, at 1.

163 *Id.*; *see also Former Executives of Evansville Plastics Company Indicted*, U.S. DEP'T OF JUSTICE (Feb, 12. 2019), https://www.justice.gov/usao-sdin/pr/former-executives-evansville-plastics-company-indicted [https://perma.cc/DCL2-UGQW] (announcing criminal indictment of the Lucent Polymers CEO and COO who "filled their pockets through fraud and numerous acts of deceit").

164 Complaint, Kuhnash, *supra* note 1, at 3.

165 *See* SEC Charges Former Executives of Plastics Manufacturer with Fraud, SEC Litigation Release No. 24397, 2019 WL 554227 (Feb. 12, 2019).

166 Complaint, Kuhnash, *supra* note 1, at 5-6.

manufacturing compan[ies]."[167] The SEC pursued officers but did not pursue any companies. The original private company had been acquired twice, including by a publicly traded plastics manufacturer.[168]

The SEC alleged that the corporate officers of Lucent Polymer violated 10(b)/10b-5 and 17(a).[169] The enforcement action thus provides an example of the SEC's enforcement of anti-fraud provisions against the officers of private companies. Perhaps most distinctive is the reminder that corporate groups can include both private and public business entities, further complicating the "private" company category.

2. Private Company Fraud that Impacts Public Market Integrity

The SEC has also brought enforcement actions against private companies that engage in fraud with implications for the IPO process or other parts of the public offering process. Private companies have used the false promise of upcoming IPOs to defraud potential investors. The concern is the impact of the fraud — making investors less trusting of the IPO process and using the formal signaling of the SEC-apparatus as a means of fraud.[170]

The SEC has periodically issued warnings to investors about a particular type of scam that promises participation in an IPO. A 2005 SEC Investor publication warned investors about *Risky Business: "Pre-IPO" Investing*.[171] (The scare quotes are in the original.) The SEC warned that "[m]any companies and stock promoters entice investors by promising an opportunity to make high returns by investing in a start-up enterprise at the ground floor level."[172] Part of the pitch was that the

[167] *Id.*

[168] *Id.* at 6, 19.

[169] *Id.* at 23-24.

[170] *Cf.* Complaint at 3, SEC v. Blockvest, LLC, No. 3:18-cv-002287 (S.D. Cal. Oct. 3, 2018) (noting the company lied to investors and perpetuated a fraudulent scheme in violation of the Securities Act); Blockvest, LLC, Litigation Release No. 24314, 2018 WL 4951800 (Oct. 11, 2018) (reporting enforcement action against a company that "promoted the ICO with a fake agency [they] created called the 'Blockchain Exchange Commission,' using a graphic similar to the SEC's seal and the same address as SEC headquarters").

[171] *Risky Business: "Pre-IPO" Investing*, SEC (Jan. 11, 2005), https://www.sec.gov/reportspubs/investor-publications/investorpubspreipohtm.html [https://perma.cc/3YFS-QSU6] ("'Pre-IPO' investing involves buying a stake in a company before the company makes its initial public offering of securities.").

[172] *Id.*

company would go public (that the company was "pre-IPO").[173] A version of this investor alert was re-issued in 2011 and 2012.[174]

A 2001 example was Prexomet Inc., a private Rhode Island company. Its founder and other officers indicated that the company owned an Arizona mine, and promised investors that the company soon would go public, resulting in returns of 500%.[175] The mine did not exist, the IPO did not happen, Prexomet dissolved, and its founder fled to Europe as soon as the SEC's securities fraud investigation began.[176]

The SEC investor warning pointed out that "companies and stock promoters" both "entice investors." As this suggests, some "pre-IPO" promises are not private company fraud. Industry professionals may also use the promise of future IPOs to sell investors somebody else's stock[177] or fraudulently sell IPO shares they simply do not have.[178] But others, like Prexomet, are companies that are and remain private, and

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[173] *See id.*

[174] *Investor Alert: Pre-IPO Investment Scams (Updated)*, SEC (Apr. 1, 2012), https://www.sec.gov/investor/alerts/pre_ipo_scams.htm [https://perma.cc/7FFQ-YVDW]; *Investor Alert: Pre-IPO Investment Scams*, SEC (Mar. 18, 2011), https://www.sec.gov/investor/alerts/pre-ipo.htm [https://perma.cc/C4UZ-7F4P]; *see also Pre-IPO Offerings — These Scammers Are Not Your Friends*, FINRA, https://www.finra.org/investors/alerts/pre-ipo-offerings-these-scammers-are-not-your-friends (last updated March 15, 2011) [https://perma.cc/9J4D-NTFJ].

[175] SEC Charges Four Individuals in IPO Offering Fraud, SEC Litigation Release No. 17080, 75 SEC Docket 1234, 2001 WL 862856 (July 30, 2001).

[176] *Id.*; *see also* New World Web Vision.com, Inc., SEC Litigation Release No. 17442, 77 SEC Docket 701, 2002 WL 461357 (Mar. 27, 2002) (settling SEC securities fraud allegations in the early 2000s that they had "offered and sold 'pre-IPO shares' at $.60 per share, and fraudulently told investors that their shares would be worth $16-$17 per share when the companies went public").

[177] *See, e.g.*, Complaint at 1-2, SEC v. Shehyn, No. 04-cv-02003 (S.D.N.Y. Mar. 15, 2004) (stating the defendant's "made fraudulent statements concerning the value of these securities and none of the companies that issued the stock have had an IPO"); SEC Sues Four Individuals Behind Millennium Financial, Ltd., a $20 Million Fraudulent Boiler Room Operation, SEC Litigation Release No. 18624A, 82 SEC Docket 1683, 2004 WL 542855 (Mar. 18, 2004) (stating boiler room salespeople pushed "so-called 'pre-initial public offering' securities of small U.S. companies" using "high pressure sales tactics and ma[king] a number of fraudulent statements concerning the value of these securities" whereas "[n]one of the companies which issued these securities have had an IPO, and Millennium's investors have typically lost most, if not all, of their investment").

[178] *See, e.g.*, SEC v. Milan Capital Group, Inc., No. 00 Civ. 108, 2000 WL 1682761, at *1 (S.D.N.Y. Nov. 9, 2000) (stating the company "lacked access to and did not obtain any IPO shares for these investors"); SEC Obtains Summary Judgment Against Three Defendants in Case Involving $9 Million IPO Stock Fraud, SEC Litigation Release No. 16802, 73 SEC Docket 1876, 2000 WL 1708383 (Nov. 16, 2000) (stating "Milan did not have access to IPOs, and never provided investors with any IPO shares").

that use the empty promise of going public to sell their own securities to hopeful investors.[179] A type, in other words, of private company fraud.

3. Private Companies that Failed to Register Securities

The SEC's attention to startups and unicorns is key to the argument that as private companies increasingly have "public-like" features, the SEC may need to step in to protect investors and to promote capital formation. But another more mundane category of enforcement action provides a reminder that the reach of the securities fraud provisions to private companies plays a role in classic fraud cases as well.

The reach of the securities fraud provisions is treated as uncontroversial in part because of the clear statutory and rule language,[180] but the examples given here also demonstrate a relatively routine intervention of the SEC into the world of private companies. This category includes private companies with securities that should have been registered. It also includes (sometimes within the same action) frauds that involve the use of both private and public companies, often controlled by the same individual(s).

One could quibble about whether these should count as private company fraud, given that they involve what should have been public offerings registered with the SEC. Regardless of their categorization, however, they provide an example of the need for information about private companies in the absence of disclosure and market price. They are also a clear example of securities fraud allegations brought by the SEC against private companies.

*a. BOG, Crude, Patriot, and the "Frack Master"*

Chris Faulkner's oil and gas industry experience was rather indirect: he worked for a website data hosting company that had oil and gas companies as clients.[181] Nonetheless, he ultimately spent a decade appearing on television as a Texas oil man, seen in some news segments

[179] *See, e.g.*, Complaint at 22, SEC v. Giga Entm't Media, Inc, No. 18-cv-06511 (E.D.N.Y. Nov. 15, 2018) ("Almost since the inception of Giga, its management has promised its investors that the company would go public . . . . In fact, as Giga and Nerlinger knew or should have known, at this time, the company was not even close to being ready to file for an IPO.").

[180] *See supra* Part II.A.

[181] Complaint at 3, SEC v. Faulkner, No. 16-cv-01735 (N.D. Tex. June 24, 2016) [hereinafter Complaint, Faulkner].

with his Texas flag pin and pocket handkerchief.[182] He got his sticky nickname — the "Frack Master" — from the publication OIL & GAS MONITOR, where he also wrote advice about cautious oil and gas investing, including in a piece titled "Oil and Gas Best Kept Secrets: Secrets of Oil and Gas Investments for the Average Individual."[183]

Cautious investors would have avoided what Faulkner was selling: investments in "'turnkey' oil and gas working interests."[184] In some ways the fraud was straightforward. Faulkner simply used investor money for personal expenses. He allegedly called one credit card his "whore card"; he and an associate used company credit cards for "gentlemen's club expenses, including nearly $40,000 in charges at a Dallas gentlemen's club over a four-day period."[185]

Putting aside the details of what the SEC called Faulkner's "lifestyle of decadence and debauchery,"[186] one of the key points for understanding private company fraud more generally is that Faulkner used a mix of entities he controlled for the fraud. They included three private entities: Breitling Oil & Gas Corporation ("BOG"), Crude Energy, LLC ("Crude"), and Patriot Energy, Inc. ("Patriot").[187] The entities he controlled and used also included a publicly traded company, Breitling Energy Corporation (ticker: BECC).

In 2016, the SEC brought an enforcement action against Faulkner, seven other individuals, the publicly traded company and the three private companies controlled by Faulkner. Securities fraud was certainly one allegation, but the list of violations was long, and included claims that some of the investments should have been registered.[188] Notably, among the allegations were 17(a) and 10(b)/10b-5 securities

[182] Dalton LaFerney, *The Rise and Fall of the 'Frack Master:' How a Dallas Tech CEO Became an Expert on Hydraulic Fracturing to a Global Audience*, DALL. MORNING NEWS (Aug. 26, 2016), http://interactives.dallasnews.com/2016/frack-master/ [https://perma.cc/Z623-MRVB]; VARNEYCO, *Breitling Energy CEO Chris Faulkner on Dropping Oil Prices*, YOUTUBE (Dec. 11, 2014), https://youtu.be/-8_UtOmIVZU [https://perma.cc/F59X-78Z5].

[183] LaFerney, *supra* note 182.

[184] SEC v. Chris Faulkner, SEC Litigation Release No. 23582, 2016 WL 9086342 (June 24, 2016).

[185] Complaint, Faulkner, *supra* note 181, at 35.

[186] *Id.* at 2.

