Written Testimony of Renee M. Jones[1]

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Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
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Good morning Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee. Thank you for inviting me to testify today and for holding this hearing on this important topic. In my testimony I plan to focus on the risks the growing number of large private companies present for investors, employees, consumers and society. My testimony today will (1) highlight the main objectives of the federal securities laws and the mechanisms Congress adopted to achieve these objectives (2) explain the statutory bases for the principal exemptions from the securities laws registration and disclosure requirements and (3) show how regulatory exemptions that once sought to clarify and reinforce the principles embodied in the statutes have evolved to the point that they are no longer are linked to the statutory purpose. Finally, I will highlight some of the unintended consequences that have flowed from fostering the proliferation of an unprecedented number of highly-capitalized private companies, also known as unicorns, with little information available to investors and the public about their performance, products, and operations.

The Main Objectives of the Federal Securities Laws

As I am sure you are aware, the federal securities laws were enacted in the aftermath of the Stock Market Crash of 1929 and the Great Depression that followed. The principal objective behind these statues is the protection of investors. The securities laws created a mandatory disclosure regime to ensure that investors have adequate information when deciding whether to purchase or sell a security and when deciding how to vote their shares.

1933 Act's Registration Requirements

The Securities Act of 1933 (the "1933 Act")[2] requires that every securities transaction be registered unless an exemption is available. The Act exempts transactions from the registration requirement in those instances where Congress determined registration would be unnecessary or superfluous.

The 1934 Act's Reporting Requirements

Whereas the 1933 Act focused principally on ensuring that investors had adequate information when purchasing securities from issuers, the Securities Exchange Act of 1934 (the "1934 Act")[3] focused mainly on ensuring that investors had adequate information when buying and selling securities in trading markets. Under the key provisions of the 1934 Act, whenever an issuer's securities trade in public markets or are held by a dispersed group of investors, the issuer must register the securities with the Securities Exchange Commission (SEC) and thereafter comply

[1] Professor of Law and Associate Dean for Academic Affairs, Boston College Law School.
[2] 15 USC § 77a et seq.
[3] 15 USC § 78a et seq.

with the 1934 Act's periodic disclosure requirements, including the obligation to file annual and quarterly reports on the company's financial performance. Until the enactment of the JOBS Act of 2012, the Exchange Act's periodic reporting requirements applied to any issuer that had filed a registration statement that became effective, had a class of securities listed securities on a national stock exchange, or had assets of $10 million and a class of equity securities held by 500 or more shareholders of record.

This last requirement, set forth in Section 12(g), prodded growing companies to begin to prepare for a future public offering. As an IPO began to seem inevitable, startups took steps to ensure they were well-positioned to face the public scrutiny a public offering entailed.[4] Rapidly growing companies would hire executives with experience working at publicly traded firms, recruit outside directors with strong reputations, and take steps to clean up conflicts of interest or other unorthodox transactions.

Changes in the structure of private securities markets and recent legal reforms have rendered these corporate housekeeping exercises unnecessary. As a result of changes in the markets, a new class of unaccountable unicorns has emerged. The growing number of unicorns pose new risks for investors and the public that existing corporate governance structures cannot adequately address.

Before exploring in depth the kinds of governance problems created by this growing class of unicorns, I will first review the basic Securities Act exemptions and Exchange Act requirements that worked reasonably well to balance society's interest in capital formation with the securities laws' investor protection mandate. My testimony will then explain how we shifted from a fairly rational system of securities exemptions to the current hodge-podge of exemptions that lack a clear relationship to the securities laws' longstanding investor protection goals.

The Indeterminacy of Statutory Exemptions

The 1933 Act provides exemptions from its registration requirements in those circumstances when the public interest is not served by registration. The most important exemption for issuers is Section 4(a)(2) which exempts "transactions by an issuer not involving any public offering."[5] For investors seeking to resell their securities, Section 4(a)(1) provides the key exemption. Section 4(a)(1) exempts transactions "by any person other than an issuer, underwriter, or dealer."[6] Because the Act's definition of "underwriter" includes any person who purchases securities with a view to distribution, or sells securities for an issuer or "control" person in connection with a distribution,[7] transactions by investors who purchased their securities in an unregistered transaction, and transactions on behalf of control persons are not exempt and may require registration.

The 1933 Act offers little clarity on the meaning of the terms "public offering," "view to distribution" or "distribution." It has thus been left to courts to flesh out the contours of the

[4] See Renee M. Jones, *The Unicorn Governance Trap*, 166 PENN L. REV. ONLINE 165, 178-89 (2017).
[5] 15 USC § 77d(a)(2).
[6] 15 USC § 77d(a)(1).
[7] 15 USC § 77b(a)(11).

