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Private Early-Stage Startup Companies Coming Under Increased SEC Scrutiny



While sophisticated participants in private markets have historically been seen as capable of bargaining for information or withstanding losses better than mom-and-pop investors, current events signal that the U.S. Securities and Exchange Commission (SEC) intends to increase regulation and scrutiny of private companies. Based on recent public statements and enforcement activity, the SEC appears to be growing more aggressive in protecting private investors who have invested in early-stage startup companies. By way of example, on April 4, 2023, the SEC announced an action against Charlie Javice, founder and CEO of TAPD, Inc. (doing business as Frank), a private startup company that was sold to a financial institution for \$175 million based on alleged false and fabricated data concerning the number of student customers. According to the SEC's complaint, Javice hired a university professor to create "synthetic data" so that it appeared the company had data on 4.25 million student customers. The SEC alleges that the company only had data on 300,000 student customers. Other recent headline-grabbing cases involve Theranos Inc., a privately held company founded by Elizabeth Holmes and touted as a breakthrough health technology company, the cryptocurrency exchange, FTX, HeadSpin, YouPlus, and others.

This increased enforcement activity has been driven by the volume of exempt private securities offerings over the past decade, which have steadily grown to significantly outpace public offerings. According to the SEC, during the period of July 2, 2021, through June 30, 2022, exempt private offerings accounted for approximately \$4.5 trillion in capital raising, compared with \$1.23 trillion raised through registered offerings. This amounts to roughly 3.5 times more capital raised in private markets than in the public markets.

In a [January 2023 keynote speech](#), SEC Commissioner Caroline Crenshaw called for increased disclosure and accountability for private companies that raise funds under the Rule 506 exemption. Among her proposed reforms is the creation of a two-tiered scaled disclosure framework for Rule 506 in which some private issuers (based on market cap, value, or size of investor base, among other factors) would be "subject to heightened requirements," analogous to Regulation A - Tier 2 disclosure requirements, and potentially ongoing public disclosure obligations like Regulation A - Tier 2 issuers. The adoption of a tiered framework, according to

Commissioner Crenshaw, recognizes that not all offerings are created equally.

Commissioner Crenshaw acknowledged the exponential growth of private securities offerings due, at least in part, to current disclosure requirements unintentionally incentivizing companies to remain private rather than go public and become subject to an invasive regulatory disclosure process. Despite conceding the unintended consequences of regulation, Commissioner Crenshaw posited that more fulsome information by private companies is essential to maintain the integrity of the securities markets and to allow private investors and regulators to make informed decisions. Meanwhile, others maintain that such disclosure obligations will be particularly challenging for startup companies and are likely to stifle innovation through increased regulation and costs.

The SEC is also considering amending [Form D](#), the disclosure form that governs most private placements, to increase investigations relating to disclosures being made to private investors.

The SEC's enforcement action against Javice, seen alongside proposed disclosure requirements, signals to all privately held companies that they should be mindful of their representations to investors, regardless of whether they are sophisticated investors. While the number of SEC enforcement cases against startup companies still pales in comparison to cases involving public companies, recent SEC enforcement activity and comments from the regulator suggest considerable forthcoming vigilance.

Although privately held companies may not be required to make the same level of disclosures to investors as publicly traded companies, it is still imperative to maintain transparency and provide relevant information to build trust and credibility. Here are some key takeaways to consider:

Best Practices

Create a board of trusted advisors. Identify individuals who will hold others accountable and check assumptions.

Create a disclosure policy. Decide what information will be shared with investors and create a policy that outlines what will be provided, how often it will be provided, and to whom it will be disclosed.

Be transparent. Timely, accurate, and complete information can help build trust and confidence. Be upfront about risks or challenges the company is facing and about plans to address them.

Keep financial information up to date. Financial information is critical for investors, so it is important to keep financial statements up to date and accurate. Consider providing quarterly or annual financial reports to all investors, and be prepared to answer questions about financial performance.

Communicate regularly with investors. Regular communication with investors can help build a strong relationship and keep them informed about the company's progress. Consider hosting regular investor calls or meetings and be available to answer questions or address concerns. Tie all representations to verified statements, financial reports, and related documents. Show the work.

Avoidable Traps

Onboard people who are only going to be "yes" people.

Provide ad hoc information to certain investors and not others. Dissention and controversy among investors can create management and regulatory difficulty.

Oversell or "fake it till you make it."

Provide stale financial information on the assumption that it will be updated later.

Delay communications with investors because of negative information. Investors recognize that startup companies face many challenges: be upfront and face those challenges.

Protect confidential information. While it is important to be transparent with investors, it is equally important to protect confidential information about the company. Consider implementing policies and procedures to safeguard sensitive information, such as nondisclosure agreements, or restrict access to certain documents.

Hire independent technical experts. Engage advisors to provide commentary on everything from assumptions to projections. Create an environment where these people know their voices will be heard and their advice considered.

Seek out honest advice. Be honest about the service(s) and/or product(s) offered by the company. Recognize where the company is in its development, and act accordingly.

Conduct thorough due diligence. Details, details, and more details. Assume investors (and enforcement agencies) will thoroughly review all information regarding the company. Understand, anticipate, and be prepared to respond to questions or concerns with specificity.

Ignore policies designed to protect the company. Ensure that employees and investors properly complete necessary paperwork to safeguard the company's confidential information.

Ignore the people hired as technical experts or advisors. Find outside individuals who will provide honest information. In the same vein, do not take on all of the work. When stretched too thin, the vision can become clouded, and conditions can seem more dire than they are. That's when poor decisions are made. Layer out the work.

Get bad (or no) advice because of fear that the idea will be taken.

Overstate subjective claims or rely on the "big picture" to tell the company's story at the expense of forgoing and sharing objective analysis.

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