[187] *Id.* at 13-14. BOG was an LLC originally organized in Oklahoma, Crude was a Nevada LLC with its principal place of business in Dallas, Texas, and Patriot Energy, Inc., was a North Dakota corporation. None of the business entities or their securities were registered with the SEC. *Id.*

[188] *Id.* at 10, 53.

fraud allegations against BOG, Crude, and Patriot — the private companies.[189]

*b. Fyre Media*

The 2017 Fyre Festival was a fiasco. Its Wikipedia page describes it simply as "a fraudulent luxury music festival."[190] Articles called it a "debacle that became a national punchline."[191] Private lawsuits by festival goers said it was "closer to . . . 'Lord of the Flies' than Coachella."[192] Documentaries soon followed: "Fyre Fraud" and "Fyre: The Greatest Party That Never Happened."[193] Photos and footage show disaster relief tents and pigs in swimming pools.[194] Ja Rule even released a track, reportedly "inspired by the rapper's role in the disastrous Fyre Festival."[195] Cover artwork was a drawing of the "viral cheese sandwich" — the photo of sad pre-sliced cheese on bread that was a viral visual contradiction of the festival's claim to luxury.[196]

The SEC described the Fyre Festival as securities fraud. In 2018, it sued William Z. ("Billy") McFarland, a few other individuals, and the companies McFarland controlled for inducing investors to invest more

[189] *Id.* at 48-50.

[190] *Fyre Festival*, WIKIPEDIA, https://en.wikipedia.org/wiki/Fyre_Festival (last visited Jan. 15, 2020) [https://perma.cc/9XXC-W8BT].

[191] Gabrielle Bluestone, *Fyre Festival's 25-Year-Old Organizer: "This Is the Worst Day of My Life,"* VICE (Apr. 28, 2017, 5:15 PM), https://www.vice.com/en_ca/article/qvz5m3/fyre-festivals-25-year-old-organizer-this-is-the-worst-day-of-my-life [https://perma.cc/65AG-7UWA].

[192] Complaint at 2, Jung v. McFarland, No. 2:17-cv-03245 (C.D. Cal. Apr. 30, 2017) [hereinafter Complaint, Jung v. McFarland].

[193] Melinda Newman, *Hulu Debuts Fyre Festival Doc Days Before Rival Netflix Project*, HOLLYWOOD REPORTER (Jan. 14, 2019, 8:00 AM PST), https://www.hollywoodreporter.com/news/hulu-debuts-fyre-festival-doc-days-before-rival-netflix-project-1175778 [https://perma.cc/6YKT-P3R3]; Netflix, *FYRE: The Greatest Party That Never Happened*, YOUTUBE (Jan. 10, 2019), https://youtu.be/uZ0KNVU2fV0 [https://perma.cc/Q58N-KTZM] ("He was lying to investors and making it seem we were making a ton of money, but we weren't." at 1:03).

[194] *E.g.*, Complaint, Jung v. McFarland, *supra* note 192, at 8 (showing Federal Emergency Management Agency ("FEMA") disaster tents that housed festival attendees); *id.* at 9 (showing photo of pig in pool and noting that "[i]n addition to the substandard accommodations, wild animals were seen in and around the festival grounds").

[195] Ilana Kaplan, *Hear Ja Rule's New Fyre Festival-Inspired Song 'FYRE,'* ROLLING STONE (Dec. 14, 2019, 1:48 PM ET), https://www.rollingstone.com/music/music-news/ja-rule-fyre-festival-song-927211/#! [https://perma.cc/3M5V-DQTS]. Some of the lyrics: "Hotter than the sun, but it wasn't that/Show of hands if you got your money back?/Just playing, I got sued for that/100 mil to be exact." *Id.*

[196] *Id.*

than $24 million in Fyre Media and Fyre Festival.[197] McFarland and Fyre Media allegedly:

> Made false statements concerning key Fyre Media and Fyre Festival financial metrics and assets; Falsified financial data; Made false claims of affiliations with talent; Created a fraudulent brokerage statement . . . ; Made false statements and created a fake document concerning purported bank loans and a purported significant pending investment in Fyre Media; Claimed, falsely, that he would obtain event cancellation insurance for Fyre Festival; and Engaged in a scheme to create the illusion that Magnises was being acquired by a third party that did not exist.[198]

Fyre Media and Magnises, Inc. were both privately held corporations.[199] The SEC alleged securities fraud under 10(b)/10b-5 and 17(a), as well as violations of registration requirements.[200] The SEC's Fyre Festival action was, in other words, an example of the SEC's pursuit of securities fraud by private companies, albeit in a context where some aspects should have been pulled into the public information system through securities registration.[201]

* * * * *

The two examples explored above, involving Fyre Festival and the "Frack Master," are simply colorful examples of a more expansive category of the SEC's securities fraud actions against private companies

[197] Complaint at 1, SEC v. McFarland, No. 18-CV-6634 (S.D.N.Y. July 24, 2018) [hereinafter Complaint, SEC v. McFarland]; *SEC Charges Failed Fyre Festival Founder and Others with $27.4 Million Offering Fraud*, SEC (July 24, 2018), https://www.sec.gov/news/press-release/2018-141 [https://perma.cc/R5RN-T6HZ].

[198] Complaint, SEC v. McFarland, *supra* note 197, at 7.

[199] *Id.* at 5. The SEC further specified that Fyre Media Inc. had "never been registered with the Commission in any capacity, and [had] never registered any securities offering with the Commission." *Id.*

[200] *Id.* at 19-20; *id.* at 21 ("No registration statement was filed or in effect with the Commission pursuant to the Securities Act with respect to the securities and transactions issued by Fyre Media and Fyre Festival described in this Complaint, and no exemption from registration — including the Rule 3a4-1 safe harbor — applies with respect to these securities and transactions.").

[201] McFarland and the companies ultimately settled with the SEC. They agreed to disgorgement that was offset by the amount given up in the parallel criminal action. The settlement did not require a civil penalty, given that the main actor went to jail. Final Judgment at 5-6, SEC v. McFarland, No. 18-CV-6634 (S.D.N.Y. Aug. 1, 2018).

that should have registered securities in the public system.[202] It is also an illustration of the need for anti-fraud tools that can address both private and public companies in order to reach this type of classic fraud in the context of a public/private mix.

4. Companies in Transition

Unlike the categories above, in which the SEC must rely on information other than a company's filings and communications with the agency, companies in transition often have more interaction with the agency. For these companies, the SEC has an inflection point at the moment of transition between public and private (or vice versa).

This section provides examples of SEC actions against companies in transition. It starts with companies that the SEC pursued for securities fraud that allegedly occurred when the company tried to go *public* through the IPO process. It then turns to enforcement actions against companies when they tried to go *private*.

*a. Going Public*

SEC securities fraud actions against private companies have taken place while the company is in transition from private to public, in the course of an IPO. This setting differs from the companies above because the IPO process itself generates information, some of which is in the form of public filings.[203]

A high-profile example is the reported SEC action against WeWork and its parent company The We Company.[204] The company's publicly available S-1 registration statement contained red flags such as the

[202] Another example is Inofin, Inc. a Massachusetts company that had never been registered or had securities registered with the SEC. Complaint at 5, SEC v. Inofin, Inc., No. 11-cv-10633 (D. Mass. Apr. 14, 2011); SEC Charges Subprime Auto Loan Lender and Executives with Fraud, SEC Litigation Release No. 21929, 100 SEC Docket 3259, 2011 WL 1431178 (Apr. 14, 2011); *see also* SEC Halts Sham Real Estate Investment Offering Fraud, SEC Litigation Release No. 24316, 2018 WL 5013654 (Oct. 12, 2018); SEC v. Eric J. "EJ" Dalius, SEC Litigation Release No. 24345, 2018 WL 5881787 (Nov. 8, 2018); *SEC Charges Giga Entertainment Media, Former Officers and Directors with Fraud in Pay-For-Download Campaign*, SEC (Nov. 15, 2018), https://www.sec.gov/news/press-release/2018-263 [https://perma.cc/5RSE-V2DH].

[203] *See* STEPHEN J. CHOI & ADAM C. PRITCHARD, SECURITIES REGULATION 498-500 (5th ed. 2019).

[204] *See* Matt Robinson, Robert Schmidt & Ellen Huet, *WeWork Is Facing SEC Inquiry into Possible Rule Violations*, BLOOMBERG (Nov. 15, 2019, 8:46 AM PST), https://www.bloomberg.com/news/articles/2019-11-15/wework-is-said-to-face-sec-inquiry-into-possible-rule-violations [https://perma.cc/K5QG-UPY5].

founder's (attempted) sale of the "we" trademark back to the company for almost six million dollars.[205]

Mary Jo White highlighted another example of problems at a newly public company in her Silicon Valley Initiative speech.[206] She pointed to the cautionary tale of biopesticide company Marrone Bio Innovations, a newly public company that was the subject of an SEC enforcement action for misstating its financials.[207] It had promised distributors of agricultural products that they had a right to return the product, but inappropriately recognized anything sold to distributors as revenue anyway.[208] The SEC pursued securities fraud claims under 10(b)/10b-5 and 17(a).[209] Because the company was in transition, the SEC was able to bring charges based on the content of the company's mandatory disclosure documents.[210]

Other examples of SEC enforcement include situations where there has been fraud in the conduct of the IPO. These include roadshow fraud,[211] fraud in the closing,[212] and false IPO registration statements because of other misconduct.[213] Even where some or all of the conduct took place when the company was private, these examples are characterized by the availability of filed disclosure documents that make up part of the "going public" process.

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[205] The We Co., Registration Statement (Form S-1) 199 (Aug. 14, 2019).

[206] *See SEC Silicon Valley Initiative Speech*, *supra* note 20 ("[J]ust last month, the Commission brought charges against a company and a former executive for inflating financial results to meet projections that it would double revenues in its first year as a public company.").

[207] *Id.*

[208] Complaint at 1, SEC v. Marrone Bio Innovations, Inc., No. 16-cv-00321 (E.D. Cal. Feb. 17, 2016) [hereinafter Complaint, Marrone Bio]; *SEC Charges Biopesticide Company and Former Executive with Accounting Fraud*, SEC (Feb. 17, 2016), https://www.sec.gov/news/pressrelease/2016-32.html [https://perma.cc/D6LC-JPRW].

[209] Complaint, Marrone Bio, *supra* note 208, at 18.

[210] *See id.*

[211] *In re* Benjamin H. Gordon, Securities Act of 1933 Release No. 10651, 2019 WL 2552338, at 2 (June 20, 2019).

[212] *E.g.*, SEC v. Heaton, SEC Litigation Release No. 14241, 57 SEC Docket 1655, 1994 WL 527077 (Sept. 19, 1994) (discussing SEC anti-fraud action for fraudulent closing of IPO); SEC Court Enters Final Judgment Against Former Busybox General Counsel Jon M. Bloodworth For IPO Fraud Scheme, SEC Litigation Release No. 19609, 87 SEC Docket 1653, 2006 WL 655968 (Mar. 16, 2006) (same); SEC Sues Former Top Officers of Busybox.com for IPO Fraud, SEC Litigation Release No. 19284, 2005 WL 1505988 (June 24, 2005) (same).

[213] SEC v. Sachdeva, SEC Litigation Release No. 15596, 66 SEC Docket 312, 1997 WL 794477 (Dec. 18, 1997); Digital Display Advertising Firm, Executives Bilk More than $2 Million from Investors, SEC Litigation Release No. 24001, 118 SEC Docket 969, 2017 WL 6016880 (Dec. 4, 2017).

