The Bleeding Edge: Theranos and the Growing Risk of an Unregulated Private Securities Market

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America’s securities laws and regulations, most of which were created in the early twentieth century, are increasingly irrelevant to the most dynamic emerging companies. Today, companies with sufficient investor interest can raise ample capital through private and exempt offerings, all while eschewing the public exchanges and the associated burdens of the initial public offering, public disclosures, and regulatory scrutiny. Airbnb, Inc., for example, quickly tapped private investors for $1 billion in April of 2020, adding to the estimated $4.4 billion the company had previously raised. The fundamental shift from public to private companies is evidenced by the so-called “unicorns,” the more than 400 private companies valued at more than $1 billion. unicorns like Uber, Airbnb, SpaceX, and WeWork have raised billions of dollars without the need to tap retail investors through the public exchanges. The unicorn phenomenon is emblematic of the shift away from public markets, with more and more companies choosing to stay private and raise capital through private placements. Despite a fast-evolving capital market, America’s

* Executive Editor, Volume 28 of the University of Miami Business Law Review; Juris Doctor Candidate, University of Miami School of Law, 2020; Bachelor of Arts, Political Science, University of Oregon, 2011. I thank Professor Teresa Verges, a tireless advocate for investors, who provided thoughtful feedback and consistent support throughout this process. I also thank the entire Executive Board of the University of Miami Business Law Review for their dedication to this publication.


securities regulations are still largely based on the 1930s-era laws passed in the aftermath of the Great Depression. Scholars and regulators have voiced concerns about the lack of regulation in the private markets and the potential harms posed by large, unregulated private companies.

At its peak, blood-testing company Theranos was a unicorn, valued at $9 billion. The valuation reflected intense investor enthusiasm for a company with significant potential to shake up the biotechnology and healthcare industries. Far from realizing its financial and business goals, Theranos perpetrated a fraud on investors, customers, and business partners. Executives misled current and prospective investors with inflated financial projections. The company’s founder and employees deceived business partners with falsified product tests. The company continued to tout its “revolutionary” blood testing technology, but, behind the scenes, employees consistently failed to achieve the necessary technological breakthroughs. Rather than admit the setbacks, Theranos deviated from established medical and scientific methods by altering tests and, when that did not work, Theranos ran the tests on its rivals’ status quo blood testing machines. Eventually, intrepid reporters, regulators, and prosecutors uncovered the fraud, culminating in a series of lawsuits brought by investors, business partners, and the Securities and Exchange Commission (“SEC”).

In the aftermath, many commentators wondered how a critically flawed company could raise so much money from prominent investors at such a high valuation. Theranos was able to perpetrate its fraud, in part, because it operated as a private company and therefore did not have to submit to the same onerous disclosures that public companies must provide to the SEC and the investing public. A public company, unlike Theranos, must register with state and federal regulators, submit periodic filings, and, importantly, certify its financials under Sarbanes-Oxley. Theranos was able to raise $700 million without providing those disclosures to its investors—disclosures that were designed to protect and inform investors. The Theranos story provides a lens through which we see the tension between private capital formation and protection of investors.
In this Note, I closely examine the Theranos collapse and the litigation that continues in its aftermath. This Note will argue that Theranos should be viewed as an example of regulatory failure. Current securities regulations allow private companies to operate in the shadows, even while these companies raise large sums from sophisticated and (increasingly) unsophisticated investors alike with little oversight and minimal transparency. This Note examines Theranos as a cautionary tale exemplifying the risks of failing to regulate private companies despite the dramatic decline in IPOs and the corresponding expansion of private companies, particularly unicorns.

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I. INTRODUCTION

Retail investors learned a hard lesson when the dot-com bubble burst in the early 2000s: it is common—even likely—to lose money investing in startups. Experienced venture capital investors, of course, already knew
that lesson well. But for many average investors, the hot initial public offerings (“IPOs”) of the 1990s were their first foray into speculating on technology companies and internet startups.

Today, venture capital investors accept the probability that most of their investments will fail to materialize because they hope that a few winners will become massively valuable companies. Indeed, academic research suggests that most start-ups fail to achieve the projected return on investment and 30 to 40 percent result in a complete loss for the investor. The high risks associated with start-up investments explain why legislators and regulators have long sought to prevent unsophisticated retail investors from investing in start-ups. For the most part, speculative early-stage investments are reserved for venture capitalists, institutional investors, and other accredited investors—at least until a start-up matures enough to successfully navigate the IPO process. To tap the public markets, then, companies must undergo the expensive and demanding initial public offering process, disclosing the company’s financial information, risks, and other important information.

The Securities Act of 1933 (“Securities Act”) imposes certain disclosure requirements on companies seeking a public offering “to promote full and fair disclosure necessary for the investor to make an informed investment decision.” President Franklin D. Roosevelt signed the Securities Act into law as part of his administration’s response to the stock market crash of 1929 and the Great Depression. In the Roaring Twenties, the American public enthusiastically bought into the soaring economy, with more Americans investing in the stock market than ever.

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3 A common refrain in venture capital is that “Nine out of 10 startups fail.” Although that statistic appears largely anecdotal and does not reflect the true startup failure rate, similarly high failure rates are often cited by venture capitalists to show the high risk associated with investing in startups. Erin Griffith, Conventional Wisdom Says 90% of Startups Fail. Data Says Otherwise. FORTUNE (June 27, 2017), http://fortune.com/2017/06/27/startup-advice-data-failure/.

4 Research by Harvard Business School’s Shikhar Ghosh estimates that between 70 to 80 percent of start-ups fail to meet the projected return on investment and 30 to 40 percent of start-ups end in a complete loss for the investor. See, Carmen Nobel, Why Companies Fail—and How Their Founders Can Bounce Back, HARVARD BUSINESS SCHOOL, WORKING KNOWLEDGE (Jan. 11, 2019, 6:29 PM), https://hbswk.hbs.edu/item/why-companies-fail-and-how-their-founders-can-bounce-back.


before—a development that made the crash all the more devastating.\(^7\) In an effort to reassure the investing public, Roosevelt signed a series of bills into law that reworked the securities markets.\(^8\) This marked a sea change that transformed American securities law “from a system of *caveat emptor* to one of *caveat vendor,*” requiring companies to make substantial disclosures before offering stock.\(^9\)

The Securities Act imposes these disclosure requirements on all securities and bars all transactions in unregistered securities, unless there is an exemption.\(^10\) Per the SEC’s website, the Securities Act accomplishes two primary goals: (1) make available to investors financial and other information related to the securities being offered, and (2) “prohibit deceit, misrepresentations, and other fraud in the sale of securities.”\(^11\) To go public, a company must complete a complicated, expensive, and time-consuming IPO process.\(^12\) If successful, the issuer must continue to comply with reporting and disclosure requirements or face reprisal from shareholders or the SEC.\(^13\)

The Securities Act carves out three primary exemptions from the Securities Act’s registration provisions: § 3 excludes certain categories of securities from registration; § 4 exempts various transactions from registration; and § 28 grants the SEC the power to make rules that expand the statutory exemptions.\(^14\) Federal securities laws and regulations effectively set a dividing line between “public” securities (those securities that are offered to the public and traded on exchanges like the New York

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\(^7\) ROBERT F. HIMMELBERG, GREAT DEPRESSION AND THE NEW DEAL 7 (2000).