Securities Act's exemptions. In a foundational case, *SEC v. Ralston Purina Co.*,[8] the Supreme Court clarified the meaning of "public offering." According to *Ralston Purina* an offering is "public" if it includes any offerees who are "unable to fend for themselves," such that they need the protection of the Act.[9] As further developed in *Ralston Purina* and later cases, an offering is public if it includes offerees who lack the financial sophistication and access to information needed to make intelligent investment decisions.[10] In determining an investor's sophistication, courts consider the investor's educational background and investment expertise. In assessing whether an investor has access to relevant information, courts examine the investor's relationship with the issuer and its executives, the quantity and quality of information voluntarily disclosed, and whether investors have had the opportunity to ask questions and receive satisfactory answers before making their investment decision. Courts have grafted the *Ralston Purina* standard and its attendant uncertainty into the interpretation of Section 4(a)(1). In these cases, courts have held that the term "distribution," on which the availability of the Section 4(a)(1) exemption turns, has the same meaning as "public offering" as interpreted by *Ralston Purina*.[11]

Regulatory Safeharbors for Securities Act Exemptions

Federal court decisions defining the contours of the Section 4(a)(1) and 4(a)(2) exemptions were anything but clear. As a result, uncertainty persisted around questions of investor sophistication, requisite disclosures, and the kind of evidence an issuer would need to produce to establish that all offerees were qualified to invest. To address the need for certainty for those planning securities transactions, the SEC, through its rulemaking prerogatives, created a series safeharbors for unregistered transactions.

<u>Safeharbors for Issuers</u>

The SEC adopted Regulation D in 1982, creating a comprehensive set of rules for two separate categories of issuer exemptions.[12] Exemptions under Rule 504 and 505 were based on the SEC's authority under Section 3(b) to exempt transactions of $5 million or less, if registration was not necessary to protect the public interest or investors. Rule 506 provides a safeharbor for Section 4(2)'s private offering exemption.[13] Under Rule 506, issuers can sell an unlimited amount of securities to up to 35 sophisticated investors, and to an unlimited number of Accredited Investors.[14] Regulation D defines Accredited Investor to include institutional and individual investors who satisfy the financial thresholds set forth in the Regulation. Individuals can qualify as Accredited Investors if they have an annual income in excess of $200,000 (or $300,000 together with a spouse), or a net worth in excess of $1,000,000.

In adopting Rule 506, the SEC substituted wealth for sophistication as a basis for exemption, distancing the safeharbor's standards from *Ralston Purina* and its progeny. As long as investors

[8] 346 US 119 (1953).
[9] *Id*.
[10] *Id*.
[11] COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 359-64 (8th ed. 2017).
[12] Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Release No. 33-6839 (Mar. 8, 1982), 47 FR 11251 (Mar. 16, 1982).
[13] Release No. 33-6839.
[14] *Id*.

were wealthy, issuers did not need to inquire into their investment sophistication. In addition, under Rule 506, investor access to information, another hallmark of private placements, was no longer required. If all investors were accredited, issuers did not need to provide any disclosure in connection with an offering. It is important to note that these wealth and income standards have never been adjusted since Regulation D was adopted in 1982. According to the SEC, if adjusted for inflation, the figures would be $490,000 in income ($600,000 with a spouse) and $2.6 million in net worth.[15]

Although Rule 506 greatly expanded the scope of the private placement exemption, transactions under the Rule were somewhat constrained by Rule 502(c)'s ban on general solicitations.[16] Rule 502(c) prohibited the use of sales meetings, newsletters, cold calling, or the internet for Regulation D transactions (subject to limited exceptions). Companies relying on Regulation D could only approach investors with whom they had pre-existing relationships, or had to work through intermediaries who had requisite connections to qualified investors.[17]

<u>Safeharbors for Selling Stockholders</u>

Although most securities transactions by ordinary investors are exempt from registration, certain investors must use caution when seeking to resell their securities. Under Section 4(a)(1), investors who acquire shares from an issuer in an unregistered transaction must establish they purchased with investment intent, and not with a "view to distribution." Under decisions interpreting Section 4(a)(1), investors can establish investment intent by holding securities for an extended period of time (2 to 3 years). In addition, Section 4(a)(1) does not protect transactions by controlling shareholders or their intermediaries if the control person's sale constitutes a "distribution." As noted above, courts interpret the term distribution to be equivalent to "public offering." Decisions interpreting the term "distribution" focus on both the volume of securities sold and the sophistication of the offerees.

