



iLLUminate Blog Transcript: Qianqian Yu on Why Entrepreneurs are Ignoring Form D

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- ANNOUNCER: 00:05 This podcast is brought to you by iLLUminate, the Lehigh Business blog. To learn more, please visit us at business.lehigh.edu/news.
- JACK CROFT: 00:17 Welcome. I'm Jack Croft, host of the iLLUminate Podcast for Lehigh University's College of Business. Today is September 5th, 2024, and we're talking with [Qianqian Yu](#) about a study she recently co-authored with her Business School colleague, [Kathleen W. Hanley](#), examining why more than half of private firms that raise money in private markets from venture capitalists fail to file a form that's required by the U.S. Securities and Exchange Commission. Dr. Yu is an assistant professor in the Perella Department of Finance, whose research primarily focuses on corporate finance, entrepreneurial finance, venture capital, and financial intermediation. Thanks for joining us on iLLUminate today, Qianqian.
- QIANQIAN YU: 01:05 Thank you for having me, Jack. Really appreciate this opportunity.
- CROFT: 01:09 Yeah. So let's, without getting too deep into the regulatory details and all that, but I think it would be helpful to have a brief overview of what the Securities and Exchange Commission's Regulation D, specifically, is designed to do.
- YU: 01:27 We would say that under the Security Regulation, or more specifically, under the Security Act of 1933, any offer to sell securities to outside investors in order to raise capital must be registered with the SEC or meet with an exemption. So if a company registers securities with the SEC, that basically means the company goes public. And that's the type of public company we have heard about, we have constantly seen. But if companies want to stay private and they still want to raise capital from external investors, then they will have to rely on some exemptions. And Regulation D is a popular exemption rule that private firms can rely on in order to raise capital from outside investors, including both accredited investors and a limited number of unaccredited investors. So when we talk about accredited investors, we are referring to those like venture capitalists or angel investors who are sophisticated and who have experience and knowledge to make investment in private equity. And if private firms, like many VC-backed firms do, they do rely on regulation exemptions to raise capital. Then they are required to file a filing, a short form called Form D, which includes the basic information about that private offering, such as the name and addresses of the companies, the names of the executive officers and board of directors, as well as the offering amount. And that form has to be filed within 15 days of the first sale.
- CROFT: 03:04 How does that form help the SEC monitor compliance with Regulation D?
- YU: 03:10 So first of all, that's a required form. If the firm relies on Regulation D exemptions to raise money from external investors, if you look at the form, it's actually not very complicated. It's a short form. But the importance of the form is that it helps the SEC to keep track of fundraising activities in the private market. And after 2009, the form has been filed electronically and posted on the [SEC EDGAR website](#), which means that the general public, whether institutional investors or any retail investors, as well as, they have access to the internet, they can search and get a copy of the Form D. So in

that sense, the majority of the investors, the general public, are also informed of the type of investment that they are considering or they might be involved in. Let's say if the SEC or say if the firm is not filing for me with SEC, then this could be a problem because now the SEC cannot easily determine whether that private offering restrictions, for example, prohibition on a general solicitation or whether there is excess sale to non-credit investors without seeing a Form D, then the SEC cannot easily determine whether this private offering restrictions are met, if that makes sense.

CROFT: 04:40

Yes, yes, that makes sense. And that kind of brings us to your study which looks again, primarily, on the role of venture capitalists in private firms that are legally required to file Form D. So let's talk a little before we get into some of the details of the study of what that role of venture capitalists is.

YU: 05:06

That's a great question. So realistically, we're unable to track all the private firms in general because these are private firms. So information, realistically, is not that much. A lot of the information we have or analysts, if you think about analysts report, financial statements, filings mostly are available for public firms. So for private firms, we really have to work hard to get their data. So unfortunately, we're not able to target all private firms in general, but we do have this excellent database called VentureXpert that allows us to analyze the funding round information of VC, venture capital, backed private firms. And that's one of the realistic reasons that we have to focus on a certain set of private firms rather than the entire universe of private firms. But economically, we think that is important and relevant for us, too, because as we know, many VC-backed firms later on after they go public or even before they're public, they play an important role in the overall economy. These are high-growth ventures. A lot of them are developing revolutionary technologies. And later on, these are high impactful companies. So that's another reason that we focus on this specific type of firms, which are venture-backed private firms.

CROFT: 06:33

And you were talking about the rounds of venture capital financing. Your study looked at 40,000 rounds of venture capital financings and found that more than half, more than 50%, do not file a Form D. So are there any general characteristics that distinguish the companies that file from those that don't?

