2022

Mythical Unicorns and How to Find Them: The Disclosure Revolution

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ABSTRACT

Special Purpose Vehicles (SPVs) are widely used by unicorn firms and venture-backed early stage startups. These structures are used to take advantage of a loophole in our federal securities laws. Both the firm and its investors benefit from this regulatory arbitrage. It allows the firms to raise large amounts of capital and stay private longer.

Venture capital (VC) investors use it to allocate more funds to the startup firm, while also keeping the startup founders and select preferred investors happy. It is a new form of a quid pro quo transaction that allows VC investors to channel new investment business back to their funds. Using SPVs, venture capitalists are allowing select preferred clients to invest in privately held venture backed firms directly. The select VC clients get access to direct investment in "hot" private firms. These private firms are not open to the general investing public, i.e., retail investors. Access to investments in privately held firms, such as unicorns, is usually reserved to accredited sophisticated investors, such as ultrarich individuals and large institutions.

Accompanying these changes is the exposure of an increasing amount of the public's capital to riskier investments in a sphere where information is unavailable in the best of times and deliberately hidden in the worst.

For comments and suggestions, thanks are due to Commissioner Allison Herron Lee, Yifat Aran, Ann Lipton, Andrew Tuch, Jay Ritter, Patrick Corrigan, Christina Danberg, Jake Diana, Bob Rapp, Juliet Kostritsky, Charlie Korsmo, Usha Rodrigues, and Cassandra Robertson. All errors are our own.

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I. INTRODUCTION

"Working people's money should not be the play toys of a bunch of idiots… There's a lot of people in this who make a lot of money off of just a lot of hoohah."

- The Hon. Leo Strine

Special Purpose Vehicles (SPVs) are popular again today and widely used by unicorn firms and venture-backed early stage startups. These structures are not new and were widely used in the buyout world. The last time that SPVs made the financial news and came to the public's attention was during the post Enron-era. Enron used SPVs to employ accounting fraud practices rather than traditional operating results.[1] Venture backed startups are now using them to take advantage of a loophole in our federal securities laws, which allows them to raise large amounts of capital and stay private longer.

How are SPVs used by unicorns today? In a typical SPV transaction, the unicorn investors choose to invest directly in a single venture-backed startup, rather than invest passively in a Venture Capital (VC) fund. The investors form a Limited Liability Company (LLC) for the specific purpose of holding direct investments in a specific startup. The startup's General Partners (GPs) are the ones that will typically create and manage the SPV. The SPV is funded by the Limited Partners (LPs) investors. This shift from passive to active investing by LPs in venture backed firms has perhaps led to a veritable democratization of venture capital.

This shift does not take place in a vacuum. Several developments are affecting this change, including the increase of public capital flowing into private markets. We have also observed a fundamental shift in how traditional venture capital investors and their new competitors behave. VC investors typically function as GPs because they are better positioned to negotiate with startups and investors, allowing the investors to invest more specifically and for shorter periods of time in specific venture backed startup firms, thanks in large part to the use of special purpose vehicles ("SPVs").

This new practice can also be viewed as a new form of an "abusive allocation practice" which is now used by VCs. In some ways,

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[1] Steven L. Schwartz, Enron and the Use and Abuse of Special Purpose Entities

it is akin to “IPO spinning” which is an abusive practice used by investment banks to get clients to give them business in the future. IPO spinning is a form of a quid pro quo transaction that allowed the investment bank to channel investment banking business back to it.[2] In an IPO spinning arrangement, an investment bank “spins” or allocates underpriced securities (prior to an IPO) to directors or executives of its other clients. These preferred clients would make a lot of money overnight by monetizing IPO underpricing.[3]

Using SPVs, venture capitalists are allowing select preferred clients to invest in privately held venture backed firms directly. These private firms are not open to the general investing public, i.e., retail investors. Access to investments in privately held firms, such as unicorns, is usually reserved to accredited sophisticated investors, such as ultrarich individuals and large institutions.[4] If things go well, these select VC clients will be able to monetize on their investments as the rounds of investing in the unicorn firm and valuations continue to increase.

The increase in valuations of unicorn firms points to even larger problems associated with the efficiency of our markets. As we will discuss, there are legitimate concerns that unicorns and other large private companies are dramatically overvalued. The loophole in US securities laws contributes to the lack of disclosure which has allowed this problem to escalate. With the increases in Section 12(g) limits, not only are more companies staying private longer, but more companies are deciding to “go dark”. The resulting shrinkage of public equity markets may be leading to increased inefficiencies in our public market valuations to go hand in hand with private market inefficiencies. While there was hope with the creation of secondary markets to allow for some liquidity, they remain largely inefficient and unable to address the problem like disclosure would.[5]

SPVs have the added benefit of allowing the venture capital funds themselves play outside the typical restrictions imposed upon them by the funds’ investors. It also runs the risk of further exacerbating the systemic inequality that the SEC seeks to address by liberating private markets. As more venture capital funds sponsor more

[2] For an analysis of spinning, see Sean J. Griffith, A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings, 69 BROOKLYN L. REV. 583 (2003-2004).

[3] For an analysis on underpricing, see Patrick Corrigan.

[4] Beck, AVCs

[5] *See infra* Section III.

SPVs, they turn to their preferred clients to reward them first before opening up to other potential investors. Relying on a hand collected data set consisting of SEC public filings, we found that many companies have substantially more beneficial owners than their shareholder of record count would indicate otherwise.[6]

Situated in the center of this pool of problems is Section 12(g). With the reality of ease of access to capital, companies can tap into private capital directly and public capital indirectly without needing to make disclosures. They reap the rewards while shifting away the risk. By addressing the threshold requirements under Section 12(g), we believe we can rebalance the equilibrium, provide the necessary protection to investors, and continue to liberate the markets to allow for a greater range of participation from a variety of sources.

Section 12(g) of the Securities Exchange Act of 1934 ("34 Act") has been referred to as "an obscure provision" and increasingly irrelevant for nearly two decades. Yet for all of its supposed irrelevance, it was amended in 2012 via the Jumpstart Our Business Startups Act ("JOBS Act") to remove what little regulatory teeth it had left. The result of the removal has been extraordinary changes in capital formation in the last decade. Investors from a wide range of size and sophistication are being pulled into financing rounds of increasing scale while simultaneously less and lower quality information is being disseminated from these firms. The delicate balancing act of our securities laws between capital formation and investor protection has dipped dramatically in favor of the former at the expense of the latter. We believe Section 12(g) is at the center of this problem and the time is ripe for reform.

Following these supposedly needed changes, and combined with the other provisions of the JOBS Act, we have seen fundamental shifts in how capital is raised and in the expected IPO cycles. Thanks to the increase in Section 12(g) thresholds and the easing of exempt capital raising restrictions under Regulation D, it is far easier for companies to stay private longer and grow to staggering sizes. Using our hand-collected data from public filings with the Securities and Exchange Commission ("SEC"), we have found the average number of shareholders of record in unicorn IPOs has nearly doubled in the decade since the passage of the JOBS Act. Valuations for unicorn IPOs have continued to soar higher every year.

Given the implications of these large firms, it must be asked whether the regulation requires updating, or rather a restoration, to ensure that the original intent behind its passage is still actually being

[6] *See infra* Section IV.

addressed. In our opinion, it is failing dramatically. When implemented in 1964 by Congress at the behest of the SEC, Section 12(g) was intended to address companies which already had significant exposure to the investing public, but were not required to comply with the typical reporting regime associated with publicly trading. It was designed to address widely held and widely traded private companies.

However, much has changed in the past six decades with regards to how we own and trade securities, how information about these securities is maintained, and the size and scale of companies. The purpose behind all of our securities regulation, to protect investors and allow for efficient allocation of capital by providing access to accurate information, is unchanged. On the other hand, many of the provisions implemented as a result of limitations in technology have not been updated to reflect the modern features of our current market environment.

The SEC is preparing to change this and demand more transparency from large venture-backed technology firms valued at over $1 billion or more, called "unicorns".[7] Regulators are concerned with the lack of oversight of the private fundraising that has fueled the rise of these firms.

The obvious question would be why should Section 12(g) be reformed before any other regulation. Some would argue that targeting the exemptions for unregistered offerings may have more of an impact. In our view, however, Section 12(g) is squarely situated within the middle of the problem: a loophole at the point at which capital formation and investor protection clash. Its thresholds allow companies to raise capital from large pools of investors, both public and private, and avoid making the disclosures typically associated with such formation activities. From the outset, it must be noted that our largest concern stems from the increase in public capital, particularly from pension funds and other retirement vessels, flowing into private markets with few disclosure mechanisms in place to protect it. If the SEC seeks to liberate access to participation in these private markets, there must be at least a minimal consideration given to protective measures. While we do not object to this liberation as we believe it may be beneficial in addressing systemic economic inequality, it must be done responsibly.

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[7] Paul Kiernan, *SEC Pushes for More Transparency from Private Companies*, WALL ST. J. (Jan. 10, 2022) ("'Unicorn' firms have a huge impact and 'absolutely no visibility' for regulators, says SEC Commissioner Allison Lee") https://www.wsj.com/articles/sec-pushes-for-more-transparency-from-private-companies-11641752489.

In addition to protecting public capital, minority shareholders and later stage investors are also at significant risk should Section 12(g) not be reformed. Employees, the largest group of minority shareholders, do not have access to information normally provided by disclosure mechanisms to allow them to assess both their economic prospects and career options. Instead, they are faced with a blindfold to go along with their "golden handcuffs". Large investors who may be late to the initial party are also faced with paying increasing prices for less and less equity. Newer players in the world of capital formation are using their capital earlier to protect their equity stakes contractually, favoring rachets to save percentages, rather than addressing legitimate corporate governance concerns. By the time more responsible and traditional investors come in, their ability to address problems has been diluted.[8]

The increase in valuations points to even larger problems associated with the efficiency of our markets. As we will discuss, there are legitimate concerns that unicorns and other large private companies are dramatically overvalued. The lack of disclosure has allowed this problem to escalate. With the increases in Section 12(g) limits, not only are more companies staying private longer, but more companies are deciding to "go dark". The resulting shrinkage of public equity markets may be leading to increased inefficiencies in our public market valuations to go hand in hand with private market inefficiencies. While there was hope with the creation of secondary markets to allow for some liquidity, they remain largely inefficient and unable to address the problem like disclosure would.[9]

With the increase of public capital flowing in, the increase in risks to smaller investors, and the inefficiencies of public and private markets increasing, we have also seen a fundamental shift in how venture capital and its new competition behave. In some instances, these shifts have led to a veritable democratization of venture capital. VC investors better positioned to negotiate with funds, allowing them to invest more specifically and for shorter periods of time, thanks in large part to the use of special purpose vehicles ("SPVs").

SPVs have the added benefit of allowing the venture capital funds themselves play outside the typical restrictions imposed upon them by the funds' investors. It also runs the risk of further exacerbating the systemic inequality that the SEC seeks to address by liberating private markets. As more venture capital funds sponsor more SPVs, they turn to their preferred clients to reward them first before opening up to other potential investors. Relying on a hand collected

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[8] *See infra* Section III.
[9] *See infra* Section V.

data set consisting of SEC public filings, we found that many companies have substantially more beneficial owners than their shareholder of record count would indicate otherwise.[10]

Situated in the center of this pool of problems is Section 12(g). With the reality of ease of access to capital, companies can tap into private capital directly and public capital indirectly without needing to make disclosures. They reap the rewards while shifting away the risk. By addressing the threshold requirements under Section 12(g), we believe we can rebalance the equilibrium, provide the necessary protection to investors, and continue to liberate the markets to allow for a greater range of participation from a variety of sources.

In Section II of this paper, we will examine how equity ownership has been consolidated, both for purposes of record holding and in reality, despite an overall increase in market participation as a percentage of the population. While more Americans invest in equities, both in volume and in value, there are fewer and fewer record holders on paper. We will then examine how Section 12(g) is being manipulated away from its original intent to ensure that disclosures that should be made are being avoided.

We will discuss the legislative history of Section 12(g), a history which would indicate the Congress which passed this provision would have it dramatically updated to reflect modern technology. In addition, we will examine how the SEC itself views Section 12(g) in its own eyes, the practical limitations it sees on how the provision can be enforced in the post-JOBS Act world, and how it and members of academia have viewed the possibility for significant reform under the SEC's own rulemaking powers.

We will also address the dramatic increase in capital formation resulting from the adjustments to Section 12(g) and other provisions of our securities laws. This capital is stemming from a multitude of sources with an increasing number of participants, but many are excluded from regulatory counts.

In Section III, using our data set, we will examine the practical effects of the combination of the factors from Section II. We will show what has occurred as a result of the consolidation of equity ownership, the explosion of exempt offerings in size and scale, and the reality of near unenforceability of our existing securities law protections.

In Section IV, we will discuss the democratization of venture capital, the new sources of funding, and the implications for receiving

[10] *See infra* Section III.

funds in unique structures. The impact of this evolution of capital formation is, in large part, the reason we believe Section 12(g) needs reformation. While capital formation is an admirable goal, investor protection must not suffer for its benefit.

In Section V, we will show the results of allowing this capital formation to happen largely in the dark and the implications of maintaining a veil of secrecy over increasingly large companies. We will then address why we believe the methodology for determining "shareholders of record" should be adjusted.

Finally in Section VI, we present our suggested reforms for returning Section 12(g) to its originally intended purpose. In doing so, we will see a far more accurate reflection of the ownership of these enterprises, thus requiring those who seek indirect access to the investing public's capital to comply with the same rules that those who directly seek access must follow. While Congressional action is needed for several of these reforms, the SEC, with its considerable own rulemaking authority, has the ability to make changes to give Section 12(g) its regulatory teeth back.

II. CLEARING THE "STREET" FOR PRIVATE GROWTH

When most investors purchase shares in a firm, they often make the reasonable assumption that as beneficial owners their shares are held in their name.[11] They receive the dividends and proxy materials, as well as retaining the right to vote the shares.[12] However, the ultimate named record holder for purposes of Section 12(g) counts is often the brokerage firm the investor uses to purchase the shares or the company.[13] This standard procedure is known as "street name" registration.