Considerable uncertainty surrounded whether an investor had purchased with "investment intent," and whether a control person's sale constituted a distribution. To address the uncertainty surrounding resales of restricted and "control" securities, the SEC adopted Rule 144 in 1972. As originally adopted, Rule 144 permitted resales, subject to certain conditions, after a two-year holding period was satisfied.[18] After three years, resales were permitted without conditions.[19]

<u>Regulatory Safeharbors Have Strayed from their Statutory Moorings</u>

When first adopted, Regulation D and Rule 144 safeharbors hewed closely to the contours of the Securities Act exemptions. Recent amendments to these same rules have detached these safeharbor provisions from their statutory and judicial moorings. As a result, current iterations

[15] SEC, Report on the Definition of Accredited Investor, Dec. 18, 2015, https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf
[16] 17 C.F.R. §230.502(c) (2017).
[17] COX ET AL., *supra* note 11, at 277-79.
[18] Small Offering Exemption and Definition of Terms "Underwriter" and "Broker's Transactions," Securities Act Release No. 33-5523, 37 Fed. Reg. 591 (Jan. 11, 1972).
[19] *Id*.

of Regulation D and Rule 144 no longer correlate with the rationales underlying their statutory basis. These changes in the law will be further discussed below.

In addition to the SEC's liberalization of exemptions through its rulemaking powers, Congress has acted recently to expand exemptions further beyond the limits the SEC had established. Most notably with the JOBS Act of 2012, Congress created a series of new exemptions that expose unsophisticated investors to high risk investment schemes. Under these new exemptions, including Crowdfunding, Regulation A+ and Rule 506(c), promoters can direct their sales efforts to all manner of investors without running afoul of the 1933 Act's registration requirements.[20]

As a result of these expansive statutory and regulatory reforms, the current panoply of exemptions available to issuers and trading shareholders show little fealty to the investor protection principles embodied in the securities laws as originally conceived. These statutory and regulatory reforms have contributed to the shrinking of the public securities markets, and have enabled the current trend toward prolonged delays in corporate IPOs. The aggregate impact of these recent reforms has been the wholesale reshaping of both public and private securities markets, and the emergence of a new class of companies, so-called unicorns, that lack the kinds of mechanisms for management accountability that investors in public and private companies have come to expect.

Emergence of the Unicorns

What is a Unicorn?

The term unicorn was adopted by industry insiders to describe privately held companies with a market valuation of $1 billion or more. When the term was first coined in 2013, the number of super-sized private companies was so small that encountering one was about as likely as spotting a mythical unicorn. Since then, the number of unicorns had increased dramatically. There are now an estimated 395 unicorns worldwide, with an aggregate valuation of $1.2 trillion.[21] This growing cohort of unicorns has important implications for startup financing and the broader securities markets.

As many commentators have noted, the number of initial public offerings (IPOs) in the US has fallen sharply from 706 in 1996 to only 190 last year. The number of public companies has also dropped by half over the past decade. The average time to an IPO has also increased, from 4 years in 1996 to more than 11 years today. Policymakers and scholars have been troubled by the shrinking size of public equity markets, whose depth and breadth were once a source of pride for the US economy. Scholars worry about the dearth of information available about these privately owned behemoths, and whether investors have sufficient information about the performance of these companies to make intelligent investment decisions.

We can trace this trend of shrinking public markets to a confluence of factors, including reforms to federal securities laws that makes private company stock more attractive to investors, while at

[20] COX ET AL, *supra* note 11, at 250.
[21] The Global Unicorn Club, https://www.cbinsights.com/research-unicorn-companies. TechCrunch puts the figure at 496 global unicorns with an aggregate valuation of $1.8 trillion. https://techcrunch.com/unicorn-leaderboard/.

the same time reducing internal and external pressure to pursue an IPO. These changes in the law coincided with changes in private equity markets which have enabled startup companies to fund their operations and sustain massive losses, all while avoiding the scrutiny that comes from accessing the public equity markets.

Changes in the Law Help Unicorns Remain Private

There has been a dramatic shift of capital from public equity markets to the startup company space. New categories of investors including sovereign wealth funds, corporate venture capital and mutual funds have joined venture capitalists as competing sources of funding for technology startups. This influx of new capital has allowed startup companies to finance their operations while remaining private for much longer than was possible in the past. This shift of investment capital to the private equity markets has also been facilitated by a series of reforms to the federal securities laws introduced over the past 15 years.

Amendments to Regulation D

Most private financing transactions proceed under Rule 506 of Regulation D, which allows companies to raise unlimited funds from an unlimited number of accredited investors.[22] The amount of funds raised under Rule 506 each year exceeds the amounts raised under other issuer exemptions and in public offerings.[23] Despite its broad success and the regulatory flexibility it offers, one condition to Regulation D irked industry insiders and complicated the private financing process.

