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ALTERNATIVE VENTURE CAPITAL: THE NEW UNICORN INVESTORS

ANAT ALON-BECK[*]

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[*] Assistant Professor, Case Western Reserve University School of Law. For comments and suggestions, thanks are due to Jonathan Adler, Constance Bagley, Lucian Bebchuk, Karen Brenner, Brian Broughman, Colleen Campbell, Patrick Corrigan, Wendy Couture, Ofer Eldar, Jill Fisch, Jessie Fried, Asaf Hamdani, Joan Heminway, Sharona Hoffman, Kobi Kastiel, Charlie Korsmo, Juliet Kostritsky, Martin Lipton, John Livingstone, Colin McEwen, Will Moon, Yaron Nili, Nizan Packin, Anna Pinedo, Bob Rapp, Asaf Raz, Cassandra Robertson, Edward Rock, Darren Rosenblum, Jerry Rosenfeld, Jeff Schwartz, Helen Scott, Omari Simmons, Eric Talley, Verity Winship, Emily Winston, Joe Grundfest, Bernard Sharfman, David Yermack, and the participants at the 2019 Law and Society Association Annual Meeting; 2019 Corporate Governance Lunch, NYU School of Law and Stern School of Business; 2019 Annual Law and Entrepreneurship Retreat; 2019 Boston University Law School Corporate & Securities Litigation Workshop; 2019 ABA Annual Meeting, Private Equity and Venture Capital Committee, Perspectives on Cutting Edge Issues; 2019 National Business Law Scholars Conference, UC Berkeley School of Law; 2019 Governing Innovation and Emerging Technology in Finance Roundtable, UC Berkeley School of Law; and 2020 AALS Annual Meeting, Emerging Voices in Securities Regulation. All errors are my own.

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The U.S. Securities and Exchange Commission has promulgated new rules designed to harmonize and improve the "patchwork" exempt offering framework, protect investors and facilitate capital formation. Additionally, the U.S. Department of Labor announced that the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974 do not prohibit fiduciaries of 401(k) and other individual account plans from investing in, and undertaking exposure to, private equity investments. These policies address the concern that retail investors are missing out on investment opportunities, due to fewer listed firms and initial public offerings, the greater role of the private market in raising money, and the rise in the number of unicorn firms.

This Article details these concerns, assesses the policy changes within the broader context of private capital formation, and argues that some of them not only fail to provide a remedy, but may also induce greater harm and should not have been undertaken. Most importantly, policymakers must consider the rise of alternative venture capital ("AVC") investors, and the ways in which those investors affect a unicorn firm, its capital needs, and the lack of disclosure of information, all of which affect future investors. Finally, this Article argues that to adequately protect retail investors, AVC investors ought to be considered when formulating policy decisions relating to investor protection and the capital formation needs of private companies.

"Increasingly seems like we are entering a new reality in Unicorn land. If you have raised more than $250mm & are NOT public, the presumption is you are losing WAY too much money, and you probably have sh[***]y unit economics."

Bill Gurley, Benchmark Capital[1]

[1] Bill Gurley (@bgurley), TWITTER (Jan. 11, 2020, 7:32 PM), https://twitter.com/bgurley/status/1216156071661719557?lang=en.

"There was a theory that the public and private markets for tech-company shares had become disconnected, that venture capitalists and (particularly) non-traditional venture investors like mutual funds and (most particularly) SoftBank were now willing to pay higher prices than the public markets were, and that when those private investors eventually tried to sell to the public markets they'd run into trouble."

Matt Levine, *Bloomberg*[2]

INTRODUCTION

The press once celebrated Elizabeth Anne Holmes as the youngest female entrepreneur and billionaire.[3] Holmes dropped out of Stanford University to start her own firm, Theranos, a blood-testing startup. Holmes quickly raised billions of dollars from investors by using private placements, which are offerings of securities that are exempt from registration with the Securities and Exchange Commission ("SEC") and not subject to broad disclosure requirements, such as audited financial statements. The investor groups were comprised of sophisticated, accredited institutional and individual investors. Thanks to the large amounts of capital that Theranos raised from these investors, it joined the prestigious "unicorn" club.[4] Indeed, Holmes seemed to be living in the fast lane.

[2] Matt Levine, *The Unicorn Stampede is Coming*, BLOOMBERG OP. (Mar. 22, 2019, 11:58 AM), https://www.bloomberg.com/opinion/articles/2019-03-22/the-unicorn-stampede-is-coming.

[3] Press Release, Forbes Staff, Forbes Announces Inaugural List of America's 50 Richest Self-Made Women (May 27, 2015), https://www.forbes.com/sites/forbespr/2015/05/27/forbes-announces-inaugural-list-of-americas-50-richest-self-made-women/#455c348124c1. Unfortunately, Holmes is starring in the news these days for other reasons. She is the subject of the HBO documentary *The Inventor: Out for Blood in Silicon Valley*, and a book, titled *Bad Blood: Secrets and Lies in a Silicon Valley Startup*.

[4] A unicorn has the following features for the purpose of this Article: young yet large, privately owned but "quasi-public," invests in research and development (R&D) with intangible assets, VC-backed with concentrated ownership and controlling shareholders, and valued at over $1 billion. The term "unicorn" was coined in 2013 by Aileen Lee. *See* Abraham J.B. Cable, *Fool's Gold? Equity Compensation & The Mature Startup*, 11 VA. L. & BUS. REV. 613 (2017); Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583 (2016). A company is considered to be VC-backed if it was financed in its early stage by a VC fund. *See* Anat Alon-Beck, *Insight: When Unicorn Employees Revolt and Push for IPO*, BLOOMBERG L. (Sept. 30, 2019), https://news.bloomberglaw.com/securities-law/insight-when-unicorn-employees-revolt-and-push-for-ipo; *see also Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment:*

Holmes appeared on the covers of magazines, while Theranos enjoyed the benefits of an "all-star" board of directors,[5] including a medical advisory board.[6]

Theranos's funding bubble burst when the SEC charged Holmes with massive fraud.[7] Holmes fooled patients, doctors, investors, journalists, White House officials, military generals, and employees.[8] Holmes, unfortunately, is not the only unicorn founder to get a lot of press coverage these days for breaking the law.[9] The Chief Executive Officers ("CEOs") of WeWork, Uber, and Zenefits have all resigned

Hearing Before the Subcomm. on Inv. Prot., Entrepreneurship, and Cap. Mkts. of the H. Comm. on Fin. Serv., 116th Cong. 10 (2019) (written statement of Renee M. Jones, Professor of Law, Boston College Law School) [hereinafter Statement of Renee Jones] (citing Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107 (2019) [hereinafter *Unicorn Stock Options*]).

[5] There were many celebrities on the Theranos Board of Directors, including U.S. Secretary of State George P. Shultz, William Perry (former U.S. Secretary of Defense), Henry Kissinger (former U.S. Secretary of State), Sam Nunn (former U.S. Senator), Bill Frist (former U.S. Senator and heart-transplant surgeon), Gary Roughead (Admiral, U.S. Navy, retired), James Mattis (General, U.S. Marine Corps), Richard Kovacevich (former Wells Fargo Chairman and CEO), and Riley Bechtel (chairman of the board and former CEO at Bechtel Group). *See* Lydia Pflanzer, *How Elizabeth Holmes Convinced Powerful Men like Henry Kissinger, James Mattis, and George Shultz to Sit on the Board of Now Disgraced Blood-Testing Startup Theranos*, BUS. INSIDER (Mar. 19, 2019, 9:44 AM), https://www.businessinsider.com/theranos-former-board-members-henry-kissinger-george-shultz-james-mattis-2019-3.

[6] The Theranos medical advisory board included past presidents and board members of the American Association for Clinical Chemistry, such as Susan A. Evans, William Foege, former director U.S. Centers for Disease Control and Prevention (CDC), David Helfet, director of the Orthopedic Trauma Service at the Hospital for Special Surgery and professors, Ann M. Gronowski, Larry J. Kricka, Jack Ladenson, Andy O. Miller and Steven Spitalnik. *See* Jon Brooks, *Theranos Turns to New Medical Advisers to Help Validate Technology*, KQED (Apr. 7, 2016), https://www.kqed.org/futureofyou/141585/theranos-says-new-medical-advisors-will-help-publish-data.

[7] In June 2018, a federal grand jury indicted Holmes on nine counts of wire fraud and two counts of conspiracy to commit wire fraud. *See Theranos Founder and Former Chief Operating Officer Charged in Alleged Wire Fraud Schemes*, U.S. ATT'Y'S OFF., N. DIST. CAL. (June 15, 2018), https://www.justice.gov/usao-ndca/pr/theranos-founder-and-former-chief-operating-officer-charged-alleged-wire-fraud-schemes.

[8] *See* Monica Torres, *4 Ways Elizabeth Holmes Manipulated Her Theranos Employees*, HUFFPOST (Mar. 22, 2019, 12:57 PM), https://www.huffpost.com/entry/elizabeth-holmes-office-employees_l_5c92abe3e4b01b140d351b6f.

[9] *See* Erin Griffith, *The Ugly Unethical Underside of Silicon Valley*, FORTUNE (Dec. 28, 2016, 6:30 AM), http://fortune.com/silicon-valley-startups-fraud-venture-capital/; Monica Watrous, *What Happened to Hampton Creek?*, FOOD BUS. NEWS (Apr. 4, 2018), https://www.foodbusinessnews.net/articles/11575-what-happened-to-hampton-creek.

within the last three years due to various allegations of mismanagement and fraud.[10]

These stories on mismanagement and fraud are drawing public attention to the operations, management, corporate governance structures, and financings of unicorn firms. Despite these reports and the risks associated with investing in private firms,[11] retail investors have been demanding a piece of the action.

Access to investments in illiquid high-risk privately held firms, such as unicorns, is usually reserved to accredited sophisticated investors, such as ultrarich individuals and large institutions. But this is changing. There are powerful industry groups, such as the Institute for Portfolio Alternatives,[12] which recently successfully lobbied lawmakers to enable more Americans to access investments in private markets.[13]

The Institute for Portfolio Alternatives is not alone. Other thought leaders and organizations, including the Committee on Capital Markets Regulation, an independent research organization with thirty-five members drawn from the finance, business, law, accounting, and academic communities, were also concerned that ordinary retail investors[14] were missing out on investment

[10] Marisa Kendall, *SEC Fines Zenefits, Ousted CEO Nearly $1 Million Over Insurance Scandal*, SILICON BEAT (Oct. 27, 2017, 9:17 AM), http://www.siliconbeat.com/2017/10/27/sec-fines-zenefits-ousted-ceo-nearly-1-million-insurance-scandal/. On the WrkRiot scandal, see Nuala Sawyer Bishari, *CEO of Tech Startup WrkRiot Convicted of Fraud*, SFWEEKLY (Feb. 5, 2018, 5:21 PM) http://www.sfweekly.com/news/ceo-of-tech-startup-wrkriot-convicted-of-fraud/.

[11] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976). For further discussion on agency problems and strategies to reduce them, see generally Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Reinier H. Kraakman et al. eds., 2d ed. 2009).

[12] *See* Mark Schoeff, Jr., *Private Fund Group Lobbies to Get Products in 401(k)s*, INV. NEWS (Sept. 17, 2020), https://www.investmentnews.com/private-fund-group-lobbies-use-products-retirement-plans-197262; *Policy Advocacy that Advances the Industry*, INST. FOR PORTFOLIO INITIATIVES (IPA), http://www.ipa.com/policy-advocacy/#issues (last visited Dec. 28, 2020).

[13] *See* Paul Kiernan, *SEC Proposes Giving More Investors Access to Private Markets*, WALL ST. J. (Dec. 18, 2019, 6:52 PM), https://www.wsj.com/articles/sec-proposes-giving-more-investors-access-to-private-markets-11576691685. *See generally* COMM. ON CAP. MKTS. REGUL., EXPANDING OPPORTUNITIES FOR U.S. INVESTORS AND RETIREES: PRIVATE EQUITY (2018).

[14] "Retail investors" refers to investors that do not qualify under the SEC's accredited investor standard or qualified purchaser standard. The accredited investor standard "prohibits investors with less than $1 million in assets or $200,000 in annual income from directly investing in private funds." COMM. ON CAP. MKTS. REGUL., *supra* note 13, at 2. The qualified purchaser standard "prohibits investors

opportunities due to the decrease in the number of publicly listed firms, the decline in the volume of initial public offerings ("IPOs"), the fact that more money is being raised in private markets, and the rise in the number of unicorns.[15] They argued that it was not "fair" that mainly institutional investors and high-net-worth individuals[16] were able to access private markets and benefit from them.[17] They advocated for change and managed to convince regulators to act, supposedly for the primary purpose of democratizing and equalizing access to the private market.

The COVID-19 outbreak, which disrupted our lives, health and financial markets,[18] also provided a fertile ground for sweeping regulatory changes. President Trump instructed the federal government agencies to level the playing field and provide opportunities for ordinary retail investors. On May 19, 2020, President Trump issued Regulatory Relief to Support Economic Recovery Executive Order 13924, which directed agencies "to remove barriers to the greatest engine of economic prosperity the world has ever known: the innovation, initiative, and drive of the American

with less than $5 million in investments from directly investing in private funds that have more than 100 investors. Approximately 87% of U.S. households do not meet the accredited investor standard, and approximately 98% of U.S. households do not meet the qualified purchaser standard." *Id.*; *see also* Letter from Hal S. Scott et al., President, Comm. on Cap. Mkts. Regul., to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n (Jan. 31, 2020).

[15] *See generally* Statement of Renee Jones, *supra* note 4.

[16] Or workers with defined-benefit pension plans. It should be noted that "since defined-benefit plans have also become a much less popular option for employer retirement offerings, retail investors have had little exposure to private equity in recent years." Jon Hartley, *401(k) Plans Finally Can Invest in Private Equity, Leveling the Playing Field*, NAT. REV. (Aug. 19, 2020), https://www.nationalreview.com/2020/08/401k-plans-investing-private-equity-levels-playing-field/.

[17] *See id.*

[18] In the United States, the pandemic constituted a national emergency beginning on March 1, 2020. *See* Anat Alon-Beck, *Amid Vast Employee Layoffs, We Should Bail Out Tech Startups During the Coronavirus Crisis*, FORBES (May 6, 2020), https://www.forbes.com/sites/anatalonbeck/2020/05/06/amid-vast-employee-layoffs-we-should-bail-out-tech-startups-during-the-coronavirus-crisis/?sh=4e0618304420; Anat Alon-Beck, *Stakeholder Capitalism: Should Employees Demand Change?*, FORBES (June 11, 2020), https://www.forbes.com/sites/anatalonbeck/2020/06/11/stakeholder-capitalism-should-employees-demand-change/?sh=70e73f733b7d; Anat Alon-Beck, *When Life Gives You Lemons, Make 'Lemonade' or Something Like It*, FORBES (July 2, 2020), https://www.forbes.com/sites/anatalonbeck/2020/07/02/when-life-gives-you-lemons-make-lemonade-or-something-like-it/?sh=75d6d37e497c.

people" so that we will be able to "overcome the effects the virus has had on our economy."[19]

Accordingly, the U.S. SEC and Department of Labor ("DOL") have promulgated new rules designed to protect investors while opening access to investments in private markets. The SEC adopted amendments to "facilitate capital formation and increase opportunities for investors by expanding access to capital for small and medium-sized businesses and entrepreneurs across the United States." The SEC enacted these amendments to "simplify, harmonize, and improve certain aspects of the exempt offering framework to promote capital formation while preserving or enhancing important investor protections."[20] Previously, the SEC also revised and modernized the "accredited investor" framework.[21]

These changes may encourage both sophisticated and non-accredited investors to invest in illiquid securities of high-risk private ventures. They may also diminish the already limited investor protections in private markets. The entire securities regulatory scheme is centered on the concept of disclosure of information to improve price discovery, efficiency and reduce information asymmetry. Without disclosure, non-accredited purchasers will not be able to make informed decisions, especially about the risks associated with investing in privately held firms.

[19] News Release, U.S. Dep't of Labor, U.S. Department of Labor Issues Information Letter on Private Equity Investments (June 3, 2020), https://www.dol.gov/newsroom/releases/ebsa/ebsa20200603-0.

20Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release No. 10884, Exchange Act Release No. 90300, Investment Company Act Release No. 34082 (Nov. 2, 2020) [hereinafter Facilitating Capital Formation and Expanding Investment Opportunities].

[21] Press Release, U.S. Sec. & Exch. Comm'n, SEC Modernizes the Accredited Investor Definition (Aug. 26, 2020), https://www.sec.gov/news/press-release/2020-191; *see also* Letter from Christine Lazaro & Samuel Edwards, President & Exec. Vice President of the Pub. Invs. Advoc. Bar Ass'n, to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n (Sept. 24, 2019) ("it appears the Commission has lost sight of its primary objective—protecting investors—in the Concept Release. With few exceptions, each section of the Concept Release—from its discussion of the 'accredited investor' definition to Secondary Trading of Certain Securities—is more concerned with providing greater access to funds for exempt offering issuers than it is in providing necessary protections to public investors."); Christopher Schelling, *The Dangerous Democratization of Alternatives*, INSTITUTIONAL INV. (Feb. 19, 2020), https://www.institutionalinvestor.com/article/b1kdx135rgwcb0/The-Dangerous-Democratization-of-Alternatives; Angela Segal, *The SEC Wants to Democratize Private Investments*, INSTITUTIONAL INV. (Sep. 19, 2020), https://www.institutionalinvestor.com/article/b1h76258fbfzjb/The-SEC-Wants-to-Democratize-Private-Investments.

Large investment firms, such as private equity funds, may also be interested in gaining access to the individual investor market. It appears that democratizing access to private markets is not only the SEC's priority. The DOL announced recently in an information letter that 401(k) plan fiduciaries have the ability to invest in private equity funds.[22] This announcement drew much criticism and media attention. There are many risks associated with investing in illiquid assets and with monitoring private fund investment advisers. To illustrate, note that the SEC recently issued a risk alert with regards to investigations and enforcement actions against private fund investment advisers on lack of disclosures of potential conflicts of interest, excessive fees, and failures to implement policies on insider trading.[23] This Article will explore some of these concerns.

Should regulators encourage retail investors to invest in private markets, which were previously limited to sophisticated and wealthy players, such as accredited individuals and institutions?[24] Despite the best intentions of regulators, their policy changes may fail to have the intended positive effect for investors, retirees, and entrepreneurs while also needlessly placing these groups at heightened risk. This Article details these concerns, takes a look at the new policies, and argues that some of them fail to provide protections and should not have been changed. These new policies create more problems than they resolve.

The central issue is that policymakers and regulators must consider the rise in alternative venture capital investors and the ways in which those investors affect a unicorn firm, its capital needs, and the lack of disclosure of information, which affects current and future investors. Taking the rise of alternative venture capital investors and their influence into account may result in better policy design and help mitigate some of the risks.

The Article sheds light on the increasingly long and intricately complex array of new investors that regulators need to consider when making policy decisions on investor protection and capital formation needs of private companies. In the last few years, new, non-traditional, deep-pocketed market actors have been making notable investments in large private technology firms, which historically were dominated by venture capital investors ("VC").

[22] *See infra* Part I.

[23] *See infra* Part I.

[24] Benjamin Bain & Sabrina Willmer, *Private Equity Abuzz Over Access to $6 Trillion 401(k) Market*, BLOOMBERG (June 26, 2020, 2:30 PM), https://www.bloombergquint.com/businessweek/private-equity-is-coming-for-the-6-trillion-401-k-market.

Institutional and high-net-worth investors, such as SoftBank, mutual funds, hedge funds, corporate venture capitalists, private equity, and sovereign wealth funds (together, "alternative venture capital" or "AVC" investors) are turning their attention to private markets in the hopes of capitalizing on the high returns of unicorn firms before they do an IPO.[25]

The interest of these deep-pocket market actors has reversed the competitive landscape of unicorn funding. Rather than unicorn firms competing for a limited pool of funding, unicorns are able to attract a nearly limitless pool of funds, leaving the deep-pockets to compete for the chance to invest. This reversal substantially alters the governance of the unicorn firm and nature of the relationships between unicorns and their investors.[26]

Currently, retail investors, researchers, and regulators do not have detailed information on the identity of the new investors in our private markets, their incentives, their risk tolerance, the contractual terms for which they negotiate, or other relevant data, which is needed to understand the new developments in the private markets. This Article fills the gap.

Alternative venture capital investors ("AVCs") are focused on financing unicorns because of their potential to disrupt the market, transform entire industries, and add value to their portfolios. In some instances, AVCs are even outbidding traditional VC investors.[27] Unicorn founders and AVCs have common interests. Unicorn founders are interested in continuing to control their firm

[25] *See* Jamie Hutchinson, Presentation at the Meeting of SEC Advisory Committee on Small and Emerging Companies: Why Are More Companies Staying Private? 2–5 (Feb. 15, 2017) (presentation slides available at https://www.sec.gov/info/smallbus/acsec/hutchinson-goodwin-presentation-acsec-021517.pdf); Matt Levine, *Unicorn Buybacks and Securities Law*, BLOOMBERG (Feb. 16, 2017, 9:33 AM), https://www.bloomberg.com/view/articles/2017-02-16/unicorn-buybacks-and-securities-law; *see also* Begum Erdogan et al., *Grow Fast or Die Slow: Why Unicorns are Staying Private*, MCKINSEY & CO. (May 11, 2016), https://www.mckinsey.com/industries/high-tech/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private. *See generally* Craig Doidge et al., *Eclipse of the Public Corporation or Eclipse of the Public Markets?*, 30 J. APPLIED CORP. FIN. 8 (2018) [Hereinafter Doidge et al., *Eclipse*]; Craig Doidge et al., *The U.S. Left Behind? Financial Globalization and the Rise of IPOs Outside the U.S.*, 110 J. FIN. ECON. 546 (2013) [hereinafter Doidge et al., *The U.S. Left Behind*]; Craig Doidge et al., *The U.S. Listing Gap*, 123 J. FIN. ECON. 464 (2017) [hereinafter Doidge et al., *The U.S. Listing Gap*]; Xiaohui Gao et al., *Where Have All the IPOs Gone?*, 48 J. FIN.& QUANTITATIVE ANALYSIS 1663 (2013).

[26] *See infra* Part III.

[27] See *infra* Part III for discussion on traditional venture capital investors.

by remaining private longer[28]—not subjecting themselves, their management decisions,[29] trade secrets, or strategy to public market scrutiny.[30] For unicorn founders, AVC is a new and very attractive path to allow early equity investors to exit, by providing liquidity for shareholders that are locked in,[31] without requiring a traditional trade sale or IPO.[32] AVCs are also interested in investing in unicorns, thanks to recent changes to our securities laws, the decline in IPOs,[33] the extended period of low interest rates, a blend of

[28] *See* Michael Ewens & Joan Farre-Mensa, *The Deregulation of the Private Equity Markets and the Decline in IPOs* 1 (Nat'l Bureau of Econ. Rsch., Working Paper No. 26317, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3461485.

[29] For a discussion on the motives to go public, see Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79, 89–92 (1997). *See generally* James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. FIN. 399 (2006) (survey on decisions to do an IPO).

[30] Les Brorsen, *Looking Behind the Declining Number of Public Companies*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 18, 2017), https://corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies/; *see* MCKINSEY & CO., MCKINSEY GLOBAL PRIVATE MARKET REVIEW 2018, THE RISE AND RISE OF PRIVATE MARKETS (2018); Josh Lerner et al., *Mutual Funds as Venture Capitalists? Evidence from Unicorns* (Euro. Corp. Governance Inst., Working Paper No. 675, 2020), https://ssrn.com/abstract=2897254; Matt Levine, *Unicorns Take Different Paths to Being Public*, BLOOMBERG (Mar. 27, 2018, 10:13 AM), https://www.bloomberg.com/opinion/articles/2018-03-27/unicorns-take-different-paths-to-being-public; *see also* Andrew Nussbaum et al., *Private Equity—Year in Review and 2020 Outlook*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 8, 2020), https://corpgov.law.harvard.edu/2020/02/08/private-equity-year-in-review-and-2020-outlook/.

[31] *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 7 (2012) (introducing the term "investor lock-in"); *see also* Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1, 26 (2004).

[32] For more on the exit strategy of traditional investors—VCs, see D. Gordon Smith, *The Exit Structure of Venture Capital* 53 UCLA L. REV. 315, 316 (2005). For helpful background on the distinction between cash-flow and control rights, see Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 784–85 (2017); *see also* William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1875 (2013); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 981–82 (2006); Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 61 (2002).