*b. Going Private*

Companies also transition from public to private and, in fact, in recent years have increasingly done so.[214] The SEC has brought actions against public companies for going-private transactions. Because of the nature of a going-private transaction, the allegations are usually that the company and its officers defrauded a sophisticated investor in a going-private transaction.[215]

One example of the SEC's securities fraud actions against companies as they go private is the SEC's enforcement action against the CEO and CFO of Constellation Healthcare Technologies, Inc., a (now-defunct) issuer in the medical-billing business.[216] The company had been traded on the London Stock Exchange's Alternative Investment Market, but company officers and directors arranged a going-private transaction with an investor described as the "family office of a high-net-worth individual."[217]

Constellation was a holding company set up to acquire healthcare billing companies. These billing companies, however, had been created by Constellation's officers, who allegedly also backdated descriptions, invented employees and customers, and provided fictionalized documentation.[218]

An inability to use PowerPoint may have been their downfall: one billing company was modeled closely on an existing Ohio company that an investment bank had previously pitched to Constellation (using a PowerPoint presentation).[219] Constellation's officers allegedly cut and pasted the business description, but could not get rid of the background

[214] *See supra* Part I.B.

[215] Matt Levine, *You Never Want to Be Suckered This Badly: Even with Due Diligence, Sophisticated Investors Still Get Hoodwinked by Fraudulent Businesses*, BLOOMBERG (May 17, 2018, 3:00 PM PDT), https://www.bloomberg.com/opinion/articles/2018-05-17/securities-fraud-can-happen-with-private-transactions [https://perma.cc/Y2M4-FS7S] (describing the SEC's action against the executives of Constellation Healthcare Technologies Inc., a public company, in a going-private transaction); *e.g.*, Complaint at 1-2, SEC v. Parmar, No. 18-cv-09284 (D.N.J. May 16, 2018) [hereinafter Complaint, Parmar] (alleging that executives of a public company committed securities fraud in a going-private transaction, in violation of section 17(a), section 10(b), and Rule 10b-5).

[216] Complaint, Parmar, *supra* note 215, at 4; *SEC Charges Three Former Healthcare Executives with Fraud*, SEC (May 16, 2018), https://www.sec.gov/news/press-release/2018-90 [https://perma.cc/WJ9W-ARTW] [hereinafter *SEC Charges Three*].

[217] Complaint, Parmar, *supra* note 215, at 1.

[218] *Id.* at 2.

[219] *Id.* at 11 ("The sham MDRX report essentially left the entire description of the Real Medical-Billing Business, including the company's organizational chart, untouched, but inflated the company's financials and simply changed the company's name to MDRX, an entirely fictitious entity.").

picture of the real company.[220] According to the SEC's complaint, the cutting and pasting led to questions from the investment banker familiar with the real company, and to terse internal emails that summed up the situation: "Not good" followed by "Oh f-."[221]

As with other securities fraud actions, the SEC alleged that these officers and directors violated section 17(a), section 10(b), and Rule 10b-5.[222] The SEC action was not the only consequence: the U.S. Attorney's Office of the District of New Jersey also filed criminal charges against the corporate officers and additional directors for conspiracy to commit securities fraud.[223]

The accompanying message from the SEC about pursuing the going-private transaction was consistent with its message about fraud in other private contexts: the setting would not immunize fraud. "Using phony balance sheets, doctored bank statements, and other fabrications to conceal the theft of investor monies, which we allege occurred in this case, will not go undetected or unpunished," said Marc P. Berger, Director of the SEC's New York Regional Office.[224] At least two targets were still fugitives as of the U.S. Attorney's press release. But message sent.[225]

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[220] *Id.* (quoting an email that forwarded the doctored description: "I am not able to remove the background image of [the Real Medical-Billing Business] in the presentation.")

[221] *Id.* at 12 (expletive omitted).

[222] *Id.* at 3.

[223] Indictment at 1, United States v. Parmar, No. 18-cr-00735 (D.N.J. Dec. 13, 2018); *Former CEO, CFO and Directors of Healthcare Services Company Indicted in Elaborate $300 Million Investment Fraud Scheme*, U.S. DEP'T JUST. U.S. ATTORNEY'S OFF. DISTRICT N.J. (Dec. 13, 2018), https://www.justice.gov/usao-nj/pr/former-ceo-cfo-and-directors-healthcare-services-company-indicted-elaborate-300-million [https://perma.cc/C798-XNYS].

[224] *SEC Charges Three*, *supra* note 216; *see also* Complaint, Parmar, *supra* note 215 at 1-2.

[225] Other examples exist. *See also Corporate Insiders Charged for Failing to Update Disclosures Involving "Going Private" Transactions*, SEC (Mar. 13, 2015), https://www.sec.gov/news/pressrelease/2015-47.html [https://perma.cc/Z7DA-GXYA] (announcing settlement of administrative actions against companies and individuals who failed to make mandatory disclosures about beneficial ownership in the context of taking International Lottery & Totalizator Systems, Inc. ("ILTS") private); *cf.* Omega Protein Corp., Release No. 33-10679, SEC Docket 4171263, 2019 WL 4171263 (Aug. 29, 2019) (describing an action against a private company for activity when it was public).

## III. ANTI-FRAUD-ONLY REGIME

To what extent does the diminishment of public companies disrupt the information available about the internal workings of these companies? This Part looks at what anti-fraud enforcement is able to do. It then analyzes the information that is lost in the move to private capital, particularly the loss of mandatory disclosure and the consequences of the absence of price information.

### *A. What Anti-Fraud Enforcement Can Do*

As with other enforcement activity, it is sometimes difficult to pinpoint an optimum level. One pattern to date is the use of high-profile statements and cases to send a signal to industry participants. The SEC was not left out in the Theranos or Fyre debacles. It followed the "Silicon Valley Initiative" by fining Zenefits in a move that was reported as unprecedented and representing an aggressive new SEC approach to unicorn startups.[226]

One mechanism that may amplify the effects of this smattering of SEC actions against private companies is their influence on Director and Officer ("D&O") insurance. This could lead to greater structural change, or at least increased attention by officers and directors in private companies. Companies buy D&O Insurance to cover legal claims against the company and directors and officers in their official roles. D&O insurance has developed separate products for private and public companies, and is sensitive to monitoring the litigation and enforcement risks faced by each category.[227] Industry commentators have increasingly tracked the SEC's approach to bringing enforcement actions against private companies, noting that the distinct package sold to private companies does not take this anti-fraud enforcement into account.[228] Given current low numbers of enforcement actions against some of the largest startups,[229] this practice may make sense, although the fact there is monitoring reinforces the idea that the landscape is shifting.

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[226] Alden, *The SEC Just Fined*, *supra* note 122.

[227] *See, e.g.*, ADVISEN, *supra* note 33 at 28-29 (describing the market for D&O insurance for private companies); LaCroix, *Executive Protection*, *supra* note 33 (noting that "the potential liability exposures and the available insurance solutions for private companies and their directors and officers are quite a bit different than for public companies").

[228] ADVISEN, *supra* note 33, at 28.

[229] *See supra* Chart 1.

As for the available information sources, ordinarily an SEC investigation begins with information about a potential violation from a variety of potential sources: "market surveillance activities, investor tips and complaints, other Divisions and Offices of the SEC, the self-regulatory organizations and other securities industry sources, and media reports."[230] The SEC has an active referral practice, including incoming from other agencies, units and entities.[231] It also has a formalized whistleblower program that provides protections and incentives for people to come forward with information about corporate fraud.[232] Some of these sources continue to be available even in the move to private capital, notably investor and insider tips as well as media reports (though the lack of mandatory disclosure may affect these as well).

### *B. The New Low-Information Regime*

Two key sources of information are missing for private companies: mandatory disclosure and price. The consequences for anti-fraud enforcement are addressed below.

#### 1. Loss of Public Company Disclosure

U.S. securities regulation is built around mandatory disclosure for public offerings and for public companies (Exchange Act Reporting Companies). This extensive and varied disclosure[233] is a key information source for investors. The public filings are the locus of some of a company's statements and misstatements, and also provide

[230] *How Investigations Work*, SEC (Jan. 27, 2017), https://www.sec.gov/enforce/how-investigations-work.html [https://perma.cc/9V4R-VLZR]. *See generally* KIRKPATRICK & LOCKHART PRESTON GATES ELLIS LLP, THE SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES (Michael J. Missal & Richard M. Phillips eds., 2d ed. 2007) [hereinafter ENFORCEMENT MANUAL] (discussing SEC enforcement investigations); SEC, ENFORCEMENT MANUAL 82-95 (2017) (same).

[231] Verity Winship, *Enforcement Networks*, 37 YALE J. ON REG. 274, 329 (2020); *see* SEC, ENFORCEMENT MANUAL, *supra* note 230, at 82-95.

[232] *Office of the Whistleblower*, SEC, https://www.sec.gov/whistleblower (last visited Sept. 20, 2020) [https://perma.cc/ZHK8-LLYP]; *see infra* Part IV.

[233] *See, e.g.*, SEC Regulation S-X, 17 C.F.R. § 210.1 (2020) (setting forth the disclosure requirements for financial statement information); SEC Regulation S-K, 17 C.F.R. § 229.10 (2020) (setting forth the disclosure requirements for non-financial statement information).

information that can be the basis for anti-fraud actions. Classic examples include Merck and Enron.[234]

Mandatory disclosures also sometimes provide additional grounds for liability. For example, corporate officers and directors must certify the accuracy of certain filings, providing an additional source of potential liability for these actors.[235]

Extensive public disclosure must be contrasted to the sparse information about private companies. Investors in private companies have a right to some information by contract or by the rules governing exemptions from securities registration.[236] And venture capital investors generally expect information rights and build them into an investors' rights agreement.[237]

However, other investors lack these rights, including employees and other minority shareholders.[238] Employees rely on the information mandated by the SEC's Rule 701.[239] However, related disclosures are limited and imperfectly aligned with what is useful to employees in this context.[240]

Moreover, even sophisticated investors may get limited information. For example, pre-IPO Uber reportedly stripped investors of information rights.[241] The governance dynamics within the startup may also limit the ability of private investors to get information.[242]

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[234] *See, e.g.*, Complaint at 5, SEC v. Fastow, No. H-02-3666 (S.D. Tex. Oct. 2, 2002) (making claims based on misrepresentations in the publicly available financial statements); Barbara Martinez, *Merck Books Co-Payments to Pharmacies as Revenue*, WALL ST. J., (June 21, 2002, 12:45 PM ET), https://www.wsj.com/articles/SB1024612521141814600 [https://perma.cc/FNW2-538D] (basing reporting on Merck's own mandatory disclosures).

[235] *See* 17 C.F.R. § 240.13a-14 (2020).

[236] *See* Fan, *supra* note 75, at 585.

[237] *Id.*

[238] *Id.* (noting that stockholders and interested parties other than venture capital investors "typically do not have rights to such information. In particular, minority investors and other stockholders, such as employees or former employees who have exercised stock options, have limited or no rights to obtain financial information and other information relevant to making an investment decision").

[239] *See* U.S. Sec. and Exch. Comm'n Rule 701, 17 C.F.R. § 230.701 (2020) (Exemption for Offers and Sales of Securities Pursuant to Certain Compensatory Benefit Plans and Contracts Relating to Compensation).