Rule 502(c)'s ban on general solicitation and advertising constrained the ability of issuers to identify prospective investors. Startups founders could only approach investors with whom they had pre-existing relationships, or had to work through intermediaries who had connections to qualified investors. As the internet emerged as a dominant communication channel, entrepreneurs chafed at Rule 502(c)'s restrictions. Promoters and founders sought regulatory dispensation to market their offerings on the internet. Despite aggressive lobbying by the financial industry, the SEC refused to ease this restriction.

Congress intervened in 2012, and as part of the JOBS Act, directed the SEC to exempt Rule 506 transactions limited to accredited investors from the ban on general solicitation.[24] Accordingly, the SEC adopted new Rule 506(c), which allows companies to engage in general solicitations, including through the internet, as long as the company takes reasonable steps to ensure that all investors are accredited.[25] The effort required to raise capital is now significantly reduced. Venture capitalists and angels can use the internet to syndicate their investments and identify new investors via newly created crowdfunding portals for Accredited Investors. Although Rule

[22] 17 C.F.R. § 230.506 (2017).
[23] SEC Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-10649, June 18, 2019, at 78.
[24] JOBS Act § 201(a)(1).
[25] 17 C.F.R. § 230.506(c) (2017).

506(c) has proven to be less attractive than the traditional Rule 506(b) exemption, since its adoption issuers have raised $466 billion under the new rule.[26]

Amendments to Rule 144

Just as the standards for the Regulation D no longer adhere to the guidance provided by *Ralston Purina* and its progeny, Rule 144's safeharbor for trading transactions show little faithfulness to judicial doctrine interpreting Section 4(a)(1). Initially, Rule 144's holding periods tracked the guidelines established by judicial doctrine interpreting 4(a)(1), which held that a three-year holding period was conclusive for establishing investment intent.[27] As issuers and investors carped about Rule 144's constraints, the SEC liberalized the Rule in a series of reforms.[28] In 1997, the SEC shortened the Rule 144 holding period from two years to one, with conditions on sales applying during the period between one and two years from acquisition.[29] In 2007, the SEC shortened Rule 144 holding periods again.[30] Now, under Rule 144 investors who acquire shares from an issuer in an unregistered transaction can resell their shares after one year with no conditions.[31]

After Rule 144's holding periods were shortened, web-based trading platforms emerged to facilitate trading in private company shares. In 2009, SharesPost and Second Market (now Nasdaq Private Market) were established to connect stockholders in startups with outside investors interested in purchasing their shares. Together, these private markets have handled more than $9 billion of transactions in shares of hundreds of private companies. Now unicorn employees and early investors can sell company stock without waiting for an IPO. These private trading markets have therefore reduced pressure on startups to create liquidity through an IPO.

Amendments to Section 12(g)

Until 2012, even thriving companies with adequate funding faced a future IPO on the horizon. As a startup company's shareholder base expanded, the startup faced the prospect of mandatory registration under the 1934 Act. As previously noted, 1934 Act Section 12(g) required companies with more than $10 million in assets and a class of equity securities held by 500 or more shareholders to register the securities with the SEC.[32] Microsoft, Google and Facebook all went public as they approached this 500 shareholder limit. As these companies grew, and their shareholder base expanded, their founders understood they would soon face the glare of public scrutiny that came with an IPO.

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[26] SEC Concept Release, *supra* note 25, at 79. Although this is a significant amount of capital, it represents only 6% of the aggregate funds raised under Regulation D during the relevant time period. *Id*.
[27] During the period between 2 and 3 years, courts engaged in a facts and circumstances analysis.
[28] The SEC also adopted Rule 144A which allows sales of unregistered securities to Qualified Institutional Buyers ("QIBs").
[29] Revision of Holding Period Requirements in Rules 144 and Rule 145, Securities Act Release No. 33-7390, 62 Fed. Reg. 9,242 (Feb. 28, 1997).
[30] Revisions to Rules 144 and 145, Securities Act Release No. 33-8869, 72 Fed. Reg. 71,546 (Dec. 17, 2007).
[31] 17 C.F.R. §230.144 (2017). For public companies, the holding period is only 6 months, with conditions on resale during the period between six months to one year from acquisition. *Id*.
[32] 15 U.S.C. §78l(g).