A. Consolidation of Equity

There are obvious benefits for such a methodology of ownership. It allows for investing practices many consider standard today such as limit orders, borrowing on margin, and near instant

[11] *It's Your Stock, Just Not in Your Name: Explaining 'Street Names,'* FINRA (Financial Industry Regulatory Authority) (Dec. 21, 2015), https://www.finra.org/investors/insights/its-your-stock-just-not-your-name-explaining-street-names [hereinafter FINRA].

[12] *Holding Your Securities Get the Facts*, U.S. SEC. & EXCH. COMM'N (Mar. 4, 2003), https://www.sec.gov/reportspubs/investor-publications/investorpubsholdsechtm.html.

[13] *Id.*

trading.[14] It avoids the expensive and time consuming process of selling physical shares, as well as avoiding the risks of losing the shares themselves.[15] While it does often delay the dispersal of dividends by a few days, in the grand scheme, the benefits typically outweigh the risks. As a result, purchases are typically automatically held in street name unless specific investor instructions are given to the contrary.[16]

Issuers prefer this form of ownership for several reasons. First, it places the onerous burden on the brokerage firms, or other nominated parties, to send out proxy materials, provide tax information, and distribute annual reports.[17] More importantly for non-public issuers, however, it allows for the record count in Section 12(g) to be dramatically reduced. If 500 investors purchase shares through a single brokerage firm, that firm reduces the record count to just one shareholder of record.[18]

Since the passage of the '34 Act and the Securities Act of 1933 ("'33 Act"), the ownership of public equity has shifted dramatically. Prior to the end of World War II, institutional investors held around 5% of equities in the United States.[19] By 2010, that had increased to 67%. In the decade that followed, the number has steadily risen.[20] Of the 10 largest publicly traded companies, the average exceeds 75%.[21] However, our securities laws have not adapted to reflect this reality. While more and more Americans are investing their wealth into equities, they are often doing so via vehicles such as mutual funds, 401(k)s, IRAs, and other institution-managed funds.[22] For the increasing minority that does hold shares outright, many do so via brokerage funds.[23] These funds are considered to be the shareholders

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[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] "*Going Dark" – A Process for Delisting and Deregistration of Public Company Securities*, DUDNICK, DETWILER, RIVIN AND STIKKER, LLP https://www.ddrs.com/going-dark-a-process-for-delisting-and-deregistration-of-public-company-securities/ (last visited Jan. 24, 2022).

[19] Marshall E. Blume & Donald B. Keim, *Institutional Investors and Stock Market Liquidity: Trends and Relationships* 4 (Aug. 21, 2012) (Jacobs Levy Equity Management Center for Quantitative Financial Research Paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2147757.

[20] *Id.*

[21] *80% of Equity Market Cap Held by Institutions*, PENSIONS & INVS. (Apr. 25, 2017), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions.

[22] *What Percentage of Americans Own Stock?,* USA FACTS (Mar. 9, 2021), https://usafacts.org/articles/what-percentage-of-americans-own-stock/.

[23] *Id.*

of record, holding the shares in their "street name" while the ultimate benefit is given to the beneficial investors.[24]

Further complicating this matter is the rise of special purpose vehicles ("SPV"), developed by sophisticated players ostensibly as liability shielding mechanisms. As part of a fundraising round, a firm may raise funds from several large investors. Rather than holding the shares outright on their books, however, these investors may pool their assets in a newly created special purpose vehicle. This SPV holds the equity on behalf of the investors and provides a degree of liability protection. Should the investee go under, the exposure is limited to the SPV, rather than potentially having a broader exposure to the investors' books. The added benefit stems from a further reduction in overall shareholders of record for the investee company. It should be noted that under the recently passed Corporate Transparency Act of 2021, FinCEN is now required to create a registry of entities formed and permitted to do business in the United States. This registry would require beneficial owners of these entities who either exert substantial control or own at least 25% of their equity to disclose their name and other information to FinCEN. There are, however, 23 exceptions to these requirements and FinCEN is still revising the proposed rule under notice and comment rulemaking.

Finally, we have seen an increase in companies with multiple classes of equity.[25] The limits of Section 12(g) apply to each individual class of equity, not the company as a whole.[26] Provided the shareholders approve the creation of a new class, the company could very well avoid ever approaching the thresholds outlined below by simply creating new classes of equity with different rights. This serves the additional purposes of tailoring investments to the liquidation option demands of large investors and allowing founders to more easily maintain control.[27]

By using these multi-equity structures, founders of unicorn firms are often able to control the board of directors allowing them to maintain their positions within their own firms.[28] Broughman and Fried

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[24] FINRA, *supra* note 2.

[25] Rani Molla, *More Tech Companies Are Selling Stock that Keeps Their Founders in Power*, VOX.COM (Apr. 11, 2019),https://www.vox.com/2019/4/11/18302102/ipo-voting-multi-dual-stock-lyft-pinterest.

[26] "The class of equity securities was held of record by fewer than 2,000 persons and fewer than 500 of those persons were not accredited investors . . . ." Registration of Securities; Exemption from Section 12(g), 17 C.F.R. § 240.12g-1.

[27] *See* Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 88 TENN. L. REV. 985 (2020).

[28] *See* Alon-Beck, *supra* note 18. *See* Joann S. Lublin & Spencer E. Ante, *A Fight in Silicon Valley: Founders Push for Control*, WALL ST. J., (July 11, 2012),

further show that the ex-ante likelihood of founders reacquiring control via IPO is extremely low, especially if we focus on control that is both strong (founders have enough voting power to ensure they remain in the saddle) and durable (control lasts at least three years).[29]

While beyond the subject of this paper, there remains disagreement regarding how best to eliminate dual-class equity structures. Regardless of this disagreement, institutional investors, academics, and others have long agreed they need to be addressed and their continued allowance remains a controversial subject. Even the key policy makers within the SEC have expressed opposition to such structures, including former Commissioner Robert J. Jackson, Jr.[30] and Rick Fleming, Director of the Office of the Investor Advocate.[31] Commissioner Jackson noted that while the vast majority of companies going public fail to include dual class structures, of those that do, "nearly half… gave corporate insiders outsized voting rights in perpetuity," requiring investors to not just trust visionary founders, but their descendants as well.[32] However, this number of companies is growing according to data compiled by Jay Ritter.[33] Controllers face little of the negative risks for their actions while remaining well insulated from the "disciplinary force of the market" which they would face should they lack voting control.[34]

There is even evidence to suggest that dynastic ownership of firms leads to underperformance relative to other firms.[35] An empirical study of dual-class companies, published after Commissioner

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https://www.wsj.com/articles/SB10001424052702303292204577519134168240 (on file with the *Columbia Business Law Review*). According to Broughman and Fried, however, only fifteen percent of VC-backed IPOs from 2010 to 2012 were dual class. Brian J. Broughman & Jesse M. Fried, *Do Founders Control Start-Up Firms That Go Public?* 10 HARV. BUS. L. REV. 49, 64 tbl.2 (2020).

[29] Broughman & Fried, *supra* note 19.

[30] Robert J. Jackson Jr., Comm'r, Sec. & Exch. Comm'n, Perpetual Dual-Class Stock: The Case Against Corporate Royalty, Remarks at University of California, Berkley (Feb. 15, 2018), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

[31] Rick Fleming, Dir. of the Office of the Inv'r Advocate, Sec. & Exch. Comm'n, Dual-Class Shares: A Recipe For Disaster, Remarks at ICGN Miami Conference, Miami Florida (Oct. 15, 2019), https://www.sec.gov/news/speech/fleming-dual-class-shares-recipe-disaster.

[32] Jackson, *supra* note 21, at par. 16-17. *See* Lucien A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 594, 606 (2017) ("Furthermore, dual-stock structures may enable the transfer of a lock on control to an heir of the founder, who might not be as able, talented, skilled or driven as her predecessor. This problem is known in the economic literature as the problem of the 'idiot heir.'").

[33] *See* Jay Ritter, *Initial Public Offerings: Dual Class Structure of IPOs Through 2021*, https://site.warrington.ufl.edu/ritter/files/IPOs-Dual-Class.pdf

[34] Bebchuk & Kastiel, *supra* note 23, at 602.

[35] *Id.* at 606.

Jackson's remarks, by Bebchuk and Kastiel, found that in over 80% of firms with such a structure, controllers needed less than a 10% equity stake to maintain their control over these firms, with many requiring less than 5%.[36] Fleming argued that dual-class structures may result in a "wave of companies with weak corporate governance" and force investors into the same game as "late-stage venture capitalists…willing to pay astronomical sums while ceding astonishing amounts of control to founders."[37]

B. Disclosure Arbitrage

The fundamental purpose of our regulatory regime is to ensure that the reasonable investor is equipped with sufficient knowledge to make informed investment decisions.[38] Regulators like the SEC, however, must balance this purpose with the reality that companies require some degree of secrecy over their operations in order to grow, function, and innovate effectively. As Congress acknowledged when passing the initial iteration of Section 12(g), when a company has crossed the set limits, the likelihood of exposure to the public is enough to offset the potential privacy concerns of the company.[39]

If a company goes over the threshold, it is sufficiently exposed to public capital normally only available to a company complying with the disclosure regime. In establishing this threshold, Congress, based on the limitations of available technology at the time of legislation, attempted to provide investor protection by including securities that were already trading over the counter in the scope of the SEC's reporting requirements .[40] Section 12(g) has been called obsolete in substance, but in reality, the methodology of using these thresholds to define exposure is the true obsolescence. The underlying purpose in

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[36] Lucian A. Bebcuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 GEO. L.J. 1453, 1457 (2018).

[37] Fleming, *supra* note 22, at par. 11.

[38] *See generally* Section 2, Securities Exchange Act of 1934 15 U.S.C. § 78b. *See also The Laws that Govern the Securities Industry*, INVESTOR.GOV https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry (last visited Jan. 24. 2022).

[39] Usha Rodrigues, *The Once and Future Irrelevancy of Section 12(g)*, 2015 U. ILL. L. REV. 1529, 1532-33 (2015) (citing Allen Ferrell, *Mandatory Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, 36 J. LEGAL STUD. 213, 219-22 (2007)); Richard M. Phillips & Morgan Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706, 706 (1964) ("The main feature of this portion is an extension of the registration, periodic reporting, proxy and insider trading provisions of sections 12, 13, 14, and 16 of the Exchange Act to larger over-the-counter companies. These provisions were formerly applicable only to listed companies.").

[40] Rodrigues, *supra* note 30, at 1533-34.

passing such a threshold is still very much relevant. But the ability to largely ignore the limits has removed any regulatory strength from it.

If we are expected to accept reasoning for provisions based solely on the intent of Congress in choosing to implement the limits in the form in which they did, we must also acknowledge the intent of Congress passing the whole statute in the first place. If these do not complement each other, it is only logical to place the statute's purpose above the purpose of the constrained methodology available to Congress at the time of passage. At the time of the passage of Section 12(g) in 1964, the SEC and Congress conceded that setting the limits based on shareholders of record was only a "rough, indirect measure of activity."[41] Any other method available to them at the time of measuring "market activity" was not feasible, meaningful, or workable.[42] The SEC further noted that shareholders of record is "the most direct and simple criterion of public-investor interest."

As Rodrigues points out, Congress "never intended for the provision to have the effect of forcing illiquid private companies into making public disclosures" but rather bringing companies which were already trading via over-the-counter ("OTC") markets into the public reporting sphere.[43] Companies were trading on these then-unregulated markets at increasing rates without oversight and the protections afforded to investors by our securities laws. Retail investors were at significant risk of exposure to investments which may or may not have been riskier. At the time of the passage of Section 12(g) in 1964, the OTC markets had grown to nearly 61% of the trading volume of national exchanges, but received none of the investor protections associated with them.[44]

However, in 1999, Congress forced nearly all OTC traded firms to make at least a bare minimum of public disclosures. For many, this was viewed as the point of irrelevancy for Section 12(g). Indeed, between 2000 and the passage of the new limits under the JOBS Act, less than 3% of firms which went public were over 400 shareholders and thus approaching the upper limits.[45] There is also no indication that the majority of these firms went public for the sole reason that they were approaching, or in the case of some, exceeding these limits. As

[41] U.S. SEC. & EXCH. COMM'N., SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 88-95, at 34 (1964).
[42] *Id.*
[43] Rodrigues, *supra* note 30, at 1534; *see also* William K. Sjostrom, Jr., *Questioning the 500 Equity Holders Trigger,* 1 Harv. Bus. L. Rev. Online 43, 44-45 (2011) (highlighting that the 1964 amendments were targeted at issuers with sufficiently liquid shares).
[44] S. REP. NO. 88-379, at 14 (1963).
[45] Rodrigues, *supra* note 30, at 1547.

we will discuss in Section V, there are a multitude of reasons for completing an IPO.

All of this then begs the question of if Section 12(g) is "largely irrelevant" or "an obscure provision of securities laws"[46], why change the thresholds at all? To answer this, we must examine the intent behind the change and its ultimate effects.

While the intent was to allow widely held, but seldom traded companies continue to avoid the high costs associated with the mandatory disclosure regime, the ultimate effect has been far broader. With the explosion of unicorns in the decade since the passage of the JOBS Act, it is logical to draw a correlation between the updates to various securities law provisions, including Section 12(g), and these firms' growth.

These companies will continue to be able to raise even more capital and remain private if the law is not updated. As noted by de Fontaney, "There is no evidence that capital is scarce today for good U.S. firms—whether public or private—and much evidence to the contrary."[47] The reality is that traditional investors in private markets, VCs and PEs, are competing with non-traditional investors over investments in unicorn firms.[48] As a result, rather than firms competing over a limited pool of funding, investors are competing over a limited group of investee companies.

The changes, accompanied by more recent changes to rules on the solicitation of 401(k) funds by hedge funds also encouraged more investors, which include non-accredited investors, to join traditional

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[46] John Markoff, *Google Flirts; Investors Wonder About Date,* N.Y. TIMES (Apr. 24, 2004, http://www.nytimes.com/2004/04/24/business/google-flirts-investors-wonder-about-date.html.

[47] *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. 13 (2019) (written testimony of Elisabeth de Fontenay, Professor of Law, Duke University.