[240] Anat Alon-Beck, *Unicorn Stock Options — Golden Goose Or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107, 183 (advocating new mandatory disclosure aimed at employees); Aran, *supra* note 148, at 873, 954-55 (arguing for disclosure to employees targeted at valuation).

[241] ISAAC, *supra* note 54, at 96 (noting that Uber stripped some private investors of information rights).

[242] Pollman, *Startup Governance*, *supra* note 103, at 160.

Minimal information is publicly available about private U.S. companies. The forms for private placements are filed with the SEC, but contain limited information. The Form D that Theranos filed in July 2010 provides an example.[243] The six-page document indicates that Theranos was incorporated in Delaware "Over Five Years Ago" and had once been called "RealTime Cures, Inc." It includes the address, corporate role and identity of Elizabeth Holmes and other directors, and identifies Theranos as a company within the biotechnology industry. In response to a section on "Issuer Size" that referred to revenue range, the company checked the box labelled "Decline to Disclose." Other than that, information in the Form D is limited to the claimed exemption from a public offering, types of securities, and offering or sale amounts ($100 million).

One might cobble together information from Form D and the state-law articles or certificate of incorporation, which is publicly available from the state of incorporation.[244] However, both of these documents provide very little detail.

The decrease in mandatory disclosure affects the intended beneficiary: investors. But disclosure also has a much broader audience, including regulators, investigative journalists, and others. If the lack of mandatory disclosure affects the media as well, it may in turn limit information available for anti-fraud actions, given the SEC's reliance at times on media reports as an information source.[245] The consequences are thus broadly felt; the loss of disclosure has a ripple effect.

### 2. No Market, No Price

Private companies are missing the pricing and information function of an efficient market. The assumption that price reflects public information underlies both economic theories and securities regulation. SEC Chair Jay Clayton summed it up this way: "public company stock prices . . . reflect not only publicly reported information but also the

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[243] Theranos Inc., Form D, *supra* note 96.

[244] Fan does this for five unicorns in *Regulating Unicorns: Disclosure and the New Private Economy*, but notes the "dearth of information." Fan, *supra* note 75, at 611-37.

[245] *See How Investigations Work*, *supra* note 230; *see also* Connie Loizos, *The SEC Has Never Been Busier Investigating Both Private and Public Companies in the Bay Area, Suggests Agency Head*, TECHCRUNCH (Sept. 6, 2018, 12:50 PM PDT), https://techcrunch.com/2018/09/06/the-sec-has-never-been-busier-investigating-both-private-and-public-companies-in-the-bay-area-suggests-agency-head/ [https://perma.cc/27BE-379L] (noting that the SEC San Francisco enforcement head "talked about how much of the agency's tips come through media accounts (the WSJ famously blew the covers off what had gone so wrong at Theranos)").

views of professional investors," benefitting, in his view, "Main Street investors."[246]

Lack of price has consequences for securities enforcement. The SEC has described its own investigations as sometimes triggered by information about a potential violation from "market surveillance activities," and have pointed to the role of trading data and brokerage records in factual development.[247] Increasing attention is being paid to the growth of *private* securities markets, and some of the SEC enforcement actions described above involved shares sold in such a market.[248] Nonetheless, market surveillance tools and other tracking of market price is generally absent in the private context.[249]

Finally, one of the consequences is the loss of any information generated by short selling. Short sellers have a built-in incentive not only to discover negative information about a company, but also to make the information public so that the short seller can benefit from a resulting decline in stock price.[250] This incentive relies on the existence of a share price and the ability of the price to reflect available information — neither of which is available in the context of the private company.

### 3. No Securities Class Actions

In the U.S. system, private and public enforcement of securities laws go hand in hand. But the move to private capital, even in the large companies with dispersed and retail shareholders that are of most regulatory concern, limits the ability of investors to bring anti-fraud suits as a class.

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[246] Clayton, *Testimony*, *supra* note 67.

[247] *How Investigations Work*, *supra* note 230. *See generally* KIRKPATRICK & LOCKHART PRESTON GATES ELLIS LLP, ENFORCEMENT MANUAL *supra* note 230 (discussing SEC enforcement investigations); SEC, ENFORCEMENT MANUAL *supra* note 230, at 82-95 (same).

[248] *See supra* notes 138–42 and accompanying text (describing the SEC's action against Jumio's officers).

[249] *See generally* Todd Ehret, *SEC's Advanced Data Analytics Helps Detect Even the Smallest Illicit Market Activity*, REUTERS (June 30, 2017, 10:11 AM), https://www.reuters.com/article/bc-finreg-data-analytics/secs-advanced-data-analytics-helps-detect-even-the-smallest-illicit-market-activity-idUSKBN19L28C [https://perma.cc/3W8K-DG6J] (describing the use of data analytics to surveil the stock market for insider trading).

[250] Barbara A. Bliss, Peter Molk & Frank Partnoy, *Negative Activism*, 97 WASH. U. L. REV. 1333, 1379 (2020) (defining "informational negative activism" and describing how it "decreases stock prices by revealing *bad* information about a company").

The information benefits from private securities litigation are deeply contested, as are the benefits of shareholder litigation overall. The hampering of private litigation may be a feature of growing privatization for some observers. Or it may be part of the explanatory story for the decline of public companies; reducing litigation risk may be part of the motivation to go or stay private.[251] For the purposes of this Article, however, the main point is simply that the market shift curtails this category of litigation and reduces the information — if any — that it generates.

Securities class actions that enforce federal anti-fraud provisions are very difficult in the private company context. One practical effect is that stock-drop suits are not possible (perhaps for the best). Despite the development of some private secondary trading markets, there is no equivalent to a publicly visible fall in price. Information must emerge through other means.

The absence of price information in an efficient market affects the availability of securities class actions, the key category of securities litigation. One element of a private plaintiff's claim for a misrepresentation or omission is that the investor relied on the statement/omission.[252] If each plaintiff had to show reliance, a class action would be impossible because the facts would be too particular and various to satisfy the requirements for certifying a class.[253]

The "fraud on the market" presumption enables securities class actions by requiring only reliance on the price, which is assumed to impound public information, including the misrepresentation/ omission.[254] An important prerequisite is that the securities be traded in an efficient market.[255] Which brings us back to one reason that anti-fraud class actions are more difficult — perhaps near impossible — in the context of a private company. These are not traded in an efficient

[251] Eric L. Talley, *Public Ownership, Firm Governance, and Litigation Risk*, 76. U. CHI. L. REV. 335, 336 (noting the litigation risk rationale for going private).

[252] Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258, 263 (2014).

[253] FED. R. CIV. P. 23 (requiring commonality); *see Halliburton*, 573 U.S. at 266 (noting that if the "fraud on the market" presumption of reliance were overruled, each securities fraud plaintiff would be required "to prove that he actually relied on the defendant's misrepresentation in deciding to buy or sell a company's stock").

[254] Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988).

[255] *Halliburton*, 573 U.S. at 268 ("[A] plaintiff must make the following showings to demonstrate that the presumption of reliance applies in a given case: (1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed.").

market, so each plaintiff should have to show reliance, preventing them from suing as a class.[256]

The fate of a putative shareholder class action against Theranos is illustrative. Theranos was sued in federal court for alleged securities fraud under California law.[257] In denying class certification, the federal court concluded:

> Rather than purchasing stocks traded at high weekly volumes in well-established, fluid markets monitored by market makers and arbitrageurs, Plaintiffs were private investors using private channels to purchase Theranos shares in discrete offerings. Thus, the Court firmly agrees with Defendants that the fraud-on-the-market presumption of reliance cannot apply here, because Theranos securities were not sold in an efficient market.[258]

The absence of an efficient market thus limits securities class actions. However, it is not to say that there are no investor actions at all against private companies.[259] Investor class actions might be based on state law with a different reliance requirement or a different legal theory.[260] And the difficulties in getting a class certified do not affect individual (or small-group) investor suits, regardless of whether they allege violations of the federal securities statutes or other laws.

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[256] Kevin LaCroix, *Though a Private Company, Uber Hit with Securities Class Action Lawsuit*, D&O DIARY (Sept. 26, 2017), https://www.dandodiary.com/2017/09/articles/securities-litigation/though-private-company-uber-hit-securities-class-action????-lawsuit/ [https://perma.cc/4DD8-ZFRD]; *see* Alison Frankel, *Uber Is a Private Company. How Can Investors Bring a Securities Class Action?*, REUTERS (Sept. 27, 2017, 12:50 PM), https://www.reuters.com/article/otc-uber-frankel/uber-is-a-private-company-how-can-investors-bring-a-securities-class-action-idUSKCN1C22UT [https://perma.cc/3RSH-GRSJ]

[257] Complaint at 48-49, Colman v. Theranos, Inc., No. 5:16-cv-06822 (N.D. Cal. Nov. 28, 2016) (bringing a class action on behalf of investors in Theranos). One of the counts was violation of the California Corporations Code, sections 25400(d) and 25500, which make material misstatements and omissions when offering securities unlawful. CAL. CORP. CODE § 25400(d) (2020); *id.* § 25500 (2020) (making liable a person who willfully participates in any act or transaction in violation of Section 25400).

[258] Colman v. Theranos, Inc., 325 F.R.D. 629, 647 (N.D. Cal. 2018). Pre-IPO Uber was also subject to a similar suit. *See* Complaint, Irving Firemen's Relief & Retirement Fund v. Uber Technologies Inc., No. 17-cv-05558 (N.D. Cal. Sept. 26, 2017) [hereinafter Complaint, Uber].

[259] *See generally* David H. Webber, *Shareholder Litigation Without Class Actions*, 57 ARIZ. L. REV. 201 (2015) (projecting what shareholder litigation would consist of without class actions, and suggesting that large institutions would still have positive-value claims).

[260] *See, e.g.*, Complaint, Uber, *supra* note 258 (making state-law allegations in an investor class action).

Theranos provides an example of individual/small group shareholder action. A hedge fund investor sued Theranos, Holmes, and Balwani in Delaware Chancery Court for making misrepresentations when soliciting its investment.[261] Using the basic facts about Theranos's "repeated lies, misrepresentations, misleading statements, and failures to disclose material information," the complaint alleged state common law fraud and contract claims,[262] as well as violations of California[263] and Delaware statutes.[264]

Pre-IPO Uber (private) provides another example. Investors sued the company for state corporate law claims that amounted to allegations that the company and its officers made misrepresentations when seeking investment in the private company.[265]

One can certainly debate the extent to which private securities litigation forces information to become available. At the very least, however, the move towards private companies cuts off the possibility of investor litigation in a major category of cases.

## IV. INCENTIVIZING INFORMATION ABOUT PRIVATE COMPANY FRAUD

The information gap between public and private companies means that it is important to pay attention to, and even cultivate, the information sources that continue to be available when companies are private. Informational substitutes are needed in this world where the companies being policed are not public companies and are not subject to disclosure requirements or trading in a public market.

This final Part puts forward one prescription to address the loss of information needed for detection and anti-fraud enforcement. The

261 Complaint at 2, Partner Investments, L.P. v. Theranos, Inc., No. 12816-VCL (Del. Ch. Ct. Apr. 6, 2016); Christopher Weaver, *Major Investor Sues Theranos*, WALL ST. J. (Oct. 10, 2016, 6:46 PM ET), https://www.wsj.com/articles/major-investor-sues-theranos-1476139613 [https://perma.cc/233V-66N8] (reporting that a "[h]edge fund accuses embattled company of a 'series of lies' to attract investment of nearly $100 million").