Now startups can avoid 1934 Act registration as long as they have fewer than 2,000 shareholders of record (excluding from the calculation shares held by employees or issued under the SEC's new Crowdfunding exemptions) or fewer than 500 unaccredited investors. According to the SEC, 87% of existing public companies would be excluded from registration under this definition, leaving only 400 companies that would be compelled to register solely because of Section 12(g).[33] As such, new Section 12(g) has essentially eliminated the prospect of mandatory registration. The cumulative impact of these recent changes in the federal securities laws means today's startup companies face few external or internal pressures to pursue IPOs. These persistent unicorns present new risks for startup investors, employees and the broader society.

New Risks Created by the Growing Number of Unicorns

As we have seen, the number of unicorns is growing and the length of time from founding to exit through an IPO has expanded. These changes in startup financing patterns have also influenced how these large private companies are managed. The most significant change affecting the governance of unicorns is the advent of the "founder-friendly" financing model, which displaced the startup governance structure, which until the mid-2010s, was defined by investor control.

Until recently, startup companies and their founders were subject to tight controls exerted by representatives of the venture capital funds that financed them. Venture capital investors traditionally insisted on board seats, had the power to veto major decisions, and through a strategy of staged investments exercised final control over whether or not a company survived. Under this governance model, founders were vulnerable to being replaced by professional managers with a track record of leading publicly traded firms. Investor control also meant founders faced intense pressure to prove their concept and profitability, so they could proceed along the pipeline toward an eventual IPO.

Venture capital funds are typically structured to liquidate after seven to ten years. Their managers sought liquidity for their portfolio companies within that time frame. If venture capitalists grew impatient with the progress of the companies they funded, they could push for a sale of the company that would allow them to recoup some of their investment or simply pull funding (by refusing to finance additional rounds) and force the fledgling startup into liquidation.

Beginning around 2010, the tables turned as startup founders began to gain the upper hand. As venture capitalists competed for access to deals with sovereign wealth funds and mutual funds, they began to offer financing on "founder-friendly" terms. In the founder-friendly model, founders receive shares with super voting power (typically ten votes per share), which enables founders to maintain control over the board of directors, despite having relatively small financial stake in the firm.

When founders control the board, an important source of discipline over the startup's operations is neutralized. The venture capitalists who once called the shots can now be outvoted by the founder and his allies on the board. This new era of founder control has created an environment at unicorns that is ripe for management abuse. The absence of meaningful board oversight at

[33] COX, ET AL., *supra* note 11, at 583. To deregister under the Exchange Act, the number of record holders at the end of the fiscal year must fall below 300. 15 U.S.C. §§78l(g)(4).

unicorns helped create the backdrop for recent scandals at Silicon Valley firms. Examples of how badly things can go awry when investors fail to monitor unicorn operations can be seen in the histories of Uber, Theranos and other unicorn firms.

Uber

The many missteps of Uber founder and former CEO Travis Kalanick provide a textbook example of how founder mismanagement can lead a promising company into chaos. In early 2017, a history of questionable conduct by Kalanick and senior Uber executives finally came to light. Almost weekly, stories emerged describing new allegations of legal violations and unethical practices at Uber. The alleged misconduct included violations of user privacy, deceiving local regulators, and misappropriating technology from Google.

In August 2017, Uber hired a new CEO who immediately embarked on an apology tour, seeking to mend fences with employees, drivers, and regulators in the US and around the world. A new investment from a Japanese conglomerate allowed disaffected shareholders to sell their shares, and Uber abandoned the dual class structure that had proven so problematic. Uber launched its IPO in May 2019. Despite lofty expectations, its stock market debut proved to be disappointing.[34] Since the IPO, Uber has reported mounting losses, and its stock now trades $13 below the $45 per share public offering price.[35]

Theranos

Another example of risks inherent in the unicorn governance model is the debacle involving the blood-testing startup Theranos. The Theranos story highlights risks that arise when unicorn directors act as boosters and protectors of the founder instead of stewards of investors' funds and the corporation's long-term interests. As described in John Carreyrou best-selling book *BAD BLOOD*, Theranos founder and CEO Elizabeth Holmes lied with impunity to Theranos directors and investors about how Theranos technology worked.[36] Theranos never actually developed the innovative blood-testing technology it marketed to corporate partners and medical patients. When Theranos employees expressed misgivings about Holmes' exaggerations and lies, many were summarily dismissed. Theranos' directors were a virtual who's who of elder statesmen from the Reagan and Bush eras. The board included nonagenarians Henry Kissinger and George Shultz, former Senator Sam Nunn and retired Marine general James Mattis. Aside from former Senator Bill Frist, a former health care executive, none of Theranos's directors had experience in health care. Their lack of expertise in the company's business and industry helps explain why Theranos's directors were so easily duped by Holmes's lies.

