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Venture Capital

Regulating Unicorns: Governance For Silicon Valley and Beyond

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On March 31, 2016, U.S. Securities and Exchange Commission Chair Mary Jo White travelled to Palo Alto to deliver the keynote address at a program co-hosted by the SEC and the Stanford University Rock Center for Corporate Governance.[1] Her remarks, and the remarks of other SEC officials with her in Stanford at the time, were seen as a warning that the SEC had begun investigating so-called unicorns (privately held companies with a valuation in excess of $1 billion) and the loftier ends of the venture capital market.[2] This was confirmed a few weeks later when Theranos, the now beleaguered blood testing company, disclosed that it was the subject of investigations by both the SEC and the Department of Justice.

Chair White's speech was not limited to jousting with unicorns, however. She also indicated that the SEC was reviewing capital formation outside of the IPO registration process at all levels, with view to assuring that it takes place in a transparent, safe and efficient way, whether pursuant to Regulation D, the new crowdfunding rules or Regulation A. In addition, Chair White noted the need for effective regulation of secondary markets for private company shares, as well as regulation addressing new "fintech" products, including applications of blockchain technology (like bitcoin), automated asset managers, or roboadvisers, and online marketplace lenders such as LendingClub Corporation. But the main thrust of her remarks was that private companies, particularly larger ones or ones that aspire to become public in the future, need to concern themselves with transparent disclosure, financial controls and overall good corporate governance.

This message is important because of a conjunction of factors, namely:

- Fewer companies have gone public in the last 10 or 15 years than in previous times;[3]
- Companies tend to be larger when they enter public markets, with more of their growth trajectory taking place while they are privately held;
- It is easier to stay private because of rules expanding the number of shareholders that a private company may have without registering under §12(g) under the Securities Exchange Act of 1934, as amended, as well as rules facilitating capital raising without registration under the Securities Act of 1933, as amended;
- Private companies, particularly in the tech industry, tend to use stock as compensation, resulting in more ownership of private company stock by individuals who may wish to liquidate their investment in secondary markets; and
- Private company valuations have been high, and large amounts have been invested in private companies, leading to speculation that the tech bubble will burst.

As a result of these factors, a fair amount of capital is tied up in essentially illiquid markets without a lot of disclosure. To this is added the various risks associated with early-stage companies, technology and innovation, including that a new product will fail or require

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substantial modifications, that a product or service will not achieve market acceptance, that a company will need to make abrupt changes in strategy, that management will lack the necessary experience or that the company will face other problems that cannot easily be predicted.

Traditional venture capital investors have been assumed to understand and manage these risks, perform their own due diligence and generally be able to fend for themselves. Venture capital firms traditionally mitigate risk by spreading their investments out over a number of different companies, some of which are expected to fail, or at least not achieve a positive return. Traditional venture capital investors might actively manage their investments by serving on company boards or providing advice on an ad hoc basis, and might impose governance controls on a company through stockholder agreements and similar contractual mechanisms. Managers of the companies receiving such investment might also be incentivized to ensure that the companies adhered to good governance practices, were responsive to investors and had appropriate financial controls, scaled to the companies' level of development.

There are a couple of reasons why this admittedly idealized scenario may not be working as it should, or may not work for all of the companies drawn into the tech and startup company ecosystem.

First, with very high valuations, the rationale that risk is spread out among various investments may not work, and does not eliminate the potential market impact of a colossal business failure like Theranos. This is one reason why it might make sense for the SEC to investigate whether there was securities fraud at the unicorn level, even if all the investors were ultra-sophisticated and ultra-wealthy. High valuations (and the pressure to achieve them) may also provide incentives for risk-taking activity on the part of companies, and may lull investors into a complacent belief that values will always go up.

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Second, not all investors in the tech ecosystem are sophisticated venture capitalists. Some are individual angel investors; some are members of management or other service providers who received their shares as compensation, possibly in lieu of cash; and some may be the founders' friends and family. These investors may need disclosure and may not understand the risks of investing in startup companies.