YU: 06:58

We indeed find that some characteristics are associated with a higher compliance rate or higher filing rate of Form D, while other characteristics can predict that such firms are less likely to file Form D. And that's why we think that the decision to file Form D is predictable and therefore it is strategic. So looking at the characteristics, we find that firms that are raising a larger amount of capital who have more investors, as well as who have a spread out investor base, meaning they have investors spread out across different states, such firms are more likely to file a Form D because our conjecture is such firms are more likely to be caught if they fail to comply with a Regulation D. While other companies—for example, private firms in their early stages, private firms in biotech sector or high-tech sector who have a lot of information to protect from being revealed to other competitors and so on—such firms are less likely to file a Form D. Also, we find that firms who are facing greater competition, having a greater threat from outside companies, from outside competition are less likely to file a Form D. So this all points to the fact that firms may strategically decide whether they want to file or not to file by weighing the potential benefit versus cost of filing Form D.

- CROFT: 08:39 Yeah. And as you looked at these things and both examined some of the data that's available, which I understand is limited.
- YU: 08:49 [laughter] Yeah.
- CROFT: 08:51 But also, I know that you talked with some lawyers and entrepreneurs about this as well. What were some of the main reasons that emerged for that strategic decision to not file the form outweighing the risk of getting caught?
- YU: 09:10 I think one general idea I got is that for some firms—like what we have talked about, like early-stage companies or biotech companies, high-tech ventures—who have a lot of proprietary information they want to protect, the benefit from not filing a Form D is substantial because by not filing Form D, they can protect their information from being revealed to their potential competitors, I mean. But the penalty of not filing Form D is relatively less compared to the perceived benefit. That is because under the current security regulation, the filing for Form D is not a condition to the availability of using exemptions under Regulation D in the future. So meaning that even if the firm is not filing a Form D, this does not make Regulation D exemptions unavailable to them for this particular offering. So that's the reason we think that the penalty compared to the benefit for many private firms is much less. That gives them an incentive to not file.
- CROFT: 10:25 The primary data-based analysis you were able to do involved firms that would be hesitant in sharing their information broadly with the public because of patent trolls. And let's explore that a little. First, what are patent trolls and what were you able to document regarding the role that they play in the failure to file?
- YU: 10:55 So patent trolls, as you probably can tell from the name, they certainly are closely related to patents. In fact, they acquire patents or hold patents. Those are like trolls, so they're not the good guys. Typically, they acquire a lot of patents and then license those patents or generate revenues from licensing patents, but they do not make or sell products or services based on the patented technologies. So what a lot of patent [trolls] actually do is they accumulate quite a number of patents and then they await an opportunity to initiate lawsuits against people who have the ability to settle a patent lawsuit. That's what patent trolls do. So what we find in our paper is that after a private firm filing a Form D after raising a round from venture capitalists, such firms are more likely to be targeted by patent trolls, meaning patent trolls are more likely to target private firms who just raised the capital. And they got to learn all their capital raises information through observing a Form D filed by the private firms. So that's actually considered as one consequence of filing a negative consequence, obviously, a private firm filing a Form D. And that's also considered as a reason we think why some private firms do not want to file Form D because it put their capital raising activities in the spot and they may be immediately targeted by outside parties who want to take advantage of the capital raise.
- CROFT: 12:43 Now, there was some evidence of that that you found within the documentation on the firms being targeted who had filed versus those who did not. What did that involve?
- YU: 12:58 In our paper, we find that filing a Form D is associated with a higher probability of being targeted by patent trolls in the next two years. That means patent trolls will take advantage of the capital raising that they observe from a Form D that a private

company filed and then try to take actions to take advantage of that deep pocket. There is another interesting result related to this is that we look at the passage of anti-patent troll laws, which are aimed to protect companies from being targeted by patent trolls for frivolous reasons. And we find that after the passage of anti-patent troll laws across different states, then private firms, venture-backed private firms are more likely to file a Form D because now they know they're better protected. So they don't have to bear the negative consequences to filing Form D.

CROFT: 14:06

And this isn't directly related, but it was another interesting little tidbit that was in the study which was, I think, based more on anecdotal evidence. But that, again, once that information was out there to the broad public that there were reports of people, or companies, the private firms suddenly getting deluged with spam emails for services, products, that kind of thing, so.