\(^8\) See EDWARD J. BALLEISEN, FRAUD: AN AMERICAN HISTORY FROM BARNUM TO MADOFF 250-52 (2017) (describing the context of the New Deal-era securities reforms).

\(^9\) THOMAS LEE HAZEN, FEDERAL SECURITIES REGULATION 1 (3d ed. 2011).


\(^14\) Id.
Stock Exchange) and “private” securities (those securities and transactions that are exempt from registration).

As will be discussed in Part II, going public requires a company to fulfill the Securities Act registration requirements and submit periodic reports under the Securities Exchange Act of 1934 (“Exchange Act”). In contrast, private companies and those securities otherwise exempted from SEC registration do not need to fulfill either requirement, allowing these companies to avoid the costly and sometimes invasive public disclosure system. Companies were historically willing to endure the expense and lack of privacy because going public offered a significant advantage, namely accessing the public markets. Over time, the calculus has changed; private placements now account for more capital raised in the United States than publicly registered stock offerings. Today, even some of the largest and most dynamic companies choose to stay private as long as possible.

There are many possible explanations for why companies elect to delay a public offering, but, whatever the cause, the maturation of the private securities market has made the decision to stay private easier and more efficient than ever before. Private securities sales often involve several problems: “high transaction costs and information costs, including difficulties matching buyers and sellers, a lack of information requiring extensive due diligence, and the costs of negotiating and papering transactions.” In the 2000s, electronic marketplaces began facilitating purchases and sales of shares in private companies, including then-popular start-ups like Facebook and LinkedIn. These electronic marketplaces

16 See Elisabeth de Fontenay, The Deregulation of Private Capital and the Decline of the Public Company, 68 Hastings L.J. 445, 472 (2017) (“Publicly registered stock offerings now represent only a minor share of the capital raised in the United States. The vast majority of U.S. corporate capital is raised instead as debt or as privately placed equity. In particular, private placements of corporate capital (both equity and debt) have rapidly overtaken public offerings, and the gap is only increasing.”)
17 See infra Part II; see also Amy Deen Westbrook & David A. Westbrook, Unicorns, Guardians, and the Concentration of the U.S. Equity Markets, 96 Neb. L. Rev. 688, 717 (2018) (“As the private market has grown, the public offering market has shrunk. In turn, there has been a marked drop-off in initial public offerings (IPOs).”).
18 See Westbrook & Westbrook, supra note 17, at 717.
improved efficiency in private transactions by connecting buyers and sellers through a central location, publishing buy-sell bid pricing, disseminating third-party research reports, and providing standardized contracts. Investment funds, institutional investors, venture capitalists, wealthy individuals, and even mutual funds can now efficiently buy up shares of private companies. The increasingly liquid market for private securities, in turn, relieved pressure on companies to go public because shareholders—typically early investors, employees, and management—could sell their shares at attractive prices quickly, legally, and without much effort. The growth of the private securities market coincides with the “‘retailization’ of private investment funds, whereby retail investors are increasingly able to participate in private side investments either directly or through mutual funds.”

Many scholars have warned that this evolution poses serious risks to the public. But, for all the many private companies that have disappointed investors, there are few examples where the harm extended beyond venture capitalists and employees. Perhaps the lack of serious, far-reaching harm explains why there has been little to no regulatory or legislative attention paid to this issue. After all, until recently, there were no massive frauds or collapses involving unicorns that would have raised public or governmental concern. Then, Theranos collapsed. The blood testing company evolved from classic Silicon Valley start-up to a media-charming, seemingly revolutionary company with a multi-billion-dollar valuation, before finally imploding amid myriad lawsuits, questions about its technology, and federal prosecutors accusing the company and its executives of fraud. Venture capitalists were not the only victims of the fraud: corporate partners lost significant millions of dollars when the partnerships collapsed; individuals suffered investment losses because the

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21 Ibrahim, supra note 20, at 38.

22 See Westbrook & Westbrook, supra note 17, at 724 (“[T]he private market is inhabited not only by wealthy individuals . . . but by a menagerie of vehicles such as venture capital funds, private equity, corporate venture capital, hedge funds, sovereign wealth funds, mutual fund complexes, and family offices. Multiple types of private investors make it possible to have ‘[e]arly stage VCs selling to Growth Equity Investors selling to Mutual Funds and Sovereign Wealth Funds.’”) (quoting Amie Hutchinson, Why Are More Companies Staying Private?, GOODWIN (Feb. 15, 2017), https://www.sec.gov/info/smallbus/acsec/hutchinson-goodwin-presentation-acsec-021517.pdf.).

23 de Fontenay, supra note 17, at 468.

24 See infra Part IV.
funds in which they invested owned Theranos shares; and Theranos’ faulty testing delivered inaccurate results to the unsuspecting public.25

Before it was exposed as a fraud, Theranos raised $700 million from private investors at ever-climbing valuations peaking at $9 billion.26 The company offered its unreliable blood-testing to customers, leading to confusion and fear by misdiagnosed patients. Theranos also misled investors—from billionaire investors like Rupert Murdoch to hedge funds and other institutional investors—with inaccurate projections and false statements. The company did this by raising funds through several private fundraising rounds over about a decade.27 Importantly, Theranos never attempted to register as a public company, allowing the company to avoid the type of financial and business disclosures that public companies provide investors and the SEC. This Note argues that had Theranos attempted to or completed an initial public offering, its many flaws would have been exposed, quickening its demise and protecting the public.

Theranos is a dramatic example of the societal and market risks posed by today’s unicorns. More broadly, Theranos is a useful case study exposing vulnerabilities in modern securities regulations and, perhaps, suggesting necessary reforms. This paper uses Theranos as a vehicle for understanding: first, the current regulatory framework and how private companies raise funds outside the public markets (Part II); second, the scale of unicorns and problems posed by these companies (Part III); and finally, third, whether proposed regulatory reforms would have prevented (or at least detected) the Theranos fraud (Part IV). The solutions offered to regulate the private securities market include increasing disclosure requirements, requiring corporate executives to certify those disclosures, and increasing transparency around private securities transactions.

25 See infra Part III, B.
27 See White Decl. ¶ 6. (White, Theranos’ then-Corporate Counsel, explaining “Theranos has instead raised money through private sales of stock to sophisticated investors through several rounds of venture financing in five different series of preferred stock: Series A Preferred stock; Series B Preferred stock; Series C Preferred stock; Series C-1 Preferred stock; and Series C-2 Preferred stock. Different series of preferred stock have different liquidation preferences. Series C, C-1, and C-2 Preferred are senior in preference to Series A and B Preferred.”).
II. MODERN SECURITIES REGULATION AND THE GROWTH OF THE SECONDARY MARKET

A. The Opportunity and Costs of Going Public

If sunlight is the best disinfectant, then the initial public offering is the market’s sunlight, forcing companies to shed light on their businesses, finances, and risks. Congress designed this disclosure and registration process back in the aftermath of the Stock Market Crash of 1929. Following the crash, Congress publicly investigated Wall Street, most famously the Pecora Commission hearings. The hearings shined a bright light on deception and abuses on Wall Street, including material misrepresentations by companies, unethical (if not illegal then) deception by brokers, and outright false statements about companies’ assets and financial health. Partly in response to the ugly practices uncovered by congressional investigations, Congress passed the Securities Act of 1933 to achieve “truth in securities,” which represented “a narrowly focused but high-powered effort to assure full and fair disclosure on the special occasion of a public offering.”