[33] The decline in IPOs has gained attention from the media, policymakers, and academics. *See* Corrie Driebusch, *IPO Market Isn't Quite Back as Many Startups Are Still Holding Out*, WALL ST. J. (July 5, 2017, 4:47 PM), https://www.wsj.com/articles/ipo-market-isnt-quite-back-as-many-startups-are-still-holding-out-1499252401; Keith Wright, *Silicon Valley Tech Bubble is Larger Than It*

financial and strategic incentives, and other geo-political considerations.[34]

This Article advances the traditional corporate governance and entrepreneurship literature, which over the last thirty years mainly focused on VCs as the dominant source of financing startups.[35] As noted in further detail in this Article, the U.S. regulatory landscape is changing in order to deal with these developments.

The analysis sheds some light on AVCs' ability and incentive to negotiate for aggressive redemption rights and anti-dilution provisions, and influence corporate governance arrangements, which are critical for monitoring unicorn managers.[36] Monitoring the actions of unicorn founders is necessary to prevent misbehavior, such as rent-seeking, corruption, or other illegal activities.[37]

This Article establishes a novel, comprehensive framework within which a deeper understanding of market contracting, regulatory changes, and policy surrounding unicorn firms can be achieved. The subsequent parts of this Article examine the rise in AVC financings, changes to traditional investment patterns in startups, and changes to the VC ecosystem.

Part I introduces the new regulatory landscape that is intended to democratize access to private markets and offer opportunities for retail investors to participate. It introduces the issues the SEC and DOL have attempted to mitigate and their proposed remedies. It breaks down why the some of the remedies are problematic due to the potential risks to investor protection.

Part II introduces some of the new rulemakings that are designed to facilitate capital formation by expanding exempt

Was in 2000, and the End is Coming, CNBC (May 22, 2018, 6:05 AM), https://www.cnbc.com/2018/05/22/tech-bubble-is-larger-than-in-2000-and-the-end-is-coming.html; *see also* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of Public Companies*, 68 HASTINGS L.J. 445, 449 (2017); Adley Bowden & Andy White, *Private vs. Public Market Investors: Who's Reaping the Gains from the Rise of Unicorns*?, PITCHBOOK (June 19, 2018), https://pitchbook.com/news/articles/private-vs-public-market-investors-whos-reaping-the-gains-from-the-rise-of-unicorns; Scott Kupor, *Where Have All the IPOs Gone*, ANDREESSEN HOROWITZ (June 19, 2017), https://a16z.com/2017/06/19/ipos/. *See generally Oversight of the U.S. Securities and Exchange Commission: Hearing Before the S. Comm. on Banking, Hous., & Urb. Affs.*, 115th Cong. (2017) (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission).

[34] *See infra* Part II.

[35] *See* Paul Gompers et al., *How Do Venture Capitalists Make Decisions?* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 22587, 2016), https://www.nber.org/papers/w22587.

[36] *See infra* Part II.

[37] *See infra* Part I.

offerings. It explains the ways in which early stage and late stage startup firms raise capital. The concern is that the current policy trend and regulatory actions to expand exempt offerings may drive the decline of public markets.

Part III explores the forces that have caused the expansion of AVC investors. It analyzes the ownership structures, control rights, monitoring, incentives, and collective bargaining powers of AVC investors and how they are shaping a new VC ecosystem. It sheds light on the motivation of AVC investors to advance capital to unicorn firms.

Part IV expands the analysis of the rise in AVC investors and the ways in which those investors affect a unicorn firm, its capital needs, and corporate governance mechanisms. It further explains how the lack of disclosure of information may affect future investors in such firms. The last part concludes.

I. DEMOCRATIZING ACCESS TO PRIVATE MARKETS

On June 18, 2019, the SEC published the Concept Release on Harmonization of Securities Offering Exemptions (the "Concept Release")[38] to solicit responses to several questions, including whether to expand investment opportunities and allow retail investors to invest in private investment funds.[39]

On September 9, 2019, while delivering a speech to the Economic Club of New York, SEC Chairman Clayton stated that the SEC is "examining whether appropriately structured funds can facilitate Main Street investor access to private investments in a manner that ensures incentive alignment with professional investors—similar to our public markets—and otherwise provides appropriate investor protections."[40]

It appears that the SEC was successful in opening access to private markets and expanding opportunities for some investors. On August 26, 2020, the SEC amended the definition of "accredited

[38] Press Release, U.S. Sec. & Exch. Comm'n, SEC Seeks Public Comment on Ways to Harmonize Private Securities Offering Exemptions (June 18, 2019), https://www.sec.gov/news/press-release/2019-97.

[39] *See* Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 10649, Exchange Act Release No. 86192, Investment Company Act Release No. 33512, 84 Fed. Reg. 30460, 30460 (June 26, 2019) (to be codified at 17 C.F.R. pt. 210, 227, 230, 239, 240, 249, 270 274, 275) [hereinafter Concept Release on Harmonization].

[40] Jay Clayton, Chairman, U.S. Sec. Exch. Comm'n, Remarks to the Economic Club of New York (Sept. 9, 2019), https://www.sec.gov/news/speech/speech-clayton-2019-09-09.

investor" in Rule 215 and Rule 501(a) of Regulation D and expanded the definition of "qualified institutional buyer" in Rule 144A, under the Securities Act of 1933. These definitions determine which individuals and institutions are able to participate in private capital markets.

As noted above, large investment firms, such as private equity funds, have been interested in tapping the individual investor market for quite some time. Some influential groups and academics support this move. To illustrate, two years ago, in November 2018, the Committee on Capital Market Regulation released a report entitled "Expanding Opportunities for Investors and Retirees: Private Equity,"[41] which included several proposals to encourage U.S. policymakers to allow non-accredited investors to invest in private equity firms and indirectly in unicorns.

The report introduced three main suggestions for expanding the current regulatory securities and labor law regimes. First, the report established a call for a securities law legislative reform to allow non-accredited investors to directly invest in private equity funds.[42] Second, the report established a call for a securities law reform to allow public closed-end funds to invest in private equity funds. Currently, the SEC has an informal 15% limit on public closed-end fund investments in private equity funds.[43] And finally, the report included a suggestion for the DOL to grant 401(k) plans the ability to invest in private equity funds.[44]

The DOL recently made the report's third proposal a reality. On June 3, 2020, the Employee Benefit Security Administration of the DOL announced in an information letter[45] that the provisions on fiduciary responsibility in the Employee Retirement Income Security Act of 1974, as amended ("ERISA") allow fiduciaries of 401(k) plans to include diversified investment options with private equity exposure, if certain requirements are met.[46] This means that 401(k)

[41] COMM. ON CAP. MKTS. REGUL., *supra* note 13.

[42] *Id.* at 36.

[43] *Id.* at 42.

[44] *Id.* at 64.

[45] Letter from Louis J. Campagna, Chair, Div. of Fiduciary Interpretations, Dep't of Lab., to Jon W. Breyfogle, Groom L. Grp. (June 3, 2020).

[46] *See* Elizabeth Dyer et al., *New DOL Guidance Provides Road Map for 401(k) Plans to Invest into PE Funds*, KIRKLAND & ELLIS (June 18, 2020) https://www.kirkland.com/publications/995harton995-alert/2020/06/dol-information-letter; *Department of Labor Allows Private Equity Investment Exposure in 401(k) Plans*, PAUL HASTINGS (June 9, 2020), https://www.paulhastings.com/publications-items/details/?id=4a527d6f-2334-6428-811c-ff00004cbded.

plan and individual retirement account fiduciaries now have a roadmap to offer investment in private equity funds.[47]

In the past, plan fiduciaries did not include investment options with an exposure to private equity ("PE") in their 401(k) plans because they were concerned about potential lawsuits and exposure to liability for breach of fiduciary duty under ERISA.[48]

The media gave this letter a lot of attention. Critics expressed their concern that this development would not benefit retail investors but rather might worsen "wealth inequality by sucking a huge pile of money out of the pockets of workers saving for retirement and shepherding it to the few fabulously wealthy owners of private equity firms."[49] Critics are especially concerned about the high, excessive, or hidden PE fee arrangements.[50]

PE investments may have high investment management fees, as compared to mutual funds and other investment vehicles that are included in these plans and, therefore, without appropriate policy design may not be suitable for individual account plans.[51] Critics have also expressed concern about PE investment options that can be too risky or complex or complex for investors to evaluate.[52]

To illustrate the risks associated with monitoring private fund investment advisers or relying on them to do the monitoring for

[47] *See* Robin Kaiser-Schatzlein, *Letting Private Equity Billionaires Rob Worker Retirement Funds,* AM. PROSPECT (June 18, 2020), https://prospect.org/economy/letting-private-equity-billionaires-rob-worker-retirement-funds/.

[48] For more on fiduciary duty, see 29 U.S.C. §§ 1103-1104 (2018) (ERISA); *see also* Dyer et al., *supra* note 46.

[49] Kaiser-Schatzlein, *supra* note 47; *see also Department of Labor is Using the Pandemic as a Pretext to Open High-Risk, High-Fees, High-Leverage Predatory Private Equity Investments to Retirees*, BETTER MKTS. (June 3, 2020), https://bettermarkets.com/newsroom/department-labor-using-pandemic-pretext-open-high-risk-high-fees-high-leverage-predatory ("The last thing the Department of Labor should be doing is enabling or encouraging retiree money to be diverted from transparent public markets with significant disclosure and investor protections to high-risk, dark private markets with little disclosure and few investor protections. To use the pandemic as a pretext for this irresponsible action is adding insult to injury.").

[50] *Department of Labor is Using the Pandemic as a Pretext, supra* note 49.

[51] Lennine Occhino, *DOL Issues Guidance about Private Equity Investments in 401(k) Plans*, MAYER BROWN (June 8, 2020), https://www.usbenefits.law/2020/06/dol-issues-guidance-about-private-equity-investments-in-401k-plans; *Department of Labor Allows Private Equity Investment Exposure in 401(k) Plans*, *supra* note 46; *DOL Gives OK to Private Equity in Diversified 401(k)Funds*, SOC'Y FOR HUM. RES. MGMT. (June 16, 2020), https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/dol-gives-ok-to-private-equity-in-diversified-401k-funds.aspx.

[52] Occhino, *supra* note 51.

retail investors, note that the SEC Office of Compliance Inspections and Examinations (OCIE) issued a risk alert on June 23, 2020.[53] The risk alert highlights numerous problems that the SEC identified after examining enforcement actions involving private fund advisers (PE and hedge funds). The risk alert addresses the following three areas: (1) lack of disclosures of potential conflicts of interest, (2) charging excessive fees, and (3) not instituting policies and procedures regarding codes of ethics and insider trading.[54]

Several politicians responded to the changes allowing 401(k) plans to invest in PE. On June 12, 2020, Senator Sherrod Brown (D-Ohio), Ranking Member of the Senate Banking Committee, along with six other senators, including Elizabeth Warren (D-Ma.) and Bernie Sanders (I-Vt.), sent a letter to DOL Secretary Eugene Scalia[55] asking the DOL to reevaluate its position, as follows:

> Private equity has a long-standing track record of profiting at the expense of workers. When investors purchase a company, they actually have little incentive to ensure the company improves its performance. The managers of the fund profit from the management fees they impose, and they are free to use the companies they acquire to take out loans that are later paid as dividends. They can sell off the assets of the companies they acquire and assume little risk for the bets they make. These perverse incentives, investor-friendly rules, and gaps in private equity transparency and governance ultimately put workers at risk of losing their pay, their benefits, their jobs, and their livelihoods.[56]

It is true that there is inequality in the sense that retail investors are not able to invest in and benefit from private investment funds or unicorn firms (unless they invested with

[53] OFF. OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM'N, RISK ALERT: OBSERVATIONS FROM EXAMINATIONS OF INVESTMENT ADVISERS MANAGING PRIVATE FUNDS (2020).

[54] There may be other risks to consider and some of these issues may not be relevant to particular funds.

[55] Letter from Sen. Sherrod Brown, Sen. Bernard Sanders, Sen. Sheldon Whitehouse, Sen. Edward J. Markey, Sen. Elizabeth Warren, Sen. Tammy Balwin, & Sen. Jeffrey A. Merkley, senators, U.S. Senate, to Eugene Scalia, Sec'y, Dep't of Lab. (June 12, 2020).

[56] *Id.*

participating mutual funds or other investment funds). However, our securities laws were designed to protect them because investing in private markets is very risky and there is a problem of illiquidity.

In light of these developments and the rise in AVC investors, this Article advocates for more, not less, investor protection. Part II deepens the analysis of how investment in unicorn firms is prone to high risks, agency costs, and collective action problems, which can "hinder price discovery, liquidity, and information quality in the absence of regulation."[57]

Accredited sophisticated investors are able to bargain and protect their interests (negotiate for anti-dilution or redemption rights) when investing in illiquid risky ventures. But who is going to protect the interests of non-accredited investors? The purpose of our trust and securities laws, specifically the Securities Act of 1933 and the Securities Exchange Act of 1934, is to provide the public with indispensable information concerning the offerings, the risks, and the companies themselves.

Retail investors should not have more exposure to private markets, via PE funds or otherwise, without more protections. If policymakers allow retail investors to invest in private markets, by using PEs or other private fund advisers, they must first adopt new laws and demand more transparency from these private market actors. They must protect investors from illegal fee practices and other issues raised above. Private ordering alone cannot substitute the protections afforded by public markets.[58]

The initiatives are meant to deal with the increasing inequality of equity ownership in the United States and provide investment opportunities for retail investors.[59] However, policymakers and

[57] Letter from Elisabeth D. de Fontenay et al., Professor of L., Duke Univ. Sch. Of L., to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n (Sept. 24, 2019) ("[I]nvesting in private securities would pose considerable additional risks for retail investors, relative to investing in public securities, and existing research suggests that these additional risks would not be sufficiently offset by higher expected returns."); *see, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

[58] *See* Letter from Elisabeth D. de Fontenay et al. to Vanessa Countryman, *supra* note 57.

[59] For more on inequality metrics and research, see Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, 118 Q.J. ECON. 1 (2003); *see also* Juliana Menasce Horowitz et al., *Trends in Income and Wealth Inequality*, PEW RSCH. CTR.: SOC. & DEMOGRAPHIC TRENDS (2020), https://www.pewsocialtrends.org/2020/01/09/trends-in-income-and-wealth-inequality/ (Since 2009, "[e]conomic inequality, whether measured through gaps in income or wealth between richer and poorer households, continues to widen.").

academics dispute the benefits of these changes to retail investors due to the fact that investments in private markets are also associated with "higher fees, less liquidity, and less regulatory oversight."[60] Private markets do not offer the same protections and disclosure of information as public markets.

Given the risks associated with investing in private firms, especially unicorn firms, the Article advocates for additional investor protections, not less. It sheds light on these new developments, the push for excessive risk in return for aggressive growth, and the incentive misalignment between the different types of accredited sophisticated investors that currently invest in private markets, specifically in unicorn firms. There are many risks associated with investing in privately held firms, including uncertainty, information asymmetry, and adverse selection.[61]

SEC Commissioner Allison Lee also expressed reservation about these developments and stated that "These proposed changes all go in one policy direction—toward expanding the pool of investors in the opaque, and indisputably high-risk, private markets."[62] Former SEC Commissioner Robert Jackson also suggested that we need to adequately analyze the relevant data prior to expanding these definitions and changing our laws.[63]

The recent changes to our securities laws make it easier for unicorns to continue to raise large amounts of capital by using more exemptions from registration. These changes also lowered some of

[60] Jeff Benjamin, *Financial Advisers Bristle at SEC's Pitch to Redefine 'Accredited Investor,'* INV. NEWS (Feb. 27, 2017), https://www.investmentnews.com/financial-advisers-bristle-at-secs-pitch-to-redefine-accredited-investor-70729; *see also Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment: Hearing Before the Subcomm. on Inv. Prot., Entrepreneurship, & Cap. Mkts. of the H. Comm. on Fin. Servs.*, 116th Cong. (2019) (written statement of Elisabeth de Fontenay, Professor of Law, Duke University) [hereinafter de Fontenay Written Statement]; Letter from James C. Allen & Stephen Dean, CFA Inst., to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n (June 12, 2020); Erik F. Gerding, *The Cost to Retail Investors and Public Markets of "Harmonizing" Securities Offering Exemptions*, CLS BLUE SKY BLOG (Oct. 1, 2019), https://clsbluesky.law.columbia.edu/2019/10/01/the-cost-to-retail-investors-and-public-markets-of-harmonizing-securities-offering-exemptions/.

[61] *See infra* Part III.

[62] Allison Herren Lee, *Statement by Commissioner Lee on Proposed Expansion of the Accredited Investor Definition*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 20, 2019), https://corpgov.law.harvard.edu/2019/12/20/statement-by-commissioner-lee-on-proposed-expansion-of-the-accredited-investor-definition/. Commissioner Lee criticized the final rule for weakening investor protection (especially for seniors), and for failing to index for inflation going forward.

[63] Robert J. Jackson, Jr., Comm'r, Sec. & Exch. Comm'n, Statement on Reducing Investor Protections Around Private Markets (Dec. 18, 2019).

the disclosure requirements for non-accredited investors. The policy goal behind the new rulemaking is meant to facilitate capital formation for private firms and expand investment opportunities for retail investors and, by doing so, also improve access to capital in private markets. Despite the best intentions of regulators, their policy changes may not help investors, retirees, and entrepreneurs and may even put them at greater risk for the reasons detailed below.

The following explains the nature of the relationships between startups and their investors and the access to capital in private markets.

II. ACCESS TO CAPITAL IN PRIVATE MARKETS

Regulators explained that one of the policy goals behind expanding the exempt offering framework is to facilitate capital formation and improve access to capital in private markets for small issuers that are underserved by traditional capital raisings.[64]

There is a need to expand access to capital to small and underserved businesses, such as those that are owned by minorities, women, and veterans, or are located in depressed regions or non-technology clusters.[65] But it is not clear that expanding the exempt offering framework will improve capital formation opportunities for such businesses.

First, location and industry concentration may be important to investors. To illustrate, note that venture capital investors who traditionally invest in startups do not have a nationwide presence, and are frequently organized as small partnerships.[66] They are "hands on" investors who prefer to monitor their investments very closely. They also provide mentoring and other management services for the startups that they invest in. Such investors usually prefer to invest in startups that are close to their geographic location, which allows them to provide these services more easily. That may be one

[64] *See* Facilitating Capital Formation and Expanding Investment Opportunities, *supra* note 20. For more information on underserved businesses, see generally OFF. OF THE ADVOC. FOR SMALL BUS. CAP. FORMATION, U.S. SEC. & EXCH. COMM'N, ANNUAL REPORT FOR FISCAL YEAR 2019 (2019).

[65] *See* Anat Alon-Beck, *The Coalition Model, A Private-Public Strategic Innovation Policy Model for Encouraging Entrepreneurship and Economic Growth in the Era of New Economic Challenges*, 17 WASH. U. GLOB. STUD. L. REV. 267 (2018); *see also* Caroline A. Crenshaw, Comm'r, Sec. & Exch. Comm'n, Statement on Harmonization of Securities Offering Exemptions (Nov. 2, 2020).

[66] *See infra* Part III.

of the reasons why it is very difficult for startups that are located in areas that do not have technology clusters to obtain funding. How would the new rules help these startups?

Second, underserved businesses may face significant bias that precludes them from raising capital. For example, startups led by women face significant bias that has made it difficult for them to attract funding from venture capitalists.[67] Unfortunately, as noted by SEC Commissioner Caroline Crenshaw, the new rules do not address this problem.[68]

Third, there is controversy over continuing the recent policy trend of expanding capital access via exempt offerings at the expense of protecting investors.[69] This trend contributes to the rise in unicorn firms, which are already raising large amounts of capital from traditional VC investors and non-traditional AVC investors. Unicorns will be able to raise even more capital more frequently and with less restrictions thanks to these changes.[70]

Critics also warn that there is no evidence that "good" private or public U.S. firms cannot attract capital from investors.[71] The reality is that traditional investors in private markets, VCs and PEs, are already competing with non-traditional investors over investments in unicorn firms.[72]

The following deepens the understanding of the ways in which firms, specifically startups, raise funding.

A. Early Stage Funding

A firm, any firm, always desires or needs to raise capital, in order to grow, hire people, or to be able to invest in new projects.

[67] *See* Crenshaw, *supra* note 65; *see also* Chloe Taylor, *Over a Third of Female Entrepreneurs Experience Gender Bias*, CNBC (Oct. 3, 2019), https://www.cnbc.com/2019/10/03/hsbc-a-third-of-the-worlds-female-entrepreneurs-face-gender-bias.html; *Why VCs Aren't Funding Women*, KNOWLEDGE@WHARTON (May 24, 2016), https://knowledge.wharton.upenn.edu/article/vcs-arent-funding-women-led-startups/.

[68] *See* Crenshaw, *supra* note 65.

[69] See *infra* Part II for a discussion on the JOBS Act.

[70] *See* Crenshaw, *supra* note 65.

[71] De Fontenay Written Statement, *supra* note 60, at 13.

[72] It should be noted that there is a distinction between an innovation driven entrepreneurial firm and a small medium business enterprise. This Article will only address policy with regards to unicorns, which are large innovation driven enterprises. For more, see Alon-Beck, *supra* note 65; *see also* William Aulet & Fiona Murray, A Tale of Two Entrepreneurs: Understanding Differences in the Types of Entrepreneurship in the Economy (May 1, 2013) (unpublished manuscript) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2259740).

Differences exist, however, between small and medium enterprises ("SMEs") and innovation driven enterprises ("IDEs").[73] Startups belong to the IDEs category because they concentrate on both local and global markets. IDEs are innovative because they adopt a new technology, process, or business model.

For proper policy design, it is not enough to distinguish between SMEs and IDEs. We must also distinguish between different types of IDEs and their stages of funding: seed and early stage funding, late stage funding, and very late stage pre-IPO funding.

Raising capital can be very different depending on the type of firm, stage, amounts of funding raised, and market conditions. An early stage startup, for example, usually experiences challenges in raising capital for the following reasons.[74] The firm's internal cash flow is not enough to support its needs.[75] It cannot support the firm's fast growing technology and research and development needs, which are comprised of intangible assets.[76] If the firm is not able to obtain an injection of new capital, it will likely go bankrupt.[77] This is not the case for the mature wealthy startup—the unicorn firm.[78] The unicorn is a different beast!

B. Late Stage and Very Late Stage Funding

Raising large amounts of capital in late stage and very late stage financings is the new norm for a unicorn firm. Unicorns are not rare anymore. A new unicorn firm is born every four days.[79] Thanks to investors that traditionally invested in public companies and now crossed over to invest in private markets, "private markets are the new public markets."[80]

The ability to raise large amounts of capital affects the unicorn firm. Unicorns are no longer dependent on an IPO (or trade sale) to

[73] *See* Alon-Beck, *supra* note 65.

[74] Ola Bengtsson & John R.M. Hand, CEO Compensation in Venture Capital Markets 2 (2008) (unpublished manuscript) (available at https://ssrn.com/abstract=1079993).

[75] *Id.* at 6.

[76] *Id.* at 7.

[77] *Id.* at 18.

[78] See *supra* note 4 for the features of a unicorn for purpose of this Article. *See also How Unicorns Grow*, HARV. BUS. REV., Jan.–Feb. 2016, at 28–30 ("Firms founded from 2012 to 2015 had a time to market cap more than twice that of firms founded from 2000 to 2003.").

[79] *See* Howie Xu, *In Venture Capital, It's Still the Age of the Unicorn*, TECHCRUNCH (Nov. 11, 2018), https://techcrunch.com/2018/11/11/age-of-the-unicorn/.

[80] Levine, *supra* note 2.

raise sufficient capital.[81] Thanks to the changes in our securities laws, specifically, the expansions of exempt offerings in recent years, unicorn founders are now able to raise large amounts of money in mega deals, push their companies to stay private longer than eleven years,[82] favor contractual "founder friendly" terms, and maintain control over the management of the firm.[83]

Founders are able to gain such powers thanks to changes in the identity of the majority or controlling shareholders of late stage IDEs. To illustrate, if we compare the IPOs of "old" successful startups, such as Apple,[84] Amazon,[85] Google,[86] or Facebook,[87] and the IPOs of "new" unicorns, such as Uber, we will find many differences. These differences include valuations, growth periods, revenue expansions, timeline to IPO, and capital raising methods. One of the most striking differences between old and new startups is the change in the identity of their largest shareholder.

In the past, the largest shareholder of a late stage startup would typically be a VC investor (or perhaps also a founder).[88] Today, the largest shareholder of a unicorn startup can also be an AVC investor. The interest of these deep-pocketed AVC investors has reversed the competitive landscape of unicorn funding. Rather than

[81] Brorsen, *supra* note 30; *see* MCKINSEY & CO., *supra* note 30; Lerner et al., *supra* note 30; Levine*, supra* note 2.

[82] *See* Sungjoung Kwon et al., *Mutual Fund Investments in Private Firms*, 136 J. FIN. ECON. 407, 425 (2020) (showing that these large amounts of capital "should enable the companies to stay private longer.").

[83] *See infra* Part II (discussing "founder friendly" terms).