[48] 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 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. GLOBAL STUD. L. REV. 267 (2018); *see also* William Aulet & Fiona Murray, *A Tale of Two Entrepreneurs: Understanding Differences in the Types of Entrepreneurship in the Economy* (May 1, 20113), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2259740 (on the difference between the two definitions).

and non-traditional groups and invest in private markets.[49] However, private markets do not offer the same protections and disclosure of information as public markets. Given the risks associated with investing in private firms, it is only logical that there should be additional investor protections, not less.

SEC Commissioner Alison 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."[50] 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.[51]

C. Practical Enforcement and Modernization

Under Section 504 of the JOBS Act, the SEC was required to commission a study to study its authority and ability to enforce the limits imposed by Section 12(g) and the related Rule 12g5-1. Of particular concern to Congress was the ability of the SEC to enforce ethe anti-evasion provision included in Rule 12g5-1(b)(3). This subsection requires number of beneficial owners to be used as the record count if an issuer knows or has reason to know that the manner of holding an issuer's securities is used *primarily* to circumvent Section 12(g).

We must acknowledge that there is debate on whether or not the SEC on its own rulemaking authority has the ability to redefine the term "held of record". Some cite to parts of the legislative history of Section 12(g) and the interpretation of securities law provisions in the years since its passage to argue that only Congress retains the power to redefine this. In particular, proponents of this position cite to the attempts in 2012 by Democrats to insert into the JOBS Act provisions explicitly authorizing the SEC to make the necessary changes without

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[49] Paul Kiernan, *SEC Gives More Investors Access to Private Equity, Hedge Funds*, Wall St. J. (Aug 26, 2020), https://www.wsj.com/articles/sec-gives-more-investors-access-to-private-equity-hedge-funds-11598452858.

[50] 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.

[51] Robert J. Jackson Jr., Comm'r, Sec. & Exch. Comm'n, Statement on Reducing Investor Protections Around Private Markets (Dec. 18, 2019), https://www.sec.gov/news/public-statement/statement-jackson-2019-12-18-accredited-investor.

congressional approval.[52] Republicans opposed this by arguing only Congress should have the exclusive discretion. However, this debate does not point in one direction or the other. If, as we believe, the SEC retained this power before the passage of the JOBS Act, Congress need not have passed any statute granting them a power which they already had. Some of the opponents of the explicit authorization even conceded they believed the SEC already had the authority, with Republican Congressman David Schweikert stating he does when asked if he believed "the SEC [was] currently empowered to take these actions on their own without Congressional approval."[53] He would later backtrack his statements by saying if the SEC does have this authority, Congress should be responsible for the ultimate policy and thus actually retains the authority.[54]

For those of us who live in the real world, there is strong evidence to suggest the SEC does, in fact, have this authority. If we examine the SEC's powers before the inconclusive debate in 2012, the key provision to consider is Section 36 of the '34 Act. Passed in 1996, it provides the SEC with expansive general exemptive authority to permit rulemaking to the extent that it is "necessary or appropriate in the public interest, and is consistent with the protection of investors." Professor George Georgiev argues this indicates the SEC's authority to redefine "held of record" is "beyond question," even if he believes it may be practically infeasible.[55] A similar position was adopted by Tyler Gellasch and Lee Reiners at Duke's Global Financial Markets Center.[56] In it, they argued revisiting the shareholder of record interpretation is necessary to bring the United States on bar with how other jurisdictions bring large companies into the reporting sphere.[57]

David Langevoort and Robert Thompson argue the SEC could presumably change the rule, citing back to a proposed rulemaking change in 2006.[58] They go on to argue that the better test for

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[52] Alexander I. Platt, *Legal Guardrails for a Unicorn Crackdown,* 10 (2022) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4033857

[53] 158 Cong. Rec. H1280 (Mar. 8, 2012).

[54] *Id*. at H1281. "If you are with us and agree, we're literally looking at two tracks here. The SEC does hold authority. At the same time, we also want this brought back to us if the SEC does see an issue. That's proper venue."

[55] George S. Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 NYU J.L. & Bus. 221, 302. (2021)

[56] Tyler Gellash and Lee Reiners, *From Laggard to Leader: Updating the Securities Regulatory Framework to Better Meet the Needs of Investors and Society*, 11 (2021)

[57] *Id*.

[58] David Langevoort and Robert Thompson, *"Publicness" in Contemporary Securities Regulation*, 101 Georgetown LJ 337, 359 (2013). Citing SEC

"publicness" should not be record ownership, but rather a metric like average daily trading volumes is better for the purposes of "gauging the extent of investor interest in and need for disclosure.[59] They also note that such information is already collected via monthly disclosures as required under existing SEC rules.[60]

Finally, the SEC itself believes it has the authority to do so. When such changes were initially proposed by Commission Allison Herren Lee, she suggested that it should be done under the SEC's rulemaking authority.[61] In the SEC report written as required under Section 504 of the JOBS Act, the SEC noted it "has the authority under Exchange Act Section 12(g)(5) to define the term "held of record" as it deems "necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions" of Section 12(g)."[62] They also noted, in the same report, that immobilized record ownership came about in "the late 1960s and early 1970s", after the initial passage of Section 12(g). In 1964, 23.7% of shares were held in street name. By 1975, this number has risen to 28.6% and by 2010, the SEC estimated this number had risen to over 85%.

D. Exempt Offerings

The ability to raise large amounts of capital affects the unicorn firm. Unicorns are no longer dependent on an IPO (or trade sale) to raise sufficient capital.[63] Thanks to alternative venture capitalists ("AVCs"), unicorn founders are able to raise large amounts of money

Advisory Comm. on Smaller Pub. Cos., Final Report 76-80 (2006) *available at* https://www.sec.gov/info/smallbus/acspc/acspc-finalreport_d.pdf

[59] *Id*. at 359-360

[60] *Id*. at 360, citing 17 C.F.R. 242.302(b).

[61] Supra note 217.

[62] U.S. SEC. & EXCH. COMM'N. REPORT ON AUTHORITY TO ENFORCE EXCHANGE ACT RULE 12G5-1 AND SUBSECTION (B)(3), 7 (Oct. 15, 2012). https://www.sec.gov/files/authority-to-enforce-rule-12g5-1.pdf

[63] 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* 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; MCKINSEY & CO., MCKINSEY GLOBAL PRIVATE MARKET REVIEW 2018, THE RISE AND RISE OF PRIVATE MARKETS (2018), https://www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/The%20rise%20and%20rise%20of%20private%20equity/The-rise-and-rise-of-private-markets-McKinsey-Global-Private-Markets-Review-2018.ashx (Feb. 2018); Matt Levine, *The Unicorn Stampede is Coming*, BLOOMBERG OP. (Mar. 22, 2019), https://www.bloomberg.com/opinion/articles/2019-03-22/the-unicorn-stampede-is-coming.

in mega deals, push their companies to stay private longer than eleven years,[64] negotiate contractual "founder friendly" terms and maintain control over the management of the firm.[65]

If we compare the IPOs of "old" successful startups, for example, Apple,[66] Amazon,[67] Google[68] or Facebook,[69] and the IPOs of unicorns, such as Uber, we will find many differences. These differences include valuations, growth periods, revenue expansions, timeline to IPO, and capital raising methods.

Unicorns are able to raise large amounts of capital from AVCs by relying on exemptions from registration with the SEC. According to federal and state securities laws, any offer or sale of securities is subject to registration, unless there are exemptions from registration.[70] Registered offerings are subject to comprehensive disclosure requirements,[71] higher compliance costs, and provide access to a broad group of potential investors.[72]

A series of reforms to the federal securities laws, which began about fifteen years ago,[73] provide exemptions from the old registration

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[64] *See* Sungjoung Kwon, Michelle Lowry & Yiming Qian, *Mutual Fund Investments in Private Firms*, 136 J. FIN. ECON. 407 (2020). Kwon et al. further show that these large amounts of capital "should enable the companies to stay private longer." *Id.* at 408.

[65] *See infra* Section II discussing "founder friendly" terms.

[66] *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/.

[67] 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/?_ga=2.187316328.1573799404.1558549549-98431006.1558549549.

[68] 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/.

[69] 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/?_ga=2.76050645.1993016262.1558632407-1496323933.1558632407.

[70] 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).

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

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

[73] *See Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment: Hearing Before the Subcomm. on Inv. Prot., Entrepreneurship, and Cap. Mkts. of the H. Comm. on Fin. Serv.*, 116th Cong. 10 (2019) (written testimony of

requirements.[74] The main legislative efforts that allow 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").[75] These were in addition to the passage of the National Securities Markets Improvement Act ("NSMIA") in 1996, which was passed with the aim of simplifying securities regulation by significantly curtailing the scope of state blue sky laws.

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. As noted, the Securities Act provides a number of exemptions from registration.[76] Investors most frequently use exemptions from registration applicable to private placements are contained in Section 506, under Regulation D of the Securities Act.[77] According to a concept release by the SEC,[78] in 2018 companies raised

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Renee M. Jones, Professor of Law and Associate Dean for Academic Affairs, Boston College Law School [hereinafter Jones, Written Testimony].

[74] *Id.*

[75] For more on these Acts, see Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Hors*e?, 2019 COLUM. BUS. L. REV. 107 (2019). *See also* Press Release, U.S. Sec. & Exch. Comm'n, SEC Seeks Public Comment on Ways to Harmonize Private Securities Offering Exemptions (June 18, 2019). The other legislations are: 1. The Financial CHOICE Act of 2017, which includes modernizing the Regulation D offering process and creates the "venture exchanges." 2. Crowdfunding regulations that were adopted by the SEC, which allow 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, *Securities Crowdfunding and Investor Protection* (Univ. of Tenn. Legal Studies Research Paper No. 292, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2810757. 3. Offerings under Regulation A+ of Title IV of the JOBS Act (Reg A+), which 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.

[76] Section 3 of the Securities Act identifies classes of securities that are exempt from the registration requirements. 15 U.S.C. § 77c. Section 4 of the Securities Act identifies a number of transactions that are exempt from the registration requirements. 15 U.S.C. § 7d. 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.

[77] *See Rule 506 of Regulation D*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/glossary/rule-506-regulation-d (last visited Jan. 24, 2022); *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 50, at 1162.

[78] *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. 30,460, 30,466 tbl.2 (June 26, 2019).

$1,500 billion using Rule 506(b) of Regulation D, [79] and $211 billion using Rule 506(c) of Regulation D.

The policymakers' intention and rationale behind the JOBS Act was to facilitate the emerging growth companies' "access to the public capital markets."[80] The Act reduced SOX regulatory requirements in the hopes of encouraging private companies to go public.[81] However, the JOBS Act's biggest achievement is "radical deregulation."[82] The exemption allows private firms to keep material information private longer, as they are now required to disclose according to the federal periodic disclosure requirements.[83] Thanks to the JOBS Act, the threshold that triggered registration with the SEC has changed.[84]

III. THE EFFECTS OF 10 YEARS IN THE WILD WEST

The original intent behind instituting limits on shareholders of record was to capture firms which already broadly trading. This methodology for limitation was chosen, however, merely as a compromise based on the limitations of implementable solutions. With the technology available today, these limitations no longer exist. It is relatively easy to calculate the volume of trading across markets of even private companies. While the thresholds were ostensibly raised to address concerns by widely held, but seldom traded companies, the

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

[80] *See* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389 (2013); Robert B. Thompson & Thomas 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).

[81] 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 60, at 85.

[82] *See Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins., and Inv. of the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. (2011); *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).

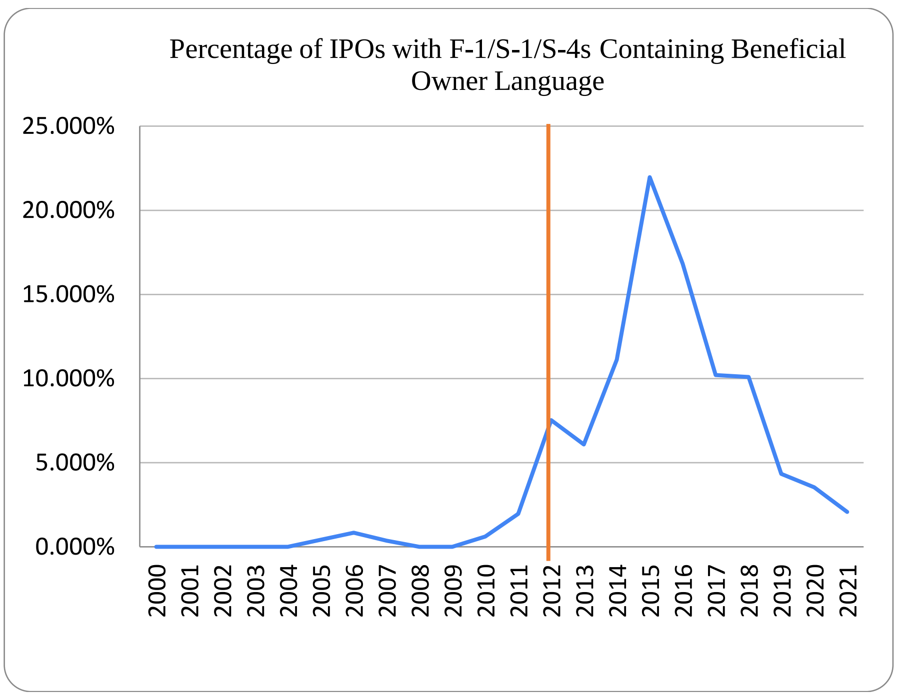
[83] *See* Gutentag, *supra* note 62, at 152.

[84] Morrison Foerster, Late Stage Financings Presentation (Apr. 26-27, 2016), https://media2.mofo.com/documents/160426latestagefinancings.pdf. ("[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."). For more, see Anna Pinedo, Late Stage Financings Presentation (Apr. 26–27, 2016) https://media2.mofo.com/documents/160426latestagefinancings.pdf.

practical effect was to shield these companies as well as companies trading at higher volumes.