While today fewer companies are choosing to go public, for the better part of the last century, going public represented a significant (and desirable) step in a company’s evolution. Public financing allows a company to expand, increase its working capital, retire preexisting debt, and give early investors and employees an opportunity to sell their shares on the public market. Going public is also thought to increase a company’s public profile and give it “an air of financial success,” helping the company raise future funds, attract new employees, and gain a stronger market position. The bargain, per federal securities legislation, is that in exchange for access to the public markets, companies must disclose material information necessary for investors to make an informed decision.

28 LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW BANKERS USE IT 92 (1914).
31 HAZEN, supra note 10, at 74-75.
32 Id.
Before a company lists on a public stock exchange, it must survive a burdensome and revealing process of disclosing financial information. The initial public offering process begins when the company hires an investment bank to underwrite the offering. The managing underwriter works with the issuer to navigate the due diligence process, determine the offering price, and recruit additional underwriters to sell the shares to the investing public. The underwriter performs a due diligence function, too. Once the underwriting process begins, the company works with its bank and legal team to navigate the necessary disclosures.

The IPO process is designed to give the public investors enough information to make an informed decision on whether to purchase the offered shares and to understand the risks associated with that decision. The mandatory disclosure system requires the issuer to file a registration statement. The statement must include a prospectus for potential investors with material information about the company. A prospectus responds to the required registration form items while delivering a compelling narrative of the company. This reflects the competing demands of a Registration Statement: to satisfy regulators and the skeptical investor while ginming up interest in the offering. The issuer must describe the company’s business and the securities being registered, explain how it will use the proceeds generated from the sale, disclose pending legal proceedings, detail any material transactions with insiders, and identify principal investors, as well as directors and officers and their compensation. Perhaps most important for investors—and most worrying for issuers—are the required disclosures related to the company’s financial health. The company must file a standard Form S-1 Registration Statement including financial statements, certain other financial data, analysis of the company’s financial condition, and disclosures related to market risk. Furthermore, going public exposes the issuer, its officers, and board of directors to potential civil and criminal

34 Id.
liability for misrepresentations and omissions related to the issued securities.\textsuperscript{39}

In 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 ("SOX") as a response to a wave of corporate accounting scandals.\textsuperscript{40} Whereas the pre-SOX regulatory regime largely left corporate governance to the states and the companies, SOX brought corporate governance under the federal securities regulation umbrella.\textsuperscript{41} SOX sought to improve corporate governance by imposing a number of disclosure requirements, setting criminal penalties for violations of securities laws, increasing oversight on accounting and auditing, and ratcheting up accountability of key corporate actors. For example, one SOX provision requires the public company’s CEO and CFO to each certify the accuracy of financial statements submitted to the SEC.\textsuperscript{42} This certification provides federal regulators and prosecutors with a basis for enforcing securities regulations when executives sign off on statements that fail to disclose fraud or include material misrepresentations.\textsuperscript{43} With the increased requirements under SOX, public companies must make extensive, regular disclosures and stand by those statements under threat of criminal penalty.

Section 404 requires public companies to submit an annual report detailing the procedures and adequacy of internal controls and financial reporting processes.\textsuperscript{44} Section 404 also requires the company's outside auditor to assess the effectiveness of those controls. Section 906 of the law requires chief executive officers and chief financial officers to certify in writing that the report "fully complies" with the applicable provisions in the Exchange Act and, most importantly, that the report "fairly presents, in all material respects, the financial condition and results of operations of


\textsuperscript{40} See Roberta Romano, \textit{The Sarbanes-Oxley Act and the Making of Quack Corporate Governance}, 114 YALE L.J. 1521, 1544 (2005) (criticizing the Sarbanes-Oxley Act and the circumstances surrounding its drafting and passage).


\textsuperscript{43} \textit{Id.} at 380 (discussing enforcement actions based on false certifications).

\textsuperscript{44} \textit{Id.}
the issuer.” Executives who willfully certify a non-compliant report face fines of up to $5 million and up to twenty years in prison.

Before SOX, the process of going public came at a significant cost to the company, in fees to advisors and staff hours spent preparing documents and navigating the process. Once the company lists on a public exchange, the costs continue with regular disclosure and reporting requirements and responding to public investors and analysts. Today, complying with reporting requirements are even greater under SOX. The risks are also significantly greater for companies and corporate executives: a misstatement could expose corporate executives to criminal prosecution. Faced with this daunting process and heightened compliance risks, large private companies increasingly seek to put off the IPO as long as possible, if the company ever registers at all.

**B. The Decline in IPOs and the Rise of Unicorns**

For many of today’s biggest and most promising companies, the public markets offer few rewards that cannot also be obtained through private fundraising. There are many theories for why companies are increasingly eschewing the public stock market in favor of staying private. Whatever the reason(s), since 2000, the number of companies going public in the U.S. has declined.

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46 Id.; see Paul Rose & Steven Davidoff Solomon, Where Have All the IPOs Gone? The Hard Life of the Small IPO, 6 HARV. BUS. L. REV. 83, 88 (2016).
47 Westbrook & Westbrook, supra note 17, at 720-21 (discussing the high costs associated with the average company’s initial public offering, particularly in the twenty-first century).
49 See id. at 718–19 (“Diminishing public companies have been exacerbated by the growing trend for companies to delay their public offering. For example, the average age of U.S. technology companies that went public in 1999 was four years. In 2014, it was eleven years.”).
50 See Xiaohui Gao, Jay R. Ritter & Zhongyan Zhu, Where Have All the IPOs Gone?, 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1690 (2013) (“During 1980-2000, an average of 310 IPOs occurred each year in the United States, but this has fallen to an average of only 99 IPOs per year during 2001-2012. Even more dramatically, an average of 165 small-company (pre-inflation-adjusted annual sales of less than $50 million) IPOs occurred each and this number has dropped by more than 80% to an average of only 28 per year during 2001-2012.”); see also de Fontenay, supra note 17, at 454-58 (summarizing the decline in exchange listings).
In trying to explain the decline in IPOs, some have also pointed specifically to Sarbanes-Oxley as the culprit, arguing that the 2002 law puts too much of an organizational and financial strain on public companies. \(^{51}\) There is evidence that SOX dampened interest in going public and imposed real costs on public companies. But legislative changes alleviated some of the burdens Sarbanes-Oxley placed on companies.\(^{52}\)

Other theories explaining the drop in IPOs include: economies of scope and economies of scale driving corporate acquisitions of smaller companies,\(^{53}\) declining analyst coverage of public companies, market conditions, the perception that public companies are more likely to be sued, the decimalization of stock prices, and changes by the SEC to rules regulating brokerage activity.\(^{54}\) Whatever the cause of declining in IPOs, one thing is certain: companies are staying private longer and raising more capital through the private markets.\(^{55}\)

The uncomfortable consequence of this shift is that more and more investor capital is flowing to private companies that are not subject to the same disclosure requirements as public companies. Companies can operate in “stealth mode,” raising millions of dollars from investors without sharing the type of information that the Securities Act requires.\(^{56}\)

Many scholars have called attention to the growth of the private investment market and suggested possible reforms to address this sea change.\(^{57}\) But rather than regulate this fast-growing market, as discussed

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\(^{51}\) Rose, supra note 47, at 88.