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[34] Mike Isaac, Michael J. de la Merced and Andrew Ross Sorkin, *How the Promise of a $120 billion Uber IPO evaporated*, N.Y. TIMES, May 15, 2019, https://www.nytimes.com/2019/05/15/technology/uber-ipo-price.html

[35] Kate Conger, *Uber posts $5.2 Billion Loss and Slowest Ever Growth Rate*, N.Y. TIMES, Aug. 8, 2019, https://www.nytimes.com/2019/08/08/technology/uber-earnings.html; see also https://finance.yahoo.com/quote/UBER/ (September 9, 2019).

[36] JOHN CARREYROU, BAD BLOOD: SECRETS AND LIES IN A SILICON VALLEY STARTUP (2018).

How the Unicorn Governance Model Impacts Employees

Uber and Theranos are the most deeply reported examples of how misconduct often thrives beneath the glossy surface of respected unicorn firms. Similar problems have arisen at unicorns like Zenefits, Social Finance and WeWork. Although many scholars have highlighted how the lack of transparency impacts unicorn investors, few have focused on risks the unicorn governance model poses to unicorns' employees.

Employees as Investors

Startup employees generally work for reduced compensation in exchange for the promise of potential future wealth. Startups grant employees stock options that increase in value as the firm grows and succeeds. Options help build loyalty and provide employees a stake in the firm, which motivates hard work and supports employee retention. When the start-up cycle lasted only four to seven years, the lock-in period was finite. Before their options expired or employees itched to leave, the company had either succeeded and employees were rewarded, or the company was liquidated and employees moved on.

With the extended timeline to an IPO, the length of time employees must wait for their promised payoff is extended. In this opaque environment, unicorn employees must make decisions about whether to exercise options.[37] The costs of exercising employee options can be formidable. In addition to having to pay the stock purchase price, employees often face daunting tax bills on the paper profits realized, despite the absence of a trading market to liquidate their shares.[38]

In one stark example, many Good Technologies employees borrowed heavily to pay taxes due when they exercised their stock options.[39] At one time, Good was valued at $1.4 billion and had filed for an IPO in 2014. Before the IPO was scuttled, Good turned down an $825 million acquisition offer. Despite negative publicity circulating about the company, Good ensured employees that everything was fine. Employees were therefore surprised when Good announced its sale to Blackberry for only $425 million. Employees soon learned their common shares, once valued at over $4 per share, were now worth just 44 cents.[40]

Square employees were likely similarly disappointed when their company went public at a stock price far below its touted $6 billion valuation. Due to special provisions in the company's charter, Square's preferred stockholders were entitled to receive additional shares. This ratchet provision came at the expense of Square employees, as 23 million shares of employee stock options were suddenly underwater.[41]

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[37] See Anat Alon-Beck, Unicorn Stock Options - Golden Goose or Trojan Horse?, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3228400

[38] See Connie Loizos, *Handcuffed to Uber*, TECHCRUNCH, Apr. 26 (2016), https://techcrunch.com/2016/04/29/handcuffed-to-uber/.

[39] Beck, *supra* note 37, at 29.

[40] Katie Benner, *When a Unicorn Start-up Stumbles, Its Employees Get Hurt*, N.Y.TIMES (Dec. 23, 2015), https://perma.cc/38FT-FTV2.

[41] Sarah Frier & Adam Satariano, *Square Employees Find Some of Their Stock Options Under Water*, BLOOMBERG BUS. (Nov. 19, 2015) https://perma.cc/3YSH-SV3Z; Goncalo de Vasconcelos, *Square IPO: How Venture Capitalists Made Money Buying $9 Shares For $15.46 - And Who Lost Out*,

The daunting costs of exercising employee options lead many unicorn employees to remain in jobs when they might prefer to leave. Stock options typically expire within 90 days after an employee leaves the firm. These termination provisions force departing employees to make the difficult choice of paying dearly to exercise their options, or leaving millions of dollars in potential profits on the table. Departing employees must make the decision about whether to exercise their options with minimal information about the firm's performance or likely exit scenario.

Toxic Work Environments

Management experts caution that as startup companies grow they must professionalize and bureaucratize if they hope to survive.[42] These same experts tell us that startup company founders often resist introducing professional processes at their firms. Instead founders tend to view formal structures and processes as bureaucratic threats, and worry about losing control and team intimacy. When founders eschew order and discipline, their companies pay a price: chaotic operations and unpredictable performance.[43]

In the absence of IPO pressure, many of today's startups are delaying investments in their human resources function. Despite head counts in the hundreds or thousands, many unicorns have human resources functions that are underdeveloped and under-resourced. The lack of an effective human resources function at many startups contributes to atmospheres where gender discrimination and other forms of employee abuse can thrive.