YU: 14:33

Right. Exactly. So that's indeed what we learned by talking to lawyers and other entrepreneurs that firms who filed a Form D almost always immediately spammed by offers of different loans, services, products that are not directly related to the private firm's business. And also, some lawyers would claim that filing a Form D will review the management, as well as, directors to the attention of the SEC. So they will be closely monitored for any wrongdoing they may have done. Another interesting piece of information that I learned, which I don't know before, that sometimes the counsels of the venture capitalists, the investors may privately advise that the startups should not file Form D until they get approval from the VC investor or their counsel. So these are kind of the information to support our conjecture that private firms, when talking about filing a Form D, they do it strategically.

CROFT: 15:37

And now, and this kind of ties into that as well, I think, on the back end, that one of the interesting things you found was that as these private companies got close to going public by offering their stock through an initial public offering, or IPO, that many of them went ahead and filed the Form D, even if it was several years after the deadline for when they should have been filed. So what is going on there?

YU: 16:10

Yeah, that's a very interesting phenomena that we observe. So our conjecture is they are cleaning the house to make sure there is no red flag in terms of complying with security violations because for many private startups that going IPO, they're [inaudible] certain of successful exit. So they don't want to get anything wrong in this process. That is why many of them check back to see if they have filed Form D and make sure everything looks all right. So yeah, so basically, we consider this as a cleaning house activity to make sure that everything looks perfect when they're about to go public, because if later on there is any red flag or bad sign revealed in the process, they are not fully compliant with the security regulations, then the investors may be hesitant to purchase their security in the IPO, which could be disastrous for the company going public.

CROFT: 17:13

You had mentioned before, some of the limitations, I think, particularly within the area of enforcement and the penalties of not filing, not exactly being the strongest deterrent to keep people from filing. So I'm just wondering if there are any potential policy implications that your paper suggests that would be worth pursuing?

YU: 17:44

In my mind, our paper shed light on two important different areas. The first one is we speak to the recent debate on whether there needs to be some changes in the filing of a Form D requirement and also the SEC were having some debate on whether changes

are needed to revisit and revise the Regulation D. So I think our analysis speaks to the potential benefit versus cost that the SEC may want to take into consideration when making those changes. And the other policy implication we may have is to help us understand why there's a decline in the number of small companies going public. Because if you think about it, Form D is a very short form that limit, asks only a few questions with limited information required. And obviously, by strategically decide whether to file Form D or not, that means small firms view even this minor requirement as very costly. So it's no wonder to me that when talking about IPO that the firms need to go through onerous disclosure requirement, private firms will view those requirements super, super costly. And so I think our study also shed some light on why we see a decline in the number of IPOs, especially small firm IPOs in the past few decades.

CROFT: 19:24

And in terms of the other side of the coin, which is the SEC and its role in regulating businesses, the widespread failure to have this information in hand for the SEC, what problems does that cause, or is it just a form that really wouldn't help them that much?

YU: 19:52

I wouldn't say that the form does not help the SEC much. In fact, as SEC claimed, and I do believe so, that this is an important tool for the SEC to keep track of the capital raising activities in the private market. If we talk about the size of capital raised in the private market, it's actually larger than the capital raised, the amount of capital raised in the public market. So it's indeed a big market. But the requirement in terms of disclosure is much less and not so clear cut. So that's what we observed with the Form D filings as well. But as the SEC claim, this is an important tool to collect information and keep the investors informed of what type of investment they are involved in and associated risk. So in that sense, I think the Form D filings are indeed very important. And that probably speaks to why a couple of the SEC commissioners in their recent speech talking about whether there should be changes not only in the filing of the Form D, the requirement related to filing Form D, but also the content of the Form D.

CROFT: 21:14

Now, so last question I'd just like to ask if there's anything I haven't asked about the study or that we haven't discussed that you think our listeners should know about this topic and why it matters.

YU: 21:26

The last thing I will say, I know many academics or investors in our audience have a renewed interest in learning more about private markets, just as the SEC does. So we probably can watch out a little bit for any recent updates to see how the SEC may want to make revisions to the Regulation D requirements. So I'm just very much interested to know how things will unfold in the future.

CROFT: 21:57

I'd like to again thank our guest, Qianqian Yu. She is published in the Journal of Financial and Quantitative Analysis, and has presented her work at top tier finance conferences, including the American Finance Association Meeting, the Western Finance Association Meeting, the Financial Management Association Meeting, and the Northern Finance Association Meeting. This podcast was brought to you by iLLUminate, the Lehigh Business blog. To hear more podcasts featuring Lehigh Business thought leaders, please visit us at business.lehigh.edu/news. You'll also find links there to follow us on your favorite social media platforms. This is Jack Croft, host of the iLLUminate Podcast. Thanks for listening.