\(^{52}\) Gao, Ritter & Zhu, supra note 51, at 1665 (“Following concerns that the implementation of [Sarbanes-Oxley], especially Section 404, was imposing excessive costs on small public companies, in June 2007 the SEC revised some of the rules, lessening the burdens on small companies.”).

\(^{53}\) Id. at 1690 (theorizing that the decline in IPOs is primarily due to increased “importance of bringing products to market quickly” and because “greater value is created in a sale to a strategic buyer in the same or a related industry.”).

\(^{54}\) See Rose, supra note 37, at 90-95.

\(^{55}\) See, generally, de Fontenay, supra note 17, at 445.

\(^{56}\) See Westbrook & Westbrook, supra note 17, at 696 (“[B]ecause the capital structure of private placements is, by definition, private, such firms are able to avoid complying with the disclosure regime under which public companies operate”).

in the following section, regulators and Congress have focused on loosening existing regulations and expanding exemptions.

C. Legislation Continues to Expand Exemptions

Of the many factors that contributed to the growth in the market for pre-IPO investments, legislation is probably the most impactful. For most of the twentieth century, companies had a significant incentive to go public: early investors, founders, and employees wanted to cash in on their shares of the company. The SEC restricted when and under what conditions start-up company shareholders could transfer their stock. 58

The registration requirement was not without exceptions. Most significantly, the Securities Act allows companies to sell its unregistered securities to “accredited investors” under Rule 506 of Regulation D. 59 The Securities Act defines accredited investors as including: certain financial institutions, such as banks, savings and loan associations, registered broker dealers, insurance companies, retirement plans, and insurance companies; qualifying business development companies and partnerships; the issuer's corporate executives and directors; trusts with total assets of more than $5 million; and individuals who meet specific net worth and income requirements. 60 Regulation D carved out a number of exemptions from registration for qualifying issues and issuers. 61

Over time, the SEC continued to relax restrictions on private placements, adopting Rule 144, which allows investors to sell stock after two years with certain conditions attached. Or, an investor could wait three years and sell the stock without any restrictions. 62 The SEC decided that even that rule was too burdensome and whittled down the rule until it was little more than a minor inconvenience for investors, who may now sell stock under Rule 144 without any restrictions after just one year. This regulatory rollback made it possible for companies like Facebook, Google, Securities Regulation, 84 FORDHAM L. REV. 1011-24 (2015) (discussing Rule 144A trading platforms and the factors that contributed to the growth of the Secondary Market).

58 See Jones, supra note 58, at 174.
60 Generally, an individual qualifies as an accredited investor if she has a personal net worth (or a joint net worth with her spouse) of more than $1 million or earned an individual income of more than $200,000 (or $300,000, if combined with a spouse) in the past two years and expects to earn the same in the current year. 17 C.F.R. § 230.501(5)-(6) (2018).
and the unicorns of today to satisfy the liquidity demands of their employees and shareholders, greatly reducing the need for a public offering.

Yet some unicorns still outgrew even these broadened exemptions; in 2012, Facebook went public to avoid surpassing the maximum record shareholder limit.63 Partly to aid future unicorns following in Facebook’s footsteps, Congress passed the Jumpstart Our Business Startups Act (“the JOBS Act”).64 The 2012 law “widen[ed] the space within which companies could stay outside the Act's regulatory reach and creat[ed] a new category of emerging growth companies that can avoid a number of the Act's regulatory requirements during the first years after an IPO”—and, of course, quadrupled the number of record shareholders allowed so that future companies would, unlike Facebook, not necessarily have to go public.65

D. The Investing Public Meets Private Offerings

Regulatory rollback and the steady expansion of exemptions have helped make it possible for companies to raise mountains of cash through private offerings. As the private market grows, retail investors are increasingly investing (however indirectly) in these private startups, bellying the myth that startups are the exclusive reserve for sophisticated, mostly institutional investors.66 In fact, a recent study suggests that the majority of the buyers and sellers in these transactions are individuals.67

One reason for this development is that technology has made buying and selling shares of private companies easier than ever before. Online

65 Id. at 342; see de Fontenay, supra note 17, at 460.
66 See Jeff Schwartz, Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund’s Investments in unicorns (and Other Startups) and the Regulatory Implications, 95 N.C.L. REV. 1341, 1349.
67 David F. Larcker, Brian Tayan, and Edward Watts, Cashing it in: Private-Company Exchanges and Employee Stock Sales Prior to IPO, STANFORD CLOSER LOOK SERIES (Sep. 12, 2018), (“Individuals make up the largest portion of both the buyer and seller populations in our sample. Individuals comprise 87 percent of the known-seller population, based on total transaction dollar amounts; institutions only 13 percent . . . . Seventy-four percent of known buyers are individuals, based on transaction dollar amounts . . . .”).
exchanges like Second Market (now NASDAQ Private Market) and SharesPost offer investors real-time data, valuation information, and a platform through which investors can buy shares from company insiders. From 2013 through December 17, 2019, NASDAQ Private Market “facilitated secondary liquidity for over 33,000 shareholders, returning over $23 [billion] of value back to founders, employees and institutional investors.” That amount does not include the shares sold on other exchanges or outside any exchange through private transactions.

Remarkably, any individual with a few thousand dollars can invest in private startups using an investment fund. In 2014, for example, SharesPost launched its SharesPost 100 Fund that provides unaccredited individuals with a way to invest in pre-IPO companies. For just $2500, an individual can purchase Class A Shares of the SharesPost 100 Fund, a continuously offered closed-end fund that “seeks capital appreciation by focusing on investments in late-stage, venture-backed private companies.”

Individuals also invest indirectly in startups through common investment vehicles like mutual funds and retirement funds, which have increasingly invested in private companies. But it is unclear whether mutual fund investors appreciate the significant risks associated with startup investments—or whether they are even aware that the fund invests in emerging companies. Some mutual funds have already had to make significant write downs on their startup investments. This is troubling

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70 Schwartz, supra note 67, at 1349 (“It is only recently that mutual funds have shown interest in putting their enormous resources behind emerging firms. Funds from the largest families, including Vanguard, Fidelity, and Blackrock, have lately begun steering investor assets toward unicorns. Allocations have risen sharply over the last few years and now total over $ 10 billion spread across over 250 funds, with Fidelity's funds leading the way. And while nascent statistics focus on unicorn investments, other startups might be on fund ledgers as well.”).
71 Id. at 1354–55 (discussing the problem of mutual funds failing to inform unsuspecting investors that the fund invests in startups).
72 Heather Somerville and Tim McLaughlin, Fidelity marks down stake in pre-IPO startups Cloudera, Dropbox, REUTERS (Mar. 30, 2016),
because some of the largest mutual fund companies, like T. Rowe Price, Fidelity, and Blackrock, are pooling these startup investments into popular mutual funds that make up many Americans’ 401(k)’s and individual retirement accounts. 73