[84] *See* Alex Wilhelm, *A Look Back in IPO: Apple, the Early PC Purveyor*, TECHCRUNCH (Sept. 15, 2017), https://techcrunch.com/2017/09/15/a-look-back-in-ipo-apple-the-early-pc-purveyor/.

[85] Amazon's IPO was in 1997. *See* Alex Wilhelm, *A Look Back in IPO: Amazon's 1997 Move*, TECHCRUNCH (June 28, 2017), https://techcrunch.com/2017/06/28/a-look-back-at-amazons-1997-ipo/.

[86] Alex Wilhelm, *A Look Back in IPO: Google, the Profit Machine*, TECHCRUNCH (Aug. 1, 2017), https://techcrunch.com/2017/07/31/a-look-back-in-ipo-google-the-profit-machine/.

[87] Alex Wilhelm, *A Look Back in IPO: Facebook's Trailing Profit and Mobile Intrigue*, TECHCRUNCH (Aug. 22, 2017), https://techcrunch.com/2017/08/22/a-look-back-in-ipo-facebooks-trailing-profit-and-mobile-intrigue/.

[88] Many have written on VCs' exit at IPO. *See, e.g.*, Christopher Barry et al., *The Role of Venture Capital in the Creation of Public Companies: Evidence from the Going Public Process*, 27 J. FIN. ECON. 447 (1990); Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133 (1996); Peggy M. Lee & Sunil Wahal, *Grandstanding, Certification, and the Underpricing of Venture Capital Backed IPOs*, 73 J. FIN. ECON. 375 (2004); William L. Megginson & Kathleen A. Weiss, *Venture Capital Certification in Initial Public Offerings*, 46 J. FIN. ECON. 879 (1991).

unicorn firms competing for a limited pool of funding, they are able to attract a nearly limitless pool of funds, leaving the deep-pockets to compete for the chance to invest.[89]

This reversal substantially alters the governance structure of unicorns and the nature of the relationships between these companies and their investors.[90] AVCs invest in late stage and very late stage IDEs and are very different from traditional VC investors.[91] VC funds are special investment vehicles that provide financing to startup firms.[92] VCs are an essential element of the U.S. national innovation system, which countries around the world extensively imitate.[93]

The funding and support from a VC fund are of tremendous importance to a budding startup, not only because it provides the startup with cash,[94] but also and more importantly because the VC managers provide services. These include mentoring and presenting the young company to networks of additional investors, potential acquirers, new partners, and customers.[95] VC financing dominates the entrepreneurial finance literature[96] due to the economic role that VCs play in reducing information costs.[97] The following builds on this literature and sheds light on the new AVC investors.

[89] For more information on the large amounts of "dry powder," i.e., private capital that is looking for investments in private offerings, see BAIN & COMPANY, GLOBAL PRIVATE EQUITY REPORT 2020, at 11 (2020) (identifying more than $2.5 trillion in worldwide private equity "dry powder," where more than half of this amount is attributable to North America); *see also* Crenshaw, *supra* note 65.

[90] For more on the influence of the new AVC investor on the unicorn firm, as well as its current and future investors, see *infra* Part III. For an example of the WeWork and SoftBank relationship, see *infra* Part IV. SoftBank Group is a Japanese multi-national conglomerate headquartered in Tokyo, Japan.

[91] For more on the difference between VCs and AVCs, see *infra* Part III.

[92] *See* Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1169 (2013); John D. Morley, *Why Do Investment Funds Have Special Securities Regulation?*, (Yale L. & Econ., Research Paper, 2019), https://ssrn.com/abstract=3375450. VCs are private vehicles that can avoid complying with the Investment Company Act. *See* 15 U.S.C. §§ 80a-1–80a-64 (2012)).

[93] *See* David H. Hsu & Martin Kenney, *Organizing Venture Capital: The Rise and Demise of American Research & Development Corporation, 1946–1973*, 14 INDUS. & CORP. CHANGE 579 (2005); Korsmo, *supra* note 92.

[94] DAN SENOR & SAUL SINGER, START-UP NATION: THE STORY OF ISRAEL'S ECONOMIC MIRACLE 161 (2009).

[95] *See infra* note 164; *see also* Yael V. Hochberg et al., *Networking as a Barrier to Entry and the Competitive Supply of Venture Capital*, 65 J. FIN. 829 (2009); Laura Lindsey, *Blurring Firm Boundaries: The Role of Venture Capital in Strategic Alliances*, 63 J. FIN. 1137 (2008).

[96] Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 720 (2010).

[97] *See supra* Part I.

The fact that the AVC investor might be the largest shareholder in a unicorn firm is not surprising since alternative investments in the U.S. market are up from around 40% a decade ago.[98] It appears that there is an endless supply of private money from AVC investors, who are willing to line up to fund unicorns. To highlight the dramatic change in the market, note that the largest proportion of deals (almost 60%) in the VC industry in 2019 involved AVC investors.[99]

In the past four years, at least one alternative investor has invested in the reported 2,000 completed VC financing rounds.[100] Furthermore, SoftBank, the Japanese telecom giant, which currently holds the largest tech investment fund in the market and in history, the $100 billion Vision Fund,[101] is credited for pushing the deal sizes upwards.[102] AVC investors play an important role in financing unicorns, and they need to be taken into account when making policy decisions on capital formation needs of startups.

Currently, retail investors, researchers, and regulators do not have detailed information on the identity of the new AVC investors in our private markets, their incentives, their risk tolerance, the contractual terms that they negotiate, or other relevant data that would be helpful in understanding the new developments in the private markets. Part III below will analyze the interactions and relationships between the different investor groups in unicorn firms in order to understand the recent developments. But first, the following explores the recent regulatory developments that opened access to capital in private markets, which led to more investments by AVC investors.

[98] PITCHBOOK & NAT'L VENTURE CAP. ASS'N, VENTURE MONITOR 27 (2019) [hereinafter PITCHBOOK NVCA 2019 REPORT]. 2018 marked the first year since the dot-com crisis of 2000 that annual investments in U.S. VC-backed firms surpassed $100 billion. *Id.* at 4.

[99] *Id.* at 27.

[100] *Id.* ("The average size of deals with tourist investor participation has surpassed $43 million during the past two years, a $15 million jump over any year prior").

[101] Sam Shead, *Silicon Valley VCs Are Being Pressured into Raising Big New Funds by the Size of SoftBank*, BUS. INSIDER (Dec. 21, 2017), https://www.businessinsider.com/sequoias-reportedly-raising-a-new-6-billion-fund-2017-12. SoftBank is actively fundraising for its Vision Fund 2 from new players such as Apple Inc. and Microsoft Corp.

[102] PITCHBOOK NVCA 2019 REPORT, *supra* note 98, at 27 ("not only because of the 50 mega-deals the firm has contributed to since 2015, but also because the competitors of its portfolio companies have been forced to cut larger checks in response.").

C. Improving Access to Capital in Private Markets

In order to improve access to capital in private markets, the SEC recently adopted amendments to harmonize and improve the "patchwork" exempt offering framework. It is important to acknowledge the need to harmonize the current complex offering framework and to give the SEC credit for trying to simplify it.[103]

According to our federal and state securities laws, any offer or sale of securities is subject to registration unless there are exemptions from registration.[104] Registered offerings are subject to comprehensive disclosure requirements,[105] higher compliance costs, and provide access to a broad group of potential investors.[106]

It is also important to note that this is not the first time that the SEC is expanding exemptions from registration requirements. This is part of a series of reforms to the federal securities laws, which began about fifteen years ago,[107] in order to provide exemptions from the old registration requirements.[108]

The primary congressional enactments that allowed companies to use exemptions are the Jumpstart Our Business Startups Act of 2012 ("JOBS Act"), the Fixing America's Surface Transportation Act of 2015 (the "FAST Act") and the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (the "Economic Growth Act").[109]

[103] This Article does not discuss the changes to Regulation Crowdfunding. Moreover, it applauds the SEC for strengthening investor protections under Regulation Crowdfunding.

[104] There is a debate on whether it contributed to the reduction of information asymmetry and agency costs. *See* Darian Ibrahim, *Public or Private Venture Capital*, 94 WASH. L. REV. 1137, 1144 (2019) ("Mandatory disclosure reduces the costs of acquiring information by forcing corporations to release it to the markets at pre-set times"); *see also* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 716, 738 (2006).

[105] *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1076 (1995).

[106] *See* EVA SU, CONG. RSCH. SERV., R45221, CAPITAL MARKETS, SECURITIES OFFERINGS, AND RELATED POLICY ISSUES 3 (2018).

[107] *See* Statement of Renee Jones, *supra* note 4.

[108] *Id.*

[109] For more on these Acts, see Alon-Beck, *Unicorn Stock Options*, *supra* note 4; *see also* Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 38. The other legislative enactments are: (1) the Financial CHOICE Act of 2017, which includes modernizing the Regulation D offering process and creates the "venture exchanges"; (2) The CROWDFUND Act, title III of the JOBS Act, which, through agency rulemaking, allows companies to use a crowdfunding platform (intermediary) for raising small amounts of equity capital (less than $1 million annually) from potentially large pools of investors over the internet, see Joan M. Heminway,

The intention and rationale behind the JOBS Act was to facilitate the emerging growth companies' "access to the public capital markets."[110] The JOBS Act reduced SOX regulatory requirements in the hopes of encouraging private companies to go public.[111] However, the JOBS Act's biggest achievement was "radical deregulation."[112] The exemption allowed private firms to keep material information private longer, as they are now required to disclose according to the federal periodic disclosure requirements.[113] Thanks to the JOBS Act, the threshold that triggered registration with the SEC has changed.[114]

These changes are balanced due to the tension between capital formation needs and investor protection. A private placement (private offering or unregistered offering) is an offering of securities to potential investors, which is exempt from registration with the SEC and is not subject to broad disclosure requirements.

Securities Crowdfunding and Investor Protection (Univ. of Tenn. Legal Stud., Working Paper No. 292, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2810757; and (3) title IV of the JOBS Act, which provides for new Regulation A exemptions (commonly referred to as "Reg A+") that increased a private company's ability to make unregistered public offerings to a maximum of $50 million to the public in any twelve-month period.

[110] *See* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389 (2013); Robert B. Thompson & Donald C. Langevoort, *Rewarding the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013); *see also* Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone? The Hard Life of the Small IPO*, 6 HARV. BUS. L. REV. 83, 84 (2016); Usha Rodrigues, *The JOBS Act at Work*, CONGLOMERATE (Sept. 11, 2015), http://www.theconglomerate.org/jobs-act/ (criticizing the JOBS Act's unrealistic endeavors to boost IPOs).

[111] According to Rose and Solomon, "The JOBS Act is primarily a response to the regulatory theory, but also takes some aims towards market structure by loosening restrictions on research analysts." Rose & Solomon, *supra* note 110, at 85.

[112] *See Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins., & Inv. Of the S. Comm. on Banking, Hous., & Urb. Affs.*, 112th Cong. (2011) [hereinafter Senate Hearing, Examining Investor Risks]; *see also* Michael D. Gutentag, *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, 175 (2013).

[113] *See* Gutentag, *supra* note 112, at 152.

[114] "[T]he JOBS Act related changes affecting the private market may be more significant[:] Title V and Title VI changes to the Exchange Act Section 12(g) threshold[,] Changes to Rule 506[, and] Legal certainty for matchmaking platforms." Susan Mac Cormack et al., Morrison & Foerster LLP, Presentation at Late Stage Financing Sessions: Late Stage Private Placements 3 (Apr. 26–27, 2016) (presentation slides available at https://media2.mofo.com/documents/160426latestagefinancings.pdf). For more, see generally ANNA PINEDO, MORRSION & FOERSTER, FOLLOWING THE WISDOM OF THE CROWD? A LOOK AT THE SEC'S FINAL CROWDFUNDING RULES (2015).

The Securities Act provides a number of exemptions from registration.[115] Investors most frequently use exemptions from registration applicable to private placements that are contained in Section 506, under Regulation D of the Securities Act.[116] According to a concept release by the SEC,[117] in 2018, companies raised $1,500 billion using Rule 506(b) of Regulation D, [118] and $211 billion using Rule 506(c) of Regulation D.

Table 1.

Exemption	**Amounts Reported or Estimated as Raised in 2018**
Rule 506(b) of Regulation D	$1,500 billion
Rule 506(c) of Regulation D	$211 billion
Regulation A: Tier 1	$0.061 billion
Regulation A: Tier 2	$0.675 billion
Rule 504 of Regulation D	$2 billion
Regulation Crowdfunding; Section 4(a)(6)	$0.055 billion
Other exempt offerings	$1,200 billion

Source: Concept Release on Harmonization, *supra* note 39, at 30462.

As indicated in the above chart, Rule 506(b) is most commonly used by investors that rely on exemptions from registration. It is so popular that, according to the Small Business Advocate Annual Report, in 2019, "Rule 506(b) exemptions raised more money than was raised by all U.S. public offerings."[119]

[115] Section 3 of the Securities Act identifies classes of securities that are exempt from the registration requirements. 15 U.S.C. § 77c (2018). Section 4 of the Securities Act identifies a number of transactions that are exempt from the registration requirements. *Id.* § 77d. Both public and private companies can use unregistered offerings (private placements) to raise funds from investors. This Article will focus on offerings made by private companies and their investors.

[116] *See Rule 506 of Regulation D*, INVESTOR.GOV: U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/answers-rule506htm.html (last updated Nov. 27, 2017); *see also* Abraham J. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 132 (2010); Rutheford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Consequences for the SEC's Crown Jewel Exemptions*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 287, 295 (2012); Ibrahim, *supra* note 104, at 1162.

[117] *See* Table 1.

[118] *See* 17 C.F.R. § 230.506(b) (2016).

[119] *See* Crenshaw, *supra* note 65.

As part of the effort to harmonize the complex disclosure regime, the SEC changed the financial information that must be provided to non-accredited investors under Rule 506(b) in order to align it with offerings under Regulation A. This change removes the audit requirement in a Rule 506(b) offering of up to $20 million with regards to non-accredited investors to align it with a Regulation A Tier 1 offering, which does not require audits of financial statements.

The idea behind the change is to encourage the participation of non-accredited investors in Rule 506(b) offerings. Prior to the change,

506(b) issuers might have had no incentive or interest to offer and sell securities to any non-accredited investors due to the expensive disclosure requirements and the fact that they are permitted to offer to no more than 35 non-accredited investors. Time will tell whether this change will encourage more participation of non-accredited investors or not.

It should be noted that the CFA Institute raised the concern that there are some problems with the change due to the fundamental differences between the regulations. Issuers using the new Rule 506(b) offerings to non-accredited investors will be required to disclose unaudited financial statements as long as the offering amount is below $20 million. If the Rule 506(b) offering is above $20 million, issuers will be required to make the disclosures according to Article 8 of Regulation S-X instead of the disclosures required in a registration statement.

The CFA Institute objects to aligning the regulations because Rule 506(b) offerings and Regulation A Tier 1 are different regulations that were traditionally designed to protect investors. Regulation A Tier 1 (and Regulation Crowdfunding) provides additional protections to non-accredited investors, which Rule 506(b) does not. In a Regulation A offering, the issuer files an offering statement with the SEC. The SEC reviews the offering statement and decides whether to declare that it is "qualified." Only after the offering statement has been qualified by the SEC may issuers begin selling securities. These "differences amplify the need for the current audit requirement in certain 506(b) offerings."[120]

The CFA Institute emphasized in their comment letter to the SEC that audited financial statements are incredibly important for investor protection and further quoted SEC Chief Accountant Sagar

[120] Letter from James C. Allen & Stephen Dean to Vanessa Countryman, *supra* note 60; Crenshaw, *supra* note 65.

Teotia to support their claim: "As Chairman Clayton has emphasized, audited financial statements are the bedrock of our financial reporting system. High-quality financial statements, prepared in accordance with a framework developed by independent standard setters, provide relevant and reliable information to investors."[121]

The SEC's intention and rationale behind this change is to harmonize the current framework and facilitate access of non-accredited investors to the private capital markets. Therefore, they reduced the regulatory requirements under Rule 506(b) in the hopes of simplifying the current offering framework and encouraging private placement offerings to non-accredited investors.

Some critics may argue that this policy continues the JOBS Act's trend of "radical deregulation,"[122] and that this change may hurt the non-accredited investor's ability to make an informed investment decision. As noted above, there are differences between Regulation D and Regulation A where Regulation A provides more protections.

Others might disagree due to the limited number of non-accredited investors that may be involved in a Rule 506(b) private placement and the fact that these investors will get financial statement information, albeit unaudited, as well as non-financial statement information.

Finally, this Article argues that large issuers, such as unicorn firms, should be required to be audited by an independent auditor before issuing securities to non-accredited purchasers. If a company is raising money at a billion-dollar valuation, the cost of such an audit should not be overly burdensome. These disclosures can improve efficiency, reduce information asymmetries, and produce increasingly equitable and sustainable participation of all investors in unicorn firms.

In any event, one thing is clear: The SEC is taking more actions to encourage investor participation in private markets. The SEC continues the policy trend that encourages issuers to raise large amounts of capital using private placements as is evident from the new amendments to the integration rules, which will allow issuers to access more capital more easily and efficiently.

[121] Sagar Teotia, Chief Acct., U.S. Sec. & Exch. Comm'n, Statement in Connection with the 2019 AICPA Conference on Current SEC and PCAOB Developments (Dec. 9, 2019).

[122] *See* Senate Hearing, Examining Investor Risks, *supra* note 112; *see also* Gutentag, *supra* note 112.

To illustrate, the SEC established a new integration framework that replaced the prior five-factor integration test.[123] It shortened the integration safe harbor under Regulation D to a thirty-day integration safe harbor, despite concern by critics that this policy might encourage more fraud and Ponzi schemes.[124] It also adopted a number of safe harbors in new Rule 152(b), which will make it easier for issuers to raise capital.[125]

The SEC's expansion of the exempt offering framework increases the risks to retail investors and also decreases the information available to investors in general. The following explains the potential risks to potential investors due to illiquidity. It supports the argument that the SEC must improve investor protections for the new investor groups that will be eligible to invest in private markets thanks to these changes.

[123] *See SEC Simplifies the Exempt Offering Framework*, MCGUIREWOODS (Nov. 23, 2020), https://www.mcguirewoods.com/client-resources/Alerts/2020/11/sec-simplifies-the-exempt-offering-framework.

[124] It should be noted that some critics object to this change. *See* Letter from Christine Lazaro & Samuel Edwards to Vanessa Countryman, *supra* note 21 ("Private placements are often heavily marketed through independent broker-dealer networks and are 'sold, not bought.' Financial professionals push these products to unsophisticated investors—those same investors do not beg their advisors for access to non-public investments. PIABA's members see the investments presented as alternative income investments appealing to elderly investors often living on a fixed income. Unscrupulous financial advisors pitch the products as offering income higher than what is available in conventional fixed-income securities, and/or also providing diversification to the investor's portfolio because their value is not correlated to the stock market or other conventional asset classes. Many clients solicited to invest in these types of products end up losing their entire investment.").

[125] For more analysis on the new changes, see DEBEVOISE & PLIMPTON, SEC EASES RULES GOVERNING PRIVATE PLACEMENTS (2020); *see also* Facilitating Capital Formation and Expanding Investment Opportunities, *supra* note 20.

D. Private Markets and Illiquidity

One of the main problems with opening access to private markets is the illiquidity associated with private investments. For example, unicorn shares are non-liquid financial assets. Whether there is an active market to trade these securities or not depends on the bargaining power of the investor and the share purchase agreement that she signed. Certain unicorns may allow some of their investors to trade their shares on secondary trading markets, but the reality is that many unicorns put restrictions on these practices and do not allow trading in order to assure compliance with our securities laws.

Historically, regulations limited the exit mechanism for investors in private firms to an IPO or a trade sale.[126] Private company investors therefore dealt with extreme "lock-in" of their capital due to the illiquidity of their stock. [127] Due to the prolonged timeline to IPO or trade sale, which is now longer than eleven years,[128] companies developed new liquidity practices to allow unicorn shareholders, such as powerful early investors (sometimes also employees), to liquidate their investments as an alternative to the traditional exit mechanisms.[129]

These new practices include secondary sales, structured liquidity programs (private tender offers), and other liquidity alternatives.[130] Existing shareholders (investors and employees) often use them as a

[126] *See* Jesse M. Fried & Brian J. Broughman, *Do Founders Control Start-Up Firms That Go Public?* (Eur. Corp. Governance Inst., Law Working Paper No. 405/2018, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171237.

[127] The private startup company legal form is set to "lock-in parties while developing vulnerable match-specific assets." *See* Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 919 (1999). This Article builds on the work of Rock and Wachter and postulates that capital lock-in is important for startup companies, including large unicorns, because the cost of investing in innovation-driven products or services is very high and risky.

[128] The timeline to IPO used to be four years and is now longer than eleven years. *See* JAY RITTER, INITIAL PUBLIC OFFERINGS: UPDATED STATISTICS 12 (2020).

[129] *See* Katie Roof, *SoftBank's Big Investment in Uber Comes to a Close*, TECHCRUNCH (Dec. 28, 2017), https://techcrunch.com/2017/12/28/softbanks-big-investment-in-uber-comes-to-a-close/; *see also* Greg Bensinger & Liz Hoffman, *SoftBank Succeeds in Tender Offer for Large Stake in Uber: Group Led by Japanese firm Is Set to Acquire About 18% of Startup at a Steep Discount*, WALL ST. J. (Dec. 28, 2017), https://www.wsj.com/articles/softbank-succeeds-in-tender-offer-for-large-stake-in-uber-1514483283.

[130] *See* DAWN BELT, PRE-IPO LIQUIDITY FOR LATE STAGE START-UPS 1 (2018).

third exit option.[131] They involve specific contractual arrangements between the various participants. These investors have divergent rights and privileges as explained in further detail below.

Many unicorn firms develop new liquidity alternatives because of the desire of the founder to push the company to stay private longer, which is now longer than eleven years.[132] The development of new dynamic secondary markets makes it easier for AVC investors to invest in private unicorn firms.[133] Would non-accredited investors be able to bargain for such opportunities?

It should be noted that historically secondary transactions were common in the private equity industry but not within the VC industry.[134] It is also important to note that the new liquidity practices, such as the secondary sales, structured liquidity programs (private tender offers), and other liquidity alternatives,[135] were designed to allow the powerful accredited unicorn shareholders to liquidate their investments as an alternative to the traditional exit mechanisms.[136]

These alternative exit mechanisms facilitate the participation of AVC investors that traditionally invested in public markets and induce them to invest in private markets. As noted, they also allow founders to continue to maintain control[137] over the management of their company.[138] For proper policy design on expanding exempt

[131] *See* Ibrahim, *supra* note 104.

[132] The timeline to IPO used to be four years and is now longer than eleven years. RITTER, *supra* note 128, at 12.

[133] There are several distinctions between secondary and primary markets. First, in the primary market, the company issues securities (stock or bonds) for the first time directly to investors. If the investors then sell the securities to a third party, then these transactions occur on the secondary markets. Second, the proceeds from the sale of securities on the primary market go to the issuing company. Whereas the proceeds from the sale of securities on secondary markets go to the selling investor and not the company that initially issued the stock. Family offices and angel investors are not going to get much attention in this Article.

[134] Chirag Modi, *Venture Capital Funding Trends & The Emergence of Secondary Funds*, MEDIUM (Jan. 13, 2019), https://medium.com/@cmodi/venture-capital-funding-trends-the-emergence-of-secondary-funds-1b615e92372d.

[135] *See* BELT, *supra* note 130.

[136] *See* Roof, *supra* note 129; *see also* Bensinger & Hoffman, *supra* note 129.

[137] Nicolas Grabar et al., *A Look Under the Hood of Spotify's Direct Listing*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 26, 2018), https://corpgov.law.harvard.edu/2018/04/26/a-look-under-the-hood-of-spotifys-direct-listing/.

[138] Before direct listing, tech founders used dual class stock. For more on dual class stock and "minority controlling shareholders" see Lucien A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 594–95 (2017). For a detailed account of the history of dual-class structures in the

offerings, capital formation, and investor protection, it is important to shed light on the operations of AVC investors.

The following introduces the AVC investors and the ways in which they are investing in startups, as compared to the traditional VC investors.

III. INVESTOR ACCESS TO PRIVATE MARKETS

Over the last thirty years, academic literature has focused on VCs as the main source of financing for private startups.[139] There is no agreed-upon definition of what constitutes a VC fund.[140] A VC firm is a type of investment vehicle that invests in startups. VCs are repeat players in the startup world that use unique contracts and organizational capabilities in order to overcome uncertainty, risk, information asymmetry, agency,[141] "lemons," and "adverse selection"[142] related problems. VC financing has prevailed since the early days of commercial activity in various forms.[143]

United States, see Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693–707 (1986). For new legislation authorizing dual class listings, see NYSE Listed Co. Manual § 313.00 (permitting the issuance of multiple classes prior to the IPO); *see also* Press Release, Council of Institutional Invs., Institutional Investors Oppose Stitch Fix Dual-Class Structure but Welcome Sunset Provision (Nov. 17, 2017), https://advisornews.com/oarticle/institutional-investors-oppose-stitch-fix-dual-class-structure-but-welcome-sunset-provision#.W-TKzZNKjIU. *See generally* Effectiveness of Proposed Rule Change Relating to Revisions and Restructuring of the NASDAQ Listing Rules, Exchange Act Release No. 34-59663, 74 Fed. Reg. 15552 (Apr. 6, 2009).