262 Complaint, *supra* note 261, at 52, 54, 57, 58, 62, 64 (alleging "Fraudulent Misrepresentation and Inducement," "Fraudulent Concealment," "Equitable Fraud," "Negligent Misrepresentation," "Contractual Indemnification," and "Breach of the Implied Covenant of Good Faith and Fair Dealing").

263 *Id.* at 55, 56, 61 (alleging Securities Fraud in Violation of Cal. Corp. Code §§ 25401, 25501, 25400(d), and 25500; and violation of California's Unfair Competition Law, Cal. Bus. & Prof. Code § 17200 et seq.).

264 *Id.* at 59, 60 (alleging violation of Delaware's Consumer Fraud Act, 6 Del. C. § 2511 et seq. and Deceptive Trade Practices Act, 6 Del. C. § 2531 et seq.).

265 Complaint at 2, Benchmark Capital Partners VII, L.P. v. Travis Kalanick, No. 2017-0575 (Del. Ch. Ct. Aug. 10, 2017).

proposal can be effectuated even without any change to disclosure that would pull more U.S. companies, public and private, into a mandatory disclosure regime,[266] although these types of approaches are not mutually exclusive. The attention to whistleblowers also has some advantages over an approach targeted only at one investor type, such as enhanced disclosure to startup employees,[267] particularly as retail investors are increasingly invited into private markets.[268] But incentivizing whistleblowers is not a panacea.[269] It is instead a pragmatic tool aimed particularly at the loss of information. More broadly, it is also an illustration of the type of reexamination of existing structures and tools needed in an increasingly private market.

This Part identifies the differences in how the securities laws governing whistleblowers treat private and public companies. It then outlines some of the aspects of a whistleblower regime that would need to be adapted to the private company context. It concludes with the mechanisms for making these changes, including ways in which the SEC's enforcement decisions described in this Article affect the incentives of whistleblowers and their lawyers.

Under current law, securities fraud whistleblowers are treated differently depending on whether they are employees of a public or a private company.[270] Given a decline in the number and percentage of U.S. public companies, and the presence of companies structured in a way that traditionally triggers investor-protection concerns, this Part examines extending the securities law whistleblower protections and incentives to private company fraud.

That whistleblowers are important to uncovering private company fraud is illustrated by the Theranos story, which is partly a story about

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[266] *See* Fan, *supra* note 75, at 586; 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, 151 (2013); Jones, *supra* note 25, at 182 (discussing this literature); *see also* Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. ON REG. 499, 503 (2020) (proposing expanding mandatory disclosure with stakeholders, rather than shareholders, as the intended beneficiary).

[267] *See* U.S. Sec. and Exch. Comm'n Rule 701, 17 C.F.R. § 230.701 (2020); Alon-Beck, *supra* note 240, at 183-84. *See generally* Aran, *supra* note 148 (advocating for changes to the disclosures that startup companies make to their employees).

[268] *See supra* notes 65–73 and accompanying text.

[269] *See generally* Miriam H. Baer, *Reconceptualizing the Whistleblower's Dilemma*, 50 UC DAVIS L. REV. 2215 (2017) (noting the small number of successful SEC whistleblower tips in comparison to the total volume of tips).

[270] *See* Chelsea Hunt Overhuls, *Unfinished Business: Dodd-Frank's Whistleblower Anti-Retaliation Protections Fall Short for Private Companies and Their Employees*, 6 J. BUS. ENTREPRENEURSHIP & L. 1, 13 (2012).

whistleblowers.[271] The head of SEC enforcement in San Francisco later described the two-year investigation of Theranos, emphasizing two information sources: investigative reporting and the SEC's whistleblower program.[272]

Most famous among the Theranos whistleblowers was Tyler Shultz. Tyler Shultz worked at Theranos as part of the immunoassay team.[273] Shultz's grandfather was former Secretary of State George Shultz, who was also on the Theranos board of directors.[274] When later interviewed for FRAUD MAGAZINE (maybe more aptly called "Anti-Fraud Magazine"), Tyler Shultz commented on whistleblowing to the SEC and other government agencies.[275] He said: "One thing I learned far too late was that any information you bring to the SEC or to the government is protected. Theranos couldn't even threaten to sue me for something I told to the United States government."[276] His story is about the potential for whistleblowers in the private context — after all, eventually Tyler Shultz and others emerged. But it is also a cautionary tale about delay, given the length of time and amount of damage caused before the information about Theranos and its medical device came out.

The differing treatment of private and public company employees results from the overlay of statutory provisions protecting and incentivizing securities fraud whistleblowers. These provisions were

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[271] *See* John Carreyrou, *Theranos Whistleblower Shook the Company — and His Family*, WALL ST. J., https://www.wsj.com/articles/theranos-whistleblower-shook-the-companyand-his-family-1479335963 (last updated Nov. 18, 2016, 11:17 AM ET) [https://perma.cc/EKJ2-X8B2].

[272] Loizos, *supra* note 245.

[273] CARREYROU, *supra* note 8, at 184-85.

[274] Parloff, *A Singular Board*, *supra* note 10. Other Theranos employees reached out as well. Alan Beam, the Theranos lab director, reportedly called a Washington, D.C. law firm known to represent whistleblowers, but was dissuaded when he could not speak directly and immediately to an attorney. CARREYROU, *supra* note 8, at 214.

[275] Emily Primeaux, *Whistleblower Helped Dismantle Biotech Juggernaut Theranos in His 'Zero-Strategy' Defense: An Interview with Tyler Shultz*, FRAUD MAG. (Sept./Oct. 2019), https://www.fraud-magazine.com/cover-article.aspx?id=4295006794 [https://perma.cc/E98B-GSQA].

[276] *Id.* ("It wasn't until I saw the word whistleblower literally written in the newspaper that I even thought about the word . . . . If I'd recognized that I was actually in a whistleblowing situation, I would have started documenting things. I would've contacted a lawyer who could tell me what I should document and what I could bring out of Theranos in a safe way. . . . The government protects people. I had no idea about that. I was just reacting to situations."). *See generally* Tyler Shultz, *Thicker Than Water: The Untold Story of the Theranos Whistleblower*, AUDIBLE (Aug. 4, 2020), https://www.audible.com/pd/Thicker-than-Water-Audiobook/B08DDCVRRC#:~:text=From%20the%20hero%20whistleblower%20of,running%20amok%20in%20Silicon%20Valley [https://perma.cc/M6SM-H9KU].

put into place in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley")[277] and the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[278] The differing treatment of private-company and public-company whistleblowers also results from the two Supreme Court opinions interpreting the scope of anti-retaliation provisions in the two acts.[279]

Sarbanes-Oxley was the main securities statute passed in the wake of Enron's dramatic collapse. Built into this statute was whistleblower protection against retaliation against employees who provide "evidence of fraud" to a list of entities. This list includes the SEC, but also includes supervisors inside the company (internal reporting).[280] Section 806 of Sarbanes-Oxley was headed "Whistleblower Protection for Employees of Publicly Traded Companies." The key phrase for the purposes of this Article is "publicly traded." The text of the statute prohibits public companies[281] from retaliating against whistleblowing employees.

In 2014, the Supreme Court addressed the reach of this provision in *Lawson v. FMR LLC*.[282] The majority determined that whistleblower protections under Sarbanes-Oxley reach employees of public companies, but also protect employees of contractors and agents of publicly traded companies from retaliation from their (private) employers.[283] One motivating concern was that companies could too easily work around whistleblower protections by structuring the firm with a mix of private and public entities.[284]

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277 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

278 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

279 Dig. Realty Tr., Inc. v. Somers, 138 S. Ct. 767, 771 (2018) (interpreting Dodd-Frank's definition of whistleblowers); Lawson v. FMR LLC, 571 U.S. 429, 465 (2014) (interpreting the scope of Sarbanes-Oxley whistleblower protection).

280 18 U.S.C. § 1514A(a)(1) (2018); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 806, 116 Stat 745, 802-804.

281 18 U.S.C. § 1514A(a)(1) (the statute reaches retaliation by companies "with a class of securities registered under (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d))"). Although the lines between public and private companies are not necessarily straightforward, see *supra* Part I.A., this is one working definition of a public company. *See, e.g.*, *Lawson*, 571 U.S. at 461 n.1 (Sotomayor, J., dissenting) (adopting this definition in her discussion of "public company").

282 *Lawson*, 571 U.S. 429.

283 *Id.* at 430.

284 *Id.* at 434. The majority also rooted the interpretation in the concerns raised by Enron's collapse, particularly as they were reflected in the congressional response. *Id.*

In the facts of *Lawson*, the public company at issue had no employees at all: it was a mutual fund.[285] Only the private mutual fund advisor (the employer of the whistleblower) had employees.[286] Given the fact that this structure was typical of the mutual fund industry, the majority reasoned that a decision not to extend whistleblower protection in this context would leave the whole industry without this source of information and monitoring.[287]

Section 806 of Sarbanes-Oxley (modified by Dodd-Frank) does, accordingly, reach some employees of private companies: when the employer is a contractor or agent of a public company, or a private subsidiary of a public company.[288] But all depend on a connection to a public company. Multiple courts have refused to extend whistleblower protections under Sarbanes-Oxley to whistleblowers who were unable to connect their whistleblowing to a public company.[289]

Employees of private companies outside of these categories do have an additional source of protection. Dodd-Frank made two significant changes to the statute governing securities fraud whistleblowers. First, it created a "bounty" system where whistleblowers could be given a

[285] *Id.* at 433 ("Plaintiffs below, petitioners here, are former employees of private companies that contract to advise or manage mutual funds. The mutual funds themselves are public companies that have no employees. Hence, if the whistle is to be blown on fraud detrimental to mutual fund investors, the whistleblowing employee must be on another company's payroll, most likely, the payroll of the mutual fund's investment adviser or manager.").

[286] *Id.*

[287] *Id.*

[288] Dodd-Frank extended whistleblower protection explicitly to subsidiaries of a public company. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929A, 124 Stat 1376, 1852 (2010) ("Protection for employees of subsidiaries and affiliates of publicly traded companies: Amends Section 806 of the Sarbanes-Oxley Act of 2002 to make clear that subsidiaries and affiliates of issuers may not retaliate against whistleblowers . . . .").