By redefining shareholders of record into a term more akin to beneficial owners, but placing limits in place for trading volume, we can restore Section 12(g) to its original intent of protecting investors while not punishing companies for dispersing their equity simultaneously. In addition, rather than slowing capital formation, it will encourage companies to turn to the public markets for necessary capital, allowing for more investors to engage in a broader range of companies. Instead of allowing for companies to remain illiquid, but continue to grow, companies will stand on their own merits and provide their shareholders, especially employees, an ability to have and make more informed investment decisions.

We examined whether firms are instituting any limits on shareholders of record. Relying on a hand collected data set consisting of SEC public filings, we found that many companies have substantially more beneficial owners than their shareholder of record count would indicate otherwise.



<u>Table 1</u>: Percentage of IPOs with F-1/S-1/S-4s Containing Beneficial Owner Language

In prospectuses filed with the SEC, companies began inserting the provision outlined below. The provision had no legal effect but did acknowledge in a public filing that companies are aware of several key facts. First, they have substantially more beneficial owners than their shareholder of record count would indicate. When viewed within the context of an S-1 or S-4, it also indicates that they know precisely who these shareholders are, their present equity holdings in the company, and how to contact them to deliver the requisite materials needed to vote on such transactions.

The earliest example of such a provision was found in 2005. In the 12 years before the passage of the JOBS Act, it was found in a total of 11 unique companies' filings. After the passage of the JOBS Act, this number increased an average of 49 unique companies annually. This chart represents the percentage of IPO which had prospectuses or merger proxies (S-1, F-1, or S-4) containing such a statement.

Example provision from Linkedin's S-1 (pre-JOBS Act)

"As of September 30, 2011, we had 22 holders of record of our Class A common stock and 571 holders of record of our Class B common stock. The actual number of stockholders is greater than this number of record holders, and includes stockholders who are beneficial owners, but whose shares are held in street name by brokers and other nominees. The number of holders of record also does not include stockholders whose shares may be held in trust by other entities."

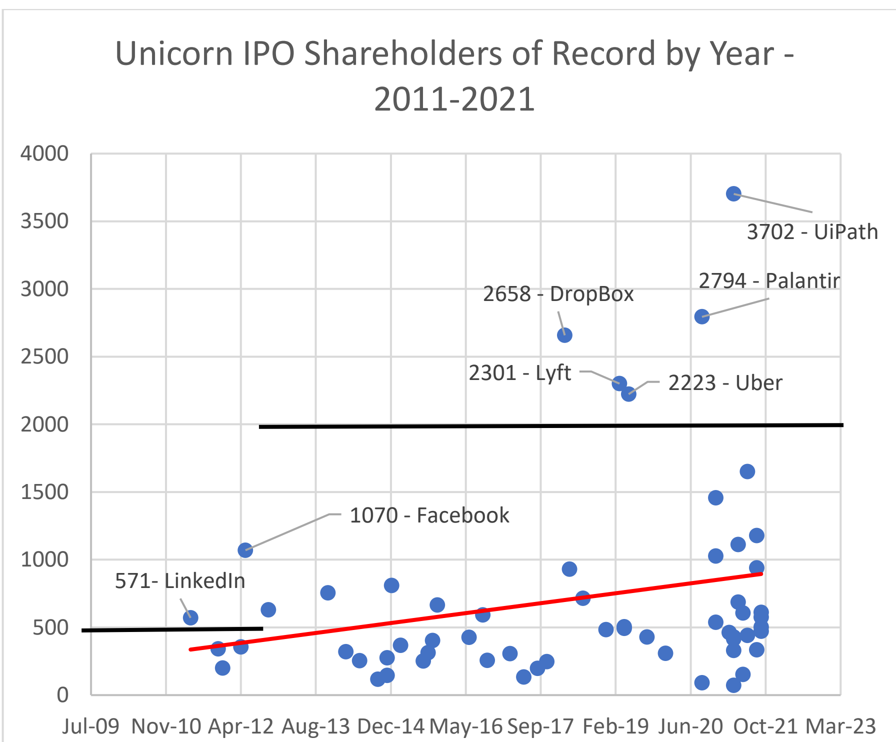


Table 2: Unicorn IPO Shareholders of Record by Year - 2011-2021

This table represents the number of shareholders of record of the largest classes of equity in unicorn IPOs immediately before and in the decade since the passage of the JOBS Act. The black lines represent the previous 500 shareholder of record threshold and its new level at 2,000 following Section 12(g)'s amendment. The red line is a linear trendline based on the data.

The table in Appendix A below represents the raw data points presented visually above. Any red highlighted box denotes a company which went public in violation of the Section 12(g) thresholds at the time of its S-1 filing. Any orange highlighted box denotes a company which has gone public since the passage of the JOBS Act and would be in violation of the previous 500 shareholder of record limit.

IV. DEMOCRATIZING VENTURE CAPITAL

Methods of raising capital can be very different depending on the firm and the market conditions. An early startup usually experiences challenges in raising capital for the following reasons.[85] The firm's internal cash flow is not enough to support its needs, including operational expansions and employee recruitment and retainment.[86] It cannot support the firm's fast growing technology, research and development needs, which are comprised of intangible assets.[87] If the firm is not able to obtain an injection of new capital, it will likely go bankrupt.[88] This is not the case for the mature wealthy startup—the unicorn firm.[89]

A. Venture Capital

Over the last 30 years, academic literature has focused on VCs as the main source of financing for private startups.[90] There is no agreed

[85] Ola Bengtsson & John R.M. Hand, *CEO Compensation in Venture Capital Markets* (2008), https://ssrn.com/abstract=1079993.
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] See Alon-Beck, *supra* note 55, for the features of a unicorn for this Article.
How Unicorns Grow, HARV. BUS. REV., Jan.–Feb. 2016, at 28–30, https://hbr.org/2016/01/how-unicorns-grow ("Firms founded from 2012 to 2015 had a time to market cap more than twice that of firms founded from 2000 to 2003.").
[90] *See* Paul Gompers, William Gornall, Steven N. Kaplan & Ilya A. Strebulaev, *How Do Venture Capitalists Make Decisions?* (Nat'l Bureau of Econ. Research, Working Paper No. 22587, 2016).

upon definition on what is a VC fund.[91] A VC firm is a type of investment vehicle that invests in startups. VCs are repeat players in the startup world, who use unique contracts and organizational capabilities in order to overcome uncertainty, risk, information asymmetry, agency,[92] "lemons" and "adverse selection"[93] related problems. VC financing has prevailed since the early days of commercial activity in various forms.[94]

Georges Doriot, a Harvard Business Professor, is the founding father of the VC industry.[95] He established the first public VC firm - American Research and Development Corporation ("ARD"), after World War II. [96] The ARD legal structure is no longer popular today and has led to its demise,[97] but its initial success influenced modern VC as we know it today. According to Korsmo, "VCs diverge sharply from the typical conception of the stockholder in a public corporation."[98] ARD's fame came from the successful $70,000 investment in Digital

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[91] *See* Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1163 (2013).

[92] *See* LEWIS M. BRANSCOMB & PHILLIP E. AUERSWALD, NAT'L INST. OF STANDARDS & TECH., NIST GCR 02-841, BETWEEN INVENTION AND INNOVATION: AN ANALYSIS OF FUNDING FOR EARLY-STAGE TECHNOLOGY DEVELOPMENT 35-38 (2002), htt://www.nist.gov/sites/default/files/documents/2017/05/09/gcr02-841.pdf; *see also* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 129 (1999). *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305, (1976). For further discussion on agency problems and strategies to reduce them, see also 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., Oxford Univ. Press 2d ed. 2009).

[93] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 83 Q.J. ECON. 488, 493 (1970); *see also* Manuel A. Utset, *Reciprocal Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms*, 2002 WIS. L. REV. 45, 56 (2002); *see also* GOMPERS & LERNER, *supra* note 72, at 129.

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

[95] SPENCER E. ANTE, CREATIVE CAPITAL: GEORGES DORIOT AND THE BIRTH OF VENTURE CAPITAL, xiii; *see* Korsmo, *supra* note 71.

[96] ANTE, *supra* note 75.

[97] David H. Hsu & Martin Kenney, *Organizing Venture Capital: The Rise and Demise of American Research & Development Corporation, 1946–1973*, 14(4) INDUS. & CORP. CHANGE 579 (2005).

[98] *See* Korsmo, *supra* note 71.

Equipment Corporation ("DEC"), which following DEC's IPO in 1968, made ARD $355 million.[99]

The VC industry has played, and continues to play, an important role in the U.S. innovation process for the following reasons.[100] First, VCs are active investors, who provide many value added services to the technology companies that they invest in. Such services can vary, and include: strategic planning, mentoring, guidance, selecting management, lawyers, accountants, writing a business plan, etc.[101] Second, VCs are fundamental to the formation of startup firms.[102] Third, VCs are actively engaged with the following innovation networks: global as well as local technology markets,[103] financial institutions,[104] specialized labor markets[105] and professional business service markets.[106] Finally, VC investment spurs more technological innovation than other investments.[107]

B. Alternative Venture Capital

Alternative investments in the U.S. market are up from around 40% a decade ago.[108] It seems 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.[109]

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[99] *American Research Development Corporation*, 1946, ENTREPRENEURIAL MIT, http://museum.mit.edu/150/78 (last visited Jan. 9, 2022).

[100] *See* Korsmo, *supra* note 71.

[101] See also GOMPERS & LERNER, *supra* note 72, for further info on services provided by VCs.

[102] *See* Gil Avnimelech & Morris Teubal, *Evaluating Venture Capital Policies: Methodological Lessons from the Israeli Experience*, SEMANTIC SCHOLAR (2003), https://www.semanticscholar.org/paper/EVALUATING-VENTURE-CAPITAL-POLICIES%3A-METHODOLOGICAL-Avnimelech-Teubal/cfd249e54acf1c50a8bbc43a5b4dbf411b0997b0.

[103] *See id.*

[104] *See id.*

[105] *See id.*

[106] *See id.*

[107] *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).

[108] PITCHBOOK & NAT'L VENTURE CAPITAL ASS'N, VENTURE MONITOR 3Q 2019 [hereinafter NVCA PITCHBOOK 2019 REPORT (Q3)]. 2018 marked the first year since the dot-com crisis of 2000 that annual investments in U.S. VC-backed firms surpassed $100 billion.

[109] NVCA PITCHBOOK 2019 REPORT (Q3), *supra* note 88.

In the past four years, at least one alternative investor has invested in the reported 2,000 completed VC financing rounds.[110] 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,[111] is credited for pushing the deal sizes upwards.[112] Investments from corporate venture capital funds ("CVCs" has jumped dramatically, with $41.2 billion being invested last year alone. Sovereign Wealth Funds ("SWFs") are also entering into the market. With an estimated $9 trillion in assets under management, they have considerable capital to deploy.

Historically, the traditional exit mechanism for investors in private firms was limited to an IPO or a trade sale.[113] Private company investors dealt with extreme "lock-in" of their capital due to the illiquidity of their stock. [114] Due to the prolonged timeline to IPO or trade sale, which is now longer than eleven years,[115] new liquidity practices were developed to allow unicorn shareholders, such as employees and early investors, to liquidate their investments as an alternative to the traditional exit mechanisms.[116]

These new practices include secondary sales, structured liquidity programs (private tender offers) and other liquidity

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[110] NVCA PITCHBOOK 2019 REPORT (Q3), *supra* note 88 ("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.").

[111] 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.

[112] NVCA PITCHBOOK 2019 REPORT (Q3), *supra* note 88 ("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.").

[113] *See* Jesse M. Fried & Brian J. Broughman, *Do Founders Control Start-Up Firms that Go Public?*, (European Corporate Governance Institute (ECGI) - Law Working Paper No. 405/2018).

[114] 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).

[115] The timeline to IPO used to be 4 years and is now longer than 11 years. *See* Jay Ritter, Initial Public Offerings: Updated Statistics, https://site.warrington.ufl.edu/ritter/files/2016/03/Initial-Public-Offerings-Updated-Statistics-2016-03-08.pdf.

[116] *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/ [https://perma.cc/V3EC-74ZN]; *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 [https://perma.cc/4AEY-P2HA].

alternatives.[117] They are often used by existing shareholders (investors and employees) as a third exit option.[118] They involve specific contractual arrangements between the various participants, including investors with divergent rights and privileges.

Unicorn shares are non-liquid financial assets. Whether there is an active market to trade these securities or not depends on the share purchase agreement. Some unicorns allow investors to trade their shares on secondary markets, but many put restrictions and do not allow trading for compliance with securities laws.

Alternative investors are now able to invest in unicorn firms thanks to the development of new dynamic secondary markets.[119] It should be noted that secondary transactions were common in the private equity industry but not within the VC industry.[120] Many unicorn firms develop new liquidity alternatives because of the prolonged timeline to IPO or trade sale, which is now longer than eleven years.[121]

Liquidity practices can allow unicorn shareholders, such as employees and early investors, to liquidate their investments as an alternative to the traditional exit mechanisms.[122] These new practices include secondary sales, structured liquidity programs (private tender offers) and other liquidity alternatives.[123]

These alternatives aim to allow shareholders to gain liquidity, while allowing founders to maintain control[124] over the management of

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[117] *See* Dawn Belt, *Pre-IPO Liquidity for Late Stage Start-Ups* (May 31, 2018), https://www.fenwick.com/FenwickDocuments/Pre-IPO-Liquidity-for-Late-Stage-Start-Up.pdf.

[118] *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1 (2012).

[119] 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.

[120] 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.

[121] The timeline to IPO used to be 4 years and is now longer than 11 years. Ritter, *supra* note 95.

[122] *See* Roof, *supra* note 96; *see also* Bensinger & Hoffman, *supra* note 96.

[123] *See* Belt, *supra* note 97.

[124] Nicolas Grabar, David Lopez & Andrea Basham, Cleary Gottlieb Steen & Hamilton LLP, *A Look Under the Hood of Spotify's Direct Listing*, HARV. L. SCH. FORUM ON CORP.

their company.[125] The development of electronic secondary markets increases liquidity for individual investors but has also raised several legal issues for the issuers. A number of unicorns allow their employees and capital investors to sell their shares on secondary markets, using electronic platforms such as NASDAQ Private Market (formerly SecondMarket) and SharesPost.[126]

There are advantages and disadvantages to this new development. On the one hand, the "direct market is improving the liquidity of start-up stocks for locked-in investors by lowering these transaction costs."[127] On the other, these markets can expose non-accredited investors to risks and uncertainties, due to current contractual arrangements, securities and tax laws.[128] Both the sellers of the shares (investors or employees) and the unicorn are subject to the risk of lawsuits by buyers, due to omissions and misstatements, under the securities law.