[139] *See* Gompers, *supra* note 88.

[140] *See* Korsmo, *supra* note 92.

[141] *See* LEWIS M. BRANSCOMB & PHILLIP E. AUERSWALD, BETWEEN INVENTION AND INNOVATION: AN ANALYSIS OF FUNDING FOR EARLY-STAGE TECHNOLOGY DEVELOPMENT 35–38 (2002); Jensen & Meckling, *supra* note 11; *see also* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 129 (1999). For further discussion on agency problems and strategies to reduce them, see Hansmann & Kraakman, *supra* note 11.

[142] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 83 Q. J. ECON. 488, 493 (1970); *see also* GOMPERS & LERNER, *supra* note 141, at 129; Utset, *supra* note 32, at 56.

[143] For the purpose of this Article, a VC fund is a qualified fund under the Investment Company Act or the Economic Growth, Regulatory Relief and Consumer Protection Act. The Economic Growth, Regulatory Relief and Consumer Protection Act was signed by President Trump on May 24, 2018. It "expands the Section 3(c)(1) exclusion under the Investment Company Act to allow up to 250 beneficial owners of smaller venture capital funds. A venture capital or other fund may still rely on the traditional Section 3(c)(1) exclusion." *New Law Creates New Venture Capital Fund*

A. VC Investor Access to Private Markets

The VC industry has played and continues to play an important role in the U.S. innovation process. The founder of the VC industry is Georges Doriot. Doriot was a Harvard Business Professor,[144] who established the first public VC firm - American Research and Development Corporation ("ARD"), after World War II. [145] ARD made history when it turned an equity investment of $70,000 into $355 million. ARD invested in Digital Equipment Corporation ("DEC"), and that investment made ARD $355 million after DEC did an IPO in 1968.[146]

ARD was the first institutional private investment firm that accepted money from new sources. The ARD legal structure is no longer popular today and has even led to its demise,[147] but its initial success influenced the design of and development of modern VC investment finance.[148]

VC investors are unique and distinct from other types of investors. VCs are different from retail or other institutional investors that invest in public companies. As noted by Korsmo, "VCs diverge sharply from the typical conception of the stockholder in a public corporation."[149] VCs are active investors (not passive), who provide many value-added services to the companies that they invest in.[150] VC investors also get credit for spurring more technological innovation than other investors.[151]

VCs are also different from AVC investors. Below is an explanation on the ways in which modern VCs are structured and run, as compared to AVC investors. The Article explores whether

Exemption Under Investment Company Act of 1940, JDSUPRA (June 8, 2018), https://www.jdsupra.com/legalnews/new-law-creates-new-venture-capital-77279/.

[144] SPENCER E. ANTE, CREATIVE CAPITAL: GEORGES DORIOT AND THE BIRTH OF VENTURE CAPITAL xiii (2008); *see also* Korsmo, *supra* note 92.

[145] ANTE, *supra* note 144.

[146] *American Research Development Corporation*, *1946*, ENTREPRENEURIAL MIT, http://museum.mit.edu/150/78 (last visited Dec. 24, 2020).

[147] Hsu & Kenney, *supra* note 93.

[148] *See* Korsmo, *supra* note 92.

[149] *Id.*

[150] For further information on services provided by VCs, see GOMPERS & LERNER, *supra* note 141. Such services can vary, and include: strategic planning, mentoring, guidance, selecting management, lawyers, accountants, writing a business plan, etc.

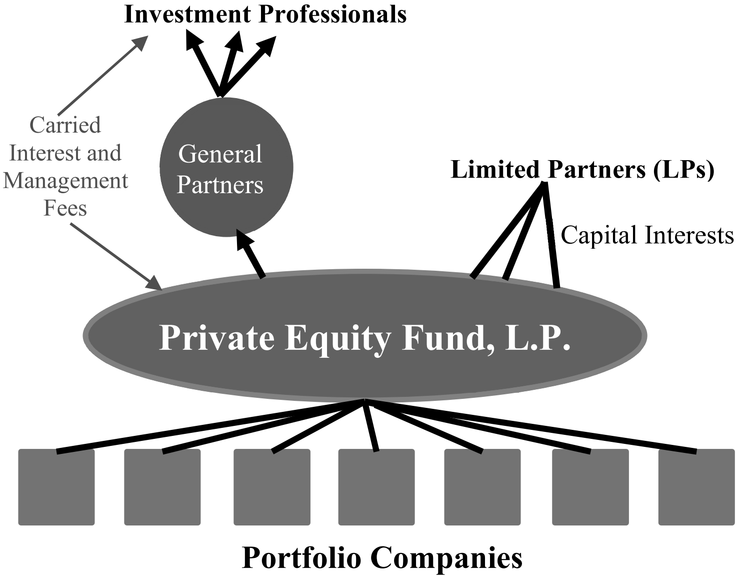
[151] *See* Samuel S. Kortum & Josh Lerner, *Assessing the Contribution of Venture Capital to Innovation*, 31 RAND J. ECON. 674 (2000); *see also* Joseph Bankman & Ronald J. Gilson, *Why Start-ups?*, 51 STAN. L. REV. 289 (1999) (reviewing tax treatment of startups).

AVC investors use the same legal structure and investment mechanisms as VC investors? If not, what are the differences between the investor groups? This comparison will shed light on the ways in which AVCs affect the innovation ecosystem, especially with regards to access to capital.

Depending on their corporate purpose and objective, AVC investors use different legal structures to invest in unicorns. The legal structures range from investment as an active general partner ("GP") that manages the investments or a passive limited partner ("LP") that simply invests capital using a separate fund structure; co-investment alongside a VC, using a GP or LP fund structure; purchasing shares indirectly through secondary markets; or direct investments in the issuer (unicorn firm).

The following chart illustrates the typical VC fund structure.

Table 2. VC Fund Structure.


Investment Professionals
Carried Interest and Management Fees
General Partners
Limited Partners (LPs)
Capital Interests
Private Equity Fund, L.P.
Portfolio Companies

Source: Adapted by author from: Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 9 (2008).

The following introduces the new players. It compares AVC and traditional VC investors.

B. AVC Investor Access to Private Markets

1. Corporate Venture Capital

Alternative investment vehicles, which economists refer to as "corporate venture capital or CVC"[152], are aggressively investing in unicorn firms. Last year, startups in the United States raised over $41.2 billion from CVC investors, according to data from the financial research company PitchBook.[153] What is a CVC?

A CVC investment is an equity investment of an established firm, such as a corporation, in an external independent startup firm.[154] Large firms typically use CVC investments in order to compete in an ever-changing technology market where new technologies and business models constantly disrupt their existing businesses.[155] CVC programs are very popular today. More than 1,600 corporations have CVC programs worldwide, including Google Ventures (GV)[156] and Microsoft's M12.[157]

The phenomenon of CVC investments in startups is not new. Large firms established CVC arms before. In the past, however, many of the CVC investment efforts usually ended up in dissolution

[152] *See also* David C. Mowery & Nathan Rosenberg, *The U.S. National Innovation System*, *in* NATIONAL INNOVATION SYSTEMS: A COMPARATIVE ANALYSIS 29 (Richard Nelson ed., 1993).

[153] Joshua Mayers, *A Senior CVC Investment Professional Makes How Much?*, PITCHBOOK (Nov. 27, 2018), https://pitchbook.com/news/articles/a-senior-cvc-investment-professional-makes-how-much.

[154] *See* Gary Dushnitsky, *Corporate Venture Capital in the 21st Century: An Integral Part of Firms' Innovation Toolkit*, *in* THE OXFORD HANDBOOK OF VENTURE CAPITAL 156, 157 (Douglas Cumming ed., 2012); Henry W. Chesbrough, *Making Sense of Corporate Venture Capital*, HARV. BUS. REV. (Mar. 2002), https://hbr.org/2002/03/making-sense-of-corporate-venture-capital/ar/1.

[155] *See* Dushnitsky, *supra* note 154*,* at 165.

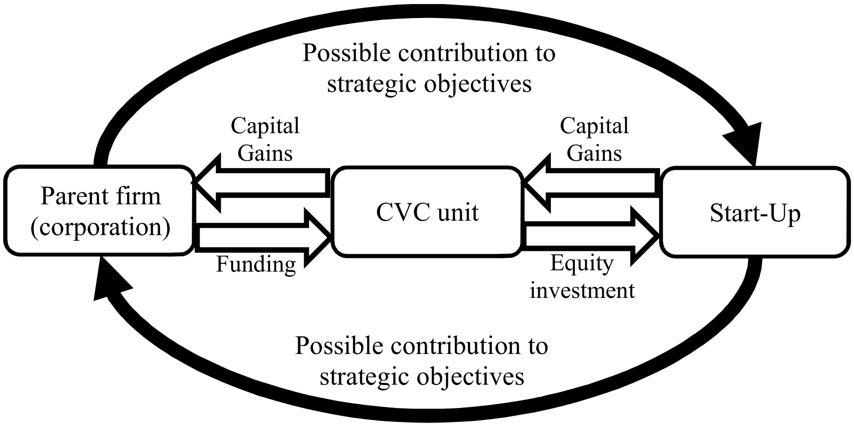
[156] GV invests "in companies across a broad range of industries, including consumer internet, software, hardware, clean-tech, bio-tech and health care. It invests amounts ranging from seed funding to tens of millions of dollars, depending on the stage of the opportunity and the company's need for capital. Also, Google has limited its focus to companies in North America." *See Google Ventures*, CBINSIGHTS, https://www.cbinsights.com/investor/google-ventures (last visited Dec. 29, 2020).

[157] *See M12*, CBINSIGHTS, https://www.cbinsights.com/investor/microsoft-ventures (last visited Dec. 29, 2020). According to the THELANDER-PITCHBOOK report, more than half of the CVCs were created since 2010. BELL MASON GRP. & J. THELANDER CONSULTING, THELANDER 2017 CVC COMPENSATION REPORT – BMG EXECUTIVE SUMMARY OF FINDINGS, TRENDS AND IMPLICATIONS 1 (2017).

or failure of the CVC arm.[158] There are significant differences between an investment by a CVC vehicle and a traditional VC, which perhaps can help explain the reasons for the previous failure stories.[159]

The following compares VC and CVC models, including legal formation, incentive structures, and compensation of CVC investors.

Table 3. A traditional CVC Fund structure.


Possible contribution to strategic objectives
Capital Gains
Capital Gains
Parent firm (corporation)
CVC unit
Start-Up
Funding
Equity investment
Possible contribution to strategic objectives

Source: Holger Ernst et al., *Corporate Venture Capital as a Strategy for External Innovation: An Exploratory Empirical Study*, 35 R&D MGMT. 233, 234 (2005).

a. Corporate Venture Capital & Comparison to Venture Capital

There are many differences between VC and CVC investment vehicles.[160] First, and foremost, the VC manages its fund from a return-on-investment stance, whereas the CVC manager is required

[158] Joseph A. McCahery et al., *Corporate Venture Capital: From Venturing to Partnering*, *in* THE OXFORD HANDBOOK OF VENTURE CAPITAL 211, 218 (Douglas Cumming ed., 2012).

[159] *Id.* at 219.

[160] *See* Rita Waite, *Corporate VC vs VC: Corporate Venture Capital's Priorities Differ From Institutional VCs*, CBINSIGHTS (Feb. 5, 2016), https://www.cbinsights.com/research/corporate-venture-capital-institutional-venture-capital/.

to successfully achieve a blend of financial and strategic goals.[161] VCs mainly invest for financial purposes, whereas CVCs might have other strategic purposes.[162]

In the event that the corporation has difficulty with directing its CVC arm on the objectives of the potential investment, for example, whether it values more financial returns versus accomplishments of strategic goals, then the CVCs will be inclined to not follow through and pull the plug on the investment.[163] For example, this might occur in cases where the CVC is not invested in order to acquire or get access to the complementary technology that the startup is developing.[164] Additionally, CVCs do not enjoy the same kind of longevity that VCs enjoy; their lifespan is significantly shorter and much more volatile.[165]

Second, typically most large corporations do not have the "VC-like" dedication to their portfolio companies, or the expertise to deal with such investment.[166] According to an Ernst and Young study,[167] large corporations do not typically select the investment opportunities on their own; rather, they piggyback and form syndicates with renowned VC funds in order to select the startups.[168]

The corporate objective and type of technology also matters. There is a difference between CVCs that invest in competing or complementary technologies. There is a negative spillover effect when the established firm invests in a startup that has a competing (or adjacent) technology.[169] Empirically, in cases with direct competition between the startup and the CVC's firm, the startup retains more board seats for itself and is reluctant to award board power to the CVC investors.[170] Strategically, however, CVC investors might be more interested in investing in competing technologies

[161] ERNST & YOUNG, GLOBAL CORPORATE VENTURE CAPITAL SURVEY 2008–09, BENCHMARKING PROGRAMS AND PRACTICES 6 (2009); *see also* BELL MASON GRP. & J. THELANDER CONSULTING, *supra* note 157.

[162] *See* ERNST & YOUNG, *supra* note 161, at 6.

[163] CVCs are more dependent on the ongoing sponsorship of their corporate owners, because the sponsors can abandon the CVC without due cause and for reasons that are utterly removed from the operations of the CVC fund itself. *See* McCahery et al., *supra* note 158, at 219.

[164] *Id.* at 221.

[165] *Id.* at 219.

[166] *See id.*

[167] ERNST & YOUNG, *supra* note 161, at 8.

[168] *Id.*

[169] *See* McCahery et al., *supra* note 158, at 219.

[170] Ronald W. Masulis & Rajarishi Nahata, *Financial Contracting with Strategic Investors: Evidence from Corporate Venture Capital Backed IPOs*, 18 J. FIN. INTERMEDIATION 599, 601 (2009); *see also* McCahery et al., *supra* note 158, at 219.

even though the CVC will conceivably be more successful with investments in complementary technologies.[171]

Third, the governance structures, compensation, and other incentive mechanisms of CVC vehicles are distinctive from VCs. For example, CVCs are not always efficient in incentivizing the division managers to maximize profits.[172] The choice of legal structure also affects the fund manager's incentives, as follows.

The large firm's decision to use a subsidiary structure for the CVC, rather than a limited partnership (which is used by traditional VC), makes a significant difference.[173] GPs in a VC limited partnership usually have an incentive to maximize profits, whereas managers of a subsidiary of the CVC are usually characterized by risk-averse behavior.[174] A contributing factor is the structure of management performance fees.[175] VCs are experts in tying a manager's salary to her performance,[176] whereas in many cases CVCs do not tie the manager's performance to her salary (instead the manager fee is included in the corporate fee-structure plans).[177] That is why many CVCs experience the revolving door problem, where senior managers frequently leave.[178]

Fourth, investment strategies differ with regard to specialization, diversification, and timing.[179] CVC funds are traditionally less diversified and encompass a narrow ground of operation (specialization) as their spheres are essentially determined by the parent company's operations.[180]

If, for any reason, the CVC fund decided not to partake in subsequent financing rounds, they could transform their investment from a strategic participation into a mere financial investment.[181]

[171] *See* McCahery et al., *supra* note 158, at 219.

[172] *See id.*

[173] *See id.*

[174] *See id.*

[175] *See id.*

[176] A manager's salary is tied to performance by frequently offering 1–2% fixed fees plus 20% fund profits. *See id.*

[177] According to McCahery et al., for this reason, top fund management talent is repeatedly recruited to profitable VC funds and away from successful CVC funds. *See id.*

[178] *See* BELL MASON GRP. & J. THELANDER CONSULTING, *supra* note 157.

[179] *See* McCahery et al., *supra* note 158, at 220.

[180] Additionally, unlike VCs, CVCs managers sometimes do not allow entrepreneurs to use their preferred IPO exit. Rather the managers control the terms of the exit strategy by using the drag-along and redemption . According to McCahery et al., the evidence confirms that VC investment returns tend to be higher than those of CVC funds. *See id.* at 220.

[181] *See id.*

The existence of "pay-to-play provisions" (provisions that punish investors that do not participate in their full pro-rata percentage of the financing) could oblige the CVC fund to convert their preferred shares into common shares, essentially forfeiting their privileges.[182]

The participation of CVC investors affects the private ordering between VC investors and founders by allowing the founders to demand founder-friendly investment rounds.[183] They not only contribute to the changes in contractual terms in the traditional VC financing documents but can also lead to conflicts of interest.[184]

CVCs can also have different models. SoftBank provides an example. SoftBank's model departs from the traditional CVC model. Most CVC funds are accountable only to their parent corporation's strategic desires because they rely on the parent corporation for funding. SoftBank, however, has recently been raising money from outside investors.[185] It is deploying outside money with its own capital, and perhaps takes other interests into account.[186] Therefore, this Article will address the SoftBank Phenomenon separately below.[187]

b. SoftBank & Comparison to Venture Capital

About three years ago, SoftBank started raising money for its $100 billion Vision Fund.[188] Due to its extra-large size and

[182] *See generally id.* at 220–23.

[183] *Id.*

[184] *See* Fan, *supra* note 4.

[185] *See* Arash Massoudi et al., *Softbank's Son Uses Rare Structure for $93bn Tech Fund*, FIN. TIMES (June 12, 2017), https://www.ft.com/content/b6fe313a-4add-11e7-a3f4-c742b9791d43.

[186] *Id.*; *see also* Taylor Hatmaker, *Apple Joins SoftBank's Vision Fund with $1 Billion Investment*, TECHCRUNCH (Jan. 4, 2017), https://techcrunch.com/2017/01/04/apple-joins-softbanks-vision-fund-with-1-billion-investment/; Jason Rowley, *How SoftBank's $100B Fund Is in a League All Its Own*, TECHCRUNCH (Aug. 9, 2017), https://techcrunch.com/2017/08/09/how-softbanks-100b-fund-is-in-a-league-all-its-own/; Sam Shead, *Japan's SoftBank Has Raised $1 Billion from Sharp for Its Colossal $100 Billion Tech Fund*, BUS. INSIDER (May 18, 2017), https://www.businessinsider.com/softbank-vision-fund-sharp-2017-5.

[187] It should be noted that there are different types of CVCs. This Article is referring to the common CVC unit structure, which is part of the main entity. The CVC arm draws money directly from the parent company on a yearly basis, which includes a dedicated team and operating budget. Other CVCs operate separately than the parent corporation "as a completely separate entity (16%) or (ii) through an LLC or off-balance sheet with an annual investment budget (26%). Only 17% rely on obtaining investment funds from the parent company on an ad hoc, case-by-case basis." BELL MASON GRP. & J. THELANDER CONSULTING, *supra* note 157, at 5.

[188] *See* Shead, *supra* note 186.

aggressive mega-deals,[189] Vision Fund has been making headlines ever since.[190] Vision Fund is much larger than "any other tech fund on the planet."[191] The fund is backed by both internal and external investors, including Apple, Sharp, and Saudi Arabia's PIF SWF.[192]

SoftBank is changing the private ordering arrangements between VC firms and startups.[193] The question is: How pervasive is the disruption? SoftBank's late stage mega deals not only provide unicorns with large amounts of capital for capital formation and growth but also transform the U.S. VC world.[194] In order to compete with SoftBank's mega deals of $100 million or more, many U.S. VC funds are either syndicating, raising large amounts of capital, or breaking up.[195]

SoftBank's Vision Fund ("SVF") has a complex fund structure, which some compare to being structured like a VC fund but others compare to a PE fund.[196] As noted, PE and VC funds both invest in startups, but there are several differences between them. The main one is that PEs invest using cash and debt whereas VCs typically invest using equity.[197] It is clear that the SVF's structure is also different due to the following reasons. According to reports, the fund managers are compensated using management fees and carried

[189] *See generally id.*

[190] *Id.*

[191] Shead, *supra* note 101.

[192] In late 2018, TechCrunch had reported that "the sovereign fund of Saudia Arabia plans to invest $45 billion into the second SoftBank Vision Fund, two years after putting the same amount into the original $100 billion Vision Fund." Catherine Shu, *Saudi Arabia's Sovereign Fund Will also Invest $45B in SoftBank's Second Vision Fund*, TECHCRUNCH (Oct. 8, 2018), https://techcrunch.com/2018/10/07/saudi-arabias-sovereign-fund-will-also-invest-45b-in-softbanks-second-vision-fund.
According to SoftBank, the LPs include: SoftBank Group Corp., Public Investment Fund, Mubadala Investment Company, Apple, Foxconn Technology Group, Qualcomm Incorporated, and Sharp Corporation. Press Release, SoftBank Grp., SoftBank Vision Fund's First Major Closing (May 22, 2017), https://group.softbank/en/news/press/20170522.

[193] *See* Nathaniel Popper et al., *The SoftBank Effect: How $100 Billion Left Workers in a Hole*, N.Y. TIMES (Nov. 12, 2019), https://www.nytimes.com/2019/11/12/technology/softbank-startups.html.

[194] Andy White & Anthony Mirhaydari, *Visualizing SoftBank's Epic Reach*, PITCHBOOK (July 23, 2018), https://pitchbook.com/news/articles/visualizing-softbanks-epic-reach.

[195] *See* Shead, *supra* note 101.

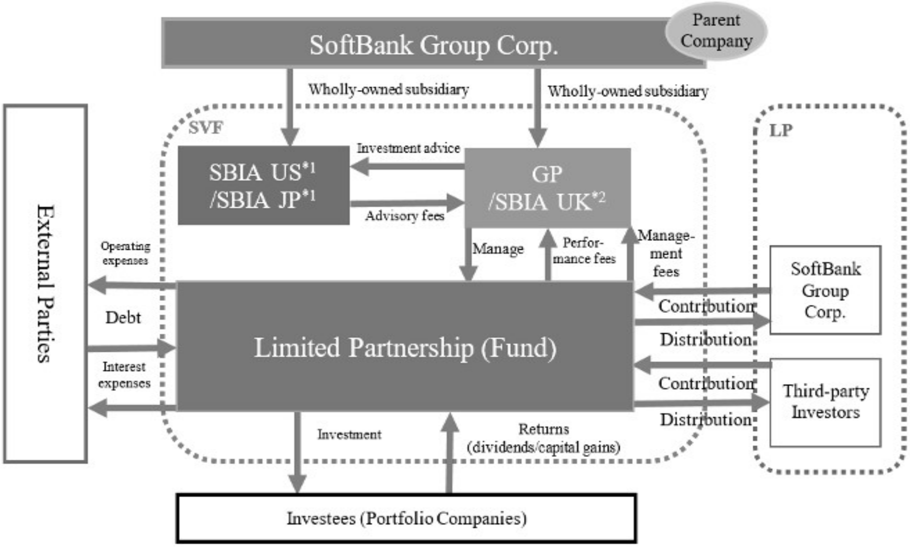
[196] Dan Primack, *The Complicated Future of SoftBank Vision Fund*, AXIOS (Oct. 8, 2019), https://www.axios.com/softbank-vision-fund-complicated-future-0c89673d-7850-47de-8a52-cb49a12cbfc3.html.

[197] *Private Equity vs. Venture Capital: What's the Difference?*, PITCHBOOK: PITCHBOOK BLOG (Aug. 4, 2020), https://pitchbook.com/blog/private-equity-vs-venture-capital-whats-the-difference.

interest as explained below.[198] Additionally, the GP collects a 1% management fee and a 20% performance fee (on all returns over 8%).[199]

The following structure is different than traditional PE structures in that 60% of the assets of SVF are held in the form of common shares (Class A), and the other 40% are in the form of preferred shares (Class B).[200] In order to attract outside investors, as LPs, SoftBank has agreed to reward them with a fixed 7% coupon, which is not tied to the performance of SVF's assets.[201]

Table 4. SoftBank Vision Fund Structure.


SoftBank Group Corp.
Parent Company
Wholly-owned subsidiary
Wholly-owned subsidiary
SVF
LP
SBIA US*1 /SBIA JP*1
Investment advice
Advisory fees
GP /SBIA UK*2
Manage
Perfor-mance fees
Manage-ment fees
External Parties
Operating expenses
Debt
Interest expenses
Limited Partnership (Fund)
Contribution
Distribution
Contribution
Distribution
SoftBank Group Corp.
Third-party Investors
Investment
Returns (dividends/capital gains)
Investees (Portfolio Companies)

*1 US and Japan based advisory companies which provide investment advisory services to SBIA UK
*2 Entity responsible for managing SVF

Source: SoftBank Grp. Corp., Presentation on the SoftBank Vision Fund: Business Model and Accounting Treatment 4 (Nov. 7, 2018).