[289] Tellez v. OTG Interactive, LLC, No. 15 CV 8984, 2019 WL 2343202, at *3 (S.D.N.Y. Jun. 3, 2019); Baskett v. Autonomous Research LLP, No. 17-CV-9237, 2018 WL 4757962, at *8 (S.D.N.Y. Sept. 28, 2018) ("[T]he contractor provision does not apply where a public company has no involvement in the conduct Congress sought to curtail by passing SOX."); Reyher v. Grant Thornton, LLP, 262 F. Supp. 3d 209, 217 (E.D. Pa. 2017) (dismissing the claim that the employee of a private company was a whistleblower under Dodd-Frank § 922 and Sarbanes-Oxley § 1514A and noting that "[a] purported whistleblower employed by a private company cannot invoke the protections of section 1514A simply because her employer happens to contract with public companies on matters unrelated to the alleged whistleblowing"); Gibney v. Evolution Mktg. Research, LLC, 25 F. Supp. 3d 741, 748 (E.D. Pa. 2014) ("[T]he specific shareholder fraud contemplated by SOX is that in which a public company — either acting on its own or acting through its contractors — makes material misrepresentations about its financial picture in order to deceive its shareholders.").

percentage of the recovery from a fraud enforcement.[290] Second, it introduced a new anti-retaliation provision, built onto the Sarbanes-Oxley one.[291] Key for this Article is that Dodd-Frank does not include any language limiting covered employers to public companies: Dodd-Frank explicitly uses the term "employer" without definition and — unlike Sarbanes-Oxley — without qualification.[292]

In *Digital Realty Trust* in 2018, the Supreme Court limited Dodd-Frank's protections by requiring employees — of public or private companies — to report misconduct "externally" to the SEC.[293] The SEC has created some workarounds within the requirement's constraints,[294] but essentially the consequence is that private company whistleblowers must report to the SEC to benefit from Dodd-Frank's retaliation protections and bounty incentives.[295] Chart 2 below summarizes the patchwork of protections and incentives available to private company employees.

[290] Dodd-Frank Wall Street Reform and Consumer Protection Act § 922 (codified at 15 U.S.C. § 78u-6(b) (2018)).

[291] Section 922 prohibits an employer from discharging an employee in retaliation for that employee having engaged in certain types of protected whistleblowing activity. *Id.* § 922(h)(1)(A) (codified at 15 U.S.C. § 78u-6(h)(1)(A) (2018)).

[292] 15 U.S.C. § 78u-6(h)(1)(A) (2018); S. REP. No. 111–176, at 46 (2010).

[293] Dig. Realty Tr., Inc. v. Somers, 138 S. Ct. 767, 780 (2018).

[294] 17 C.F.R. § 240.21F-4(c)(3) (b)(7) (2011) (implementing reporting rules that allow some reporting to other entities as long as the report to the SEC is within 120 days of that initial information); Order Determining Whistleblower Award Claim, Exchange Act Release No. 85936, 2019 WL 2252911 (May 24, 2019) (making a whistleblower award to a whistleblower who reported internally, triggering self-reporting by the company to the SEC and an internal investigation that was provided to the SEC).

[295] A 2019 opinion granting summary judgment on whistleblower retaliation claims provides an example. *See, e.g.*, Tellez v. OTG Interactive, LLC, No. 15-CV-8984, 2019 WL 10837668 (S.D.N.Y. Jun. 3, 2019) (noting employees of a private company claimed protection under Sarbanes-Oxley and Dodd-Frank, but the court reasoned that the private company did not fit into any of *Larson*'s definitions for contractors with public companies); *id.* at 3-4. The whistleblower did not qualify for protection under Dodd-Frank because he had not reported externally to the SEC. *Id.* at 4 (citing *Digital Realty*).

Chart 2. Whistleblower Protections and Incentives

| **Company Type** | | **Reported internally only** | **Reported to the SEC** |
|---|---|---|---|
| Public company | | SOX* | SOX and/or Dodd-Frank |
| Private company | Contractor or agent of public company (*Lawson* re SOX 806) | SOX* | SOX and/or Dodd-Frank |
| | Subsidiary of public company (Dodd-Frank re SOX 806) | SOX* | SOX and/or Dodd-Frank |
| | Unconnected to public company | Nothing | Dodd-Frank |

* Dodd-Frank indirectly through SOX incorporation[296]

This discussion has so far focused on treating private company whistleblowers consistently with public company whistleblowers. But the private company context certainly differs from that of a public company, and efforts to implement effective whistleblower protections would have to address these differences. Below are highlighted three aspects of structuring whistleblowing that would need attention: (1) identifying the covered private companies, (2) defining reporting requirements, and (3) pricing of awards.

Of particular policy concern are the large "public-like" companies that include unicorns and that raise some of the regulatory concerns that public companies do. To target this population of private companies, any statutory change could simply identify a size cut off for private company employers.[297] Size could be measured by number of investors and total assets, as in Exchange Act 12(g),[298] but the

[296] Dodd-Frank lists the types of disclosures that the retaliation provision reaches, cross-referencing Sarbanes-Oxley: "disclosures that are required or protected under the Sarbanes-Oxley Act of 2002." 15 U.S.C. § 78u-6(h)(1)(A)(iii).

[297] This limitation would also address a concern that Justice Sotomayor raised in *Lawson* that these whistleblowing rules would reach traditionally private relationships. She gave the example of "a babysitter [who could] bring a federal case against his employer — a parent who happens to work at the local Walmart (a public company) — if the parent stops employing the babysitter after he expresses concern that the parent's teenage son may have participated in an Internet purchase fraud." Lawson v. FMR LLC, 571 U.S. 429, 462 (2014) (Sotomayor, J., dissenting).

[298] *See* 15 U.S.C. § 78l(g) (2018) (triggering reporting status when a company has a minimum number of investors (for non-financial issuers the limit is 2,000 persons or 500 persons who are not accredited investors) and a minimum level of total assets ($10 million)).

assessment of firm size might also include the number of employees, particularly given the concern with protection of investor-employees.[299]

Even without formal limitation in statutes or rules, however, some practical aspects of whistleblowing suggest that this population of private companies would tend to be the target, at least to the extent to which larger companies have more employees and larger amounts at stake.[300] According to whistleblower lawyers, the agency pursues actions that involve large amounts, which may be more likely in these larger companies.[301] Anonymity is also an important consideration for whistleblowers.[302] The SEC whistleblower program is somewhat unusual in that whistleblowers are able to report anonymously.[303] Whistleblowers are likely to find anonymity more difficult to maintain in companies with fewer employees, so may encounter reputational and employment deterrents more intensely in smaller companies. In short, SEC whistleblowing in private companies may be most incentivized in larger private companies because of the choices of various gatekeepers and other actors.

The reporting requirements might also play out differently in the private context. The current requirement that employees report externally to the SEC may have particular impact on private companies and private company employees. The SEC is more obviously a primary regulator of the conduct of public companies, given reporting and compliance requirements as well as, in some cases, trading of company stock on an exchange. The SEC may have less salience, however, for employees of private companies because of fewer contact points with

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[299] *See supra* notes 147–48 and accompanying text.

[300] Cable, *supra* note 147, at 636 (noting in a section titled "Employee #5,000" that "mature startups of today appear to have more employees than the iconic startups of the dot-com era").

[301] *See, e.g.*, STEPHEN MARTIN KOHN, THE NEW WHISTLEBLOWER'S HANDBOOK: A STEP-BY-STEP GUIDE TO DOING WHAT'S RIGHT AND PROTECTING YOURSELF (3d ed. 2017).

[302] *Id.* at 105 (noting that anonymity "benefits the employee who fears retaliation" and reduces the risk that the "government will inadvertently disclose the identity of the whistleblower to their bosses"); LABATON SUCHAROW, REPORTING WITHOUT REGRETS: THE SEC WHISTLEBLOWER HANDBOOK 3 (2019), https://www.secwhistleblowerадvocate.com/pdf/SEC_Whistleblower_Program_Handbook.pdf [https://perma.cc/T4EV-E8EW] ("The ability to report possible misconduct anonymously is one of the most important pillars of the SEC Whistleblower Program . . . . The ability to report possible misconduct anonymously is the best protection against potential retaliation and blacklisting.").

[303] 17 C.F.R. § 240.21F-7(b) (2020); KOHN, *supra* note 301, at 105 (noting that Dodd-Frank allows anonymous whistleblowing and that this "new feature" was "unique in American whistleblowing law"). The whistleblower can remain anonymous until the award process, when the SEC needs the identity to confirm eligibility, but even then the name is kept confidential. *Id.*

the regulator. As a consequence, even private company employees who report externally might be more inclined to report to other regulators, such as local, state, or industry-specific regulators (e.g., insurance in the case of Zenefits).[304] Accordingly, one aspect of incentivizing private company whistleblowing would be to expand the external options for reporting.

Under current law, Dodd-Frank whistleblowers must report to the SEC rather than to other regulators to receive the protections and incentives provided by the statute, but SEC rules modify this slightly within the constraints. A whistleblower who reports to the SEC within 120 days after initially reporting to "Congress, any other authority of the Federal government, a state Attorney General or securities regulatory authority, any self-regulatory organization, or the Public Company Accounting Oversight Board" counts as having submitted information to the Commission on the same initial date.[305] Not all of the entities on this list are relevant for private companies (including, for example, SROs and the PCAOB). Nonetheless, the SEC Rule models the possibility of expanding what counts as external reporting. It also seems to acknowledge that whistleblowers may not know to go directly to the SEC. Indeed, lack of awareness should not be a surprise given statements like Tyler Shultz's that "It wasn't until I saw the word whistleblower literally written in the newspaper that I even thought about the word."[306]

Awarding and protecting whistleblowers who report internally would also address concerns about reporting in the private company context. There is some evidence of support for reinstating internal reporting, including proposed bipartisan legislation: the "Whistleblower Programs Improvement Act."[307] The Act would extend whistleblower protections to internal reporting, undoing the Supreme Court's 2018 decision in *Digital Realty Trust*.[308] The drafting and discussion would have to

304 Thank you to Renee Jones for this observation.

305 17 C.F.R. § 240.21F-4(b)(7).

306 Primeaux, *supra* note 275.

307 *See generally* Whistleblower Programs Improvement Act, S. 2529, 116th Cong. § 2 (2019) (indicating the support for internal reporting). For an example of the argument that companies would prefer internal reporting, see Henry Cutter, *Whistleblower Ruling Adds a Risk for Companies*, DOW JONES INSTITUTIONAL NEWS (2018) (reporting the concern that requiring external reporting hurts companies by undermining their compliance functions).

308 Whistleblower Programs Improvement Act, *supra* note 307; *see also* Whistleblower Protection Reform Act of 2019, H.R. 2515, 116th Cong. (2019) (bill enacted by the House in July 2019).

wrestle with equalizing protections for private and public employees,[309] but the rationale developed here provides additional support for legislative change that would reinstate internal reporting.

Determining awards for private company whistleblowers would have to respond to differences in the connection between employees and their companies. In the private context, particularly for startups, compensation is linked to company valuation and exit plans through stock option awards.[310] Stock options are also used in public companies[311] and reach some categories of employees who, according to whistleblower attorneys, are within their client base.[312] This kind of compensation, however, is certainly less central to the pay structure and culture of public companies than it is to private startups. A larger proportion of compensation and wealth for private company employees comes in the form of illiquid equity awards,[313] potentially creating disincentives to identify any negative information about the employer. Whistleblower awards to private company whistleblowers would accordingly have to be designed and priced in a way that addresses these potential disincentives.