1. SoftBank

About three years ago SoftBank started raising money for its $100 billion Vision Fund.[129] Due to its extra-large size and aggressive mega-deals,[130] Vision Fund has been making headlines ever since.[131]

GOVERNANCE (Apr. 26, 2018), https://corpgov.law.harvard.edu/2018/04/26/a-look-under-the-hood-of-spotifys-direct-listing/ [http://perma.cc/BP3D-S24B].

[125] Before direct listing, tech founders used dual class stock. For more on dual class stock and "minority controlling shareholders," see Bebchuk and Kastiel, *supra* note 23. For a detailed account of the history of dual-class structures in the 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* NASDAQ Stock Market Rule 5640, Release No. 34-59663, File No. SR-NASDAQ-2009-018; *see* 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 [http://perma.cc/8SGE-4Z4L].

[126] *See* Ibrahim, *supra* note 98, at 22.

[127] *Id*.

[128] *See* Adi Osovsky, *The Curious Case of the Secondary Market with Respect to Investor Protection*, 82 TENN. L. REV. 83, 130 (2014) ("the democratization of Secondary Market transactions exposes non-accredited investors to new risks and uncertainties."); *see also* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 182 (2012).

[129] *See* 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..

[130] *See* Shead, *supra* note 109.

[131] *See* Shead, *supra* note 109.

Vision Fund is much larger than "any other tech fund on the planet."[132] The fund is backed by both internal and external investors, including Apple, Sharp, and Saudi Arabia's PIF SWF.[133]

Softbank is changing the private ordering arrangements between VC firms and startups. 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.[134] 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.[135]

Initially, it was reported that the SoftBank's Vision Fund ("SVF") is structured like a VC fund, but now it is reported that it is structured like a private equity ("PE") fund. There are several differences between private equity firms and VC funds. The main one is that PE invest using cash and debt, whereas VCs invest using equity. It is clear that the SVFs structure is unique due to the following reasons. According to reports, the fund managers are compensated using management fees and carried interest, as explained below.[136] Additionally, the GP collects 1% management fees and a 20% performance fee (on all returns over 8%).[137]

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).[138] In order to attract outside investors, as

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[132] *See* Shead, *supra* note 91.

[133] In late 2018, Bloomberg had reported that "Saudi Arabia's sovereign wealth fund is set to pour $45 billion into SoftBank's second Vision Fund, after already investing the same amount in the first one." Riad Hamade, Matthew Martin & Archana Narayanan, *Saudi Arabia Doubles Down on SoftBank Bet with Extra $45 Billion*, BLOOMBERG (Oct. 7, 2018), https://www.bloomberg.com/news/articles/2018-10-05/saudi-arabia-doubles-down-on-softbank-bet-with-extra-45-billion. According to Softbank, the LPs include: SoftBank Group Corp., Public Investment Fund, Mubadala Investment Company, Apple, Foxconn Technology Group, Qualcomm Incorporated and Sharp Corporation.

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

[135] *See* Shead, *supra* note 109.

[136] 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.

[137] Eric J. Savitz, *SoftBank Unveils Plans for $108 Billion Vision Fund 2*, BARRONS (July 25, 2019 10:56 PM), https://www.barrons.com/articles/softbank-new-vision-fund-51564109519.

[138] *Id.*

LPs, SoftBank has agreed to reward them with a fixed 7% coupon, which is not tied to the performance of SVF's assets.[139]

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).[140] 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). 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.[141] They are "hands on" investors who monitor their investments very closely.[142] They provide mentoring and management services for the startups that they invest in, such as accounting, networking, finding partners, investors and even new management.[143] 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).[144]

VCs offer "optimal services" to an entrepreneurial firm that is positioned within the fund's concentrated industry, which is usually very narrowly defined.[145] SoftBank is investing very broadly, ranging from "artificial intelligence and machine learning to optimize every industry that affects our lives—from real estate to food to

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[139] 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.

[140] *See* John C. Coffee, Jr., *Toxic Unicorns: What Has Been Missed About WeWork's Fiasco*, 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, Henny Sender & Leo Lewis, *SoftBank Investors Brace for Vision Fund Writedowns*, FIN. TIMES (Sept. 16, 2019), https://www.ft.com/content/ccdaa9c6-d60d-11e9-8367-807ebd53ab77.

[141] *Id*.

[142] *Id*.

[143] *Id*.

[144] *See* LARS OLA BENGTSSON, REPEATED RELATIONSHIPS BETWEEN VENTURE CAPITALISTS AND ENTREPRENEURS 3 (2006); *see also* Avraham Ravid & Ola Bengtsson, *The Geography of Venture Capital Contracts* (2009) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1361827; *see also* Ola Bengtsson & David H. Hsu, *How Do Venture Capital Partners Match with Startup Founders?* (Mar. 11, 2010) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568131 [https://perma.cc/9HS3-9JJW].

[145] Bengtsson & Hsu, *supra* note 124.

transportation."[146] The changes to market structures as a result of SoftBank's aggressive investment strategy in unicorns and high-technology goods can reduce significantly the ability of other new firms to grow in size and scope.[147]

Third, there are mixed reports on monitoring the management and appointing 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. See more on SoftBank's investment[148] in WeWork below. Others claim that SVF does not care about monitoring right but rather contracts for downside protection.

Unfortunately, there are mixed reports on SoftBank monitoring its investments, and whether SoftBank appoints directors to the board of directors or truly advises portfolio companies on business plan and strategy. It is not surprising that SoftBank made headlines again when it considered "spending up to $20 billion for a majority stake in WeWork." But, it ended up investing a smaller amount after reports that "the co-working giant's leadership isn't willing to give up control."[149] In October 2019, SoftBank ousted Adam Neumann as CEO and controls over 80% of WeWork.[150]

Fourth, SoftBank is investing in competing businesses. This raises the question of whether it requires the startups to waive corporate opportunity provisions and fiduciary duty doctrines?[151] As noted above, there are several reports on conflict of interests between SoftBank and LPs, as well as investments in competing technologies. SoftBank representatives are perhaps serving on boards of multiple

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[146] 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("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.").

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

[148] 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.

[149] Liz Hoffman, Eliot Brown & Maureen Farrell, *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.

[150] 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.

[151] *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).

portfolio companies. This is a common practice among VC and PE fund representatives. 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).

This sort of behavior raises not only concerns about potential anti-competitive behavior of SoftBank, but also requires companies to abandon corporate fiduciary duties, which affect private ordering. For example, there are rumors of consolidation in many industries as a result of direct SoftBank investments. For example, the ride-hailing businesses are consolidated as a direct result of the SoftBank investments. 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.[152]

Southeast Asia is considered a growth market due to its "population of over 600 million people, 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."[153] 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. It was further reported that Uber got "a 27.5 percent stake in Grab and Uber CEO Dara Khosrowshahi will join Grab's board."[154] 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." Uber and Grab are not the only car sharing companies, Softbank also invested in Chinese Didi Chuxing, using its Delta Fund.[155] 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 its effects.[156]

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[152] Grace Dobush, *SoftBank is Placing Another Huge Bet on Ridesharing with Its $100 Billion Vision Fund*, FORTUNE (Oct. 5, 2018), https://fortune.com/2018/10/05/softbank-grab-500-million-investment/.

[153] Jon Russell, *It's Official: Uber Sells Southeast Asia Business to Grab*, TECHCRUNCH (Mar. 25, 2018), https://techcrunch.com/2018/03/25/gruber-official/.

[154] Johana Bhuiyan, *Uber Is Selling Its Southeast Asia Business to Competitor Grab*, VOX.COM (Mar. 25, 2018), https://www.vox.com/2018/3/25/17162972/uber-grab-southeast-asia-sale-acquisition-taxi-ride-share-dara-khosrowshahi.

[155] For more on SoftBank investments, see SoftBank Grp., *SoftBank Vision Fund and Delta Fund Segment*, https://group.softbank/en/corp/business/svf/ (last visited Feb. 11, 2020).

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

Fifth, some commentators are accusing SoftBank for not pursuing strictly financial objectives, but also for having strategic ones because of its main investors. For example, PIF is one of the largest investors in SoftBank's Vision Fund. 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).[157] PIF recently declared that it will make another investment of $45 billion to establish another fund Vision Fund II.[158]

Finally, some VCs expressed concern about the entrance of new nontraditional foreign players who are investing directly in the market,[159] and their adverse effect on the traditional startup funding model,[160] which is discussed below. 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 discussed below.

2. Corporate Venture Capital

In recent years, many large U.S. firms have halted some of their internal research and development efforts due to short-termism and shareholder supremacy,[161] which has led to a revival in another alternative investment vehicle, referred to by economists as "corporate venture capital or CVC."[162] In the first half of 2021, startups in the United States raised over $79 billion from CVC investors.[163] [[UPDATE text and fn for annual data from PitchBook when available.]]

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[157] Andrew Torchia, Stephen Kalia & Marwa Rashad, *Saudi's PIF Invested in 50-60 Firms Via SoftBank Fund: Director,* REUTERS (Oct. 23, 2018), 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 Group Corp., SoftBank Group Corp. to Establish SoftBank Vision Fund With a Strategic Partnership with the Public Investment Fund of Saudi Arabia (Oct. 14, 2016), https://group.softbank/en/corp/news/press/sb/2016/20161014_01/.

[158] *See* Press Release, SoftBank Group Corp., *supra* note 137.

[159] 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/.

[160] "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 (2017), https://pitchbook.com/news/reports/2017-annual-unicorn-report. https://www.financialpoise.com/co-investment-spvs/.

[161] LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 7 (2012).

[162] *See also* Mowery & Rosenberg, *supra* note 127, at 29.

[163] *The 2021 Mid-Year Global CVC Report*, CBINSIGHTS (Aug. 5, 2021), https://www.cbinsights.com/research/report/corporate-venture-capital-trends-h1-2021/.

CVC is used to describe an "investment of corporate funds directly in external start-up companies", according to Chesbrough.[164] The CVC vehicle is an equity investment (sponsorship) in an entrepreneurial firm by an established firm.[165] Large corporations are using CVC investments in order to compete in an ever-changing technology market where new technologies and business models constantly disrupt their existing businesses.[166]

More than 1,600 corporations have CVC programs worldwide, including Google Ventures (GV)[167] and Microsoft's M12,[168] according to the 2017 Thelander-PitchBook Investment Firm Compensation Report.[169] In the past, many of the CVC investment efforts in high growth companies usually ended up in dissolution or failure of the CVC arm,[170] perhaps due to the significant differences between an investment by a CVC vehicle and a traditional VC. The following compares between VC and CVC models, including incentive structures and compensation of CVC investors.

There are many differences between VC and CVC investment vehicles.[171] First, and foremost, the VC manages her fund from a

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[164] *See* 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.

[165] *See* Gary Dushnitsky, *Corporate Venture Capital in the 21st Century: An Integral Part of Firms' Innovation Toolkit*, *in* THE OXFORD HANDBOOK OF VENTURE CAPITAL (Douglas Cumming ed., 2012), http://dushnitsky.com/uploads/2/7/8/3/2783896/dushnitsky_2012_oup_handbook_of_vc.pdf.

[166] There are several reasons to why they turn to CVC, including to "accelerate time to market and exploit windows of opportunity, and to test the waters before entering new markets." *Id*.

[167] 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." *See Google Ventures*, CBINSIGHTS, https://www.cbinsights.com/investor/google-ventures (last visited Jan. 24, 2022).

[168] *See M12*, CBINSIGHTS, https://www.cbinsights.com/investor/microsoft-ventures (last visited Jan. 24, 2022).

[169] According to the report, more than half of the CVCs were created since 2010. THELANDER-PITCHBOOK 2017 INVESTMENT FIRM COMPENSATION REPORT.

[170] *See also* Joseph A. McCahery, Erik P.M. Vermeulen & Andrew M. Banks, *Corporate Venture Capital: From Venturing to Partnering*, *in* THE OXFORD HANDBOOK OF VENTURE CAPITAL 211 (Douglas Cumming ed., 2012), http://www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780195391596.001.0001/oxfordhb-9780195391596-e-7.

[171] *See* Rita Waite (guest post), *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/.

return-on-investment stance, whereas the CVC manager is required to successfully achieve a blend of financial and strategic goals.[172] VCs mainly invest for financial purposes, whereas CVCs might have other, strategic purposes.

In the event that the corporation has difficulty with directing its CVCs on the objectives of the potential investment (financial versus strategic goals), then the CVCs will be inclined to not follow through and pull the plug on the investment.[173] For example, if the CVC is not invested in acquiring the complementary technology. Additionally, CVCs do not enjoy the same kind of longevity that VCs enjoy; their lifespan is significantly shorter and much more volatile.[174]

Second, typically most large corporations do not have the "VC like" dedication to their portfolio companies, or the expertise to deal with such investment.[175] According to an Earnst & Young study,[176] large corporations don't select the investment opportunities alone, but rather piggyback and form syndicates with renowned VC funds in order to select the startups.[177]

There is a negative spillover effect when the startup firm in question has a competing (or adjacent) technology to the established firms.[178] Empirically, in cases with direct competition between the startup and the CVC firm, the startup retains more board seats for itself and is reluctant to award board power to the CVC investors.[179] Strategically, however, CVC investors might be more interested in investing in competing technologies, even though the CVC will

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[172] ERNST & YOUNG, GLOBAL CORPORATE VENTURE CAPITAL SURVEY 2008-09, BENCHMARKING PROGRAMS AND PRACTICES, EY.COM (2009), http://www.ey.com/Publication/vwLUAssets/SGM_VC_ Global_corporate_survey_2008_2009/$FILE/SGM_VC_Global_corporate_survey_2008_2009.pdf. *See also* THELANDER-PITCHBOOK 2017 INVESTMENT FIRM COMPENSATION REPORT.