The SoftBank Group Corp. ("SBG") is the parent corporation and owns the following subsidiaries ("sub"): SB Investment Advisers (UK) Limited ("SBIA UK"), a wholly-owned sub, which is the GP

[198] Dana Olsen, *Vision Fund 101: Inside SoftBank's $98B Vehicle*, PITCHBOOK (Aug. 2, 2017), https://pitchbook.com/news/articles/vision-fund-101-inside-softbanks-93b-vehicle.

[199] Eric J. Savitz, *SoftBank Unveils Plans for $108 Billion Vision Fund 2*, BARRONS (July 25, 2019), https://www.barrons.com/articles/softbank-new-vision-fund-51564109519.

[200] *Id.*

[201] *See* Primack, *supra* note 196.

that manages the SVF (that is a LP); SBIA US and SBIA JP are wholly-owned subs, which are U.S.- and Japan-based advisory companies that provide investment advisory services to SBIA UK; and the Limited Partnership (Fund).[202]

SVF invests in startups in several ways, including direct equity investments (directly in the company) and tender offers (secondary stock purchases from existing shareholders).[203] With regard to the size of investment and financing rounds, SoftBank is pouring unprecedented amounts of capital into unicorns that it identifies as market leaders.[204] It is reported that it requires its fund managers to make a minimum of a $100 million investment in a startup.[205]

The following are some of the challenges that are associated with SVF investments, as compared to traditional VC investments. There are several reports on conflicts of interest between SVF, some of its foreign LPs (investors), and investees as detailed below.

First, as noted above, following the WeWork IPO failure, there is a concern among academics and the press that SVF negotiated for aggressive contractual provisions, IPO ratchets, or other anti-dilution provisions, which will be triggered in an event of a low valuation following an IPO (compared to the large round of financing).[206] The idea is that SVF negotiated for a downside protection that is very large due to the outsized amount of money that it invests in portfolio companies (to protect its investments).[207]

[202] SoftBank Grp. Corp., Presentation on the SoftBank Vision Fund: Business Model and Accounting Treatment 51 (Nov. 7, 2018) (presentation slides available at https://group.softbank/system/files/pdf/ir/presentations/2019/investor_20181107_02_en.pdf). According to SoftBank, the distribution and performance fees are allocated in the following order. First, the foreign LPs holding Class B (preferred) receive the coupon (a fixed proportion of the investment principal). Second, SBIA UK (GP) receives performance fees. Finally, the Class A LP (SoftBank) receives a distribution based on investment performance. *Id.* at 21.

[203] *Id.* at 31.

[204] *See* White & Mirhaydari, *supra* note 194; *see also* Katrina Brooker, *The Most Powerful Person in Silicon Valley*, FAST CO. (Jan. 14, 2019), https://www.fastcompany.com/90285552/the-most-powerful-person-in-silicon-valley.

[205] Brooker, *supra* note 204 ("The Vision Fund's minimum investment in startups is $100 million, and in just over two years since its October 2016 debut, it's committed more than $70 billion").

[206] *See* John C. Coffee, Jr., *Toxic Unicorns: What Has Been Missed about WeWork's Fiasco*, COLUM. L. SCH.: CLS BLUE SKY BLOG (Nov. 6, 2019), https://clsbluesky.law.columbia.edu/2019/11/06/toxic-unicorns-what-has-been-missed-about-weworks-fiasco/; *see also* Kana Inagaki et al., *SoftBank Investors Brace for Vision Fund Writedowns*, FIN. TIMES (Sept. 16, 2019), https://www.ft.com/content/ccdaa9c6-d60d-11e9-8367-807ebd53ab77.

[207] Inagaki et al., *supra* note 206.

There is a need to conduct more investigations on this, especially compared to other unicorns that recently went public.

Second, most traditional VC funds do not have a nationwide presence and are frequently organized as small partnerships.[208] They are "hands on" investors who monitor their investments very closely.[209] They provide mentoring and management services for the startups that they invest in, such as accounting, networking, and finding partners, investors, and even new management.[210] Therefore, VC funds usually prefer to invest in startups that are close to their geographic location, which allows them to provide services more easily (there are exceptions – Israel).[211]

VCs offer "optimal services" to an entrepreneurial firm that is positioned within the fund's concentrated industry, which is usually very narrowly defined.[212] SoftBank, on the other hand, is investing very broadly. Its investments are reported to range from "artificial intelligence and machine learning to optimize every industry that affects our lives—from real estate to food to transportation."[213]

Third, there are mixed reports on monitoring the management and on the appointing of directors to the board of directors. Some claim that SVF tries to influence the management and board of directors of the companies that it invests in.[214] Others claim that SVF does not care about monitoring rights but rather contracts for downside protection.[215]

[208] *See* Bob Zider, *How Venture Capital Works*, HARV. BUS. REV. (Nov.–Dec. 1998), https://hbr.org/1998/11/how-venture-capital-works.

[209] *See generally id.*

[210] *See generally id.*

[211] *See* LARS OLA BENGTSSON, REPEATED RELATIONSHIPS BETWEEN VENTURE CAPITALISTS AND ENTREPRENEURS 3 (2006); *see also* Ola Bengtsson & David H. Hsu, How Do Venture Capital Partners Match with Startup Founders? 1 (Mar. 11, 2010) (unpublished manuscript) (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568131); Avraham Ravid & Ola Bengtsson, The Geography of Venture Capital Contracts 6 (2009) (unpublished manuscript) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361827) (under review).

[212] Bengtsson & Hsu, *supra* note 211.

[213] Brooker, *supra* note 204 ("The Vision Fund's minimum investment in startups is $100 million, and in just over two years since its October 2016 debut, it's committed more than $70 billion.").

[214] *See, e.g.*, Eliot Brown, *SoftBank Scraps $16 Billion Plan to Buy Most of WeWork*, WALL ST. J. (Jan. 7, 2019), https://www.wsj.com/articles/softbank-scraps-16-billion-plan-to-buy-most-of-wework-11546905398; Liz Hoffman et al., *SoftBank's Biggest Backers Balk at Planned $16 Billion Acquisition of WeWork*, WALL ST. J. (Dec. 19, 2018), https://www.wsj.com/articles/softbank-finds-limits-to-its-love-for-wework-as-investors-push-back-11545225988.

[215] *See* Inagaki et al., *supra* note 206.

Unfortunately, there are mixed reports on SoftBank monitoring its investments and on whether SoftBank appoints directors to the board of directors or truly advises portfolio companies on business plan and strategy.[216] For more analysis on this, see the discussion of SoftBank's investment[217] in WeWork below.

Fourth, SoftBank is investing in competing businesses.[218] This raises the question of whether it requires the startups to waive corporate opportunity provisions and fiduciary duty doctrines.[219] As noted above, there are several reports on conflicts of interests between SoftBank and its LPs involving investments in competing technologies.[220] SoftBank representatives are perhaps serving on boards of multiple portfolio companies.[221] This is a common practice among VC and PE fund representatives.[222] It is also common that portfolio companies will compete, operate in the same line of business, or even share what is considered proprietary information (including business partners, customers, or employees).[223]

This sort of behavior raises concerns not only about potential anti-competitive behavior of SoftBank, but also requires companies to abandon corporate fiduciary duties, which affect private ordering. For example, there are suggestions by journalists on consolidation in many industries as a result of direct SoftBank investments.[224] For

[216] *See, e.g.*, Stephanie Findlay, *SoftBank Appoints Telecoms Veteran as India Country Head*, FIN. TIMES (Jan. 22, 2020), https://www.ft.com/content/32f5cd68-3d19-11ea-a01a-bae547046735; Ingrid Lunden, *SoftBank-Backed Fair Appoints New CEO: Bradley Stewart, ex-CEO of XOJet*, TECHCRUNCH (May 11, 2020), https://techcrunch.com/2020/05/11/softbank-backed-fair-appoints-new-ceo-bradley-stewart-ex-ceo-of-xojet/.

[217] Brown, *supra* note 214.

[218] Robbie Whelan & Eliot Brown, *SoftBank is Funding Every Side of a Bruising Startup Battle*, WALL ST. J. (Jan 20, 2020, 10:41 AM), https://www.wsj.com/articles/softbank-is-funding-every-side-of-latin-americas-bruising-startup-battle-11580398900.

[219] *See* Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075 (2017).

[220] *See, e.g.*, Findlay, *supra* note 216; Lunden, *supra* note 216.

[221] *The Visionaries and Portfolio Companies*, SOFTBANK VISION FUND, https://visionfund.com/portfolio (last visited Dec. 29, 2020).

[222] *See id.*

[223] *See id.*

[224] *See, e.g.*, Tatiana Bautzer, *Japan's SoftBank Sees Consolidation in Latam Food Delivery*, REUTERS (May 13, 2020), https://www.reuters.com/article/us-softbank-group-latam/japans-softbank-sees-consolidation-in-latam-food-delivery-idUSKBN22P2GR; Karan Choudhury, *How SoftBank is Steering E-Commerce Consolidation Against Google, Amazon*, BUS. STANDARD (Apr. 23, 2018),

example, it has been suggested that some ride-hailing businesses are consolidated as a direct result of the SoftBank investments.[225]

TechCrunch and Recode reported that Uber engaged in anti-competitive arrangements with Grab in Southeast Asia as a direct result of the PIF and SoftBank investments in Uber.[226] Antitrust analysis is outside the scope of this Article, but there are several scholars who are currently trying to track these developments and are concerned about their effects.[227]

Fifth, some commentators are also accusing SoftBank of not pursuing strictly financial objectives, but rather for having strategic goals because of its main investors.[228] For example, PIF is one of the

https://www.business-standard.com/article/companies/how-softbank-is-steering-e-commerce-consolidation-against-google-amazon-118042300008_1.html.

[225] *See* Whelan & Brown, *supra* note 218.

[226] *See* Johana Bhuiyan, *Uber Is Selling Its Southeast Asia Business to Competitor Grab*, VOX (Mar. 25, 2018, 10:14 PM), https://www.vox.com/2018/3/25/17162972/uber-grab-southeast-asia-sale-acquisition-taxi-ride-share-dara-khosrowshahi; Jon Russell, *Uber and Grab Hit With $9.5M in Fines over 'Anti-Competitive' Merger*, TECHCRUNCH (Sep. 24, 2018, 12:13 AM), https://techcrunch.com/2018/09/23/uber-and-grab-hit-with-9-5m-in-fines/ [hereinafter Russell, *Uber and Grab Hit*]. According to these reports, Southeast Asia is considered a growth market due to its "cumulative population of over 600 million people," and many of whom are coming online for the first time, but it is also considered a loss-making market for new industries like ride-sharing—particularly when two companies are locked in a subsidies war. Jon Russell, *Report: Southeast Asia's Internet Economy to Grow to $200B by 2025*, TECHCRUNCH (May 24, 2016, 4:59 AM), https://techcrunch.com/2016/05/24/report-southeast-asias-internet-economy-to-grow-to-200b-by-2025/. Uber, which had presence in eight countries in Southeast Asia, agreed to sell to the local rival Grab, which is also owned by PIF and SoftBank. Russell, *Uber and Grab Hit*, *supra*. It was further reported that Uber got "a 27.5 percent stake in" Grab, and that Uber CEO Dara Khosrowshahi would join Grab's board. Bhuiyan, *supra*. The Singapore antitrust agency levied $9.5 million in fines on Uber and Grab, accusing Grab of using its "position as market leader to unfairly raise fares after the Uber exit." Grace Dobush, *SoftBank is Placing Another Huge Bet on Ridesharing with Its $100 Billion Vision Fund*, FORTUNE (Oct. 5, 2018, 3:41 AM), https://fortune.com/2018/10/05/softbank-grab-500-million-investment/. Uber and Grab are not the only car sharing companies, Softbank also invested in Chinese Didi Chuxing, using its Delta Fund. *SoftBank's Son Says to Create World's Biggest Solar Power Company in Saudi Arabia*, REUTERS (Mar. 27, 2018, 10:02 PM), https://fr.reuters.com/article/saudi-softbank-group-idAFL3N1RA21P.

[227] Sing. Mgmt. Univ., *The Case for Cross-ownership*, ASIANSCIENTIST (Sept. 17, 2019), https://www.asianscientist.com/2019/09/features/cross-ownership-investment-finance/.

[228] *See* Edward Ongweso, Jr. *SoftBank's New Strategy: Screw Over Startups Not Investors*, VICE: MOTHERBOARD (Jan. 13, 2020), https://www.vice.com/en_us/article/y3mdej/softbanks-new-strategy-screw-over-startups-not-investors.

largest investors in SoftBank's Vision Fund.[229] Commentators suggest that PIF perhaps uses Softbank in order to invest in leading startups indirectly (PIF invested in 50 or 60 tech companies through SoftBank).[230] It was recently reported, however, that PIF will not invest in Vision Fund II.[231]

Finally, some VCs expressed concern about the entrance of new nontraditional foreign players investing directly in the market,[232] and their adverse effect on the traditional startup funding model,[233] which is discussed below. It should be noted, on the flip side, that other VCs (and the NVCA) are concerned about the new powers of the U.S. government to scrutinize the investments of foreign strategic investors, which is also discussed below.

2. Sovereign Wealth Funds

In addition to recent increases in investment activity from CVCs, there is an explosion in sovereign wealth funds ("SWFs")[234] that are

[229] Isobel Asher Hamilton, *Saudi Arabia is Reportedly Talking to SoftBank About Pouring Billions into Its Second Vision Fund*, BUS. INSIDER (Oct. 28, 2019), https://www.businessinsider.com/saudi-arabia-reportedly-considers-investing-in-softbank-vision-fund-2-2019-10.

[230] Andrew Torchia et al., *Saudi's PIF Invested in 50-60 Firms Via SoftBank Fund: Director*, REUTERS (Oct. 23, 2018, 2:55 AM), https://www.reuters.com/article/us-saudi-investment-pif/saudis-pif-invested-in-50-60-firms-via-softbank-fund-director-idUSKCN1MX12X; *see* Press Release, SoftBank Grp. Corp., About the Establishment of SoftBank Vision Fund: Strategic Alliance with Public Investment Fund of Saudi Arabia (Oct. 14, 2016), https://group.softbank/en/corp/news/press/sb/2016/20161014_01/.

[231] *See* Zubair Naeem Paracha, *PIF Won't Invest in Vision Fund 2*, MENABYTES (Jan. 24, 2020), https://www.menabytes.com/pif-wont-invest-vision-fund-2/.

[232] Jason D. Rowley, *Venture Capital's Sovereign Wealth Crisis Cometh*, CRUNCHBASE (Dec. 31, 2018), https://news.crunchbase.com/news/venture-capitals-sovereign-wealth-crisis-cometh/.

[233] "Many venerable VCs view the unicorn phenomenon with scorn, operating under the assumption that billion- dollar valuations are a distraction—and potentially a detriment—to the traditional startup funding model." PITCHBOOK, UNICORN REPORT: 2017 ANNUAL 3 (2017).

[234] Sovereign wealth funds (SWFs) are a type of sovereign investment vehicle, which has an independent corporate identity in order to invest for commercial return (often for a long term). BOCCONI UNIV., HUNTING UNICORNS: SOVEREIGN WEALTH FUND ANNUAL REPORT 2016 8 (2016) [hereinafter HUNTING UNICORNS]; *see also* Sofia Johan et al., *Determinants of Sovereign Wealth Fund Investment in Private Equity* (TILEC, Discussion Paper No. 2010-044, 2011), http://ssrn.com/abstract=1722206 ("the first SWF may have been established in 1953 by the establishment of the Kuwait Investment Authority"). Andrew Rozanov is credited with coining the term "Sovereign Wealth Fund" in 2005. *See generally* ANDREW ROZANOV, WHO HOLDS THE WEALTH OF NATIONS? (2005).

deploying large amounts of capital to unicorns, which are considered high risk investments in private equities.[235] What is a SWF? There is no universally accepted definition of a SWF. However, for the purpose of this Article, a SWF will be defined as a type of "investment fund[] owned and managed by national governments."[236] The term was first coined by Andrew Rozanov, an executive of State Street Global Advisors.[237]

SWFs are completely different investment vehicles than private entities, such as VCs. SWFs are formed by numerous types of governments, ranging from autocratic to democratic, in order to manage resources (savings and investments) for future generations.[238] As detailed below, there are different types and structures of SWF investment vehicles, varying from independent financial institutions to central banks. [239] There is controversy among academics and policymakers surrounding the lack of transparency of these funds; their extra-large size; possible non-commercial, non-financial goals; and potential influence over the financial stability of their target nations.[240]

Foreign actors and governments are directly investing in unicorns using SWF vehicles by accumulating large stakes in purely private entities that once were solely in the domain of specialized VC investors. Many commentators are concerned about these trends, including Edwin Truman, a former assistant secretary for the U.S. Treasury, who stated that, "This characteristic is unnerving and disquieting. It calls into question our most basic assumptions about the structure and functioning of our economies and the international financial system."[241]

[235] *See* Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1347–48 (2008).

[236] *See* MARTIN A. WEISS, CONG. RSCH. SERV., RL34336, SOVEREIGN WEALTH FUNDS: BACKGROUND AND POLICY ISSUES FOR CONGRESS 5 (2009).

[237] ROZANOV, *supra* note 234.

[238] *See* Andrew Ang, The Four Benchmarks of Sovereign Wealth Funds 1 (Sept. 21, 2010) (unpublished manuscript) (available at https://ssrn.com/abstract=1680485).

[239] *Id.*

[240] *See* WEISS, *supra* note 236, at 8; Gilson & Milhaupt, *supra* note 235, at 1360–61; Johan et al., *supra* note 234, at 2.

[241] *Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications: Hearing Before the S. Comm. on Banking, Hous., & Urb. Affs.*, 110th Cong. 58 (2007) (written statement of Edwin M. Truman, Senior Fellow, Peterson Institute for International Economics); Peterson Inst. for Int'l Econ., *Sovereign Wealth Fund Scoreboard: Uneven Progress, Featuring Edwin M. Truman*, PIIE (Nov.

From Asia to oil-rich Middle Eastern and European countries,[242] the number of SWFs' assets under management is estimated at $6.31–$8 trillion.[243] In the past, SWFs did not invest in risky tech ventures. The new investment trend in unicorn firms represents a shift in SWFs' investment strategy and ordinary risk profile.[244]

The changes in investment strategies of SWFs can be the result of several factors.[245] First, unicorns and tech companies are perceived as having high-growth potential.[246] Second, SWFs are able to diversify their portfolio, which traditionally comprised of traditional conservative investment.[247] Finally, investments by SWFs in unicorns can help stimulate their local economies.[248]

One of the most significant developments is that some SWFs are changing not only the types of assets that they invest in but also the patterns of investment.[249] Despite the lack of transparency in their operations and strategies, there are recent news reports on cases where SWFs changed their investment patterns altogether from passive to active (direct participation) investments.[250] A "direct" SWF investment refers to a situation in which the SWF invests in the securities of a private firm directly, and not passively, using a separate investment vehicle, such as a private equity fund.[251] Until recently, SWFs invested passively as LPs in tech companies, using the help of professional money managers, i.e., PEs or VCs to do the investments for them.

These developments raise several questions. First, what is the role that governments play in the innovation process and in managing wealth for future generations? Throughout U.S. history, the government has played the role of catalyst and even venture

3, 2016), https://www.piie.com/experts/peterson-perspectives/sovereign-wealth-fund-scoreboard-uneven-progress; *see also* Gilson & Milhaupt, *supra* note 235, at 1347.

[242] *See* HUNTING UNICORNS, *supra* note 234, at 8.

[243] Joseph A. McCahery & F. Alexander de Roode, *Co-Investments of Sovereign Wealth Funds in Private Equity*, *in* THE OXFORD HANDBOOK OF SOVEREIGN WEALTH FUNDS 247, n.1 (Douglas Cumming et al. eds., 2017). For the most recent estimate, see Adam Putz, *What Is a Sovereign Wealth Fund?*, PITCHBOOK (Jan. 23, 2019), https://pitchbook.com/news/author/adam-putz.

[244] *See* HUNTING UNICORNS, *supra* note 234, at 5.

[245] Jerome Engel et al., Pursuing Innovation: Sovereign Wealth Fundsand Technology Investment (Nov. 2016) (unpublished manuscript), (available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2864853).

[246] *Id.*

[247] *Id.*

[248] *Id.*

[249] *See* McCahery & de Roode, *supra* note 243, at 247.

[250] *Id.* at 263.

[251] *Id.* at 249.

capitalist to promote innovation, technological research, development, and commercialization.[252] As described in detail below, U.S. policymakers are concerned when foreign governments are directly intervening, "playing" in the U.S. high-growth technology, innovation, and industrial spheres. This raises the question of whether foreign governments are deliberately interfering in the U.S. innovation process for political reasons. There are also redistribution geopolitical issues. According to Ang, the rise of SWFs is perhaps meant to redistribute wealth from the West to the East.[253]

This Article will turn to the impact of these alternative investments on unicorn firms, by starting with an explanation of the different structures, objectives and incentives of the players.

a. Sovereign Wealth Funds & Comparison to Venture Capital

There are different categories of SWFs depending on their objectives and goals. The International Money Fund divides a SWF into the following three primary types: (1) Stabilization funds, which "tend to be more conservative in their investment decisions, focusing on fixed income rather than equity investments";[254] (2) Savings funds which "invest in a broader range of assets, including bonds and equities, as well as other forms of alternative investments, such as real estate, private equity, hedge funds, and commodities";[255] and (3) reserve investment corporations, which "seek higher returns than other SWFs and use leverage (i.e., debt) in their investments."[256]

There are also many ways in which governments can choose to structure SWFs, depending on their objectives, origin, and governance; therefore, a one-size-fits-all structure chart is not appropriate here. SWFs have different investments goals, risk profiles, and strategies. Therefore, for the purpose of this Article, we will refer only to the funds that are investing in unicorn firms, directly or indirectly.

SWFs are distinct from VCs and other types of investment funds. First, they report directly to their sovereign states and are not

[252] *See* Constance E. Bagley & Anat Alon-Beck, *Preparing for the Apocalypse: A Multi-Prong Proposal to Develop Countermeasures for Chemical, Biological, Radiological, and Nuclear Threats*, 40 CARDOZO L. REV. 823, 835 (2018).

[253] *See* Ang, *supra* note 238.

[254] *See* WEISS, *supra* note 236, at 3.

[255] *Id.*

[256] *Id.* at 4.

subject to any financial scrutiny from other investors.[257] Second, they have different legal structures and management styles depending on their origin.[258] Third, it is not clear if they have to comply with any regulations or reporting requirements;[259] rather, it depends on the laws and regulations of the sovereign state that appoints their managers or members of the SWF board of directors. Fourth, they might have non-financial objectives, such as increasing their political influence by making investments overseas.[260]

Fifth, they are usually long-term investors and share the goals of preserving the wealth of the sovereign nation for future use.[261] Sixth, they frequently acquire large stakes in the target firms.[262] Seventh, they have flexibility in choosing their investments.[263] Finally, it is not clear if SWFs have the ability or desire to monitor their investments because it will depend on whether the SWF chooses to take control rights using contractual mechanisms, such as voting rights or observation or board seats.[264]

It is also important to distinguish between a passive investment by a SWF and the new trend of a hybrid or direct active investment. It seems that western governments and policymakers are not as concerned, as they are with LPs, if SWF investments are passive. If, however, the SWFs are active and starting to act like VCs by intervening in the market directly, then the question is whether SWFs can succeed, capitalize on their investments, recruit the right talent, and source suitable deals.[265] Because SWFs are very different from VC funds, it is hard to compare between the management style and incentive structures of these vehicles, especially due to lack of information and overall opaqueness.

SWF investments in unicorns change the traditional VC investment patterns and affect private ordering because of the massive deployment of capital into the hands of founders (agency

[257] *See* April M. Knill et al., Bilateral Political Relations and the Impact of Sovereign Wealth Fund Investment 9 (Mar. 9, 2011) (unpublished manuscript) (available at https://ssrn.com/abstract=1498518); s*ee also* Adair Morse, Large Investors' Influence in Private Equity Funds 5 (Mar. 2011) (unpublished manuscript) (available at https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.650.5714&rep=rep1&type=pdf).

[258] Knill et al., *supra* note 257.

[259] *Id.*

[260] *Id.*

[261] *Id.*

[262] *Id.*

[263] *Id.*

[264] *Id.*

[265] *See* HUNTING UNICORNS, *supra* note 234, at 47–48.

cost). By joining late stage investment rounds, they contribute to high valuations and cause the companies to stay private longer, which can contribute to volatility and inaccurate pricing.[266] In terms of corporate governance, more research needs to be done to determine whether SWFs are bargaining for any control rights. Due to the geopolitical nature of these investments, the following is an account of why U.S. and other Western policymakers are concerned about these developments.[267]

SWFs are not only growing rapidly in size and number,[268] but as noted, they are also changing their investment strategy by directly investing in unicorns. They are doing so by opening offices in Palo Alto, forming joint ventures with other investment funds, and co-investing as GPs alongside private equity, not merely as LPs.[269] They have also been accused of "hunting unicorns,"[270] and these accusations stem from news reports of hiring and stuffing their offices with experienced Western dealmakers that are charged with directly investing in these firms.

