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The SEC's Curiosity about Unicorns

By Vysali Soundararajan (Guest Blogger)

Unicorn status is much coveted in Silicon Valley, and for obvious reasons. However, as I've written before[1], some people are concerned that the valuation of some unicorns might be inflated. As it turns out, it's not just private investors who are concerned about Unicorns and other Silicon Valley-weighted issues, including secondary markets and Regulation A+ crowdfunding[2]. In the following guest post, Vysali Soundararajan, Senior Claims Consultant at Woodruff-Sawyer in our Corporate & Executive Protection Group, discusses SEC Chair Mary Jo White's recent speech on these topics, and provides some important recommendations for companies that would prefer to avoid the SEC's gaze.

— Priya Cherian Huskins

The Securities and Exchange Commission can—and will—investigate private companies. As SEC Chair Mary Jo White discussed in a recent speech at Stanford University Rock Center for Corporate Governance[3], the SEC's core mission is to protect investors, whether public or private. Private companies are not beyond the reach of securities regulations or the "official curiosity" of SEC investigators.

For example, private companies must still comply with the anti-fraud rules of the Securities Exchange Act of 1934, including Rule 10b-5. As Chair White reminded the audience in her speech, these rules "apply to all companies and we must be vigorous in ferreting out and punishing wrongdoers wherever they operate."

Similarly, private companies still owe fiduciary duties to their shareholders, and as such, have obligations to their investors beyond securities regulations. But even in the face of such obligations and considering its limited resources, does SEC scrutiny of private companies make sense?

Many sophisticated investors, including venture capital funds, are typically aware of the risks they are taking when they invest in private companies. Such investors are in a better position to judge whether they are being misled or not. But Chair White argues that the downstream effects of these failures are real when it doesn't work out, intimating that the SEC may pursue private companies even if their investors don't.

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[1] https://wsandco.com/do-notebook/unicorns-down-rounds-and-independent-directors/

[2] https://wsandco.com/do-notebook/regulation-crowdfunding/

[3] https://law.stanford.edu/arthur-and-toni-rembe-rock-center-for-corporate-governance/#slsnav-about-us

From a securities law perspective, the theory behind the private markets is that sophisticated investors do not need the protections offered by the robust mandatory disclosure provisions of the 1933 Securities Act. So, if those participants choose – with eyes wide open – to invest in private companies at valuations that may be ethereal or overinflated, who loses when the truth behind inflated valuations is revealed? I think we all do. Not just the VC and private equity funds, but also smaller retail investors and the next Stanford student whose great idea needs funding, but investors are unwilling to take a bet on her because they were burned last time.

Whatever the source of scrutiny, even the most cursory SEC interest in a company can escalate to an expensive affair. More robust investigations often cost companies several million—a tab that insurance will not always pick up. While D&O insurance usually covers SEC investigations of directors and officers, SEC investigations of corporate entities are not always covered by insurance (a topic we've visited previously[4]).

New endorsements have recently been developed to address this gap. These endorsements provide coverage for SEC inquiries and investigations of entities, on a look-back and/or look-forward basis, when followed or preceded by a related securities class action. Unfortunately, insurance carriers are unlikely to offer this product on private company policy forms due to the normally much lower premiums and retentions that the private company market demands.

Wrangling Unicorns

The good news for most private companies is bad news for unicorns; SEC curiosity into private companies has largely been piqued by companies with billion dollar valuations. For those private companies that have significant valuations—or aim to—Chair White recommended enhanced internal controls, transparency and corporate governance mechanisms:

Being a private company obviously does not mean that you can disregard the interests of investors. Indeed, being a private company comes with serious obligations to investors and the markets… the resulting candor and fair dealing should be fundamentally the same.

Relevantly, Chair White recognized that private companies are not required to have the same level of internal controls over financial reporting that companies must have; nevertheless, she was highly encouraging of these compliance activities for unicorns, stating:

And beyond any specific regulatory requirements, some of the principles that characterize public companies – transparency with investors, controls on financial reporting, strong corporate governance – have applicability and relevance to private companies, especially those pre-IPO companies that aspire to go public, and should not be overlooked or avoided, whether or not mandated by federal law or an SEC regulation.