[173] 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, e.g.*, McCahery, Vermeulen & Banks, *supra* note 150.

[174] *See* McCahery, Vermeulen & Banks, *supra* note 150.

[175] *Id*. ("investing in risky businesses and high-growth companies does not belong to a multinational's core business").

[176] ERNST & YOUNG, *supra* note 152.

[177] *Id*.

[178] *See also* McCahery, Vermeulen & Banks, *supra* note 150.

[179] Ronald W. Masulis & Rajarishi Nahata, *Financial Contracting with Strategic Investors: Evidence from Corporate Venture Capital Backed IPOs*, 18 J. FIN. INTERMEDIATION 599-631 (2009); *see also* McCahery, Vermeulen & Banks, *supra* note 150.

conceivably be more successful with investments in complementary technologies.[180]

Third, the governance structures, compensation and other incentive mechanisms of CVC vehicles are distinctive, and not always efficient in incentivizing the division managers to maximize profits.[181]

The decision to use a subsidiary structure for the CVC, rather than the limited partnership (which is used by traditional VC) also makes a significant difference.[182] General partners 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.[183] A contributing factor is the structure of management performance fees. VCs are experts in tying a manager's salary to her performance,[184] 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).[185] That is why many CVCs experience the revolving door problem,[186] where senior managers frequently leave.[187]

Fourth, investment strategies also differ with regards to specialization, diversification and timing. 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.[188]

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. The existence of "pay-to-play provisions" (provisions that punish investors that do not participate in their full pro-rata percentage of the financing)

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[180] *See* McCahery, Vermeulen & Banks, *supra* note 150.
[181] *Id*.
[182] *Id*.
[183] *See also* McCahery, Vermeulen & Banks, *supra* note 150.
[184] By frequently offering 1-2% fixed fees plus 20% fund profits. *See id*.
[185] According to McCahery, Vermeulen and Banks, for this reason, top fund management talent is repeatedly recruited to profitable VC funds and away from successful CVC funds. *See id*.
[186] "Revolving door" refers to a situation where a manager in a public position leaves for a higher paid private position.
[187] *See* THELANDER-PITCHBOOK 2017 INVESTMENT FIRM COMPENSATION REPORT.
[188] Additionally, unlike VCs, CVCs managers sometimes don't allow entrepreneurs to use their preferred IPO exit, but rather the managers control the terms of the exit strategy by using the drag-along and redemption . According to McCahery, Vermeulen and Banks, the evidence confirms that VC investment returns tend to be higher than those of CVC funds. *See* McCahery, Vermeulen & Banks, *supra* note 150.

could oblige the CVC fund to convert their preferred shares into common shares, essentially forfeiting their privileges.[189]

The participation of CVC investors affects the private ordering between VC investors and founders, allowing the founders to demand founder friendly investment rounds. They not only contribute to the changes in contractual terms in the traditional VC financing documents but can also lead to conflicts of interest.[190]

SoftBank's model departs from the traditional CVC model. Most CVC funds are only accountable to their parent corporation's strategic desires, because they rely on the parent corporation for funding. Whereas SoftBank has recently been raising money from outside investors. It is deploying outside money with its own capital, and perhaps takes other interests into account.[191]

3. Sovereign Wealth

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.[192] As detailed below, there are different types and structures of SWF investment vehicles, varying from independent financial institutions to central banks. [193] There is controversy among academics and policymakers surrounding the opaqueness (lack of transparency) of

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[189] *See id.*

[190] *See* Jennifer S. Fan, Regulating Unicorns: Disclosure and the New Private Economy 57 B.C. L. Rev. 583 (2016).

[191] According to research done by the *Financial Times*, Softbank's Vision Fund has raised money from the following partners, including: $45 billion from Saudi Arabia's Public Investment Fund; $15 billion from Abu Dhabi's Mubadala Investment Company; $1 billion from Apple; $1 billion from Sharp; and $3 billion from Qualcomm, Foxconn and Oracle founder Larry Ellison's family office. *See* Arash Massoudi, Kana Inagaki & Leslie Hook, *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. *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/; Shead, *supra* note 109; 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/.

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

[193] *See* Ang, *supra* note 172.

these funds, their extra-large size, possible non-commercial non-financial goals, and potential influence over the financial stability of their target nations.[194]

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, such as Edwin Truman, a former assistant U.S. Treasury secretary, are concerned about these trends, stating 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."[195]

From Asia to oil rich Middle Eastern and European countries,[196] the number of SWFs assets under management is estimated at $9 trillion.[197] In the past, SWFs didn't invest in risky tech ventures. The new investment trend in unicorn firms represents a shift in SWFs investment strategy and ordinary risk profile, "from real, safe assets to the frontiers of venture capital."[198]

The changes in investment strategies of SWFs can be the result of several factors, according to Engel, Hamirani and Saklatvala. First, unicorns and tech companies are perceived as having high growth

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[194] *See* Sofia Johan, April M. Knill & Nathan Mauck, *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"); *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; *see* MARTIN A. WEISS, CONG. RESEARCH SERV., RL34336, SOVEREIGN WEALTH FUNDS: BACKGROUND AND POLICY ISSUES FOR CONGRESS 5 (2009), http://fpc.state.gov/documents/organization/110750.pdf.

[195] *Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications, Testimony before the Comm. on Banking, Hous. & Urban Affairs, U.S. Senate* (Nov. 14, 2007) (statement of Edwin M. Truman, Senior Fellow, Peterson Institute for International Economics), https://www.banking.senate.gov/imo/media/doc/111407_Truman.pdf; Peterson Inst. for International Econ., *Sovereign Wealth Fund Scoreboard: Uneven Progress, Featuring Edwin M. Truman (PIIE)* (Nov. 3, 2016), https://www.piie.com/experts/peterson-perspectives/sovereign-wealth-fund-scoreboard-uneven-progress; *see also* Gilson & Milhaupt, *supra* note 174.

[196] *See* BOCCONI UNIV., HUNTING UNICORNS: SOVEREIGN WEALTH FUND ANNUAL REPORT 2016, 7 (2016) [hereinafter HUNTING UNICORNS].

[197] 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). See most recent estimate by Adam Putz, *What Is a Sovereign Wealth Fund?*, PITCHBOOK (Jan. 23, 2019), https://pitchbook.com/news/author/adam-putz.

[198] *See* HUNTING UNICORNS, *supra* note 176.

potential. Second, SWFs are able to diversify their portfolio, which traditionally comprised of traditional conservative investments to "idiosyncratic growth drivers." Finally, an investment in innovative technology can affect not only their entire portfolio, but perhaps can help stimulate their local economies.

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. 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.[199] A "direct" SWF investment is referred to as a situation where 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. Until recently, SWFs invested passively as limited partners (LPs) in tech companies, using the help of professional money managers, i.e., private equity funds (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 capitalist to promote innovation, technological research, development, and commercialization.[200] 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.[201]

SWFs are distinct from VCs and other types of investment funds. First, they report directly to their sovereign states and are not subject to any financial scrutiny from other investors. Second, they have different legal structures and management styles, depending on their origin. Third, it is not clear if they have to comply with any regulations or reporting requirements. 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-

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[199] *See* McCahery & de Roode, *supra* note 177.

[200] *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 (2018).

[201] *See* Ang, *supra* note 172.

financial objectives, such as increasing their political influence by making investments overseas.[202]

Fifth, they are usually long-term investors, and share the goals of preserving the wealth of the sovereign nation for future use. Sixth, they frequently acquire large stakes in the target firms. Seventh, they have flexibility in choosing their investments. 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.

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 if SWF investments are passive (as LPs). 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.[203] Due to the fact that 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 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.[204] In terms of corporate governance, more research needs to be done, in order 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.[205]

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[202] *See* April M. Knill, Bong-Soo Lee & Nathan Mauck, *Bilateral Political Relations and the Impact of Sovereign Wealth Fund Investment* (Mar. 9, 2011), https://ssrn.com/abstract=1498518. *See also* Adaire Morse, *Large Investors' Influence in Private Equity Funds* (Univ. of Chicago, Booth Sch. of Bus., Working Paper, 2000), https://pdfs.semanticscholar.org/dbcc/ff178276f66967599183e4a579ab2a84bffa.pdf.

[203] *See* HUNTING UNICORNS, *supra* note 176.

[204] *See* McCahery & de Roode, *supra* note 177.

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

SWFs are not only growing rapidly in size and number,[206] but as noted 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 general partners (GPs) alongside PEs (not merely as LPs).[207] They are also accused of "hunting unicorns"[208] due to 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.[209] SWFs pose many challenges for U.S. regulators.[210] 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 companies that they invest in (tunneling), transfer jobs or assets abroad to their home country, or even compromise the operation of strategically important companies.[211]

C. Special Purpose Vehicles

Even with the increases in thresholds and removal of employees from their count under the JOBS Act, companies still found themselves bumping against them. As a result, companies found the need to layer their capital, using further count reducing methods of raising capital from investors. The method of choice for most was a special purpose

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[206] *See* Kratsas & Truby, *supra* note 185.

[207] *See* 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.

[208] *See* HUNTING UNICORNS, *supra* note 176.

[209] 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/.

[210] *See* McCahery & de Roode, *supra* note 177.

[211] *See* Johan, Knill & Mauck, *supra* note 174; *see* Simon Johnson, Rafael La Porta, Andrie Shleifer & Florencio Lopez-de-Silanes, *Tunneling*, 90(2) AMER. ECON. REV. 22 (2000); *see* 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; *see* 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 (2010).

vehicle. These SPVs (also known as special purpose entities), typically structured as limited partnerships or limited liability companies ("LLCs"), allow for investments to be pooled into a shell company.[212] The shell company is the nominal owner, with the investors in the shell being the ultimate beneficiaries.

Under normal circumstances, a company formed for the purpose of acquiring and holding assets as investments would be required to register under Section 3 of the Investment Company Act ("ICA") of 1940.[213] However, nearly all SPVs rely upon one of three exclusions under the ICA and its corresponding rules.[214] The most common is an exclusion under Rule 3a-7, whereby the SPV would be excluded as an issuer who does not issue redeemable securities.[215] Instead, the SPV holds the assets and simply generates a cash flow out to its owners. Because of the simplicity of its purpose, it "[conducts] no business and [has] no need for employees or management structures."[216]

By structuring an investment into a private company as an SPV, the number of owners decreases from potentially hundreds down to a single entity. It is typical that wealthy, sophisticated investors are the financial backers of such vehicles. These investors are capable and willing to write checks in excess of $500,000 to join these SPVs set up by venture funds.[217]

It also opens the door for investors who would not normally have the access to make investments in these markets. By pooling their assets, smaller retail investors can combine their assets to invest in riskier, private companies. By capitalizing an SPV with a fundraising round under an exemption like Regulation Crowdfunding ("Reg CF"), investments can be garnered in any amount from any investor. Reg CF was originally passed as part of the JOBS Act with an annual limit of $1 million with annual adjustments for inflation.[218] However, in 2020, the SEC raised these limits to $5 million annually over the objections

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[212] *Structured Finance Special Purpose Vehicles and FinCEN's CDD Rule* WHITE & CASE (Oct. 22, 2019), https://www.whitecase.com/publications/article/structured-finance-special-purpose-vehicles-and-fincens-cdd-rule

[213] 15 U.S.C. § 80a-3.

[214] WHITE & CASE, *supra* note 192.

[215] 17 C.F.R. § 270.3a-7.

[216] WHITE & CASE, *supra* note 192.

[217] Connie Loizos, *A New Way to Fund Unicorns Starts to Look Less Magical*, TECHCRUNCH (Nov. 23, 2015), https://techcrunch.com/2015/11/23/a-new-way-to-fund-unicorns-starts-to-look-less-magical/.

[218] JOBS Act Section 302, Crowdfunding Exemption; Securities Act of 1933, as amended (15 U.S.C. § 77d(a)(6).

of Commissioners Lee and Crenshaw.[219] We are now seeing companies conduct Reg CF rounds via SPVs and overtly stating they did so because of the Section 12(g) limits.[220]

According to Mercury, the new regulations coincided with their Series B fundraise and made it easier for Mercury to run a community round. Mercury was able to use the same subscription agreement for both types of investors: their community round and their other accredited Series B investors. Mercury used the SPV to group community-round investors on a single line on their cap table.[221] This allowed them to raise capital from approximately 2,500 investors without risking the 12(g) thresholds. Given that the average investment was $2,000 and that nearly 30% of the investments were less than $500, it is logical to assume the majority of investors were unaccredited. Without an SPV, it is likely the company would have crossed each 12(g) threshold independently.

Another important development is that the SPV also helped Mercury to streamline their communications to investors. Specifically, it allowed Mercury to communicate with a single point of contact—the lead investor of their community round, Sahil Lavingia, CEO of ecommerce platform Gumroad. It should be noted that Gumroad was the first company to take advantage of the new crowdfunding rule, raising $5M in March 2021.[222]

SPVs are not new in the buyout world. The voice chat app Clubhouse raised $100 million via an SPV in 2021.[223] Other publicized examples include data analytics company Palantir Technologies,[224] which used SPVs to raise more than $1 billion and the grocery delivery platform Instacart.[225] UiPath, which went public with over 3,700

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[219] Jacob Rund, *Startups and Crowdfunding Limits: SEC Rule Changes Explained*, BLOOMBERG LAW (Mar. 30, 2021), https://news.bloomberglaw.com/securities-law/startups-and-crowdfunding-limits-sec-rule-changes-explained.

[220] Lucia Qian, *What We Learned from Our $5M Community Round,* MERCURY (Jan. 17, 2022), https://mercury.com/blog/company-news/community-round-learnings ("We also used the SPV to group community-round investors on a single line on our cap table. This allowed us to avoid trigger SEC rule Section 12(g), which mandates that companies with 2K+ shareholders, or 500+ unaccredited investors and $25M+ in assets, report as public companies.").

[221] *Id.*

[222] *Id*.

[223] Dan Primack, *Voice Chat App Clubhouse Raises $100 Million*, AXIOS (Jan. 25, 2021), https://www.axios.com/clubhouse-andreessen-horowitz-3a10475a-becd-4483-a81e-9ce76d24e85f.html.