There is a heated debate on whether the U.S. government should regulate or limit certain investments in entrepreneurial high-growth and high-tech startup firms and the impact of such an effort on our economy.[271] SWFs pose many challenges for U.S. regulators.[272] There is a concern that SWFs are ultimately controlled by foreign governments and therefore their managers can take non-financial measures into account, such as political and strategic.

The national security concerns are that SWFs may use their economic influence to obtain critical sensitive information from the

[266] *See* McCahery & de Roode, *supra* note 243, at 247.

[267] *See* Georges Kratsas & Jon Truby, *Regulating Sovereign Wealth Funds to Avoid Investment Protectionism*, 1 J. FIN. REG. 95, 95 (2015).

[268] *Id.*

[269] *See, e.g.*, Michael J. de la Merced, *Sovereign Wealth Funds Embrace Their Growing Ambitions*, N.Y. TIMES (Oct. 8, 2018), https://www.nytimes.com/2018/10/08/business/dealbook/sovereign-wealth-funds-embrace-their-ambitions.html; *Saudi Arabia's Public Investment Fund Buys Significant Stakes in U.S. Companies*, U.S.–SAUDI BUS. COUNCIL (May 29, 2020), https://us-sabc.org/saudi-arabias-public-investment-fund-buys-significant-stakes-in-u-s-companies/.

[270] *See* HUNTING UNICORNS, *supra* note 234, at 5; *see also Unicorn Hunters: These Investors Have Backed the Most Billion-Dollar Companies*, CBINSIGHTS (May 7, 2019), https://www.cbinsights.com/research/best-venture-capital-unicorn-spotters-2/.

[271] *See, e.g.*, Jeff Farrah, *Foreign Investment Scrutiny: 5 Questions Every Venture Investor Should Know the Answer to*, NVCA BLOG (Oct. 15, 2018), https://nvca.org/blog/foreign-investment-scrutiny-5-questions-every-venture-investor-know-answer/.

[272] *See generally* McCahery & de Roode, *supra* note 243.

companies that they invest in (tunneling), transfer jobs or assets abroad to their home country, or even compromise the operation of strategically important companies.[273]

More research needs to be done to understand the extent to which SWFs use non-financial, strategic, or political objectives. More information on their legal status, board structure, oversight, control rights, and political objectives will also be helpful. Though there are some data samples on these issues, they are not comprehensive.[274]

Private firms can be more vulnerable to tunneling because they operate under the radar, do not to disclose information to the public, and often lack the same formal corporate governance mechanisms as public companies.[275] It is plausible that certain SWFs may choose to invest in private firms where they are blocked from investing in public firms.[276]

The following new legislation is changing the ways in which American and multinational companies are raising capital from foreigners.

b. The Future of Foreign Investment & CFIUS

On August 13, 2018, President Trump signed the John S. McCain National Defense Authorization Act for Fiscal Year 2019 ("FY 2019 NDAA"), which is an omnibus bill that authorizes defense spending. It incorporates the Foreign Investment Risk Review Modernization Act ("FIRRMA").[277] FIRRMA is meant to deal with the economic and

[273] *See* Johan et al., *supra* note 234, at 6; *see also* S. Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 22 (2000); Rumu Sarkar, *Sovereign Wealth Funds as a Development Tool for ASEAN Nations: From Social Wealth to Social Responsibility*, 41 GEO. J. INT'L L. 621, 625, 643 (2010); Tony Tassel & Joanna Chung, *How Sovereign Wealth Funds are Muscling in on Global Markets*, FIN. TIMES (May 24, 2007), https://www.ft.com/content/ffcc6948-0a21-11dc-93ae-000b5df10621.

[274] Johan et al., *supra* note 234, at 7.

[275] *Id.* at 10.

[276] *Id.*

[277] *See* Press Release, John Cornyn, U.S. Sen. for Tex., U.S. Senate, Cornyn, Feinstein, Burr Introduce Bill to Strengthen the CFIUS Review Process, Safeguard Nat'l Security (Nov. 8, 2017), https://votesmart.org/public-statement/1204881/cornyn-feinstein-burr-introduce-bill-to-strengthen-the-cfius-review-process-safeguard-national-security#.XDhyeC2ZPEZ; *see also* Farhad Jalinous et al., *Client Alert, CFIUS Reform Becomes Law: What FIRRMA Means for Industry*, WHITE & CASE (Aug. 13, 2018), https://www.whitecase.com/publications/alert/cfius-reform-becomes-law-what-firrma-means-industry; Robert Williams, *CFIUS Reform and U.S. Government Concerns over Chinese Investment: A Primer*, LAWFARE BLOG (Nov. 13, 2017), https://www.lawfareblog.com/cfius-reform-and-us-government-concerns-over-chinese-investment-primer; Stephanie Zable, *The Foreign Investment Risk Review*

security impact of foreign investments in emerging technologies in the United States. After a lengthy wait, the Treasury Department released the rules that implement FIRRMA, which have been in effect since February 13, 2020.[278]

FIRRMA amended the review process of the Committee on Foreign Investment in the United States ("CFIUS"). It also incorporates the Export Control Reform Act of 2018 ("ECRA"). FIRRMA gives CFIUS the ability to review investments by foreign entities in critical U.S. technology firms.[279] It gives power to the U.S. government to scrutinize foreign investments.[280]

In the past, CFIUS had authority to review transactions with controlling investments, but today, due to the new reforms, CFIUS can review even minority, non-controlling investments.[281] The following events can trigger review: if the foreign investor has: (1) access to material non-public technical information; (2) a seat on the board of directors or observer rights; and (3) substantive decision-making capability (other than voting shares).[282] VC funds are now also required to carefully evaluate what information or rights they can transfer to the LP foreign investor if the investment is made in "critical technology."[283]

CFIUS is now a powerful actor in the U.S. entrepreneurship ecosystem. To illustrate, CFIUS recently intervened in several transactions concerning startups, emerging technology, and data aggregation by requiring Chinese companies to divest.[284] PatientsLikeMe, Grindr, and TikTok are recent examples. PatientsLikeMe is a healthcare

Modernization Act of 2018, LAWFARE BLOG (Aug. 2, 2018), https://www.lawfareblog.com/foreign-investment-risk-review-modernization-act-2018.

[278] Press Release, U.S. Dep't of the Treasury, Treasury Releases Regulations to Reform National Security Reviews for Certain Foreign Investments and Other Transactions in the United States (Jan. 13, 2020), https://home.treasury.gov/news/press-releases/sm872.

[279] *See generally* GIBSON DUNN, CFIUS REFORM: TOP TEN TAKEAWAYS FROM THE FINAL FIRRMA RULES (2020).

[280] *See generally id.*

[281] *Final CFIUS Regulations Implement Significant Changes by Broadening Jurisdiction and Updating Scope of Reviews*, SHEARMAN & STERLING (Jan. 14, 2020), https://www.shearman.com/perspectives/2020/01/final-cfius-regulations-implement-changes-by-broadening-jurisdiction-and-updating-scope-of-reviews.

[282] *See* 31 C.F.R. § 800.211 (2020).

[283] Farrah, *supra* note 271.

[284] *See generally* Henry Clark et al., *Grindr and PatientsLikeMe Outcomes Show Non-Cleared Transactions' Exposure to CFIUS Scrutiny, Especially When PII is Involved*, JDSUPRA (Apr. 24, 2019), https://www.jdsupra.com/legalnews/grindr-and-patientslikeme-outcomes-show-76276/.

startup that was forced into a fire sale after CFIUS's intervention.[285] In 2017, PatientsLikeMe sold a controlling stake to Chinese iCarbonX, an artificial intelligence technology company.[286] CFIUS intervened due to concerns over the Chinese government gaining access to the data of U.S. health care customers.[287]

Similarly, Grindr, the LGBTQ dating app, also collects personal data of its users.[288] CFIUS intervened over concerns that the Chinese government can access data on American officials' sexual orientation or dating habits, and use it to blackmail or influence these officials in the future.[289] TikTok, the dance app, recently filed a petition with a U.S. Court of Appeals asking for a review of actions by CFIUS.[290] CFIUS had instructed its parent company, ByteDance Ltd., which is a Chinese company, to divest its ownership of American assets.[291]

The new rules will continue to have an impact on the entrepreneurial ecosystem, especially on a startup firm's ability to raise capital privately from foreign investments, including but not limited to foreign VCs, foreign CVCs, foreign individuals, or family offices.[292] One of the main developments is the impact on direct investments, which can trigger a CFIUS filing, if the foreign LP will bargain for a board seat or be able to gain access to sensitive information.[293]

The question of whether the existence of direct or indirect foreign investors justifies the adoption of a particular set of national or

[285] Christina Farr & Ari Levy, *The Trump Administration is Forcing this Health Start-up that Took Chinese Money into a Fire Sale,* CNBC (Apr. 4, 2019, 12:57 PM), https://www.cnbc.com/2019/04/04/cfius-forces-patientslikeme-into-fire-sale-booting-chinese-investor.html.

[286] *Id.*

[287] *Id.*

[288] David E. Sanger, *Grindr Is Owned by a Chinese Firm, and the U.S. Is Trying to Force It to Sell*, N.Y. TIMES (Mar. 28, 2019), https://www.nytimes.com/2019/03/28/us/politics/grindr-china-national-security.html.

[289] For more examples on this, see MoneyGram and Ant Financial, Huawei and others. *See* Ana Swanson & Paul Mozur, *MoneyGram and Ant Financial Call Off Merger, Citing Regulatory Concerns*, N.Y. TIMES (Jan. 2, 2018), https://www.nytimes.com/2018/01/02/business/moneygram-ant-financial-china-cfius.html.

290 Rachel Lerman & Jeanne Whalen, *TikTok Sale Deadline Is Thursday, but a Proposed Deal Has Not Moved Forward*, WASHINGTON POST (Nov. 11, 2020), https://www.washingtonpost.com/technology/2020/11/10/tiktok-petition-stop-sale/.

[291] *Id.*

[292] *See* Jeff Farrah, *CFIUS & VC: 3 Takeaways from the Final Rules and What Investors Must Know*, NVCA BLOG (Jan. 27, 2020), https://nvca.org/cfius-vc-3-takeaways-from-the-final-rules-and-what-investors-must-know/; *see also* Farhad Jalinous et al., *CFIUS Finalizes New FIRRMA Regulations*, WHITE & CASE (Jan. 22, 2020), https://www.whitecase.com/publications/alert/cfius-finalizes-new-firrma-regulations.

[293] For more on the changes and the NVCAs advocacy on this, see Farrah, *supra* note 271.

international foreign investment regulations is outside the scope of this Article.[294]

3. Crossover Funds

Crossover funds are funds that traditionally invest in publicly traded companies and cross over to invest in privately held companies. Mutual fund and hedge fund managers are turning their attention to the private market in the hopes of capitalizing on the high returns of unicorns before they do an IPO. Prominent examples of crossover fund investors include multibillion-dollar firms Tiger Global and Fidelity Investments.

Unicorns are interested in securing crossover financings in order to buy them more time before they do an IPO. Crossover mutual funds and hedge fund investors are interested in investing in a pre-IPO unicorn for several reasons. The crossover investors can access information about the unicorn before it goes pubic and can potentially get an opportunity to invest by getting a discount on their investment (which can increase their return if the IPO goes well).

The following is an account of these developments.

a. Mutual Funds & Comparison to Venture Capital

A mutual fund ("MF") is a type of an investment company,[295] which pools money of many investors (individuals and entities) and then invests in a diversified portfolio[296] of investment securities such as "pools of stocks, bonds, and other."[297] Members of the public can

[294] For more on SWFs, see Anat Alon-Beck, Who Gets to Invest in Private Markets? (unpublished manuscript) (on file with author) (work in progress).

[295] Section 3(a)(1) of the Investment Company Act defines an "investment company" for purposes of the federal securities laws. 15 U.S.C. § 80a-3(a)(1) (2018). Section 3(a)(1)(A) of the Investment Company Act defines an investment company as an issuer which is or "holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." *Id.* § 80a-3(a)(1)(A). Section 3(a)(1)(C) of the Investment Company Act also defines an investment company as an issuer that is engaged or "proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40[%] of the value of [its] total assets (exclusive of Government securities and cash items) on an unconsolidated basis." *Id.* § 80a-3(a)(1)(C).

[296] Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 94 (2017).

[297] *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1234 (2014). The

buy shares in these funds and usually have a right to "redeem" them daily.[298] Redemption means that the shareholders have a right to "return their shares to the funds in exchange for the cash value of their shares."[299]

Illiquid assets are the new favorite investment vehicle for MFs, and many academics and policymakers are concerned about the managers' ability to manage such investments.[300] The issue is that MF[301] managers[302] invest in unicorn shares through primary and secondary transactions. Unicorns' shares are assets that are less liquid than cash, making the ability to exit and liquidate the investment more uncertain. Therefore, there is a concern about the ability of the managers to manage the liquidity mismatch.[303]

primary law that governs investment companies is the Investment Company Act of 1940 (the "Investment Company Act"). The SEC has adopted various regulations under the Investment Company Act that further govern investment company operations. These regulations are published in Title 17 of the Code of Federal Regulations ("CFR"), Part 270. Investment companies are also subject to other federal securities laws (e.g., the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934). The SEC has also adopted various regulations generally applicable to investment companies under these laws.

[298] *See* 15 U.S.C. § 80a-5(a)(1) (Supp. 1987). The term "redeemable security" is defined in Section 2(a)(32) of the Investment Company Act. MFs hold a portfolio of securities, typically managed by an investment adviser. MFs generally offer an unlimited number of their shares to the public on a continuous basis.

[299] Morley, *supra* note 297, at 1235. Open-end companies ("mutual funds") are management investment companies that offer or have outstanding redeemable securities of which they are the issuers. *See* § 80a-5(a)(1). The term "redeemable security" is defined in Section 2(a)(32) of the Investment Company Act. Mutual funds hold a portfolio of securities, typically managed by an investment adviser. Mutual funds generally offer an unlimited number of their shares to the public on a continuous basis.

[300] *See* Qi Chen et al., *Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows*, 97 J. FIN. ECON. 239, 240 (2010); Itay Goldstein et al., *Investor Flows and Fragility in Corporate Bond Funds*, 126 J. FIN. ECON. 592, 593 (2017); Sergey Chernenko & Adi Sunderam, *Liquidity Transformation in Asset Management: Evidence from the Cash Holdings of Mutual Funds* 1–2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 22391, 2016), https://www.nber.org/papers/w22391.

[301] Management companies are divided into open-end companies and closed-end companies. *See* § 80a-5(a)(1)–(2). This Article is referring to the open-end companies.

[302] It should be noted that investment funds usually enter into contracts with "investment advisers," to manage the portfolios. *See* Bebchuk et al., *supra* note 296, at 94. For more on fund managers, see Morley, *supra* note 297, at 1245.

[303] THE INT'L ORG. OF SEC. COMM'NS, OPEN-ENDED FUND LIQUIDITY AND RISK MANAGEMENT — GOOD PRACTICES AND ISSUES FOR CONSIDERATION: FINAL REPORT 2 (2018).

On July 29, 2019, *Business Insider* reported that the SEC is "stepping up scrutiny of mutual funds that have poured money into unicorns, like WeWork and Airbnb," to protect mom-and-pop investors that invest in these funds.[304] There are increasing calls for action from academics and regulators[305] concerning the liquidity disparity and financial instability of open-end MFs because of the increase in their illiquid asset holdings.[306]

One scholar, Zeng, warns that such investments can increase the probability for a bank-run-like scenario if investors are concerned about the nature or illiquidity of their investments.[307] In the event of a future recession or economic crisis, the public stock market and their investors can be affected by the behavior of unicorn firms and their new investors.[308]

However, it must be noted that MFs have a long tradition of investing in illiquid assets. They invested in mature private companies[309] and thinly traded debt instruments.[310] From 2010,[311]

[304] Bradley Saacks & Dakin Campbell, *The SEC is Stepping Up Scrutiny of Mutual Funds that Have Poured Money into Unicorns Like WeWork and Airbnb*, BUS. INSIDER (July 29, 2019), https://www.businessinsider.com/sec-steps-up-scrutiny-of-private-stakes-held-by-funds-2019-7.

[305] *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules to Modernize Information Reported by Funds, Require Liquidity Risk Management Programs, and Permit Swing Pricing (Oct. 13, 2016), https://www.sec.gov/news/pressrelease/2016-215.html; *see also* FIN. STABILITY OVERSIGHT COUNCIL 2015 ANNUAL REPORT 110–20 (2015); INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: APRIL 2015, at 93–135 (2015); Yao Zeng, *A Dynamic Theory of Mutual Fund Runs and Liquidity Management* 1 (Eur. Systemic Risk B., Working Paper No. 42, Jan. 3, 2016), https://www.econstor.eu/bitstream/10419/193549/1/esrb-wp42.pdf ("regulators are worried about the potential for a bank-run-like scenario on mutual funds ").

[306] *See* Zeng, *supra* note 305, at 1.

[307] A large number of funds have experienced bank-run-like redemptions in 2015 and 2016. *See* Zeng, *supra* note 305, at 1 n.2. In 2016, many real estate funds in the UK also experienced severe runs after the vote for the Brexit. *Id.*

[308] The other concern is about liquidity. If the liquidity dries up in public markets, it can cause volatility. *See* Kate Rooney, *Private Equity's Allure Poses Big Risks for the Stock Market and Its Investors in the Next Recession*, CNBC (May 11, 2019, 10:00 AM), https://www.cnbc.com/2019/05/10/private-equitys-allure-poses-big-risks-for-the-stock-market-and-its-investors-in-the-next-recession.html. BlackRock CEO Larry Fink is warning that "some investors may be over-allocating to alternatives as liquidity shrinks." *See* Bloomberg Daybreak: Americas, TV Shows, *BlackRock CEO Fink Warns on Alternative Investments*, BLOOMBERG (May 8, 2019, 8:37 AM), https://www.bloomberg.com/news/videos/2019-05-08/blackrock-ceo-fink-warns-on-alternative-investments-video.

[309] For more on MFs investing in illiquid privately-owned firms, see Restricted Securities, Investment Company Act Release No. 5847, 35 Fed. Reg. 19,989 (Dec. 31, 1970).

large U.S. MFs directly invested in unicorns.[312] Examples include Fidelity and T. Rowe Price.[313] MFs hold more than $8 billion in unicorn stock, and this amount is increasing steadily.[314] In order to invest in unicorns, MFs need to police the seven-day redemption requirement and limit the investments in their overall illiquid assets to 15% of their portfolios.[315]

There is a need for a clear policy from the SEC on the question of whether MFs should continue to invest in unicorn firms and, if so, how they can monitor their investments and protect their investors. The following is a comparison to VCs.

MF managers are very different than traditional VC managers. First, if we compare the managers' incentive, VC fund managers have stronger incentive for high investment returns, due to their compensation structure contracts.[316] MF manager contracts usually do not allow the managers to capture a significant portion of (excess) returns.[317]

Second, in general, the contractual provisions associated with the investments in the unicorns depend on timing of financing rounds, participating investors and performance of the startup. As noted above, VCs typically invest in earlier rounds than MFs, and

[310] For more on MFs investing in illiquid debt, see Money Market Fund Reform; Amendments to Form PF, Securities Act Release No. 9616, 79 Fed. Reg. 47,736 (Aug. 14, 2014) (discussing mutual-fund investments in illiquid debt).

[311] *See* Kwon et al., *supra* note 82, at 415; Lerner et al., *supra* note 30, at 25 ("[O]ver the 2010–2016 period, the number of distinct mutual funds directly investing in unicorns has increased from less than 10 to more than 140.").

[312] PITCHBOOK, *supra* note 233. Fidelity, for example, holds the second-highest number of current unicorns in any portfolio. *See* Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1343–44 (2017).

[313] William Gornall & Ilya Strebulaev, *Squaring Venture Capital Valuations with Reality* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 23895, 2017).

[314] Lerner et al., *supra* note 30, at 24–25; *see also* Gornall & Strabulaev, *supra* note 313, at 2.

[315] *See* Schwartz, *supra* note 312, at 1365. Under SEC Guidelines, illiquid assets are defined as those "which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment[.]" Revision of Guidelines to Form N-1A, 57 Fed. Reg. 9828, 9829 (Mar. 20, 1992) (to be codified at 17 C.F.R. pt. 239, 274).

316 *See* Alon Brav et al., *Hedge Fund Activism: A Review* 2 (Found. & Trends in Fin., Working Paper No. 1947049, 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1947049.

[317] *Id.*

bargain for preferred stock, extensive control rights, and control of the startup's board of directors.[318]

MFs are likely to invest in late stage rounds. Lerner et al. found that MF investments in unicorns are different than traditional VC because they are associated with fewer cash flow and control rights, for the following reasons.[319] First, MFs will use straight convertible preferred stock rather than put emphasis on participating preferred stock,[320] liquidation multiples that are greater than one,[321] or cumulative dividends.

Second, VCs routinely bargain for board and voting rights, and appoint directors to the board of their portfolio startups. Lerner et al. found that MFs are "less likely to include representation on the board of directors: mutual fund [rounds]. . . are thus less likely to directly monitor portfolio firms through board intervention or voting on important corporate actions."[322] This Article would like to add to this finding and explain it from a legal perspective.

MFs are probably not going to directly appoint their own designee director to boards of unicorns because they can be dragged into shareholder litigation suits for breach of fiduciary duty concerning the decisions of their designee directors. Such appointment can create an imminent risk of liability for the MF if it gets sued for structural conflicts of interest under Delaware Corporate law.

It should be noted that compared to VC fund managers, MF managers are heavily regulated and subject to strict fiduciary standards (such as those expressed in ERISA).[323] Under current Delaware Corporate law, a director owes a fiduciary duty to the common shareholders and cannot solely take into account the interests of any one special class.[324] The MF designee director can be

[318] *See* Fried & Ganor, *supra* note 32, at 970 n.9.

[319] *See* Lerner et al., *supra* note 30, at 3.

[320] *Id.* at 5; *see also* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 286 (2003).

[321] For an explanation on liquidation multiples, see Lerner et al., *supra* note 30, at 14–15.

[322] *Id.* at 5.

[323] For a discussion on ERISA and fiduciary duties, see David H. Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106 (2014).

[324] For example, in the following two decisions, the Delaware Court of Chancery addressed the conflicts between preferred and common stockholders in the M&A context. In *Frederic Hsu Living Trust v. ODN Holding Corp.*, the court refused to dismiss claims that a private equity fund and the directors of one of its portfolio companies breached their fiduciary duties to common stockholders by selling certain

accused of having a direct conflict of interest because of her ties to the economic interests of the MF that designated her.[325] If things do not go well with regards to the startup's performance, then the director can be put in direct conflict when deciding between the interests of common shareholders and the special classes. The board does not have a fiduciary duty to facilitate the MF's request for redemption or to maximize current market value for the investors.[326]

Common shareholders can bring suit against the MF designated director, alleging that the director breached her fiduciary duty to the common shareholders by voting in favor of the MF's redemption needs and to the detriment of the common.[327] Therefore, appointing a director to the board can drag the MF into very costly litigation and unwanted publicity and reputational damage due to public scrutiny. In cases of a conflict of interest, the director cannot rely on the business judgment rule,[328] and cannot get indemnification for breach of the duty of loyalty.

Therefore, the question of whether MFs are to be considered "dumb money" investing in unicorns that they cannot monitor or understand is a complicated one. On the one hand, MFs will not appoint directors to the board or provide other "direct corporate governance services similar to VCs," and some scholars will claim that they are not monitoring their investments.[329]

of the company's business lines and assets in order to fund a mandatory redemption of preferred stock. No. 12108-VCL, 2017 WL 1437308, at *13–27 (Del. Ch. Apr. 14, 2017). In *In re Appraisal of GoodCents Holdings, Inc.*, the court determined that common stockholders who had received no consideration in a 2015 merger were entitled to a pro rata share of the merger proceeds. No. 11723-VCMR, 2017 WL 2463665, at *3–5 (Del. Ch. June 7, 2017). For more on these cases, see John L. Hardiman & Melissa Sawyer, *Delaware's Most Recent Thinking on the Preferred-Common Conflict*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 17, 2017), https://corpgov.law.harvard.edu/2017/08/17/delawares-most-recent-thinking-on-the-preferred-common-conflict/.

[325] *Frederic Hsu Living Tr.*, 2017 WL 1437308, at *13–27.