But the SEC, far from concerned, believes retail investors should have more access to private offerings. In a speech to the Economic Club of New York, SEC Chairman Jay Clayton told the audience that the SEC was exploring “whether appropriately structured funds can facilitate Main Street investor access to private investments . . . .”74 In Chairman Clayton’s view, the SEC “should . . . . increase the type and quality of opportunities for our Main Street investors in our private markets.”75

The incredible collapse of Theranos shows how loosely regulated private companies pose a serious threat to investors and the public generally. As press reports and investor lawsuits have shown, Theranos’ harm extended to myriad diverse stakeholders including: patients that used Theranos’ blood tests; institutional investors, such as hedge funds, a mutual fund company, and a sovereign wealth fund; Theranos’ employees; and corporate partners, such as Walgreens and Safeway, and those companies’ shareholders. The widespread harm suggests that the SEC should more tightly regulate private companies and reconsider its efforts to encourage retail investment in private offerings.76

III. THERANOS’ ASCENT AND THE PUBLIC HARM

A. A Silicon Valley Star is Born

In 2004, Elizabeth Holmes dropped out of Stanford University’s School of Engineering to start a company she believed would revolutionize blood testing. Holmes, who lacked significant medical or scientific experience, wanted to perform a battery of more than 200 tests using only a few drops of blood—far less blood than the industry standard

73 David Gelles and Conor Dougherty, Americans’ Retirement Funds Increasingly Contain Tech Start-Up Stocks, N.Y. TIMES (Mar. 22, 2015)
74 Jay Clayton, Chairman, SEC, Remarks to the Economic Club of New York (Sept. 9, 2019).
75 Id.
blood testing equipment used. She ignored warnings from experts like Stanford medical professor Phyllis Gardner, who advised the young entrepreneur that her blood testing idea was not medically possible, and her own engineers who laid out the technical obstacles.\textsuperscript{77} Undeterred, Holmes developed a blood testing device, Edison, that she claimed performed more than 240 faster than competing devices and with less blood.\textsuperscript{78} But, in 2014, several years after Theranos launch, Edison only performed 15 tests and even those few tests were often inaccurate.\textsuperscript{79} Under pressure to deliver the “breakthrough technology” that she had promised, Holmes tried to mask its failures by having Theranos perform tests on its competitors’ traditional machines and hiding inaccurate test results.\textsuperscript{80}

In many ways, Theranos epitomized the typical Silicon Valley start-up. Nowhere is that more clear than with Holmes, a brash young founder of the Steve Jobs-archetype, hocking a (largely unproven) vision for revolutionizing not just an entire industry, but the whole world. As the company’s public profile grew, however, Holmes’ lofty idea of offering faster, less intrusive, and more comprehensive blood testing failed to materialize. The company faced myriad problems, including infighting among managers, a hostile workplace, product delays, regulatory issues, and seemingly insurmountable technological challenges.\textsuperscript{81} As a private company, Theranos managed to keep much of its troubles from the public, even as Theranos began offering its unreliable blood-testing to unsuspecting customers.

\textbf{B. Private Investors Pour Money into the Company}

Theranos’ struggles to deliver on its lofty promises did not dampen investors’ excitement about the company’s technology.\textsuperscript{82} Starting around 2010, when Theranos filed a notice that it sold $45 million shares,\textsuperscript{83} the

\textsuperscript{77} \textit{John Carreyrou}, \textit{Bad Blood: Secrets and Lies in a Silicon Valley Startup} 218-19 (2018).
\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{83} Form Regulation D filed by Theranos, Inc., \textit{SECURITIES AND EXCHANGE COMMISSION}, (July 8, 2010) available at
fledgling company shaped a myth about its product and the technological advances it represented. In the ensuing years, Theranos managed to fool investors, customers, its board, regulators, and much of the press, taking the usual Silicon Valley attitude of “fake it till you make it” to unprecedented heights of deception.

Theranos did not inform its investors about the company’s poor financial health and early investors continued to pour more money into the company at ever-higher valuations. Critically, as a private company, Theranos did not need to make regular disclosures to the SEC, and the company’s financials were not subject to the type of scrutiny public companies endure. The company provided investors with some evidence of the company’s success by way of marketing materials, investor presentations, product demos, and meetings with executives; the company also disclosed some information through its Form D filings. But, for the most part, as a private company Theranos was not required to share much information with investors, even as the company took in hundreds of millions of dollars. When Theranos did share information with investors, Holmes and the company’s president and COO, Sunny Balwani, created financial projections that were extremely optimistic and had no basis in reality.

Notably, Theranos achieved its remarkable $9 billion valuation through a fundraising round in which the company offered investors financial projections that were “five- to twelvefold” higher than its internal projections. Most public companies of Theranos’ size have a chief financial officer (CFO), or similar executive, who oversees the company’s finances and can provide investors with a picture of the company’s financial health. But Theranos fired its CFO in 2006 and never hired a real

https://www.sec.gov/Archives/edgar/data/1313697/000131369710000004/xslFormDX01/primary_doc.xml.


85 Theranos was uniquely credible in its argument that it could provide only limited information to investors and the inquiring public. Theranos jealously guarded its proprietary technology, which seemed reasonable given that the company was seeking to revolutionize a highly competitive biotechnology industry.

86 On February 4, 2014, a hedge fund purchased $96 million worth of Theranos stock at $17 a share, setting the company’s valuation at $9 billion. Balwani induced the hedge fund executives to buy the stock by sending a spreadsheet with financial projections that were multiples of Theranos’ own internal projections. See, Carreyrou, supra note 78, at 182 (2018).

87 Id. at 182-83.
replacement. Danise Yam, a “corporate controller” at Theranos, was the closest approximation to the critical CFO role, but she had little responsibility for the company’s finances and her financial projections were overly inflated. Balwani surpassed even those rosy projections, creating revenue and profit projections “from whole cloth.”88 Balwani persuaded a hedge fund, Partner Fund Management, to invest $96 million by fabricating financial data and grossly misrepresenting the capabilities of Theranos’ blood testing technology.89 Partner Fund’s investment valued the company at $9 billion.90

This deception probably would not have been possible if Theranos was a public company. If Theranos filed for an initial public offering, the company would engage an investment bank that would, in turn, conduct an extensive due diligence process. The bank would pour over financial data and scrutinize Balwani’s fabricated numbers. Legal counsel and auditing firms would similarly examine the company's books and make sure that Theranos provided investors with a realistic picture of the company's financial health and risks.

Theranos’ registration statement would include a prospectus that provides potential investors with all material information about the company. Theranos would need to disclose pending legal proceedings, of which there were many given Theranos' proclivity for legal action against reporters, rivals, and its own employees. The registration statement would include an S-1 filing, complete with the company's financial data and disclosures of material risk. It is unlikely that auditors and banks would accept Yam and Balwani’s inflated figures. Further, it is unclear whether those executives would have made those misrepresentations if they had to certify the accuracy of the financial statements under threat of criminal prosecution, like public company executives must do under SOX.