[224] Douglas MacMillan, *In Silicon Valley Frenzy, VCs Create New Inside Track*, WALL ST. J. (Apr.2, 2015), https://www.wsj.com/articles/in-silicon-valley-frenzy-vcs-create-new-inside-track-1427992176.

[225] *Instacart*, GRIP MARKETPLACE, https://gripinvestments.com/wp-content/uploads/2021/01/Instacart-report.pdf (last visited Jan. 24, 2022).

shareholders of record, was partially owned by an LLC known only as UiPath Angels, LLC. We were only able to track these entities down after hand reviewing numerous SEC filings and using the related names to draw conclusions.

It must be noted that the investors in these funds are not assembling them. If you are an established venture capital firm, like Anderseen Horowitz or FirstMark Capital or a known investment bank, like a JP Morgan or Goldman Sachs, you are probably creating SPVs for your clients. If an established VC fund is behind it, an SPV can be created in a matter of days, and usually targets accredited investors, such as institutional investors, friends or business associates of the fund managers. They also give alternative venture capital (AVC) market actors exclusive access and ability to invest in well-known private companies.

They are also significantly easier to disguise as ordinary LLCs or LPs that these venture capital funds normally use to limit their liability and manage their various holdings. If Sequoia Capital or SoftBank's Vision Fund assembles an SPV and names it generically, it joins the dozens of entities in existence hiding behind LLC and LP secrecy laws. SVF Fast (Cayman) Ltd. held over 50 million shares of DoorDash went it went public in 2021.[226] This limited company created offshore was itself owned by another LP which itself is owned by the full SoftBank Vision Fund. Sequoia Capital often chooses to name their entities even more generally with such examples as "Sequoia Capital Global Growth Fund II, L.P.", "Sequoia Capital U.S. Global Growth Fund VII, L.P.", and "Sequoia Capital Global Growth II Principals Fund, L.P.", all of which significant combined holdings in DoorDash.[227] By using the classification of "affiliated" entities, the VC funds can set up SPVs alongside their own investments to conceal who is really behind the funding and the purpose for the structure.

There can be several reasons for structuring a two-part deal like this. First, the SPV investors may want to cut the middleman (VC) and invest directly in the startup. It allows AVCs to make a single investment through a vehicle that is created for that sole purpose, without having to invest for a longer term in multiple firms through a traditional fund. It also reduces the fee structure often associated with investing in a VC fund. Despite them doing the initial groundwork to create and capitalize the SPV, the VC is likely not participating in any

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[226] https://www.sec.gov/Archives/edgar/data/1792789/000119312520311490/d752207ds1a.htm#toc

[227] *Id.*

active management of the SPV's investment outside their role in managing their own investment.

Regardless of whether the investment occurs alongside a VC, there are still other reasons SPVs are sought after. In addition to the aforementioned advantage of allowing companies to keep their cap record counts low, it allows venture capitalist to join the party and invest large sums directly if they choose to do so. SPV funds allow VCs to invest more money in the short term, rather than committing to a long term diversified fund. Second, it allows investment bankers to get the startup to pick them as a lead underwriter when they decide to do an IPO. Finally, other benefits include no need for financials, no need for capital calls, no management fees (or management company) or low fees, up to 250 accredited investors can invest without triggering the registration requirement, allows for comparatively small investment minimums, a deal-by-deal carry[228], the empowerment of high-volume investment syndicates, and keeps the startup cap tables (also known as capitalization tables or ledgers) clean.

A cap table is a table or spread sheet which details all the equity holdings of the participating members/shareholders/investors. The cap table for an SPV needs to list all of the entity's participating investors and their relevant information. This cap table will be used and referred to frequently throughout the lifecycle of the SPV. The cap table is a requirement to ensure proper record keeping and–more to the point–to enable that they pay federal and state taxes and make distributions to participating investors. The startup founders love SPV structures because they allow them to raise large sums very quickly.

Of course, there are downsides to such a structure. The SPV fund is structure for the purpose of investing in a unicorn firm, where it is hard to value its assets.[229] Since valuations can be disputed, it is important to make sure that SPV 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

[228] "The compensation norm for smaller VC SPVs is around 1/10 (1% management fee per year and 10% carry.) The carry is 'deal carry' which is much more valuable than fund carry, since the individual losers are not netted against each of the winners." John Backus, *Should You Co-Invest? 10 Considerations for Co-Investment SPVs*, FINANCIAL POISE (June 12, 2021), https://www.financialpoise.com/co-investment-spvs/.

[229] Gregory W. Brown, Oleg R. Gredil & Steven N. Kaplan, *Do Private Equity Funds Manipulate Reported Returns?*, 132 J. FIN. ECON. 267, 267 (2019).

funds.[230] Because it is more akin to direct investing, rather than investing in a fund, the losses will be felt more acutely.[231]

There is always a possibility that SPV managers will overstate their portfolio net asset values (NAVs) in an attempt to attract investors to future funds.[232] The assets that the fund will invest in are private, and there is no liquid market for these assets.[233] There is no diversification.

Another concern is with regards to fees. There is a possibility that fund managers will fail to fully inform investors about their benefits from fees. 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 and unicorns, note that unicorn shares are non-liquid financial assets. Some unicorns allow investors to trade their shares on secondary markets, but many put restrictions and do not allow trading in order to comply with our securities laws.[234] As noted by Gornall and Strabulaev, there is also controversy with regards to aggressive valuations of these firms.[235]

V. GOING DARK

The explosive growth of private markets is the most important development in securities markets in the new millennium, according to Commissioner Lee.[236] The shift in equities in the United States from public markets to private markets has significant implications for different stakeholder groups. As companies continue to stay private longer and raise more capital in private markets, our regulators are pressured into changing the current trend. There are two main

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[230] *Id.*

[231] Loizos, *supra* note 197.

[232] *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/.

[233] Brown, Gredil & Kaplan, *supra* note 207, at 267–68.

[234] *See* Alon-Beck, *supra* note 55, at 172–74.

[235] William Gornall & Ilya Strebulaev, *Squaring Venture Capital Valuations with Reality* (Nat'l Bureau of Econ. Rsch., Working Paper No. 23895, 2017). *See* also, McCahery & de Roode.

[236] Allison Herren Lee, Commissioner, U.S. Sec. & Exch. Comm'n, Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy (Oct. 12, 2021), https://www.sec.gov/news/speech/lee-sec-speaks-2021-10-12.

approaches that regulators take, eighter democratizing access of retail investors to private markets or forcing private companies into public markets.

A. The Growth of Private Markets

Legal and regulatory structures influence the shift in equities from public markets to private markets. While the amendments to the '34 Act were implemented ostensibly to encourage capital formation, there was considerable lobbying by major tech companies who were rapidly approaching the limits, or in the case of some, already over these limits. Facebook, one of the largest IPOs in history, went public before the JOBS Act limits went into effect with more than double the number of allowed shareholders.[237] WorkDay, which went public shortly after the limits went into effect would have been in violation had the increase not occurred.[238] LinkedIn, who went public in late 2011, initially filed under the limit, but the ultimately effective registration statement was in excess of the existing limits.[239] They even noted in their registration statement that "[t]he actual number of stockholders is greater than this number of record holders, and includes stock holders who are beneficial owners, but whose shares are held in street name by brokers and other nominees."[240]

After the passage of the JOBS Act, the limits allowed companies to stay private longer. However, we are now seeing companies going public in violation of the new higher limits. Palantir upon their IPO via direct listing had nearly 2800 shareholders of record.[241] As companies continue to stay private longer and grow even larger with continued rounds of capital raising, it is likely this is to be an increasingly common occurrence.

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237 Facebook (now Meta Platforms) S-1/A, Mar. 27, 2012, https://www.sec.gov/Archives/edgar/data/0001326801/000119312512134663/d287954ds1a.htm.

238 WorkDay, Inc., Pre-Effective Amendment No. 3 to Form S-1, Registration Statement 111 (Form S-1/A) (Oct. 11, 2012) https://www.sec.gov/Archives/edgar/data/0001327811/000119312512420693/d385110ds1a.htm#toc385110_16.

239 LinkedIn Corp., Amendment No. 2 to Form S-1, Registration Statement 35 (Form S-1/A) (Nov. 16, 2011) https://www.sec.gov/Archives/edgar/data/1271024/000119312511314369/d250692ds1a.htm.

240 *Id.*

241 Palantir Techs. Inc., Amendment No. 5 to Form S-1, Registration Statement 217 (Form S-1/A) (Sept. 21, 2020) https://www.sec.gov/Archives/edgar/data/1321655/000119312520249544/d904406ds1a.htm.

For decades, debate has raged on whether we should ever force a company to join the public markets and at what point the line for obligation is crossed. Congress and the SEC have recognized that once this genie is let out the proverbial lamp, there is no going back. Instead of pulling the cork, regulators have instead adopted the carrot and the stick approach of gently nudging companies in the direction of the path countless firms have taken on their own accord: an IPO.

There are a variety of reasons for these companies to complete an IPO.[242] Capital formation and providing liquidity for existing shareholders are the obvious reasons.[243] There is considerable prestige associated with being a publicly traded company.[244] Finally, subsequent efforts in capital formation were now generally considered easier given the access to public investors an IPO granted.[245]

However, with the dramatic acceleration of capital formation in private markets over the last two decades, as well as slackening in regulatory requirements, much of the reason to go public has evaporated. The policy changes enacted under the JOBS Act, SOX, and others have resulted in a self-defeating regulatory arc.[246] As disclosure obligations increase for public companies, private markets have been largely deregulated in the hopes of jumpstarting capital formation.[247] Yet, there is no indication that such a policy goal was ever in need of addressing.

Capital formation in the private markets is considerably easier and is preferred for a variety of reasons by large private firms.[248] No longer do these firms, predominantly unicorns or soon-to-be unicorns, need access to the public's capital to continue their growth. The creation of secondary markets and increasingly sophisticated exit mechanisms negotiated by large institutional investors have decreased the attraction of liquidity mechanisms for many of the shareholder base.[249] Finally, the consolidation of ownership of equity in the United States into largely institutional holders has diminished the prestige associated with going public. Companies who go public may very well find their overall ownership changes only minimally following an IPO.

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[242] Rodrigues, *supra* note 30, at 1544-45.
[243] *Id.*
[244] *Id*. at 1554.
[245] *Id*.
[246] Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of Public Companies*, 68 HASTINGS L.J. 445, 451 (2017).
[247] *Id*.
[248] Rodrigues, *supra* note 30, at 1538.
[249] *See generally* Alon-Beck, *supra* note 18.

Of course, for minority shareholders, particularly employees, the liquidity an IPO provides is still desperately sought after. The restrictions they face associated with their stock options and equity grants often serve as an increasingly tightening pair of "golden handcuffs."[250]

Given the access to the capital necessary for these companies to grow found in the private markets, the downsides of going public are thrust to the forefront. There are very real direct and indirect costs associated with going public.[251] Companies face the large accounting, auditing, and legal expenses necessary to comply with the '34 Act requirements and SEC proxy regulations.[252] The indirect costs are often even greater, with heightened exposure to liability, increases in D&O insurance costs, public scrutiny, and the distractions to the leadership of the firm associated with all of these.[253] For founders and majority shareholders, it throws open the door for costly proxy fights and increases the chance of takeover bids from which there is little hope to recover the control they have become accustomed to.[254]

With the lack of a need for access to public markets and the increased emphasis placed on the negatives associated with being public, it is no wonder there has been a dramatic downturn in IPOs over the last 40 years. According to research by Gao, Ritter, and Zhu, the average number of IPOs from 1980 to 2000 hovered at just over 300 per year.[255] Between 2001 and 2012, that number has fallen to just 99 per year, with significant drops for smaller firms.[256] For the last two years, the number has accelerated to record levels with 480 in 2020 and over 1000 so far in 2021.[257] However, this number is driven overwhelmingly by the volume of Special Purpose Acquisition Companies ("SPACs") entering the market.[258] The sheer number of these companies searching within an increasingly limited pool of potential targets is a further indicator of the easy access to large amounts of capital.

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[250] *See generally* Alon-Beck, *supra* note 18.
[251] William K. Sjostrom, Jr., *The Birth of 144A Equity Offerings,* 56 UCLA L. REV. 409, 435-41 (2008).
[252] *Id.* at 435-36.
[253] *Id*. at 438.
[254] *See* Broughman & Fried, *supra* note 19.
[255] Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, *Where Have All the IPOs Gone?* 2 (Aug. 26, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954788.
[256] *Id*.
[257] *IPO Statistics*, STOCK ANALYSIS, https://stockanalysis.com/ipos/statistics/ (last visited Jan. 25, 2022).
[258] Sara B. Potter, *US IPO Market: SPACs Drive 2020 IPOs to a New Record,* FACTSET (Jan. 7, 2021*),* https://insight.factset.com/u.s.-ipo-market-spacs-drive-2020-ipos-to-a-new-record.

As a result, the desire to avoid these negatives for many firms far outweighs the positives of conducting an IPO. The question for management then shifts from when and how to prepare the company for an IPO to the methods necessary to prevent the need to conduct one from ever arising. If capital formation is no longer an issue and access to public equity is no longer needed, regulatory thresholds effectively requiring companies to make public disclosures is the last hurtle to staying dark. Clearly, for firms of any consequential size, the $10 million asset threshold is effectively irrelevant, especially when viewed in the context of the listing requirements on any national stock exchange. Thus, the only relevant position would be the shareholder of record thresholds, the true target of the amendments of the JOBS Act.

B. The Impact on Investors and the Economy

The current market trends are affecting policymakers, shareholders, investors, employees, markets, and the public at large. Private markets are plagued with asymmetric information, illiquidity, and long holding periods. This needs to be take into account in any serious policy response.

The transparency associated with public markets only remains effective so long as a sufficient number of firms actually participate in public markets. As these numbers fall, the transparency of public markets will diminish.[259] Instead, opacity will once again become the norm in equity markets, likely causing a diminishment of support for the corporate sector in the long term. However, regulators and the market itself will more likely require public market-like disclosures to come into the private markets as more public capital flows into it. As its role in capital formation begins to accelerate and influence our corporate world in ways which exceed public markets, it will face significant pressure from both to give some degree of transparency. We see this already with increased disclosure requirements on OTC markets being implemented in 1999 and renewed efforts now to push for increased transparency during the Biden Administration.

