



SEC and DOJ Targeting Fraud Involving Pre-IPO Companies Historically regulators have been reluctant to interfere with the complex world of pre-IPO financing and private market transactions, which tend to involve the most sophisticated investors.

However, several recent public statements make it clear that both the U.S. Department of Justice (DOJ) and the U.S. Securities and Exchange Commission (SEC) are focused on finding fraud and other civil and criminal violations at private Silicon Valley companies. Citing multiple ongoing investigations, Northern California representatives from both the DOJ and the SEC boldly predicted a notable increase in criminal prosecutions (DOJ) and civil enforcement actions (SEC) within the next year. On March 31, 2016, SEC Chair Mary Jo White delivered the keynote address at an event entitled "The Silicon Valley Initiative: Protecting Investments in Pre-IPO Issuers" at Stanford's Rock Center for Corporate Governance. Chair White addressed pre-IPO finance,

secondary markets, and valuation, issues that impact the start-up, venture capital and private equity worlds rooted in Silicon Valley. Chair White stated that it is essential that the SEC fully engage Silicon Valley so that the Commission could better understand the unique features of its investors and financings. However, Chair White's conciliatory "open dialogue" overture to Silicon Valley should be juxtaposed with the government's *enforcement* focus, which became more pointed at the recent Securities Enforcement Forum West conference in San Francisco on May 12, 2016. Erin E. Schneider, Associate Regional Director for Enforcement in the SEC's San Francisco office, told attendees that her office is seeing more allegations of fraud involving not-yet-public Silicon Valley companies. Importantly, Schneider acknowledged that the SEC understands that valuing private companies is difficult and often subjective. As a result, it is more likely to look at fiduciaries, including venture capital firms, to ensure that the policies and procedures used to value companies are fair and consistently followed. Schneider also cited instances where private company employees did not understand the value of their stock, as well as others where founders told employees to not sell their stock when, in reality, the company was failing and liquidation preferences were going to leave them with nothing. At the same time, however, she said that widespread enforcement probably is not the answer given the SEC's limited resources. Rather, Schneider said her office is selecting cases carefully based on the most egregious conduct. Schneider also cautioned private companies to think seriously about their internal controls. While the SEC typically would not have the ability to bring an enforcement action against private companies based on insufficient internal controls, she encouraged companies of all sizes to adopt effective controls early because, as companies grow, the lack of proper controls may create a risky environment. At the same conference, Kyle F. Waldinger, Assistant United States Attorney in the Northern District of California, revealed that the DOJ and the SEC now meet quarterly to discuss their respective ongoing investigations and potential coordination, including on matters involving Silicon Valley companies. According to Waldinger, while most prosecutors do not think of themselves as "securities regulators," the DOJ has more prosecutorial weapons than the SEC and his office is going after the "liars, cheaters, and stealers" in Silicon Valley. Like his SEC counterpart, Waldinger emphasized that the DOJ is going to be active looking into private companies with large valuations. Schneider and Waldinger jointly predicted that the next year will see an uptick in private company cases brought by both the SEC and DOJ. Schneider noted that the SEC is likely to pursue more secondary market and security swaps cases, and potentially cases related to valuation fraud. Waldinger stated that the number of criminal investigations involving private companies already has increased, and his office is looking for the right cases to prosecute. His expectation is to pursue cases that will be attractive to Northern California judges and carry the toughest sentences.

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