Finally, many tech and startup companies do not have, and may never have, institutional venture capital investment, and their investors may never have the ability to do effective due diligence or impose effective governance controls on the company. Yet these companies may still attract significant numbers of investors and significant investment dollars. With the SEC's new Regulation Crowdfunding adopted under the Securities Act and the Securities Exchange Act, as well as rules permitting general solicitation and general advertising under Rule 506(c) under the Securities Act, there may be a growing number of companies with small investments made by retail investors with little connection to the company or any ability to influence the governance of the company.

For these reasons, it is important to think through expectations concerning transparent disclosure, financial accountability and corporate governance for private companies that receive significant investment.

The relationship of all companies with their investors is governed by Rule 10b-5 under the Securities Exchange Act, which is a general prohibition against fraud in the sale of securities, and the corporation law (or other entity law) of the jurisdiction in which the company was formed. Essentially, private companies must avoid committing securities fraud and should adhere to the governance practices required under the state corporation law and their certificate of incorporation and bylaws. In addition, the company may have obligations to

investors set forth in agreements such as stockholder agreements. Tax laws and the ability to make use of certain tax benefits may also drive corporate governance decisions. Other principles that affect corporate governance of private companies are derived from the basic financial controls necessary to have financial statements prepared in accordance with generally accepted accounting principles or to ensure compliance with law. The actual practices that are required will vary with the circumstances, including the scale and complexity of the company's operations and the type of business that it conducts.

Chair White's speech suggested that when the company reaches the size of a unicorn, it is appropriate to look to public company models for basic principles of behavior, even if the specific provisions of public company rules do not apply. For such companies, one would expect transparent disclosures to investors relating to risk, vigorous internal controls and a board of directors that was engaged and able to act as a counterweight to the interests of management or a dominant shareholder. For example, although we do not know the details, one might have expected the board of Theranos to have questioned management concerning the reliability of its testing mechanisms at some point before Theranos began expansion.

Chair White also suggested that if a company is to be a good candidate for an IPO, it should begin adopting internal controls and governance practices similar to those it would need as a public company, at least a year or so before it files a registration statement with the SEC. This helps to provide assurance that when the company registers its securities, its historical financial statements and trend lines are reliable and that internal controls and governance policies are in place. It provides the company with a "dry run," to work out the kinks in its governance systems before it is required to rely on them as a public company. This does not mean, however, that every aspiring "pre-IPO company" must essentially behave as a public company does with respect to internal controls and corporate governance, but simply that when the company does go public, it should be ready, and its historical financial reporting should be sound.

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One complaint about Chair White's remarks was lodged by Mark Cuban, who said, in effect, that because there are "no rules," it is unfair to impose standards developed for public companies in the private market.[4] To some extent, he has a point: The lack of clear standards may make it harder to provide guidance to management and the board of large and complex private companies. But governance and disclosure issues are inherently difficult on questions of any importance, and just because some degree of judgment is required, does not mean that there are no rules.

The recent focus of the SEC on Silicon Valley and the high valuations among technology startups is a good reminder of basic principles under Rule 10b-5 and state corporation law duties of companies and their boards of directors. These principles of course apply to public and private companies of all sizes. For private companies of significant size and complexity, even as startups, these basic principles require transparent disclosure of risk and strong corporate governance.

1. Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative, March 31, 2016, available at https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html.

2. Ross Todd, "SEC Casts Its (Unwelcome) Eye on Valley Economy," The Recorder (April 1, 2016).

3. There are numerous discussions and analyses of the decline in the number of public companies and IPOs since the late 1990s. See, for example, Barry Ritholz, "Where Have All the Public Companies Gone?" Bloomberg.com (June 24, 2015).

4. Biz Carlson, "Mark Cuban blasts the SEC for going after Silicon Valley's billion-dollar 'unicorn' start-ups," Business Insider (April 1, 2016).

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