No one denies that there are benefits associated with both public and private capital markets. Indeed, the ability to seek capital from either has facilitated decades of economic growth. The fact that the financing for intangible assets is better sourced from private markets is a reality any regulator will be faced with when attempting to broaden disclosure requirements.

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[259] Craig Doidge, Kathleen M. Kahle, G. Andrew Karolyi & René M. Stulz, *Eclipse of the Public Corporation or Eclipse of the Public Markets*?, 30 J. APPLIED CORP. FIN. 8 (2018).

Nonetheless, as more money from an increasing variety of sources flows in, there must be some degree of protection implemented to ensure investors of all sophistication can make informed decisions. To maintain support for our corporate sector, the transparency of private markets must increase as society's access increases to them.

First, regulators should enhance not reduce disclosure standards and investor protections. Initially, our securities laws were designed to protect all investors, including employees as investors. That meant that all the companies in the United States were required to disclose financial and other information about the offering firm, prior to offering securities to the public. Our laws, specifically the Securities Act of 1933 (the "Securities Act"), required that a company that offers to sell its securities must first register the securities with the SEC. During the registration process, the issuing company disclosed certain facts, including certified financial statements, a description of its assets and business operations, management composition and more.

One of the largest sources of pressure to go public came from the largest group of minority shareholders: the firm's own employees. Things changed. Startups today enjoy several exemptions from registration. Thanks to a series of reforms to the federal securities laws, which began in 1988.[260] The following changes dramatically reduced the ability for this group to pressure for an IPO. First, with the passage of the JOBS Act in 2012, Section 12(g) of the '34 Act was amended to increase the number of shareholders of record a company was permitted to have from 500 persons to 2000 persons.[261] Second, the '34 Act was further amended to remove employees who received shares as part of exempt employee compensation plans from the shareholder of record count.[262]

There is consensus that there is a need for more disclosure. However, there is also debate on what information should private companies disclose to alleviate this problem. There are several approaches to disclosure. According to Yifat Aran, they include a maximalist, minimalist, and intermediate approach.[263] One thing is

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[260] *See* Jones, Written Testimony, *supra* note 53 (citing Alon-Beck, *supra* note 55).

[261] See Jumpstart Our Business Startups Act, § 501, Pub. L. No. 112-106, 126 Stat. 306 (2012), https://www.govinfo.gov/content/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

[262] See Jumpstart Our Business Startups Act, § 502, Pub. L. No. 112-106, 126 Stat. 306 (2012), https://www.govinfo.gov/content/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf.

[263] It should be noted that there are several views in academia and practice on the type of information that should be provided to employees. According to Aran, I represent the maximalist approach (for more, see Alon-Beck, *supra* note 55), practitioners represent a minimalist one, and Aran proposes an intermediate

clear though, we need a better disclosure regime to "prevent the market for equity-based compensation from becoming a market for lemons."[264] Aran warns that employees will lose trust in equity compensation arrangements. This is already happening, as evident from employees complaining on public platforms such as Glassdoors and PaySa.[265] Some employees as shareholders turn to the courts for help.

Other stakeholders affected by the high private market demand include retail investors and the public at large. There is pressure on deal valuations. The rise in dry powder, along with reported and perceived reductions in illiquidity premiums, suggests a market that may be overheating.

Despite the fact that the institutional investor base has long-term liabilities, private company assets are highly illiquid. These investors might face issues with short-term cash flow obligations in the event that the private markets will enter a negative downturn correction. Note that some institutional funds have restrictive requirements, such as maintaining daily liquidity requirements.

There is a need to examine the systemic implications of growing private market exposure among institutional investors such as pension funds. There is a rise in exposure of AVC investors to private markets, such as sovereign wealth funds, government plan sponsors, pension funds. Their exposure affects the end users, the investors that our securities laws are supposed to protect, the savers and retirees.

VI. SUGGESTIONS FOR REFORM

Given the high thresholds and the penchant for companies to avoid them through commonly accepted methods of business, there is a growing call for reform on Section 12(g) to restore it to its original purpose: ensuring investors are protected when companies reach a

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approach to the regulation of disclosures to start-up employees. *See* Yifat Aran, *Making Disclosure Work for Start-Up Employees,* 2019 COLUM. BUS. L. REV. 867 (2019).

264 *See* Alon-Beck, *supra* note 55. *See also* Aran, *supra* note 241.

265 These sites rank the "Best Companies to Work For" and employees pay "careful attention . . . to Employee Engagement Scores that link corporate reputation, employee motivation, and productivity." Judy Samuelson, *Why Do We Still Call It Capitalism?*, QUARTZ (Apr. 9, 2018), https://work.qz.com/1247835/spotifys-ipo-should-make-us-consider-why-we-still-use-the-term-capitalism/. Unicorn employee complaints are not private anymore, as the "conversation has moved to employee hangouts, both virtual and real, to interview rooms on college campuses, and to public conversations about Board diversity, the glass ceiling, and in the talent pool." *Id.*

certain level of exposure to the public markets. SEC Chairman Gary Gensler announced examining Section 12(g) as part of his agenda for 2022 and Commissioner Allison Lee had previously called for such reforms. It will undoubtedly be an uphill battle with two Republican commissioners already announcing their opposition to changes which, in their view, threaten the facilitation of capital formation.

We do not share the views of Commissioners Pierce and Roisman on this matter. There is no indication that the large companies which would be most affected by reforms are having any difficulty seeking capital. Since the passage of the JOBS Act, the number of unicorns has increased from around a dozen to nearly 1,000 worldwide, with nearly half being found in the United States. This number continues to grow nearly exponentially. With more and more money flowing into our private markets and with greater access being given to retail investors, we must take active steps to ensure investors are properly protected.

Potential reforms are wide ranging, with many requiring Congressional action. Given the divisions we currently face in Washington, substantial reform is unlikely. However, there are actions the SEC can take under its independent rule making authority which would still lead to a bare minimum increase in protective measures. We will begin by outlining the reforms requiring Congressional approval and then move on to those under the SEC's rulemaking power.

Congress should repeal Section 502 of the JOBS Act which specifically excludes employees who receive shares under an employee compensation plan from the shareholder of record count. This provision dramatically undercuts the employees' ability to pressure companies to ever go public and further restricts their ability to escape their golden handcuffs. It also relegates them to a proverbial second-class status as investors. They are required to make investment decisions without access to information simply because they are employees. There is no indication that the average employee is privy to the inside information necessary for them to make informed choices. In fact, there are signs that many employees never exercise their options because of an inability to make that informed choice.[266] Congress has enabled these companies to force employees to gamble with their own financial future and by doing so removed their power as shareholders.

[266] Schwab Study: Equity Plan Participants Average Nearly $100,000 in Vested Stock; Less Than Half Have Ever Sold or Exercised Their Shares (11/13/2019) https://www.aboutschwab.com/press-releases

Congress should also consider implementing a float-based test akin to one suggested by Professor John Coffee. Other academics have long endorsed such a method as being a more accurate reflection of the public exposure to a company. If there is significant OTC trading associated with an enterprise, it is indicative that a sufficient portion of the investing public may have the ability to obtain such shares. By implementing a provision to include both the expanded shareholder of record test and the public float test, large private companies who have long remained private may continue to do so. But companies who are actively trading, but on smaller secondary markets, cannot escape the regulatory schemes designed to protect the smaller retail investors who do not have the leverage or sophistication necessary to obtain information.

Under its own rulemaking power, the SEC should redefine the term “held of record” to more accurately reflect those who are making and benefitting from the investment decision to hold the shares in question. By redefining the term to reflect those who are actually voting the shares, the count will better reflect who is really the investor. Even if the shares are owned under the street name of the beneficial owner’s broker, the beneficial owner still ultimately receives the proxy materials and the right to vote their shares. The company is required to pass the material along to the appropriate shareholders. This is not a new concept. During the comment stage of rulemaking following the JOBS Act passage, there were calls for a “proxy count” to be implemented instead of a “record count” to avoid the reduction in numbers resulting from street name ownership, SPVs, and other layering methods.

The implementation of look through efforts would take even less effort with the passage of the Corporate Transparency Act of 2020, the Financial Crimes Enforcement Network (“FinCEN”) is now required to implement a registry of beneficial owners of nearly all domestic entities formed under state corporate law and foreign entities registered to do business in the United States. The beneficial owners are required to report this information and it is expected that broker dealers will have an obligation to crosscheck information their clients provide with this registry. While the primary purpose of creating such a registry is to combat money laundering, tax evasion, and terrorist financing, it could easily be applied to a broader definition of shareholder of record.

The SEC should also amend Rule 12g5-1(b)(3) to remove the “primary” requirement from the catch-all provision of record holder. If the company knows or has reason to know that a particular method of ownership is being used to avoid or reduce the record count, the count should be reflective of the true beneficial owner. In its 2012 report on the SEC's enforcement authority of the anti-circumvention provision, the SEC itself conceded that the rule "may be applicable only in limited circumstances."[267]

In addition, the SEC should consider modernizing the limits for accredited investor. The minimum income and net worth requirements for accreditation status were implemented in 1982 and have not been adjusted since.[268] In that time, the number of households capable of qualifying for status has increased by more than tenfold.[269] On top of this, the SEC has also expanded the definition to encompass even more investors who would qualify based on professional credentials, as opposed to net worth. While many of these individuals would have qualified already, it still represents a willingness to continue the self-defeating arc of regulation. The SEC is required to review the definition every four years under Section 413(b)(2)(A) of Dodd-Frank and the next review is set to occur in 2023.[270]

Finally, the SEC should consider narrowing the definition of employee compensation plan to reflect only equity grants, rather than stock options. Equity grants are truly compensation in that moment as outright income. Stock options, on the other hand, are instead the ability to make an investment decision. The decision to exercise or not, however, ultimately remains with the employee. By narrowing the definition, the rule would be more reflective of the term "compensation" and allow for these employees to be viewed as what they truly are: minority shareholders.

VII. CONCLUSION

While our securities laws were implemented to ensure both smooth capital formation and sufficient investor protection, there must be a balance sought between them. If one is continually favored, with the other neglected, the underlying reasoning is defeated. With the passage of the JOBS Act, capital formation has never been easier. By any metric, be it size, frequency of deal, or percentage of the market, exempt offerings have come to play the leading role in this arena.

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[267] *Id*. at 21-22.

[268] U.S. SEC. & EXCH. COMM'N, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 18-19 (2015,) https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf [hereinafter SEC REPORT].

[269] *See also id*. at 50 (In the report, the Commission acknowledged that even if the 1983 thresholds were left in place, but adjusted for inflation, the number of households encompassed by the status would still have tripled as of 2015.). Kiernan, *supra* note 40.

[270] *See* SEC REPORT, *supra* note 245.

Because of these exempt offerings, in our view, the Section 12(g) loophole is squarely situated at the point at which capital formation and investor protection clash. Its thresholds allow companies to raise capital from numerous investors while avoiding public disclosure requirements. They are allowed to see tremendous growth at the expense of good governance, prudent disclosure, and investor protection. By addressing the threshold requirements under Section 12(g), we believe we can rebalance the equilibrium, provide the necessary protection to investors, and continue to liberate the markets to allow for a greater range of participation from a variety of sources.

With the SEC moving to allow retail investors to play a part in these offerings, both directly and indirectly, it is imperative that we take the steps necessary to protect their capital. Regulators have a duty to watch on behalf of all investors, not just those with the loudest voices. The paradigm of an ordinary investor making a reasonable investment decision only works if they have the information necessary to make it an informed one. It is our obligation to ensure that they do and bringing about change to Section 12(g) is an important step to making this a reality.

APPENDIX I

The table below represents the raw data points presented visually above. Any red highlighted box denotes a company which went public in violation of the Section 12(g) thresholds at the time of its S-1 filing. Any orange highlighted box denotes a company which has gone public since the passage of the JOBS Act and would be in violation of the previous 500 shareholder of record limit.

Year	Company	Shareholders of Record
May-11	LinkedIn	571
Nov-11	Groupon	341
Dec-11	Zynga	200
Apr-12	Okta	355
May-12	Facebook	1070
Oct-12	WorkDay	630
Nov-13	Twitter	755
Mar-14	Quotient Technology	321
Jun-14	GoPro	255
Oct-14	Wayfair	116
Dec-14	Lending Club	275
Dec-14	New Relic	145
Jan-15	Box	810
Mar-15	MuleSoft	367
Aug-15	Sunrun	252
Sep-15	Cloudflare	313
Oct-15	Pure Storage	402
Nov-15	Square	665
Jun-16	NantHealth	426
Sep-16	Nutanix	591
Oct-16	Coupa	257
Mar-17	Snap Inc	305
Jun-17	Blue Apron	133
Sep-17	Roku, Inc.	198
Nov-17	Stitch Fix	247
Mar-18	DropBox	2658
Apr-18	Pivotal	931
Jul-18	Bloom Energy	715
Dec-18	Moderna Therapeutics	484
Mar-19	Lyft	2301
Apr-19	Pinterest	505

Apr-19	Slack Technologies	494
May-19	Uber	2223
Sep-19	Peloton	428
Jan-20	One Medical	308
Sep-20	JFrog	92
Sep-20	Palantir	2794
Dec-20	Airbnb	1457
Dec-20	DoorDash	537
Dec-20	Snowflake	1026
Mar-21	Oscar Health	461
Apr-21	AppLovin	72
Apr-21	Coinbase	430
Apr-21	Compass	414
Apr-21	Twilio	329
Apr-21	UiPath	3702
May-21	Flywire	687
May-21	Squarespace	1112
Jun-21	Confluent	607
Jun-21	WalkMe	153
Jul-21	Duolingo	442
Jul-21	Robinhood	1650
Sep-21	Amplitude	334
Sep-21	Freshworks	1178
Sep-21	Toast	939
Oct-21	AvidXchange	503
Oct-21	Gitlab	612
Oct-21	Rent the Runway	575
Oct-21	Udemy	471