C. Others Fail to Recognize Theranos’ Fraud

The technology industry, the press, and regulators also largely accepted Holmes’ story at face value. Theranos’ largely compliant board—made up of highly accomplished business, military, and government leaders—rarely questioned Holmes.91 Government regulators, for the most part, failed to uncover the extensive compliance problems in Theranos’ laboratories—despite numerous inspections of the facilities.

88 CARREYROU, supra note 78, at 182.
89 Id. at 179-183.
90 Id. at 183.
91 For a close examination of corporate governance and board failures at unicorns, See Jones, supra note 58, at 165.
Although some reporters raised questions about the company, several media outlets published fawning coverage regurgitating Holmes’ claims about what the company had accomplished. Starting in 2015, reporters started seriously investigating the company’s technology and whether the supposedly revolutionary blood tests could deliver on the myriad promises made by CEO Elizabeth Holmes.

While many of Holmes’ claims regarding the technology can be chalked up to the boundless (and often baseless) optimism that infects many of Silicon Valley’s entrepreneurs, Holmes blatantly deceived her audience at critical moments in the company’s rise. For example, when a blood-testing machine malfunctioned during a demonstration for European drug maker Novartis, Holmes simply faked the test. Holmes and her team completed a live, unsuccessful test in Europe but Theranos’ team in California sent a fabricated result to Novartis as evidence of the technology’s capability.

Holmes also employed deception to dupe investors and business partners. While the company claimed its blood analyzers were capable of running more than 200 tests using just few drops of blood, in fact, the readers often malfunctioned and Theranos routinely ran tests using traditional machines made by competitors like Siemens. Balwani then inflated the company’s financial projections to convince investors to give more money at higher valuations. And so it went for years. The company’s executives would use ineffective technology on patients, misrepresent its capabilities to win over business partners, and use those business deals (or sometimes wholly invented deals) to lure unsuspecting investors.

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92 See generally CARREYROU, supra note 78 (Wall Street Journal reporter John Carreyrou’s account of efforts to investigate Theranos).
93 It is instructive that Theranos generated little press interest until it was required to disclose a fundraising transaction in 2010. On July 8th, 2010, an online publication, Xconomy, published a short article about Theranos’ $45 million raise. There appears to be scant coverage of the startup until this point. See Luke Timmerman, Theranos Raises $45M for Personalized Medicine, XCONOMY (July 8, 2010), https://xconomy.com/san-francisco/2010/07/08/theranos-raises-45m-for-personalized-medicine/.
94 Carreyrou, supra note 78.
95 CARREYROU, supra note 78, at 3-7.
96 Id. at 169.
97 On February 4, 2014, a hedge fund purchased $96 million worth of Theranos stock at $17 a share, setting the company’s valuation at $9 billion. Balwani induced the hedge fund executives to buy the stock by sending a spreadsheet with financial projections that were multiples of Theranos’ own internal projections. See, CARREYROU, supra note 78, at 182.
The company continued to perpetrate its fraud until 2018 when the SEC formally charged Holmes and Balwani with securities fraud. The company and its executives are now engulfed in lawsuits by regulators, the Department of Justice, investors, blood-testing patients, business partners, and even documentary filmmakers. In 2018, Theranos announced it would dissolve.

D. Theranos’ Victims

Before examining the regulatory solutions that may have prevented Theranos’ fraud, it is important to first consider the harm Theranos caused to corporate partners, the public, and investors.

1. More Than Just a Few Sophisticated Investors

A class action lawsuit filed in California reveals the unspoken truth in private company fundraising: there are more investors than just those listed on the capitalization table. In *Colman v. Theranos*, the investors who sued Theranos for fraud, misrepresentation, and market manipulation were not direct investors in the company. The class members were so-called “indirect investors,” or “investors who purchased interests in entities that bought Theranos stock.”

Although the district court ultimately denied the plaintiff's motion for class certification, the ruling and the documents offered in support of the action reveal the extensive trading in Theranos shares by direct investors and indirect investors. The named plaintiff Robert Colman provides an example of these transactions occurring in the private securities market. “[F]rom January 2013 to October 2016, Theranos sold Series C–1 and C–

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100 Letter from David Taylor, CEO and General Counsel, Theranos, to Theranos stockholders (Sept. 4, 2018); see also, Daniel Kass, *The Bloody Saga That Made Theranos Finally Call It Quits*, LAW360.
102 Id.
103 Id. at 634.
Preferred Stock to over 30 individuals and investment entities.\textsuperscript{104} Lucas Venture Group XI, LLC was among that group, purchasing nearly half a million Series C-1 shares for a little more than $7 million.\textsuperscript{105} The Lucas fund was able to purchase these shares because it had its own investors like Colman, who purchased interests in the fund.\textsuperscript{106} Colman, for example, spent $500,000 to buy interests in the Lucas fund with the "express purpose of making corresponding purchases of Theranos securities."\textsuperscript{107} Colman was not alone; plaintiffs produced a list of more than 200 individuals who indirectly invested in at least twelve investment funds with the purpose of financing purchases of Theranos shares.\textsuperscript{108} These individuals’ investments ranged in size from $15,000 to more than $17 million.\textsuperscript{109}

This lawsuit reveals private companies like Theranos are increasingly financed by a variety of different investor types, not just venture capital firms or institutional investors.\textsuperscript{110} As a result, the private-public securities regulation framework appears outdated in the face of such a complicated and expansive private fundraising universe, where hundreds of individuals can indirectly invest in an unregulated private company through investment funds and even trade those shares on a liquid secondary exchange.

2. Corporate Partners Invest Millions

The Theranos fraud harmed more than its investors; Theranos formed numerous partnerships with corporations—most notably Walgreens Boots Alliance and Safeway Inc.—whose businesses suffered when the partnerships failed to produce the expected gains. Like Theranos’ investors and customers, these business partners fell for the company’s lofty promises of revolutionary technology and seemingly infinite potential. When Theranos failed to deliver, however, these companies (and their shareholders) suffered and in the case of Walgreens, customers’ health were put at risk.

Safeway, the grocery chain, spent at least four years and an incredible $350 million building clinics so that it could offer Theranos’ blood tests to

\textsuperscript{104} Id. at 635.
\textsuperscript{105} Id.
\textsuperscript{106} Id.
\textsuperscript{107} Id. at 637.
\textsuperscript{108} Id. at 639; see Kathrein Decl. Exs. CC–HH (ECF 177–7)
\textsuperscript{109} Colman, 325 F.R.D. at 640.
\textsuperscript{110} See generally Schwartz, supra note 33.
customers inside its grocery stores.\textsuperscript{111} Similarly, Walgreens formed a 2010 partnership with Theranos that eventually led to the drugstore chain offering Theranos blood testing in as many as forty stores. In a subsequent lawsuit, Walgreens sued Theranos for $140 million, which represented its investment in the Theranos partnership. That figure also reportedly included a convertible-debt note and investment in the company.\textsuperscript{112}

Walgreens and Safeway staked their respective brands on the promising technology Theranos pitched. Safeway even completed a massive redesign of its stores to feature Theranos.\textsuperscript{113} But the blood tests proved unreliable, customers complained of surprising test results, and doctors began expressing their concerns about the accuracy of Theranos’ testing. Ultimately, both partnerships failed, costing Walgreens and Safeway millions of dollars and potentially causing physical harm to Walgreens’ customers.