Whistleblowing always has downsides for the whistleblower, and social and reputational constraints may influence the possibility of

[309] The Whistleblower Protection Reform Act of 2019 (H.R. 2515) would expand protections to whistleblowers who provide information to supervisors at the employer (internal reporting), but limit "employer" to "an entity registered with or required to be registered with the Commission, a self-regulatory organization, or a State securities commission or office performing like functions." Whistleblower Protection Reform Act of 2019, *supra* note 308. *See* Jason Zuckerman & Matthew Stock, *Senators Introduce Bipartisan Legislation Strengthening Corporate Whistleblower Protections and Improving the SEC and CFTC Whistleblower Programs*, WHISTLEBLOWER PROTECTION LAW & SEC WHISTLEBLOWER AWARDS BLOG, https://www.zuckermanlaw.com/whistleblower_programs_improvement_act/ (last updated Sept. 24, 2019) [https://perma.cc/ZQW7-54GC] (noting that the proposed language would include "employees of privately owned broker-dealers and investment advisers, and employees of hedge funds that are registered with the SEC").

[310] *See* Aran, *supra* note 148, at 869; Matthew T. Bodie, *Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5*, 88 IOWA L. REV. 539, 548 (2003); Cable, *supra* note 147, at 631.

[311] Aran, *supra* note 148, at 869 n.2 (citing data from the National Center for Employee Ownership).

[312] Some law firms that represent whistleblowers suggest that senior executives make up most of their clients. *See, e.g.*, SUCHAROW, *supra* note 302, at 3.

[313] David F. Larcker, Brian Tayan & Edwards M. Watts, *Cashing It In: Private-Company Exchanges and Employee Stock Sales Prior to IPO*, ROCK CTR. FOR CORP. GOVERNANCE AT STAN. U. CLOSER LOOK SERIES (Sept. 12, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247877 [https://perma.cc/5B5Z-YP55].

whistleblowing.[314] This may be particularly true in the interwoven tech employment marketplace. However, some of the changes in the characteristics of private companies detailed above make incentivizing private company whistleblowers an increasingly promising approach. Private companies grow in valuation but also sometimes in size in other respects, including the numbers of employees.[315] As these companies are bigger, whistleblowing becomes more possible. Not only may anonymity be easier to maintain in this larger setting, but also early employees may feel more constrained than employees who are later hires.

Finally, plausible mechanisms exist for implementing changes to the laws governing private company whistleblowers. Whistleblower protections and incentives is an area in which lawmakers have signaled willingness to intervene, so statutory change may be a possible route.[316] The SEC has also engaged in rulemaking in this area, most recently to revise their treatment of large awards.[317]

Even under current law, however, the SEC has some power to incentivize private company whistleblowers through its enforcement and whistleblower award decisions. In fact, the discussions of private company whistleblowers and SEC enforcement activities against private companies are intertwined. Law firms and lawyers have become specialized in representing whistleblowers, and this specialized whistleblower bar is attuned to the SEC's practices and signals.[318] The

[314] S. REP. NO. 111-176, at 111 (2010) ("[W]histleblowers often face the difficult choice between telling the truth and the risk of committing 'career suicide.'"); *see, e.g.*, *Whistleblower Representation*, CONSTANTINE CANNON, https://constantinecannon.com/practice/whistleblower/ (last visited Sept. 12, 2020) [https://perma.cc/3HG5-M9SA] (noting that "[w]histleblowing can be a stressful process stretching over many years").

[315] Cable, *supra* note 147, at 636.

[316] *See* Whistleblower Programs Improvement Act, S. 2529, 116th Cong. (2019); Whistleblower Protection Reform Act of 2019, H.R. 2515, 116th Cong. (2019).

[317] Whistleblower Program Rules, Final Rule, Exchange Act of 1934 Release No. 34-89963, 2020 WL 5763381 (Sept. 23, 2020); Press Release, SEC, SEC Adds Clarity, Efficiency and Transparency to Its Successful Whistleblower Award Program (Sept. 23, 2020), https://www.sec.gov/news/press-release/2020-219 [https://perma.cc/96NW-2KFL] (asserting the SEC's discretion to adjust award amounts).

[318] *See, e.g.*, ZUCKERMAN LAW, SEC WHISTLEBLOWER PROGRAM: TIPS FROM SEC WHISTLEBLOWER ATTORNEYS TO MAXIMIZE AN SEC WHISTLEBLOWER AWARD (2017), https://www.zuckermanlaw.com/wp-content/uploads/2017/05/SEC-Whistleblower-Program-Tips-from-SEC-Whistleblower-Attorneys-to-Maximize-an-SEC-Whistleblower-Award-1.pdf [https://perma.cc/4XW6-EPWB] (detailing tips from lawyers about maximizing whistleblower awards); *Whistleblower Insider Blog*, CONSTANTINE CANNON, https://constantinecannon.com/practice/whistleblower/blog/ (last visited Oct. 20, 2020) [https://perma.cc/YL35-WLYN] (providing news about whistleblowers and highlighting a team of experienced whistleblower lawyers); Lisa M. Noller, Pamela L. Johnston, Bryan B. House & Angelica L. Novick, *A Review of Recent Whistleblower Developments*,

dearth of SEC actions against large private companies to date[319] means that the SEC has not sent signals that would encourage the representation of private company employees. If the SEC decided that it made policy sense to incentivize private company whistleblowers, SEC enforcement could simply bring more actions and give whistleblower awards in this area, knowing that the specialized whistleblower bar and other lawyers are paying attention.

## CONCLUSION

The shift of investment capital towards private companies in the U.S. is well established.[320] But legal analysis has not caught up with the profound consequences of the declining role of public companies in the U.S. economy. This Article explores one of the potential effects of the diminished public sphere for U.S. corporations: the loss of information needed to detect and punish fraud. It tracks the move from a robust public disclosure-based ecosystem with a range of regulatory tools, to a low-information regime where the principal regulatory tool is anti-fraud litigation and enforcement.

Much of the apparatus of U.S. securities law is designed to force disclosure when securities are offered publicly or force periodic disclosure for certain registered companies. But some large companies are not subject to either set of securities disclosure requirements. The key anti-fraud provisions of the securities laws do, however, apply broadly to all companies, whether private or public.

The Article examines the SEC's securities fraud enforcements against private companies, identifying information that led to the detection and punishment of fraud in the private company. In the context of the current trajectory towards an increasingly private marketplace, it advocates an extension of full whistleblower protections, in contrast to the current disparate treatment of employees of public and private companies. Ultimately, the Article argues that an anti-fraud-only regulatory regime needs enhanced information incentives to make up for the lack of information about private companies under the current regulatory system.

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FOLEY & LARDNER LLP (Oct. 29, 2019), https://www.foley.com/en/insights/publications/2020/04/a-review-of-recent-whistleblower-developments [https://perma.cc/HHU4-5XE4] (reporting change in SEC whistleblower awards); *SEC Whistleblower Eligibility Calculator*, LABATON SUCHAROW, https://www.secwhistleblowerадvocate.com/eligibility-calculator/ (last visited Oct. 20, 2020) [https://perma.cc/T6RD-Q6FE] (providing among other information, an "Eligibility Calculator").

319 *See supra* Chart 1.

320 *See supra* Part I.B.

## APPENDIX: SEC SECURITIES FRAUD ENFORCEMENT ACTIONS AGAINST PRIVATE COMPANIES, FY2016-FY2019[321]

This appendix lists SEC enforcement actions against private companies that include an allegation of securities fraud for SEC fiscal years 2016 through 2019 (Oct. 1, 2015 to Sept. 30, 2019). It does not include actions brought against individuals only. It includes actions that also allege registration violations although, as the Article points out, these raise different informational issues given that they should have become part of the public disclosure system.

| Year Filed | Case | Release No. | Securities Fraud 17(a) &/or 10(b) | Registration Violations 5(a) & 5(c) |
|---|---|---|---|---|
| FY2016 | SEC v. Ascenergy LLC, et al. | LR-23394 | X | |
| FY2016 | SEC v. William M. Apostelos, et al. | LR-23397 | X | |
| FY2016 | SEC v. EB5 Asset Manager, LLC, et al. | LR-23409 | X | |
| FY2016 | SEC v. Earl D. Miller, et al. | LR-23405 | X | |

[321] The actions were identified as follows. The underlying source was the SEC's reports of its enforcement actions in 2019 SEC ENFORCEMENT DIVISION ANN. REP., *supra* note 23; SEC, ANNUAL REPORT: DIVISION OF ENFORCEMENT (2018), https://www.sec.gov/files/enforcement-annual-report-2018.pdf [https://perma.cc/Z6TM-3PG2]; SEC, SELECT SEC AND MARKET DATA: FISCAL 2017, https://www.sec.gov/files/enforcement-annual-report-2017-addendum-061918.pdf [https://perma.cc/W2Z7-M5PY]; SEC, SELECT SEC AND MARKET DATA: FISCAL 2016, https://www.sec.gov/files/2017-03/secstats2016.pdf [https://perma.cc/7LBE-632P]. The enforcement actions listed in the SEC documents were manually reviewed, including review of the SEC's public release and the underlying complaint, if available.

These data were supplemented by manual review of enforcement actions identified through a search in the LexisSecuritiesMosaic SEC Enforcement database for SEC actions commenced against companies between Oct. 1, 2015 and Sept. 30, 2019. It was limited to actions that alleged violation of Exchange Act Section 10 and/or Securities Act Section 17, but that did not include registration violations. It was also supplemented by additional searches of SEC litigation releases, as well as law firm memos and other secondary sources.

The appendix excludes SEC actions against companies for securities fraud that allegedly occurred in the transition from private to public or vice versa. Actions against financial firms like investment advisors, broker-dealers, or transfer agents are excluded. This is consistent with other lists that break down the private company category. *See* ADVISEN, *supra* note 33. Accordingly, actions that the SEC categorized as Broker-Dealer and Investment Advisors/Investment Companies were excluded from review. Delinquent Filings and Follow-on Administrative Procedures were also excluded.