[326] See generally, with regards to conflict of interests of VC directors, Gardner F. Davis & Richard E. Guyer, *Venture Capital Firms and their Portfolio Company Directors Face Risk of Liability for Conflicts of Interest*, FOLEY & LARDNER LLP (Apr. 27, 2018), https://www.foley.com/en/insights/publications/2018/04/venture-capital-firms-and-their-portfolio-company.

[327] *Frederic Hsu Living Tr.*, 2017 WL 1437308, at *13–27.

[328] The business judgment rule protects directors from liability for good faith mistakes if there was no conflict. *See generally* LINDSAY C. LLEWELLYN, BREAKING DOWN THE BUSINESS-JUDGMENT RULE (2013).

[329] *See generally* Sergey Chernenko et al., Mutual Funds as Venture Capitalists? Evidence from Unicorns 4 (Dec. 2018) (unpublished manuscript) (available at https://ecgi.global/sites/default/files/Mutual%20Funds%20as%20Venture%20Capitalists%3F%20Evidence%20from%20Unicorns-%20Paper.pdf).

On the other hand, MFs have other ways to protect their investments contractually and provide corporate governance services for monitoring. One, MFs are likely to negotiate for aggressive redemption rights and ask the firm to redeem their stake if certain conditions are not met.[330] They can threaten the unicorn management with "exit" by "voting with their feet." It should be noted that this is also problematic in the case of private unicorn firms (versus public companies) because MFs can find it very difficult to sell the shares due to the illiquidity of the secondary market.

Additionally, MF managers have an obligation to value their investments on a daily basis;[331] however, these valuations are subject to the manager's discretion because there is no established market price, and many unicorns experience fluctuations in valuations. Therefore, some scholars are concerned that these prices are inaccurate.[332] They warn about the opportunity for the manager's misconduct, due to her discretion in valuation. A MF manager has incentives to choose high valuations, "which among other benefits to the fund, makes them appear more successful than their peers and increases the fees collected from investors." [333] This may allow the manager to "report losses and gains when most advantageous for the fund rather than when they occur."[334]

There is also a question of whether the MF managers are going to use their "voice," engage with the unicorn firm, and influence the firm's governance decisions. Appel et al. suggest that even passive MFs influence a firm's governance choices and increase firm value and longer-term performance.[335] MFs can use "voice" to engage with management to try to institute change.[336] It must be noted, however,

[330] "[S]tronger redemption rights may also make the preferred stock easier to trade in the secondary market." *Id.* at 5 n.4; *see also* 15 U.S.C. §§ 80a-18–80a-22 (2018); 17 C.F.R. § 274.150 (2018).

[331] Fund managers are required to value them each day. *See* 17 C.F.R. § 270.22c-1(b)(1) (2016).

[332] *See* Schwartz, *supra* note 312, at 1344. Funds have made headlines for marking down the values of their startups. *See, e.g.*, Rolfe Winkler, *Fidelity Marks Down Startups Including Dropbox, Zenefits*, WALL ST. J. (Mar. 30, 2016, 1:34 PM), http://www.wsj.com/articles/fidelity-marks-down-startups-including-dropbox-zenefits-1459346847; Rolfe Winkler, *T. Rowe Price Marks Down Most of Its Tech Startups*, WALL ST. J. (Apr. 15, 2016, 6:52 PM), http://www.wsj.com/articles/t-rowe-price-marks-down-most-of-its-tech-startups-1460759094.

[333] Schwartz, *supra* note 312, at 1344; *see also* Lerner et al., *supra* note 30.

[334] Schwartz, *supra* note 312, at 1344–45.

[335] Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 111–13 (2016).

[336] *See* Brav et al., *supra* note 316, at 2 (discussing institutional engagement).

that there is a lot of criticism about the uncertainty and nature of MF engagement practices.[337] More research is needed to determine whether MFs are using voice and engagement practices when investing in unicorns.

Finally, Gornall and Strebulaev, and Lerner et al. demonstrated that MFs are likely to negotiate for IPO-related rights.[338] They suggest an example of an investor's contractual protection mechanism to require IPO ratchets, which can guarantee that the MFs will get a certain agreed upon return in the event the company does an IPO.[339] It should be noted that according to several interviews with lawyers who represent clients in late stage private placements and law firms' materials, there is a need to distinguish between full ratchet and weighted average.[340] Accordingly, the MFs can negotiate full ratchet if the valuation is very high; however, this is very unusual, and "investors usually require weighted average using same formula as previous rounds."[341]

Another mechanism that the MF investors can use to protect their interests according to Lerner et al. is to retain veto rights on down-valuation IPOs. According to Gornall and Strebulaev, "most unicorns gave recent investors major protections such as an IPO return guarantees (14%), vetoes over down-IPOs (24%), or seniority to all other investors (32%)."[342]

These new market dynamics affect the unicorn firm shareholders, managers, and employees. Lowery, Qian, and Kwon show that unicorn startups are now able to raise large amounts of capital from MFs and this capital "should enable the companies to

[337] *See* Alex Edmans & Clifford Holderness, *Blockholders: A Survey of Theory and Evidence*, *in* HANDBOOK OF CORPORATE GOVERNANCE (Benjamin Hermalin & Mike Weisbach eds., 2017); *see also* Joseph McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2906 (2016).

[338] *See* Gornall & Strebulaev, *supra* note 313; Lerner et al., *supra* note 30.

[339] *See* Gornall & Strebulaev, *supra* note 313; Lerner et al., *supra* note 30.

[340] *See* Kevin Gsell et al., Mayer Brown LLP, Presentation at Mayer Brown Seminar: Late Stage Private Placements & Private Secondary Market Liquidity 23 (Feb. 26, 2019) (presentation slides available at https://www.mayerbrown.com/-/media/files/perspectives-events/events/2019/02/latestageprivateplacementsprivatesecondarymarketli.pdf); Morrison & Foerster LLP, Presentation: Late Stage Private Placements 26 (Dec. 2016) (presentation slides available at https://media2.mofo.com/documents/161213-late-stage-private-placements.pdf).

[341] *See* Kevin Gsell et al., *supra* note 340; *see* Morrison & Foerster LLP, *supra* note 340.

[342] Gornall & Strebulaev, *supra* note 313, at 1.

stay private longer."[343] This Article therefore joins Lerner et al.; Gornall and Strebulaev; and Kwon, Lowry, and Qian in concluding that unicorn investments are "becoming a more important part of the portfolios of open-end mutual funds."[344]

There is evidence that the social return on research and development (especially early stage technology development) is much higher than the private return on research and development.[345] Therefore, the MF[346] investment in a unicorn firm can be viewed as a quasi-IPO because the investment provides the firm with a large amount of capital. It allows the firm's founder to defer the costs associated with going public[347] and avoid the pressures associated with being a public company,[348] especially

[343] Kwon et al., *supra* note 82, at 425.

[344] Lerner et al., *supra* note 30, at 26; *see also* Gornall & Strebulaev, *supra* note 313, at 2.

[345] *See* Zvi Griliches, *The Search for R&D Spillovers*, 94 SCAND. J. ECON. 29, 29–31 (1992).

[346] *See What are Mutual Funds,* BLACKROCK, https://www.blackrock.com/us/individual/education/mutual-funds (last visited Aug. 24, 2019).

[347] Kwon et al., *supra* note 82, at 408. On the regulatory costs of going public, see Anne Beyer et al., *The Financial Reporting Environment: Review of the Recent Literature*, J. ACCT. ECON. 296 (2010).

[348] Another plausible cause for the rise of the unicorn firms is that lucrative technology companies choose to stay private as long as possible in order to escape the pressures of short-term strategies that stem from public ownership. *See* LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 7, 11 (2012); *Rival Versions of Capitalism, The Endangered Public Company*, ECONOMIST (May 19, 2012), https://www.economist.com/leaders/2012/05/19/the-endangered-public-company; *see also* Thomas J. Chemmanur & Yawen Jiao, Dual Class IPOs, Share Recapitalizations, and Unifications: A Theoretical Analysis (Mar. 2007) (unpublished manuscript) (available at https://ssrn.com/abstract=1108857); Ira M. Millstein, *Re-examining Board Priorities in an Era of Activism*, N.Y. TIMES (Mar. 8, 2013), http://dealbook.nytimes.com/2013/03/08/re-examining-board-priorities-in-an-era-of-activism/?_r=0 ("corporate boards around the country should re-examine their priorities and figure out to whom they owe their fiduciary duties"). For a discussion on shareholder value, see COLIN MAYER, FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE TRUST IN IT (2013). Stout also expresses this concern with regards to the innovation ability of large public companies. *See* Lynn A. Stout, *The Corporation as Time Machine: Intergenerational Equity, Intergenerational Efficiency, and the Corporate Form*, 38 SEATTLE U. L. REV. 685, 711 (2015); *see, e.g.*, Henry Hansmann & Reinier Kraakman, *What is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW: A FUNCTIONAL AND COMPARATIVE ANALYSIS 1–28 (2004); David Ciepley, *Beyond Public and Private: Toward a Political Theory of the Corporation*, 107 AM. POL. SCI. REV. 139, 149 (2013); Bill Buxton, *The Price of Forgoing Basic Research*, BUS. WK. (Dec. 17, 2008), http://www.businessweek.com/stories/2008-12-17/the-price-of-forgoing-basic-researchbusinessweek-business-news-stock-market-and-financial-advice; *The Rise*

pressures to not invest in innovation and focus on short-term results.[349]

This Article leaves open for future research the question of what the incentives of institutional investors are to invest in early stage technology development when they cannot capture the full benefits of such technologies.[350]

This Article also puts forth the view that these new market players influence the ways in which VCs invest in unicorns, as VCs continue to play an important role in the governance structure of startup firms.[351] The hypothesis is that perhaps as a result of the entrance of these new market players, unicorn founders now have more leverage to negotiate founder-friendly rounds with VCs, as demonstrated below.

In conversations with several MFs' legal advisors, they indicated that MFs invest in rounds where hedge funds participate.[352] They rely on the activist hedge fund to do the monitoring for them. The question of whether the economic consequences of hedge fund intervention in the unicorn market can lead to optimal firm value and good corporate governance is yet to be determined. Perhaps we can learn from the effects of activist hedge fund interventions in public companies as compared to VCs and other institutional investors.[353]

and Fall of Corporate R&D: Out of Dusty Labs, ECONOMIST (Mar. 1, 2007), http://www.economist.com/node/8769863.

[349] Kwon et al., *supra* note 82, at 408; *see also* John Asker et al., *Corporate Investment and Stock Market Listing: A Puzzle?*, 28 REV. FIN. STUD. 342, 346 (2015).

[350] *See* BRANSCOMB & AUERSWALD, *supra* note 141; BRONWYN H. HALL, THE PRIVATE AND SOCIAL RETURNS TO RESEARCH AND DEVELOPMENT, IN TECHNOLOGY, R&D, AND THE ECONOMY 140 (Bruce L.R. Smith & Claude E. Barfield eds., 1995) (providing evidence that the social return to R&D is much above the private return); Griliches, *supra* note 345, at 29–44 (evaluating calculations of the social rates of return for research and development); *see also* Yoram Margalioth, *Not a Panacea for Economic Growth: The Case of Accelerated Depreciation*, 26 VA. TAX REV. 493, 500–01 (2007).

[351] *See* Robert P. Bartlett, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 44 (2006).

[352] Gornall and Strabulaev also conducted interviews and stated that many financial investors might be unable to provide effective governance and therefore instead focus on provisions for liquidity. Gornall & Strabulaev, *supra* note 313.

[353] *See* Zach Cutler, *4 Big Challenges that Startups Face*, ENTREPRENEUR (Dec. 11, 2014), https://www.entrepreneur.com/article/240742.

b. Hedge Funds & Comparison to Venture Capital

Hedge funds also traditionally invest primarily in publicly traded firms. There are many reports on hedge funds investments in unicorn firms. Additionally, as noted, MFs often use hedge fund activism as a corporate governance mechanism to transform the operational, financial, and governance practices of a target corporation.[354]

"Private funds are pooled investment vehicles that are excluded from the definition of investment company under the Investment Company Act of 1940 by Section 3(c)(1) or 3(c)(7) of that Act."[355] There are many proposed definitions to the term "hedge fund."[356] According to the SEC:

> Hedge funds pool investors' money and invest the money in an effort to make a positive return. Hedge funds typically have more flexible investment strategies than, for example, mutual funds. Many hedge funds seek to profit in all kinds of markets by using leverage (in other words, borrowing to increase investment exposure as well as risk), short-selling and other speculative investment practices that are not often used by mutual funds.[357]

Hedge funds and VC funds both appeal to accredited investors or qualified purchasers. Generally, most U.S. hedge funds are structured as limited partnerships.[358] In order to align the interests of the fund managers and their investors, hedge fund managers typically invest significant amounts of personal capital in these funds. The manager is compensated with a management fee and a

[354] *See* Lucian Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015); *see also* Brav et al., *supra* note 316.

[355] *Private Fund Adviser Overview*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/divisions/investment/guidance/private-fund-adviser-resources.htm (last updated Oct. 21, 2016).

[356] David A. Vaughan, Partner, Dechert LLP, Comments for the U.S. Sec. & Exch. Comm'n Roundtable on Hedge Funds (May 14–15, 2003).

[357] U.S. SEC. & EXCH. COMM'N, INVESTOR BULLETIN, HEDGE FUNDS 1 (2013).

[358] It should be noted that the specific fund structure can vary. *See* Managed Funds Ass'n, Presentation on Hedge Fund Fundamentals: How Hedge Funds Are Structured 2 (June 2016) (presentation slides available at https://www.managedfunds.org/wp-content/uploads/2016/06/06.09.16-How-HFs-are-Structured.pdf).

performance fee.[359] The manager is only able to get a performance fee if the fund exceeds the agreed-upon benchmarks. Hedge fund managers are charged with making the investment decisions for the fund, managing portfolio risk, and determining the fund strategy.[360]

There are some similarities and many differences between these types of funds. First, similar to VC fund managers, hedge fund managers have strong financial incentives to make profits. Hedge fund managers typically collect a significant percentage (e.g., 20%) of excess returns in the form of performance fees in addition to fixed management fees.[361]

Both fund managers have strong incentives. The difference is that hedge fund managers invest a larger substantial amount from their personal wealth into their own funds (as compared to VCs).[362] Hedge fund managers cause a lock-up mechanism. A lock-up period is a window of time when the investors that invested in the fund are not allowed to redeem or sell their shares.[363] The lock-up period depends on the specific hedge fund, but, typically, it can be for a period of eight months.[364] Depending on the fund, the hedge fund investor might be able to withdraw its funds early and pay a penalty unless there is a "hard lock." If there is a hard lock, then the investor will not be able to withdraw its funds until the end of that period. [365]

Generally, hedge fund managers have the flexibility to intervene in the invested companies.[366] The main difference between VCs and hedge fund managers is the long term versus short term investment horizon. Hedge funds typically focus on short-term profits and look for a quick exit, whereas VC funds usually invest for the long-term potential and hold an interest in the portfolio company for several years before an exit.

There is a well-known debate on the issue of hedge fund activism between Marty Lipton and Lucian Bebchuk. On the one hand, Bebchuk, who is a proponent of the economic consequences of hedge fund activism, asserts that hedge fund engagement with shareholders mitigates agency costs, and thus such companies are

[359] Hedge fund managers are regulated by the SEC and CFTC. U.S. SEC. & EXCH. COMM'N, *supra* note 357.

[360] *See* Managed Funds Ass'n, *supra* note 358, at 4.

[361] *See* Brav et al., *supra* note 316, at 4.

[362] Compare to MF managers.

[363] *See* Managed Funds Ass'n, *supra* note 358, at 14.

[364] *Id.*

[365] *Id.*

[366] *See* Brav et al., *supra* note 316, at 2–3.

more likely to succeed.[367] On the other, Lipton claims that hedge funds focus on short term results that can contribute to management myopia.[368]

More research needs to be done in order to determine the effects of hedge fund investment in the unicorn (target firm) and whether or not such activism creates value for unicorn shareholders and hedge fund investors. Are the hedge funds investing for longer than a year? How are they engaging with the portfolio companies?

These new developments affect the governance arrangements in unicorn firms. In *Unicorn Stock Options*,[369] I demonstrated that founders are able to push for "founder friendly" financing rounds.

The following sheds light on the power of AVC investors to dictate favorable terms for themselves to mitigate their own risk. These powers combined with the exacerbated asymmetry of information between private firms and retail investors presents a riskier private market for unsophisticated non-accredited investors.

IV. BALANCING TRADEOFFS: INVESTOR PROTECTION & CAPITAL FORMATION

Private markets are expanding while public markets are shrinking. As noted, the SEC is trying to facilitate access of non-accredited investors to private markets. The following issues need to be considered by regulators for proper policy design.

A. Capital Formation & New Firm Formation

One of the policy goals is meant to encourage capital formation for small and medium businesses to survive. [370] However, this Article warns that changing our securities laws to allow more retail investor participation in private markets might lead instead to a decline in public markets, new firm formation, innovation, and competition.[371]

[367] Lucian Bebchuk, *The Myth of Hedge Funds as 'Myopic Activists'*, WALL ST. J. (Aug. 6, 2013), https://www.wsj.com/articles/SB10001424127887323309404578614004210782388; *see also* Bebchuk et al., *supra* note 354.

[368] Martin Lipton et al., *Empiricism and Experience; Activism and Short-Termism; The Real World of Business*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 28, 2013), https://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business/.

[369] Alon-Beck, *Unicorn Stock Options*, *supra* note 4, at 154.

[370] *See* Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 305.

[371] *See* Shai Bernstein, *Does Going Public Affect Innovation?*, 70 J. FIN. 1365, 1365–66 (2015); *see also* DAVID BROWN ET AL., LOOKING BEHIND THE DECLINING

The SEC is rightfully concerned about the decline in our public markets. As noted by SEC Chairman Jay Clayton, "our public capital markets are . . . less attractive to growing businesses than in the past."[372] Policymakers, regulators, investors, academics,[373] and the press have been documenting the present decline in public market.[374]

Until about eleven years ago, private tech companies turned to our public markets in order to raise large amounts of money.[375] They did an IPO, transformed into public companies, and raised large amounts of capital from public markets. This transformation affected the firm's human capital management. The public firm attracted new talent and allowed the old talent to leave and compete with the firm.[376] The following further explains the changes to the firm following an IPO and why public markets are so important.

Small IDEs are important to our economy because historically it was small firms that initially developed the most innovations in the twentieth century.[377] Typically, new IDEs are created by

NUMBER OF PUBLIC COMPANIES: AN ANALYSIS OF TRENDS IN US CAPITAL MARKETS 2 (2017).
(noting that these companies had "an average market capitalization of $1.8b in today's dollars"); *see* also de Fontenay, *supra* note 33, at 447; Doidge et al., *Eclipse*, *supra* note 25, at 8.

[372] Clayton, *supra* note 33.

[373] There are many theories that try to explain the decline in IPOs. *See* Francesco Bova et al., *The Sarbanes-Oxley Act and Exit Strategies of Private Firms*, 31 CONTEMP. ACCT. RSCH. 818, 819–20 (2014); Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165, 170–71 (2017) (explaining that new regulations caused a corporate governance problem by creating unicorns that are not subject to the oversight of the market or supervised regular private company investors). Bova and others claim that the expense of regulatory compliance with the 2002 Sarbanes-Oxley Act ("SOX") is a factor in the decline of IPOs. *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered titles of U.S.C.). Compliance with the SOX requirements shifted the incentive for private firms. Bova et al., *supra* note 373, at 819. The new exit strategy of private firms is to be acquired by a public acquirer as opposed to doing an IPO. *Id.* On the other hand, some scholars argue that SOX and other early 2000s regulatory changes are not the cause for the decline in small firm IPOs. *See* Doidge et al., *The U.S. Left Behind*, *supra* note 25, at 569; Doidge et al., *The U.S. Listing Gap*, *supra* note 25, at 486; Gao et al., *supra* note 25, at 1690; Rose & Solomon, *supra* note 110, at 86–87.

[374] *See* de Fontenay, *supra* note 33, at 447; Doidge et al., *Eclipse*, *supra* note 25.

[375] *See, e.g.*, Bernstein, *supra* note 371, at 1365–66.

[376] *Id.*

[377] The economists Zoltan Acs and David Audertsch examined which firms developed the most important innovations of the twentieth century and found that small and new firms contributed nearly half of the innovations that they examined. They also found that the contribution of smaller and new firms was greater in

entrepreneurs that leave their incumbent firm and start a new firm in order to try and commercialize the perceived value of their knowledge.[378] IDEs take advantage of market opportunities that the managers of established firms perhaps miss or do not see,[379] especially in emergent industries, where market power is not concentrated.[380]

Entrepreneurs start new firms because they are not able to commercialize their knowledge within the incumbent firms that they work for.[381] Another explanation is weak incentive systems in large incumbent firms.[382] In *Unicorn Stock Options*,[383] I explained that large firms typically have weak incentive systems compared to the smaller IDEs. IDEs use substantial compensation packages that are filled with stock options.[384] It might be hard for established, large firms to design similar strong incentive systems because innovation projects are inherently risky and associated with uncertainty.[385]

During the IPO process, the startup company transforms from a privately held corporation to one that is publicly traded on an exchange with dispersed ownership. This transformation not only allows the startup to raise large amounts of capital from the public, but also allows the startup to manage and retain its human

immature industries, where market power was rather unconcentrated. *See* Zoltan Acs & David Audretsch, *Innovation in Large and Small Firms: An Empirical Analysis*, 78 AM. ECON. REV. 678, 678–90 (1988); *see also* ZOLTAN ACS & DAVID AUDRETSCH, INNOVATION AND SMALL FIRMS 37–44 (1990); JOSH LERNER, BOULEVARD OF BROKEN DREAMS: WHY PUBLIC EFFORTS TO BOOST ENTREPRENEURSHIP AND VENTURE CAPITAL HAVE FAILED—AND WHAT TO DO ABOUT IT 47 (2009).

[378] *See* DAVID B. AUDRETSCH ET AL., ENTREPRENEURSHIP AND ECONOMIC GROWTH 51 (2016); *see also* Margalioth, *supra* note 350, at 500–01.

[379] *See* LERNER, *supra* note 377, at 48; *see also* Acs & Audertsch*, supra* note 377, at 678–90 (finding that the contribution of smaller and new firms was greater in immature industries where market power was rather unconcentrated).

[380] *See* Acs & Audertsch, *supra* note 377, at 678–90. Audretsch analyzes the factors that influence the rate of new firms and observes that there are "industries in which small firms account for a greater percentage of the industry's innovations"; in such industries, he finds that it is more likely for new startups to be formed. David B. Audretsch & Max Keilbach, The Knowledge Spillover Theory of Entrepreneurship 24 (Nov. 2005) (unpublished manuscript) (available at http://web.mit.edu/iandeseminar/Papers/Fall2005/audretschkeilbach.pdf.).

[381] LERNER, *supra* note 377, at 48 (citing RICHARD N. FOSTER, INNOVATION: THE ATTACKERS' ADVANTAGE (1986)).

[382] *Id.*

[383] Alon-Beck, *Unicorn Stock Options*, at 154.

[384] *Id.*

[385] *Id.* There is no telling if proposed innovative projects will be successful, how long will they last, how many participants they will require, or how complex they are going to be.

capital.[386] Employees who contributed to the growth of the startup are able to cash in following an IPO (by exercising their options and selling their stock) and use the proceeds to leave and compete.

As noted in *Unicorn Stock Options*, when firms stay private longer and do not do an IPO, the practice of awarding stock options with "golden handcuffs"[387] essentially locks-in employees who may prefer to leave, compete, or go work for a younger startup with more cutting-edge technology.[388] Therefore, allowing unicorns or other tech companies to continue to raise large amounts of capital in private markets, combined with the new market conditions where AVCs continue to invest in unicorns, may not only cause unicorns to stay private longer, but perhaps also harm the ability of talent to leave, compete, and contribute to the innovation necessary for a growing economy. It may contribute to a decline in new firm formation.

New firms are more likely to open new markets because they are risk takers, which allows their managers to choose riskier projects and strategies compared to established firms who choose more traditional projects.[389] Established firms may be reluctant to open up new markets due to the risk of failure and uncertainty of results and efficiency.[390] Therefore, this policy design may also affect knowledge spillover, competition, and innovation.

[386] *Id.* at 138 (concluding that public firms are able to attract new human capital).

[387] There is a heated debate in Silicon Valley concerning the use of the so-called "golden handcuffs," the 90-day stock option exercise period applicable to departing startup employees, and whether such practice is fair or efficient due to the new market dynamics. *See id.* at Part III.

[388] *See* Yifat Aran, Note, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235, 1239–40 (2018) ("[T]he lock-in effect of stock options might significantly impede the departure of much-needed entrepreneurial talent from the most successful private firms.").

[389] Debra J. Aron & Edward P. Lazear, *The Introduction of New Products*, 80 AM. ECON. REV. 421, 421 (1990) ("[N]ew markets are likely to be opened up by new entrants . . . While incumbents may be reluctant to open up new markets, they can be induced to follow into the new product line."); *see also* LERNER, *supra* note 377, at 48.