Press accounts of the workplace culture at Uber and Theranos suggest that unicorn investors have failed to create accountability mechanisms for managers who abuse their positions or mistreat employees. A slew of press accounts reported that women working at Uber were systematically subject to discrimination and harassment.[44] Employees who complained about their treatment alleged that they were rebuffed or ignored.[45] An independent investigation into the sexual harassment complaints ended with the dismissal for misconduct of 20 Uber employees.[46] Theranos similarly suffered from a toxic corporate culture. Its CEO maintained a culture of secrecy and silence. Holmes forbade Theranos employees from talking about their

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https://www.forbes.com/sites/goncalodevasconcelos/2015/11/29/square-ipo-how-venture-capitalists-made-money-buying-9-shares-for-15-46-and-who-lost-out/#46137b783b9d

[42] Ranjay Gulati and Alicia DeSantola, *Start-Ups That Last*, HARV. BUS. REV., Mar. 2016, https://hbr.org/2016/03/start-ups-that-last. According to the authors, "[f]irms must *hire functional experts* to take the enterprise to the next level, *add management structures* to accommodate increased head count while maintaining, *build planning and forecasting capabilities*, and *spell out and reinforce the cultural values* that will sustain the business."

[43] *Id*.

[44] Mike Isaac, *Inside Uber's Aggressive, Unrestrained Workplace Culture*, N.Y. TIMES, Feb. 22, 2017, www.nytimes.com/2017/02/22/technology/uber-workplace-culture.html.

[45] Susan J. Fowler, Reflecting on One Very Strange Year at Uber, Feb. 29, 2017, https://www.susanjfowler.com/blog/2017/2/19/reflecting-on-one-very-strange-year-at-uber.

[46] Craig Timbert & Elizabeth Dwoskin, *Uber Fires 20 Employees as Part of Sexual Harassment Investigation*, WASH. POST, June 6, 2017, https://www.washingtonpost.com/news/the-switch/wp/2017/06/06/uber-fires-more-than-20-employees-as-part-of-sexual-harassment-investigation/?utm_term=.98a14ca0587b.

jobs, even to each other.[47] She also retaliated against employees who questioned the company or its products.[48] This culture of intimidation enabled Holmes to conceal the reality that Theranos's technology did not work as claimed.[49]

Impact on Consumers and Society

The impact of management dysfunction at unicorns extends beyond investors and employees (who arguably knowingly embrace these risks). Consumers and society also suffer when unicorns engage in illegal conduct or otherwise seek to skirt existing law. Although many observers embrace the disruption caused by tech companies like Airbnb and Uber that flout conventions and local regulations, others point to the externalities their brash approach to compliance with the law can create.

Moreover, customers of Uber, Theranos and Lyft have suffered direct harm due to fraudulent marketing of Theranos' blood testing technologies and Uber's and Lyft's lax approach to conducting background checks for drivers.[50] Similarly Airbnb customers have frequently complained about discriminatory treatment by "hosts"[51] and many communities lament the fraying of social fabric when residential buildings and neighborhoods become transformed into quasi-transient communities.

Solutions

To address the many shortcomings in unicorn governance structures, Congress should consider a number of reforms. To improve governance at these increasingly significant firms, Congress should consider the following steps:

Study the Impact of Dual Class Capitalization

Dual class capitalization has become a standard feature for many startup companies and the structure has carried through in unicorn IPOs. To ensure that investors in both private and public companies have the ability to influence fundamental corporate decisions, including who serves on the board of directors and the senior management team, Congress should direct the SEC to study the implications of this trend and make recommendations for reform.[52] One

[47] *See* Nick Bilton, *How Elizabeth Holmes's House of Cards Came Tumbling Down*, VANITY FAIR, Oct. 2016. https://www.vanityfair.com/news/2016/09/elizabeth-holmes-theranos-exclusive
[48] See generally CARREYROU, BAD BLOOD.
[49] John Carreyrou, *Hot Startup Theranos Has Struggled with its Blood-Test Technology*, WALL ST. J., Oct. 16, 2015.
[50] *See* Janet Burns, *Rider Lawsuit says Lyft Mishandles Assaults, Rapes, Its 'Sexual Predator Crisis*, FORBES, Sept. 5, 2019 https://www.forbes.com/sites/janetwburns/2019/09/05/lyft-lawsuit-14-former-riders-allege-sexual-assault-rape-since-2018/#71f29d6d7512
[51] Elaine Glusac, *As Airbnb grows, So do Claims of Discrimination*, N.Y. TIMES, June 21, 2016, https://www.nytimes.com/2016/06/26/travel/airbnb-discrimination-lawsuit.html; *see also* Benjamin Edelman, Michael Luca, and Dan Svirsky, *Racial Discrimination in the Sharing Economy: Evidence from a Field Experiment*, http://www.benedelman.org/publications/airbnb-guest-discrimination-2016-09-16.pdf
[52] *See* Perpetual Dual-Class Stock: The Case Against Corporate Royalty, Remarks of Robert J. Jackson, Jr., Feb. 15, 2018. https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty

proposal that deserves consideration is a sunset provision for supervoting shares after a set period of time, or when a founder's percentage ownership falls below a predetermined threshold.[53]

Revisit JOBS Act Amendments to Section 12(g)

The most effective way for Congress to shore up shrinking public equity markets is to reverse the JOBS Act amendments to Section 12(g). As it now stands Section 12(g) allows unicorns to delay an IPO indefinitely, allowing these important companies to operate in secrecy, shrouded from public scrutiny and accountability. The growth of private trading markets like SharesPost and Nasdaq Private Market means unicorn shares can trade for years with little public information available to investors about these companies and their financial performance.

At the very least, Congress should impose minimum disclosure obligations for companies of a certain size with dispersed ownership patterns. Such a reform would increase pressure for an IPO or sale, and provide needed information for investors considering purchasing shares. Enhanced disclosure obligations for large public companies would also require directors to learn more about the inner-workings of their firms, as directors would face potential liability for misleading corporate disclosures.

Comments on Proposed Legislation

Although my testimony has focused on broad issues affecting public and private securities markets, I am pleased to share my thoughts on the bills and legislative proposals currently before the subcommittee.

1. The Private Securities Transparency and Reform Act (Discussion Draft)

   This proposed bill would direct the SEC to adopt rules requiring issuers to file a Form D upon the first sale of securities under Rule 506(b), or upon the commencement of a general solicitation for an offering under Rule 506(c). The bill would also require that issuers file a closing amendment at the conclusion of every Regulation D offering. The closing amendment would include such information as the amount of securities sold, the number of investors, amounts raised from various classes of investors and fees and commissions paid by the issuer or investors in connection with the offering.

   The proposed bill would also require the SEC to provide a comprehensive report to Congress on the state of private equity markets including the relationship between private offerings, quasi-private offerings and initial public offerings. The information garnered from such a report would enable Congressional committees to make informed choices when considering amendments to the securities laws.

   These proposals, if adopted, would bring needed transparency to the opaque private securities markets and aid researchers, regulators and legislators in gathering necessary data on the benefits and risks that characterize these markets. The SEC's report would

[53] *See* Lucian Bebchuk and Kobi Kastiel, *The Untenable Case for Perpetual Dual Class Stock*, 103 VA. L. REV. 585 (2017), http://www.virginialawreview.org/sites/virginialawreview.org/files/Bebchuk%20%26%20Kastiel_Book.pdf

shed light on the extent to which retail investors seek to participate in private offerings and the risks they encounter in these markets. Ideally, such a report would also bring to more clarity on why private markets are growing and public markets are shrinking and how policymakers should address these shifts. For these reasons I endorse the discussion draft.

2. SEC Study on Private Securities Offerings (Discussion Draft)

Another discussion draft proposes to require the SEC to conduct a study about private securities offerings as a precursor to major amendments to private offering rules. Regulators would benefit from a thorough study of the private securities markets, and it is clearly desirable for the SEC to be as informed as possible before adopting major reforms. Although the impetus behind the discussion draft is understandable, the committee should consider whether the proposal, as drafted, unduly constrains the SEC's rulemaking authority. One can imagine situations when the agency would want to act quickly to address market trends. The SEC's rulemaking procedures require study and analysis before adopting new rules. By specifying in detail how such studies must be conducted, Congress might unintentionally complicate the agency's ability to adopt new rules efficiently.

3. Family Office Technical Corrections Act (HR 3972)

This bill brings family offices with more than $5 million of assets under management within the definition of Accredited Investor. This amendment will simplify the inquiry into whether family offices are qualified to participate in certain Regulation D offerings. This proposal is consistent with earlier amendments to the Investment Advisers Act that exempts family offices from the Advisers Act's registration requirements. This bill makes minor technical amendments to the definition of Accredited Investor and seems to be a reasonable addition to the definition.

4. Other Legislation

Although I have some reservations regarding the other bills under consideration, I will refrain from making specific comments as the substance of proposals falls outside my direct area of expertise.

Thank you for the opportunity to testify today. I would be happy to answer any questions.