As gatekeepers, the board of directors watches over the business, communicates expectations and asks the tough questions. This is true of the board of directors of any company. However, as Chair White emphasized, companies with sizeable valuations need to be particularly mindful of the makeup of their boards.

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[4] *https://wsandco.com/do-notebook/coverage-sec/*

She elaborated with a list of questions that private companies should ask themselves when evaluating their boards:

- "Is your board expanding from founders and venture seats to include outsiders with larger, and ideally public, company experience?"
- "Do you have the right regulatory and financial expertise on your boards to appropriately make decisions on behalf of all investors?"
- "Do you have the relevant expertise in the particular industry in which your company functions to bring to bear different viewpoints and spot critical issues?"
- "Is your company, in short, being run and governed for the benefit of all of your investors."

(Our private company guide to D&O insurance[5] is a good place to start on how to ensure that your private company directors are protected through insurance.)

New Types of Capital Formation

While the focus may be on unicorns, those private companies without magic horns are not out of the woods just yet. The SEC is also looking toward how private companies are managing capital formation, such as through Regulation A+ crowdfunding[6] and secondary market trading.

With secondary market trading, the SEC is particularly concerned about the effect of private company valuations on secondary market actors. Protecting small investors has always been of particular importance to the SEC, so companies should expect scrutiny in this area to be sustained and intense.

Secondary Trading Market

To recruit the best and the brightest, startups usually offer equity-heavy compensation packages to potential employees. This places enormous upward pressure on companies to inflate stock value so as to woo—and keep—their superstars.

But there may be situations in which these stock valuations don't always align with what other employees or investors have been told, or what the open market might fairly predict.

In Chair White's own words:

> *In the unicorn context, there is a worry that the tail may wag the horn, so to speak, on valuation disclosures. The concern is whether the prestige associated with reaching a sky high valuation fast drives companies to try to appear more valuable than they actually are.*

(For more on what happens when valuations go wrong and how independent directors can respond, check out an earlier post here[7].)

Separately, private companies often severely restrict the transfer of shares, making company shares nearly illiquid, but are not always sufficiently transparent about these restrictions to their employee investors.

Chair White admitted that investors in these markets may not be interested in selling until the big IPO event. Still, she emphasized that the SEC would continue scrutinizing these and similar practices to make sure that secondary market actors have transparency around both value and trading.

To address these concerns, private companies should develop mechanisms to monitor recruiting behavior, company disclosures and trading practices.

Valuations should be fair, true and accurate. Disclosures should be thorough.

Written policies and procedures should be in place to address compensation, insider trading and financial reporting.

We also recommend implementing a formal whistleblower program. The SEC has positioned itself as the whistleblower's advocate[8].

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[5] *https://wsandco.com/do-notebook/priv-comp-do-guide/*
[6] *https://wsandco.com/do-notebook/regulation-crowdfunding/ https://wsandco.com/do-notebook/unicorns-down-rounds-and-independent-directors/*
[7] *https://wsandco.com/do-notebook/unicorns-down-rounds-and-independent-directors/*
[8] *http://www.sec.gov/news/speech/chair-white-remarks-at-garrett-institute.html*

If the SEC becomes more visible in its efforts to regulate private companies, whistleblower complaints by private company employees will proliferate. Developing a formal mechanism to allow employees to raise concerns about management and governance will mitigate the risk that employees will seek other avenues to air their grievances and seek relief.

The curious eye of the SEC can be turned away if its gaze finds only good governance and disclosure. Moreover, good governance controls and transparency is good for—and looks good to D&O insurance carriers as well.

In the face of increasing scrutiny by the SEC, private companies should revisit these issues with their board, advisors and outside counsel.

This content originally appeared as a guest blog post in "D&O Notebook: Directors & Officers Liability Blog," Woodruff-Sawyer & Co., June 2016. www.wsandco.com/do-notebook/secs-curiosity-unicorns/

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