3. Patients and the Unsuspecting Public

Importantly, Theranos’ partnership with Walgreens extended beyond a financial investment. Like many Silicon Valley companies, the technology was a work in progress and the company’s executives exaggerated the products’ potential. But, unlike other Silicon Valley companies, Theranos operated in the highly regulated biotechnology industry and tested its faulty products on unsuspecting patients. Theranos offered its blood tests to patients in multiple states, particularly Arizona—the primary test market for the Walgreens-Theranos joint venture—and even in Mexico. According to the Walgreens suit, in 2012, Theranos and Walgreens formed a joint venture and Walgreens invested $140 million into the startup.\textsuperscript{114} Under the partnership, Walgreens would offer Theranos' blood tests at “Wellness Center” clinics in Arizona and California.\textsuperscript{115} The plaintiffs in Walgreens suggest that Theranos, through

\textsuperscript{113} CARREYROU, supra note 78, at 117-18.
\textsuperscript{114} *Walgreens In re Arizona Theranos, Inc.*, Litigation, 256 F.Supp.3d 1009, 1020 (2017).
\textsuperscript{115} Id.
its partnership with Walgreens, tested thousands of patients, who were essentially subjected to “beta testing” of an incomplete and unreliable blood testing device.\footnote{Id. at 1021.} Indeed, Theranos was not adhering to industry standards and its tests often produced results that were inconsistent with traditional (and more reliable) blood testing.\footnote{Journalist John Carreyrou recounts his experience personally testing Theranos’ device with a doctor against a traditional LabCorp blood test. The results were significantly different and, as with many Theranos patients, suggested alarming health problems from high blood pressure to Addison’s disease. \textit{See}, CARREYROU, supra note 52, at 232-236.} Many patients received alarming results from faulty Theranos blood tests.\footnote{See Christopher Weaver, \textit{Agony, Alarm and Anger for People Hurt by Theranos’s Botched Blood Tests}, WALL ST. J. (Oct. 20, 2016 9:52 PM), \url{https://www.wsj.com/articles/the-patients-hurt-by-theranos-1476973026} (describing how patients received erroneous test results and adjusted critical medication as a result).}

It is tempting to consider Theranos as an outlier among startups because most unicorns operate in industries that seem to pose a lower risk of physical harm to the public, such as e-commerce and internet software.\footnote{“The largest share of the unicorn companies are internet software & services companies (15%), followed by e-commerce (14%) and fintech (12%).” CB INSIGHTS, \url{https://www.cbinsights.com/research/unicorn-startup-market-map/}.} But the reality is that many of the more than 400 unicorns interact with the public in ways similar to Theranos and, in at least a few cases, with the potential for great public harm.\footnote{CB INSIGHTS: THE GLOBAL UNICORN CLUB (Jan. 2019), \url{https://www.cbinsights.com/research/unicorn-companies}.}

23andMe is a biotechnology startup that offers direct-to-consumer genetic testing. Uber and Lyft employ millions of drivers, transport millions more riders, and both companies have experimented with self-driving cars. Airbnb arranges for homeowners across the world to rent their residences to strangers.\footnote{The 2020 COVID-19 pandemic provided a stark example of the scope of Airbnb’s business and the risks to investors and the public. \textit{See}, e.g., Tripp Mickle and Preetika Rana, \textit{A Bargain With the Devil’ - Bill Comes Due for Overextended Airbnb Hosts}, WALL ST. J. (Apr. 28, 2020 10:15 AM), \url{https://www.wsj.com/articles/a-bargain-with-the-devil-bill-comes-due-for-overextended-airbnb-hosts-11588083336} (reporting how entrepreneurs who built Airbnb-rental “empires” have seen their rentals decline and “their plight has ripple effects that go far beyond their own listings” to cleaning services, interior decorators, and other dependent businesses).}

At its peak, WeWork employed 12,500 workers\footnote{Samantha Sharf, \textit{WeWork Unraveling Continues With New Layoff Round}, FORBES (Apr. 30, 2020 7:02 PM),} and managed a $50
billion portfolio of office leases. Its largest investor, SoftBank, has invested more than $12 billion into the company, providing an object lesson in the risks of investing in young high-risk companies. These are just a few of the more than 400 unicorns and many more private companies with sub-$1 billion valuations offer the public services with little oversight or disclosures.

IV. THE NEED TO REGULATE PRIVATE COMPANIES

A. An Anomaly or a Sign of What is to Come?

Theranos is, in some ways, an anomaly. A number of factors exacerbated the fraud: a compelling narrative largely accepted by the media; an extraordinary board of directors who inspired investor and public confidence in the company but lacked the skepticism or relevant experience to fulfill its oversight duties; seemingly insatiable investor appetite for high-growth technology companies; a charismatic leader who enjoyed little resistance from inside or outside the company; a lax medical regulatory regime that was repeatedly fooled by Theranos’ smoke and mirrors; and a total lack of scrutiny by securities regulators. While some of these factors may emerge again in another private company, it seems unlikely that a similar set of circumstances will occur with such regularity as to require a broad reform to the private capital markets.

But several important factors support changing the current regulatory regime: (1) the private investment market continues to grow; (2) private companies have, in turn, grown in size, scope, and valuation; (3) there is ample evidence that even sophisticated and/or institutional investors are vulnerable to fraud; (4) as Theranos showed, unpoliced private companies pose serious risks to the broader investing public—not just accredited investors.


investors and institutions; (5) reforms to protect investors are feasible and not unduly burdensome on companies.

B. Possible Regulatory Reforms

1. Require Unicorns to Disclose Certain Financial Information

Theranos was able to pull off an elaborate fraud with remarkable ease. As a private company, Theranos needed only to persuade enough wealthy investors to take the company at its word. Unlike public companies, Theranos’ did not certify its financial projections; unrestrained, its executives grossly inflated the company’s numbers. Drawn in by lofty numbers and unsubstantiated promises, investors poured millions of dollars into Theranos, valuing the company at $9 billion. Troublingly, Theranos raised the funds without making any substantial financial disclosures to the SEC.

Theranos is not alone in this respect; unicorns routinely raise millions of dollars in funding rounds without offering investors the type of exhaustive disclosures that public companies must regularly submit to the public.\(^{125}\) Many companies justify this reluctance to share information with investors as protecting trade secrets, proprietary technology, or competitive advantages. But the truth is that companies have little financial incentive to share information unless a securities law mandates disclosure.\(^{126}\) This has led some to propose revising the securities law framework to require greater disclosure of at least some private companies.\(^{127}\)

One such proposal by University of Washington School of Law Professor Jennifer S. Fan would require unicorns to share their restated certificate of incorporation publicly and make the company’s up-to-date financial information available to all stockholders and employees, rather than just major investors.\(^{128}\) Under this “hybrid disclosure” system, a unicorn would have to disclose this otherwise private information to key stakeholders within ninety days of closing a financing valuing the

\(^{125}\) See Fan, supra note 77, at 587-88 (discussing the ubiquity of unicorns and the ease by which private companies secure millions of dollars in financing); de Fontenay, supra note 17, at 448 (“Today, private companies can raise ample, cheap capital with relative ease.”).