Because some of these actions involve multiple targets and multiple stages, the SEC may have issued several public releases. The listed release reports the action against the private company (if any) or the earliest within the set of releases.

| Year Filed | Case | Release No. | Securities Fraud 17(a) &/or 10(b) | Registration Violations 5(a) & 5(c) |
|---|---|---|---|---|
| FY2016 | SEC v. James A. Torchia, et al. | LR-23416 | X | X |
| FY2016 | SEC v. Robert Yang, et al. | LR-23414 | X | |
| FY2016 | SEC v. Homero Joshua Garza, et al. | LR-23415 | X | X |
| FY2016 | SEC v. Vu H. Le a/k/a Vinh H. Le, et al. | LR-23432 | X | X |
| FY2016 | SEC v. CAUSwave, Inc., et al. | LR-23435 | X | X |
| FY2016 | SEC v. Southern Cross Resources Group, Inc., et al. | LR-23436 | X | X |
| FY2016 | SEC v. Marquis Properties, LLC, et al. | LR-23451 | X | X |
| FY2016 | SEC v. Kenneth W. Crumbley, et al. | LR-23453 | X | |
| FY2016 | SEC v. Optimum Income Property, LLC, et al. | LR-23464 | X | |
| FY2016 | SEC v. Nathan Halsey, et al. | LR-23473 | X | |
| FY2016 | SEC v. BIC Real Estate Development Corporation, et al. | LR-23487 | X | X |
| FY2016 | SEC v. Daniel Rivera, et al. | LR-23506 | X | |
| FY2016 | SEC v. William E. Mapp, III, et al. | LR-23515 | X | X |
| FY2016 | SEC v. Ariel Quiros, et al. | LR-23520 | X | |
| FY2016 | SEC v. James R. Trolice, et al. | LR-23532 | X | X |
| FY2016 | SEC v. Christopher R. Esposito, et al. | LR-23545 | X | X |
| FY2016 | SEC v. Charles C. Liu, et al. | LR-23556 | X | |
| FY2016 | SEC v. Thomas J. Connerton, et al. | LR-23565 | X | X |
| FY2016 | SEC v. Andrew K. Proctor, et al. | LR-23568 | X | X |
| FY2016 | SEC v. Chris A. Faulkner, et. al. | LR-23582 | X | X |
| FY2016 | SEC v. Traffic Monsoon, LLC, et al. | LR-23604 | X | X |
| FY2016 | SEC v. Jeffery A. McCollum, et al. | LR-23603 | X | |
| FY2016 | SEC v. Matthew White, et al. | LR-23607 | X | |
| FY2016 | SEC v. Edwin Ruh, Jr., et al. | LR-23614 | X | |
| FY2016 | SEC v. Secured Income Reserve, Inc., et al. | LR-23626 | X | |
| FY2016 | SEC v. Enviro Board Corporation, et al. | LR-23628 | X | X |
| FY2016 | SEC v. Donald V. Watkins Sr., Esq., et al. | LR-23634 | X | |
| FY2016 | SEC v. Contrarian Press, LLC, et al. | LR-23636 | X | |

| Year Filed | Case | Release No. | Securities Fraud 17(a) &/or 10(b) | Registration Violations 5(a) & 5(c) |
|---|---|---|---|---|
| FY2016 | SEC v. Tycoon Energy, Inc., et al. | LR-23643 | X | X |
| FY2016 | In the Matter of Fusion Pharm, Inc. | 33-10210 | X | X |
| FY2016 | In the Matter of Microcap Management LLC, et al. | 33-10213 | X | X |
| FY2016 | SEC v. Aegis Oil, LLC, et al. | LR-23663 | X | X |
| FY2017 | SEC v. Joseph Meli, et al. | LR-23731 | X | |
| FY2017 | SEC v. Brian S. Hudnall, et al. | LR-23732 | X | X |
| FY2017 | SEC v. Darrell Glenn Hardaway, et al. | LR-23753 | X | X |
| FY2017 | SEC v. Lidingo Holdings, LLC, et al. | LR-23802 | X | |
| FY2017 | SEC v. CSIR Group, LLC, et al. | LR-23802 | X | |
| FY2017 | In the Matter of Michael A. McCarthy, et al. | 33-10343 | X | |
| FY2017 | In the Matter of Edward Borrelli, et al. | 33-10341 | X | |
| FY2017 | SEC v. 4D Circle, LLC, a/k/a Enoetics, LLC, et al. | LR-23806 | X | |
| FY2017 | SEC v. Matthew W. Fox, et al. | LR-23809 | X | |
| FY2017 | SEC v. Hadsell Chemical Processing, LLC, et al. | LR-23835 | X | X |
| FY2017 | SEC v. Renwick Haddow, et al. | LR-23870 | X | |
| FY2017 | SEC v. Petroforce Energy, LLC, et al. | LR-23884 | X | X |
| FY2017 | SEC v. John Anthony Giunti, et al. | LR-23887 | X | |
| FY2017 | SEC v. Cash Capital, LLC, et al. | LR-23890 | X | X |
| FY2017 | SEC v. Patrick S. Muraca, et al. | LR-23893 | X | |
| FY2017 | SEC v. 7S Oil & Gas, LLC, et al. | LR-23896 | X | X |
| FY2017 | SEC v. Hidalgo Mining Corp., et al. | LR-23903 | X | X |
| FY2017 | SEC v. Jay Belson, et al. | LR-23906 | X | |
| FY2017 | SEC v. Tennstar Energy, Inc., et al. | LR-23924 | X | |
| FY2017 | SEC v. Vergeous, LLC, et al. | LR-23909 | X | X |
| FY2017 | SEC v. Christopher A. Faulkner, et al. | LR-23979 | X | |
| FY2017 | SEC v. Ronald Van Den Heuvel, et al. | LR-23938 | X | |
| FY2017 | SEC v. Edward Chen, et al. | LR-23944 | X | |
| FY2017 | SEC v. Pedro Fort Berbel, et al. | 2017-208 | X | X |
| FY2017 | SEC v. Accelera Innovations, Inc., et al. | LR-23969 | X | X |

| Year Filed | Case | Release No. | Securities Fraud 17(a) &/or 10(b) | Registration Violations 5(a) & 5(c) |
|---|---|---|---|---|
| FY2017 | SEC v. The Leonard Vincent Group, et al. | 2017-182 | X | |
| FY2017 | SEC v. REcoin Group Foundation, LLC, et al. | 2017-185 | X | X |
| FY2018 | In the Matter of Mergenet Medical, Inc., et al. | 33-10426 | X | |
| FY2018 | In the Matter of YourPeople, Inc., dba Zenefits FTW Insurance Services, et al. | 33-10429 | X | |
| FY2018 | SEC v. PlexCorps, et al. | LR-24079 | X | X |
| FY2018 | SEC v. Donald E. MacCord, Jr., et al. | LR-24001 | X | |
| FY2018 | SEC v. David S. Haddad, et al. | LR-24028 | X | |
| FY2018 | SEC v. Daniel B. Vazquez, Sr., et al. | LR-24031 | X | |
| FY2018 | SEC v. AriseBank, et al. | LR-24088 | X | X |
| FY2018 | In the Matter of Barry M. Skinner, et al. | 33-10458 | X | |
| FY2018 | SEC v. Jersey Consulting, LLC, et al. | LR-24064 | X | X |
| FY2018 | SEC v. Steven Ventre, et al. | LR-24055 | X | X |
| FY2018 | SEC v. AmeraTex Energy, Inc., et al. | LR-24057 | X | X |
| FY2018 | SEC v. Americrude, Inc., et al. | LR-24068 | X | X |
| FY2018 | SEC v. Elizabeth Holmes, et al. | LR-24069 | X | |
| FY2018 | SEC v. Michael A. Liberty, et al. | LR-24092 | X | X |
| FY2018 | SEC v. Peter H. Pocklington, et al. | LR-24098 | X | X |
| FY2018 | SEC v. The Lifepay Group, LLC, et al. | LR-24107 | X | X |
| FY2018 | SEC v. Arthur Lamar Adams, et al. | LR-24129 | X | |
| FY2018 | SEC v. The Falls Event Center, LLC, et al. | LR-24139 | X | |
| FY2018 | SEC v. Brent Borland, et al. | LR-24147 | X | |
| FY2018 | SEC v. Titanium Blockchain Infrastructure Services, Inc., et al. | LR-24160 | X | X |
| FY2018 | SEC v. Isaac Grossman, et al. | LR-24162 | X | |
| FY2018 | SEC v. Paul Gilman, et al. | LR-24156 | X | |
| FY2018 | SEC v. Ralph T. Iannelli, et al. | LR-24158 | X | |
| FY2018 | SEC v. Texas Coastal Energy Company, LLC, et al. | LR-24169 | X | X |
| FY2018 | SEC v. Perry Santillo, et al. | LR-24172 | X | |

| Year Filed | Case | Release No. | Securities Fraud 17(a) &/or 10(b) | Registration Violations 5(a) & 5(c) |
|---|---|---|---|---|
| FY2018 | SEC v. The Owings Group, LLC, et al. | LR-24187 | X | X |
| FY2018 | SEC v. Moddha Interactive, Inc., et al. | LR-24199 | X | |
| FY2018 | SEC v. Edward A. Young, et al. | LR-24211 | X | X |
| FY2018 | SEC v. Daniel Rudden, et al. | LR-24216 | X | |
| FY2018 | SEC v. William Z. ("Billy") McFarland, et al. | LR-24213 | X | X |
| FY2018 | SEC v. Palm House Hotel, LLLP, et al. | LR-24224 | X | |
| FY2018 | In the Matter of Tomahawk Exploration, LLC, et al. | 33-10530 | X | X |
| FY2018 | SEC v. Equitybuild, Inc., et al. | LR-24237 | X | X |
| FY2018 | SEC v. 1 Global Capital, LLC, et al. | LR-24249 | X | X |
| FY2018 | SEC v. Sandy J. Masselli Jr., et al. | LR-24248 | X | |
| FY2018 | SEC v. Kevin B. Merrill, et al. | 2018-201 | X | |
| FY2018 | SEC v. James Thomas Bramlette, et al. | LR-24289 | X | |
| FY2018 | SEC v. NL Technology, LLC, et al. | LR-24293 | X | X |
| FY2018 | SEC v. Russell Craig, et al. | LR-24303 | X | |
| FY2019 | SEC v. Susan Werth, a/k/a Susan Worth, et al. | LR-24316 | X | X |
| FY2019 | SEC v. Eric J. "EJ" Dalius, et al. | LR-24345 | X | X |
| FY2019 | SEC v. Blockvest, LLC, et al. | LR-24314 | X | X |
| FY2019 | SEC v. Giga Entertainment Media, Inc., et al. | LR-24355 | X | X |
| FY2019 | SEC v. Robert Alexander, et al. | LR-24392 | X | |
| FY2019 | SEC v. Daniel R. Adams et al. | LR-24411 | X | |
| FY2019 | SEC v. Jeffrey E. Wall, et al. | LR-24443 | X | X |
| FY2019 | SEC v. Natural Diamonds Investment Co., et al. | LR-24473 | X | X |
| FY2019 | SEC v. Collector's Coffee et al. | LR-24469 | X | |
| FY2019 | SEC v. Henry Ford, f/k/a Cleothus Lefty Jackson, et al. | LR-24482 | X | |
| FY2019 | SEC v. Donald A. Milne, III, et al. | LR-24484 | X | X |
| FY2019 | SEC v. Alton Perkins, et al. | LR-24502 | X | X |
| FY2019 | SEC v. Equal Earth, Inc., et al. | LR-24504 | X | X |
| FY2019 | SEC v. Bettor Investments, LLC, et al. | LR-24547 | X | X |

| Year Filed | Case | Release No. | Securities Fraud 17(a) &/or 10(b) | Registration Violations 5(a) & 5(c) |
|---|---|---|---|---|
| FY2019 | SEC v. Crystal World Holdings, Inc., et al. | LR-24571 | X | X |
| FY2019 | SEC v. Terry Wayne Kelly, et al. | LR-24573 | X | X |
| FY2019 | SEC v. BitQyck, Inc., et al. | LR-24582 | X | X |
| FY2019 | SEC v. John F. Thomas, et al. | LR-24585 | X | X |
| FY2019 | SEC v. Northridge Holdings, Ltd., et al. | LR-24594 | X | X |
| FY2019 | SEC v. Jay Daniel Seinfeld, et al. | LR-24596A | X | |
| FY2019 | SEC v. John Henderson, et al. | LR-24597 | X | X |
| FY2019 | SEC v. Zvi Feiner, et al. | LR-24605 | X | |
| FY2019 | SEC v. Mark Ray, et al. | LR-24627 | X | X |