[390] LERNER, *supra* note 377, at 48; Aron & Lazear, *supra* note 389, at 421; *see also* Thomas J. Prusa & James A. Schmitz, Jr., *Can Companies Maintain Their Initial Innovation Thrust? A Study of the PC Software Industry*, 76 REV. ECON. & STAT. 523, 524 (1994) (demonstrating that new firms are more effective in introducing innovative products in the software industry.). However, it must be noted that established firms are encouraged to follow the new technology once developed by entrepreneurial firms. *See* Aron & Lazear, *supra* note 389, at 421; *see also* LERNER, *supra* note 377, at 48; Prusa & Schmitz, Jr., *supra*, at 524.

B. Investor Protection & Access to Private Markets

Our securities laws were designed to protect investors, and that is why we have rules and restrictions that regulate investments in private markets. This Article asks whether U.S. policymakers should allow non-accredited retail investors to invest in private firms. The following are concerns, suggestions, and recommendations about some of the proposed policies and solutions discussed above.

In order to decide or design a policy to allow non-accredited investors to invest in private firms, we need to consider the risks associated with such investment and think about the cost-benefit analysis of such changes to our current system. As explained above, private markets are plagued with high risk, information asymmetry, and agency costs. Therefore, the proposed policies on this issue can be troublesome for the following reasons.

First, with regards to private equity, it is common knowledge that PE funds hold assets that are very hard to value.[391] Since valuations can be disputed, it is important to make sure that PE fund managers will not have incentives to distort such reported valuations, especially if they need to use reports in order to make decisions on commitments for subsequent funds.[392] Some of the hard questions that need to be considered are: What if underperforming PE fund managers decide to inflate the reported returns during times when fundraising takes place? Could non-accredited investors see through these manipulations? The following are some concerns and questions for further research in this area.

In the past, there have been several SEC inquiries that examined the possibility that PE GPs overstated their portfolio net asset values (NAVs) in an attempt to attract investors to future funds.[393] Most of the assets that are held by PE funds are private, and there is no liquid market for these assets.[394] Therefore, traditionally, the investors, who are known as LPs, usually "rely on

[391] Gregory W. Brown et al., *Do Private Equity Funds Manipulate Reported Returns?*, 132 J. FIN. ECON. 267, 267 (2019).

[392] *Id.*

[393] *See, e.g.*, Karen Kroll, *SEC Turns Up the Heat on Private Equity, Hedge Funds*, COMPLIANCE WK. (Mar. 5, 2012), https://www.complianceweek.com/sec-turns-up-the-heat-on-private-equity-hedge-funds/4328.article; *see also* Peter Lattman, *Private Equity Industry Attracts S.E.C. Scrutiny*, N.Y. TIMES: DEALBOOK (Feb. 12, 2012, 9:15 PM), https://dealbook.nytimes.com/2012/02/12/private-equity-industry-attracts-s-e-c-scrutiny/.

[394] Brown et al., *supra* note 391, at 267–68.

estimates of NAVs in quarterly reports provided by" the PE's GPs.[395] Often, according to Brown et al., "NAVs are determined by outside valuation consultants and auditors, but the process is nonetheless subjective and is based on data produced by the portfolio companies that are directly owned by the funds."[396]

Another concern is with regards to fees. Note that in the past the SEC settled cases with PE fund managers for failing to fully inform investors about their benefits from fees. For example, in 2015, three PE fund advisers from The Blackstone Group settled charges for approximately $39 million for failing "to fully inform investors about benefits that the advisers obtained from accelerated monitoring fees and discounts on legal fees."[397] It is very important to design a policy that will take this into account and protect retail investors from illegal fee practices.

With regard to illiquidity concerns, as noted, unicorn shares are non-liquid and many unicorns put restrictions on secondary trading.[398] There is also controversy with regards to aggressive valuations of these firms.[399] Policymakers should continue to review the secondary trading market with the goal of improving liquidity.

Regarding the suggestion to use public closed-end funds that will invest in private equity funds (and perhaps also requiring that funds get more than 50% of their capital commitments from institutional investors), there is a need for further research on this option. Retail investors can perhaps benefit from sophisticated players that can do

[395] *Id.* (An earlier version of this paper states, "LPs seeking to make investments in private funds face the problem of deciding which GPs to invest with. Very little, if anything, is known about what specific investments will be undertaken by the GPs after capital has been committed to a fund. Consequently, investors are forced to rely largely on reported values of previous funds and soft information about the value-relevant qualities of GPs (e.g., access to deal flow, reputation in the industry, etc.) when selecting private equity managers. Given that valuations from existing and past funds represent most of the hard information available to investors, it is not surprising that anecdotal evidence suggests that LPs make decisions under a prior belief of persistent performance of GPs. Academic evidence suggests that this is likely to be a valid part of the selection process. For example, Kaplan and Schoar (2005) document that absolute and relative performance of early funds predicts that of subsequent funds managed by the same private equity firm. . . ."). Brown et al., Do Private Equity Funds Game Returns? (Feb. 28, 2015) (unpublished manuscript) (available at http://somfin.gmu.edu/seminars/papers/S2016/brown_gredil_kaplan_16_do_PE_funds_game_returns.pdf).

[396] Brown et al., *supra* note 391, at 267.

[397] Press Release, U.S. Sec. & Exch. Comm'n, Blackstone Charged with Disclosure Failures (Oct. 7, 2015), https://www.sec.gov/news/pressrelease/2015-235.html.

[398] *See* Alon-Beck, *Unicorn Stock Options*, *supra* note 4, at 172–74.

[399] *See supra* note 249 and accompanying text.

the monitoring for them and negotiate the contractual terms with the PE funds. However, there are many unanswered questions that need to be answered regarding fee structures and disclosure of fees and information regarding uninvested capital. There is a need for more research on asymmetric information of these funds and best practices in order to answer these questions. For example, should the SEC mandate a waiver of management fees on uninvested capital by closed-end funds? Should the SEC put restrictions (or limits) on underlying PE fund management fees? These discussions are outside the scope of this Article.

The following is a discussion of how the rise in AVC investors is affecting unicorn ownership structures, decision making mechanisms, and corporate governance arrangements. It highlights the risks associated with investing in a unicorn firm.

C. Investor Protection & Rise in AVC Investors

Unicorn ownership structures are different from traditional patterns of privately held startup firms or large-scale public firms. Classical theories of entrepreneurship, ownership of the firm, and corporate governance does not capture the new structures and special attributes of the unicorn firm.[400]

Several scholars have examined the distinctive characteristics of firm ownership. Specifically, Williamson, Klein, Crawford, Alchian, Hansmann, Kraakman and most recently Pollman discussed the impact of "transaction-specific investments on the assignment of ownership."[401] The following builds on their theories and explains the various costs associated with ownership of a unicorn firm.

AVCs have divergent interests concerning the conduct of the unicorn firm's affairs. AVCs do not share the same characteristics or interests and do not transact with the firm under similar circumstances (or market contracting). They act strategically to advance their own benefits. Therefore, their collective decision-making costs are very high. As postulated by Hansmann, "[E]ven if

[400] *See generally* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996); Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019). For a discussion of and historical review of the establishment of the firm and the notion of entity shielding, see Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006) (describing the development of entity shielding in four historical epochs: ancient Rome, the Italian Middle Ages, England of the 17th–19th centuries, and the United States from the 19th century to the present).

[401] Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267, 268 (1988).

no patron acts strategically such processes may yield decisions that are collectively inefficient in the sense that they do not maximize aggregate patron surplus."[402] This is evident from the recent stories on unicorn market performance post-IPO and corporate governance failures. For example, see the recent story of the WeWork catastrophe below.

Unicorn shareholders may deal with "horizontal" governance issues.[403] Horizontal disputes between shareholders arise when some shareholders take advantage of other shareholders by exercising influence and control.[404] Therefore, exploring the rise in AVCs as new investor groups, specifically, their contractual rights, control rights, fiduciary duties, and power struggles, is extremely important because courts may be required to decide on disputes between unicorn investors in the future.

Note that Delaware courts already grapple with determining which strategic or powerful contractual rights (such as consent or blocking powers) deem an investor (or debtor) in a startup to be a "controlling stockholder" who also owes a fiduciary duty to the company.[405] Are AVCs controlling stockholders?

As illustrated in this Article, AVCs are comprised of many different types of investors with different incentives, contractual rights, and characteristics, including pooled investment vehicles that owe fiduciary duties to their own investors. The decision to deem an investor a controlling stockholder imposes fiduciary duties on a third party that has powerful contractual rights and obligates it to act in the best interests of the other stockholders (especially minority).

There are opposing views on whether courts should base their decision to enforce the parties' rights according to contract law or fiduciary doctrine (where preferred stock is required to maximize

[402] *Id.* at 278.

[403] Robert Bartlett & Eric Talley, *Law and Corporate Governance*, *in* 1 THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 177, 179 (Benjamin E. Hermalin & Michael S. Weisbach eds., 2017).

[404] *Id.* at 185–86.

[405] VCs traditionally invest in startups using convertible preferred stock. *See* Fried & Ganor, *supra* note 32, at 981–82; Kaplan & Strömberg, *supra* note 320; William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473 (1990). For more on this, see Juliet P. Kostritsky, *One Size Does Not Fit All: A Contextual Approach to Fiduciary Duties Owed to Preferred Stockholders from Venture Capital to Public Preferred to Family Business*, 70 RUTGERS L. REV. 43, 43 (2017) (examining "whether corporations should owe fiduciary duties to their preferred stockholders as preferred stockholders across all settings of preferred stock holding.").

firm value and is subordinate to the rights of common).[406] The courts' decisions on these matters are important for the future of strategic investments in startup firms. Scholars have focused on power struggles between venture capitalists as preferred shareholders and other common shareholders. There is a need to pay attention to the new phenomenon of AVC investors and the ways in which they invest.

Another factor to consider concerning investor protection is a concern that the valuations of unicorn firms are inflated and their public debut might be disappointing to future investors. To illustrate, note that last year marked the beginning of the "unicorn stampede,"[407] where twenty-eight unicorn firms finally went public.[408] Unfortunately, the stock performance of the largest unicorns, including Uber and Lyft, was very disappointing despite the fact that they raised billions of dollars before going public.[409]

Uber raised $14 billion in pre-IPO private financing rounds, and its stock lost approximately 17%.[410] Lyft raised $5 billion in pre-IPO rounds, and its stock lost approximately 34%.[411] These companies entered the public markets after years of raising large amounts in private financing rounds from AVC investors.[412] Are these stories

[406] See the *Trados* case to illustrate the issues that arise in VC-backed startups, where the board of directors are usually appointed by the investors. Additionally, depending on the proposed transaction, preferred stockholders and common stockholders might have conflicting interests. *Trados* involved claims against the board of a startup that was sold in a merger transaction. The court applied the fairness review standard. *See generally In re* Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013). For an example of a subsequent court attempting to interpret *Trados*'s holding on the mechanics of fairness review, see generally In re Nine Sys. Corp. S'holder Litig., No. 3940-VCN, 2014 WL 4383127 (Del. Ch. 2014). *See* Abraham J.B. Cable, *Opportunity-Cost Conflicts in Corporate Law,* 66 CASE W. RSRV. L. REV. 51, 75–76 (2015); Abraham J.B. Cable, *Does* Trados *Matter?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 7, 2019), https://corpgov.law.harvard.edu/2019/11/07/does-trados-matter/; *see also* Bratton & Wachter, *supra* note 32; Adam Katz, *Addressing the Harm to Common Stockholders in* Trados *and* Nine Systems, 119 COLUM. L. REV. ONLINE 234 (2018); Kostritsky, *supra* note 405.

[407] This term was coined by Matt Levine. *See* Levine, *supra* note 2.

[408] Julia Boorstin, *Era of Mega-Funded, Money-Losing Unicorn Start-Ups Is Coming to an End*, CNBC (Jan. 23, 2020, 4:15 PM), https://www.cnbc.com/2020/01/23/era-of-mega-funded-money-losing-unicorns-is-coming-to-an-end.html.

[409] *Id.*

[410] *Id.*

[411] *Id.*

[412] Daniel Strauss, *Goldman Sachs Analyzed 4,481 IPOs Over 25 Years and Concluded That These 5 Attributes Can Make or Break a Newly Public Company*, BUS. INSIDER (Oct. 8, 2019, 8:11 AM), https://markets.businessinsider.com/news/stocks/5-most-important-factors-for-successful-ipo-performance-goldman-sachs-2019-9-1028507003#sector-and-industry1.

going to have affect the decision of unicorn founders to go public in the near future? Maybe.

Matt Levine, from *Bloomberg*, was spot-on when he stated that "private markets are the new public markets."[413] Firms are raising more money in private financing rounds than in public ones.[414] In 2018, companies raised $2.9 trillion in unregistered, exempt private placements, which is more than double the amount that they raised in public registered markets ($1.4 trillion).[415] It is not surprising that retail investors want to invest in private markets, when private offerings are perceived as more lucrative than public markets despite the risks that are associated with these investments.[416]

Moreover, and more importantly, unicorns are already flush with capital and are able to attract large amounts of financing from AVCs. Moreover, some AVCs may bargain for different contractual rights than traditional VC investors when investing in unicorns, and those rights include aggressive redemption rights and post-IPO pricing "ratchets." These contractual mechanisms are designed to protect AVCs from down rounds and lower post-IPO valuation.

However, there are many risks associated with private investments. The following WeWork example illustrates the risks associated with AVC investments to investor protection, especially concerning the conflict of interest between the various investors in unicorn firms that contribute to moral hazard problems and mispricing of IPOs.

The recent WeWork failed IPO fiasco is a perfect example of the new "toxic unicorn bubble."[417] The We Company, originally called

[413] Matt Levine, *Private Markets Might Be Too Nic*e, BLOOMBERG OP. (Oct. 31, 2019, 12:12 PM), https://www.bloomberg.com/opinion/articles/2019-10-31/private-markets-might-be-too-nice; *see* Anat Alon-Beck, *SEC Commissioner Hester Peirce: 'Regulation Can Stifle the Creative Juices in People'*, FORBES (Jan. 13, 2020, 12:27 PM), https://www.forbes.com/sites/anatalonbeck/2020/01/13/sec-commissioner-hester-peirce-regulation-can-stifle-the-creative-juices-in-people/#6b2b3b8b2539; Anat Alon-Beck, *The Unicorn War for Talent: The Employees Fire Back. WeWork Is the Latest Example*, FORBES (Jan. 29, 2020, 12:12 PM), https://www.forbes.com/sites/anatalonbeck/2020/01/29/the-unicorn-war-for-talent-the-employees-fire-back-wework-is-the-latest-example/#75c8c98635da.

[414] de Fontenay, *supra* note 33, at 448–50; *see* Kupor, *supra* note 33; *see also* Statement of Renee Jones, *supra* note 4, at 6.

[415] Concept Release on Harmonization, *supra* note 39, at 30465.

[416] IRA M. MILLSTEIN CTR., COLUMBIA L. SCH., PRIVATE OWNERSHIP AT A PUBLIC CROSSROADS: STUDYING THE RAPIDLY EVOLVING WORLD OF CORPORATE OWNERSHIP 1 (2019) ("Capital formation in the United States is currently in the midst of a significant transition . . . .").

[417] Coffee, Jr., *supra* note 206.

WeWork, decided to postpone its IPO last year.[418] There could be several reasons for that move, including a sharp decline in its reported valuation, a call to fix its corporate governance mechanisms, and a successful initiative to oust the company's founder Adam Neumann as CEO.[419] In October 2019, one of WeWork's AVC investors—SoftBank—ousted Adam Neumann as CEO and then took control over 80% of WeWork.[420]

WeWork is a technology-based real estate business, which provides shared workspaces for small businesses and startups and is a member of the notorious unicorn club.[421] A look into WeWork's S-1 filings (and revised filings) with the SEC reveals how AVC investors bargained for different contractual rights than traditional VCs investors. WeWork's AVC investors obtained new contractual rights in order to protect their expected rate of return (instead of monitoring rights) at the expense of other shareholders, including future shareholders.[422]

As noted above in Part III, finance scholars, specifically Lerner et al., have been documenting the different contractual rights that

[418] *Id.*

[419] *Id.*

[420] Annie Palmer & Christine Wang, *SoftBank Takes 80% Ownership of WeWork, Announces $5 Billion in New Financing Package*, CNBC (Oct. 22, 2019, 9:52 PM), https://www.cnbc.com/2019/10/23/softbank-to-take-control-of-wework.html.

[421] *See, e.g.*, Scott Austin et al., *The Billion Dollar Startup Club*, WALL ST. J. (Feb. 18, 2015), https://www.wsj.com/graphics/billion-dollar-club/ (showing list and valuation of firms as of May 2017); Ben Zimmer, *How 'Unicorns' Became Silicon Valley Companies*, WALL ST. J. (Mar. 20, 2015, 10:26 AM), http://www.wsj.com/articles/how-unicorns-became-silicon-valley-companies-1426861606; *Billion Dollar Startups*, CNN TECH., https://money.cnn.com/interactive/technology/billion-dollar-startups/ (last visited Jan. 1, 2021); *The Global Unicorn Club*, CB INSIGHTS, https://www.cbinsights.com/research-unicorn-companies (last visited Jan. 1, 2021); *The Unicorn List*, FORTUNE (2016), http://fortune.com/unicorns/. Companies that are valued at over $10 billion are called "decacorns." *See* Sarah Frier & Eric Newcomer, *The Fuzzy, Insane Math That's Creating So Many Billion-Dollar Tech Companies*, BLOOMBERG TECH. (Mar. 17, 2015, 9:00 AM), https://www.bloomberg.com/news/articles/2015-03-17/the-fuzzy-insane-math-that-s-creating-so-many-billion-dollar-tech-companies (coining the term "decacorns"); *see also* Jillian D'onfro, *There Are So Many $10 Billion Startups That There's a New Name for Them: 'Decacorns'*, BUS. INSIDER (Mar. 18, 2015, 9:42 AM), http://www.businessinsider.com/decacorn-is-the-new-unicorn-2015-3.

[422] Coffee, Jr., *supra* note 206; *see WeWork's Anti-Dilution Provisions Could Grant $400 Million to SoftBank and Others*, RENAISSANCE CAP. (Sept. 12, 2019), https://www.renaissancecapital.com/IPO-Center/News/64947/WeWork's-anti-dilution-provisions-could-grant-$400-million-to-SoftBank-and; *see also* Kate Rooney, *WeWork Investors Like SoftBank Have an Obscure Protection Worth Millions in a Devalued IPO*, CNBC (Sept. 24, 2019, 12:10 PM), https://www.cnbc.com/2019/09/24/softbank-has-a-multi-million-dollar-protection-in-weworks-ipo.html.

MFs bargain for when investing in unicorns, which include redemption rights and pricing "ratchets." This Article is part of a research project that sheds light on the new contractual provisions for which AVCs bargain.

MFs are not the only AVC investors that bargain for anti-dilution protection. SoftBank, for example, also bargained for an anti-dilution provision when it invested in WeWork. John C. Coffee[423] was the first to report that SoftBank holds IPO ratchet clauses, as follows:

> According to a computation by Renaissance Capital, LLC, which specializes in analyzing IPOs, the ratchet clause held by SoftBank would have entitled it to more than $400 million in additional shares if WeWork's IPO were to come in with less than a $14.5 billion valuation. If the IPO came in as low as $10.5 billion, the shares to which SoftBank (and certain other holders of similar ratchet clauses) would have been entitled jumped to slightly over $500 million. Today, WeWork is probably worth well less than $10 billion. But nothing about this potential dilution was disclosed to the public. Instead, WeWork's prospectus said (way back in its financial statements at page F-115) only that:
>
> "The conversion ratio for the Senior Preferred Stock is adjusted on a broad weighted-average basis in the event of an issuance (or deemed issuance) below the applicable Senior Preferred stock price, as adjusted."

Unfortunately, as noted by Coffee, this cryptic disclosure tells the IPO investor very little about SoftBank's rights. IPO ratchets are contractual rights that give investors additional shares if the valuation following the IPO falls below the valuation before the IPO (that is measured by the valuation in the last round of financing).[424] What this means is that in the event that the IPO price falls below the latest valuation prior to IPO, more shares are issued to the alternative investor, at the expense of the public investors.

[423] Coffee, Jr., *supra* note 206.

[424] *Id.*

The WeWork example illustrates that investors can be left in the dark when it comes to the financings of unicorn firms. AVCs sometimes bargain for these provisions and WeWork is not the only case.[425] That is why we need a policy that ensures more disclosures and not less.

There is a moral hazard problem where AVC investors have an incentive to continue to invest in late stage rounds and drive the valuation of the unicorn up because they negotiated for provisions that protect them from future post-IPO lower valuation ("down round").[426]

If policymakers and regulators are going to let retail investors invest in private markets and privately held unicorns despite the misalignment of incentives between their current investors, then there is a need for more disclosure of information and policy design that affords more protections for retail investors.

CONCLUSION

Alternative venture capital investors (AVCs), which include mutual funds, hedge funds, sovereign wealth funds, and corporate venture capitalists, have rightly been singled out for "hunting unicorns." They look for the next billion-dollar startup, invest large amounts of capital in late stage rounds, and provide incentives to the management team and board of directors to stay private longer.[427]

Recent changes to our securities laws, coupled with new market conditions and geopolitical considerations, allow AVCs to invest in unicorn firms.[428] Thanks to these developments, there is a dramatic increase in alternative financing vehicles and new capital sources,[429]

[425] *Id.* ("[L]ate stage investors in Square, Inc. held a full ratchet when Square went public in 2015, which resulted in the issuance of $93 million in additional shares. Chegg, Inc.'s IPO in 2013 had a similar clause that resulted in $146 million in additional shares, and Box, Inc.'s IPO in 2015 saw an additional issuance of $67 million pursuant to its ratchet clause.").

[426] *Id.*

[427] *See* PITCHBOOK & NAT'L VENTURE CAP. ASS'N, VENTURE MONITOR 4Q (2018); Lerner et al., *supra* note 30.

[428] *See generally* COMM. ON CAP. MKTS. REGUL., U.S. PUBLIC EQUITY MARKETS ARE STAGNATING (2017).

[429] Brorsen, *supra* note 30; *See* MCKINSEY & CO., *supra* note 30, at 6–7 (noting that private fundraising in 2017 reached nearly $750 billion—more than six times the level of private funds raised fifteen years ago); Lerner et al., *supra* note 30; *see also* Levine, *supra* note 30 ("[L]ate-stage private investors now are doing the job that the post-IPO public investors used to do. . . .").

which contribute to the fact that equity ownership is changing in the United States.

The traditional Anglo-American[430] corporate law tale used to begin with a story about technology dictating that a few well-off individuals alone cannot provide enough capital for large enterprises to scale.[431] Capital, therefore, must be pulled from many estranged shareholders.[432] Ownership was further dispersed due to shareholders who diversify their own holdings.[433] This tale no longer holds.

In reality, there has been a dramatic increase in alternative capital sources.[434] These changes contribute to incentive misalignment between the various groups of AVCs and raise the concern that these developments may affect private ordering. As a direct result, VC investment rounds in unicorn firms are structured as "founder-friendly" financing rounds.

The contractual mechanisms that VC investors traditionally used to avoid opportunism by founders have also changed. These changes give unicorn founders greater power vis-à-vis preferred shareholders and minority common shareholders to oppose a sale and keep the company private longer. AVC investors may have an incentive to continue investing in later stages, and so they ex-ante bargain for contractual provisions, such as redemptions and anti-dilutive IPO ratchets rather than monitoring rights.

These changes not only affect the actions of unicorn founders and their management teams but can have serious effects on economic activity. Monitoring founders and management is extremely important, because misbehavior, such as rent-seeking, corruption, or other illegal activities, might hamper not only managers' decision-making process but may also reduce incentives and opportunities to invest in other innovative enterprises in the future.

Both innovation and greater access to capital are important policy goals. However, our securities laws are also designed to protect investors. Policymakers must consider the ways in which

[430] For an examination of the origins of the private company in Britain, see Ron Harris, *The Private Origins of the Private Company: Britain 1862–1907*, 33 OXFORD J. LEGAL STUD. 339 (2013). According to Harris, "[C]ontrary to a common misconception, business corporations did not begin small (and private) and only then grew bigger (and public)." *Id.* at 340.

[431] Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 10 (1991).

[432] *Id.*

[433] *Id.*

[434] *See supra* note 29 and accompanying text.

AVCs are investing in unicorn firms and disrupting the private market ecosystem. They heighten the effects of information asymmetry for retail investors and highlight the risks associated with expanding exempt offerings while allowing retail investors into private markets without adequate protections.

This Article cautions that investing in private markets and private firms is risky due to information asymmetry and illiquidity. Policymakers should consider ways to enhance our public markets and investor protections rather than trying to substitute them.