\(^{126}\) See id. at 477-78 (discussing private companies’ reluctance to participate in the public markets mandatory disclosure system).

\(^{127}\) See Fan, supra note 77, at 598-611;

\(^{128}\) Id. at 609.
company at $1 billion or more (the unicorn threshold). Setting the threshold at $1 billion valuation may be somewhat arbitrary, but setting the threshold too low risks overburdening startups and smaller companies that could not afford to comply with even a modest disclosure system. Some larger private companies already provide audited financials to their investors, suggesting that established businesses are capable and even willing to participate in a system like this.

The hybrid disclosure system is incomplete unless there is a third-party auditing requirement. Otherwise, Theranos—and other similarly inclined unicorns—could evade detection by exaggerating or misrepresenting its disclosed financials. Indeed, Sarbanes-Oxley was passed partly as a reaction to the accounting scandals and securities fraud of the 1990s and early 2000s (namely, Enron and Worldcom), which showed that corporate executives were willing and able to exaggerate, manipulate, and blatantly lie to deceive investors. Similarly, Theranos executives consistently showed a willingness to lie to investors, the media, and the public about the company’s financial health and its technology. Any disclosure system aimed at preventing fraud and protecting investors must have a mechanism whereby a disinterested third party verifies the company’s financial statements and disclosures.

A mandatory unicorn disclosure system like the one Professor Fan proposes would undoubtedly receive pushback from unicorns but improved financial transparency would benefit all investors in the long run and alleviate some of the problems unicorns face.

2. Certification of Financials and Operations

129 Id.
130 de Fontenay, supra note 17, at 480–81 (“Larger private companies often choose to be audited regularly and disclose their financial statements to at least some subset of their investors.”).
132 Indeed, America’s regulatory system is premised on the notion that, generally, more transparency benefits the investor.
133 Professor Fan notes that, without changes, some unicorns may die off, “as evidenced [in 2015] by mutual fund markdowns, fewer unicorn births, and a substantial decrease in mega-round financings.” Fan, supra note 77, at 640-641.
The hybrid disclosure system should also require executives to review and certify the financial information provided to investors, similar to the Sarbanes-Oxley Act’s certification requirement. Under SOX, corporate executives must review and certify the company’s annual and quarterly reports. Executives at private companies, however, operate without this liability and therefore feel little pressure to investigate or question the validity of financial statements and projections. At Theranos, for example, Holmes and Balwani misled investors with inflated revenue projections and fictitious sales agreements with pharmaceutical companies. Balwani provided investors with wholly fabricated financial projections that had no basis in reality—and therefore could have easily been exposed by a third-party audit. Requiring executives at unicorns to review and certify financial projections rightly places the burden of verifying the numbers on the company.

In the event that a company like Theranos defrauds investors, the certification requirement provides strong proof that the executive-signatories were aware of the company’s financial health, making it easier to hold these executives liable for any misrepresentations. Thus, this certification requirement would expose executives to civil and even criminal liability if they knowingly certified figures they knew to be false. In the case of Theranos, for example, Balwani may not have chosen to reject the corporate controller’s lower figures if he knew that he, as well as other Theranos executives, would have to personally acknowledge that the figures contained no omissions or misrepresentations.

On its own, a SOX-like certification requirement would not sufficiently address the problem, but it would be a powerful reminder to the corporate executive that she is exposing herself to civil and criminal liability if she knowingly misrepresents the company’s financial health. Further, the certification will aid law enforcement seeking to hold those executives accountable once the fraud is exposed. Finally, certification will give private litigants strong evidence against companies and executives.

3. Disclosing Transactions in the Private Securities Market

The SEC could impose mandatory disclosures for all private securities transactions. While this may seem radical, the SEC adopted a rule proposed by the Financial Industry Regulatory Authority (FINRA) in 2013.

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134 See Carreyrou, supra note 52, at 7-8, 49-50, 182-83.
135 See, Bartos, supra note 6, at 158.
that required dissemination of certain Rule 144A transactions.\textsuperscript{136} The purpose of this rule was to improve price transparency in these transactions, which, in turn, would “enhance pre-trade price discovery, foster more competitive pricing, reduce costs to investors and assist market participants in determining the quality of their executions.”\textsuperscript{137} The SEC and FINRA also predicted that the dissemination would “improve the quality of the valuation of securities and derivative positions for publicly issued securities of the Securities Act Rule 144A issuer and for similar securities.”\textsuperscript{138} A similar rule change with respect to applicable Rule 144A equity transactions and Regulation D exempt transactions could dramatically increase transparency in the secondary market. Such a move would not only increase market efficiency, but it would have the added benefit of arming investors with up-to-date information on pre-IPO companies.

V. Conclusion

Financial regulatory reforms are rarely popular. History has shown, high-profile financial scandals often act as a catalyst for legislative interest, regulatory attention, and, occasionally, substantial regulatory reforms. The Great Depression and the notorious Wall Street “bucket shops” led to the Pecora hearings and the passage of the Securities Act and the Exchange Act.\textsuperscript{139} The Savings and Loan Crisis of the 1980s, a systemic banking crisis involving more than a thousand thrift banks, led to the Financial Institutions Reform, Recovery and Enforcement Act of 1989.\textsuperscript{140} The corporate finance scandals and bankruptcies of the early 2000s, most notably Enron Corporation and WorldCom, shined a light on corporate greed and galvanized legislative support for Sarbanes-Oxley.\textsuperscript{141} The Great Recession and the sub-prime-loan-fueled housing collapse ushered in substantial financial reforms (namely, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) of 2010). The financial wrongdoing also led to widespread protests and public hearings, such as the Senate Permanent Subcommittee on Investigations, where Senator Carl Levin memorably excoriated Goldman Sachs witnesses for profiting

\textsuperscript{136} 2013 SEC LEXIS 2088, *1-2.
\textsuperscript{137} \textit{Id.} at *12.
\textsuperscript{138} \textit{Id.}
\textsuperscript{139} \textit{Id.} at 18.
\textsuperscript{141} \textit{See} Kathleen F. Brickey, \textit{Andersen's Fall from Grace}, 81 WASH. U. L.Q. 917, 958-59 (2003).
during the financial crisis while the bank’s clients lost money. But still, regulatory reform is never easy; even the reforms passed after the 1929 crash and the housing collapse of 2007 faced substantial pushback.

Theranos may prove to be a watershed moment for securities regulation, but, now more than three years after the company unraveled, there is little reason to expect the type of legislative response that followed the historical financial scandals. More likely, Theranos will be the canary in the coal mine, warning investors, regulators, and the public of the dangers of ever-growing unregulated private companies. The type of reforms discussed in this Note, such as requiring unicorns to disclose material information to regulators and the public, would represent important steps toward transparency and could prevent future frauds from ascending to the heights that Theranos reached. The seismic shift in the capital markets away from publicly listed companies and toward private ownership demands regulatory solution to promote market stability and protect investors.

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143 See George W. Madison, Financial Regulatory Reform: Key Changes That Reduced Systemic Risk, BANKING & FIN. SERVICES POL’Y REP., January 2015, at 17, 18 (comparing criticism of the regulatory reforms in the 1930s with criticism of Dodd-Frank legislation).