

Cooperation with the SEC – Value?

Cooperation is frequently touted as the “secret sauce” that can help an issuer or individual facing potentially harsh regulatory scrutiny and sanctions for wrongful conduct mitigate the resolution of the action. Different regulators take different approaches to this issue but most, if not all, tout the notion that cooperation can mitigate sanctions. A variety of approaches are used. The Financial Fraud Office in the U.K. offers to discount the amount of the potential monetary sanctions by a designated percentage of the total monetary sanctions. The Department of Justice in criminal cases uses a similar approach using the sentencing guideline calculations and consideration of the charges to be brought.

The Commission at times has offered to mitigate the charges that might be brought and/or drop the penalty but not the disgorgement. This approach was used in its very successful Share Class Selection program recently. While it has long stated that cooperation will be rewarded, and at times notes that the remedial efforts of a party have been considered, in most instances it is very difficult to determine the impact of cooperation absent participation in a specific program such as the Share Class Selection Program. Consider, for example, its latest offering in this area, *SEC v. HeadSpin, Inc.*, Civil Action No. 5:22-cv-00576 (N.D. Cal. Filed January 28, 2022).

The case

Defendant HeadSpin, based in Palo Alto, gives customers hardware and software tools to test their mobile software applications across the world. Over two-years its former CEO, Manish Lachwani, engaged in a fraudulent scheme which pushed its valuation to over \$1 billion not by delivering a superior product or services, but through financial fraud.

The \$1 billion valuation was an illusion. To create that illusion the company and its CEO inflated the value of numerous customer deals. In addition, transactions under discussion with the potential customer were invoiced as if they were actually based on guaranteed

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future payments. This was done by creating false invoices. These fraudulent techniques propelled the company valuation upward.

In the fall of 2018 the company and its CEO took additional steps. Prior to a Series B fundraising round, HeadSpin's valuation was about half a billion dollars. One year later that valuation reached about \$1.1 billion during a Series C round of financing, giving the start-up company "unicorn" status. The inflation was based on fabricated claims and stories spun to investors. Those investors executed long-term contracts valued at tens of millions of dollars per year. Those investors were some of Silicon Valley's biggest, high-profile companies.

Following an internal investigation in 2020 by the board of directors the fraud unraveled, the CEO was forced to resign and the billion dollar valuation collapsed. The company was valued at about \$300,000.

The company implemented a series of remedial acts. Those included: 1) An internal investigation conducted by the board; 2) repaying investors; 3) the retention of new senior management; and 4) the adoption of new policies and procedures to enhance transparency and facilitate accurate reporting.

The complaint alleges violations of Securities Act Section 17(a) and Exchange Act Section 10(b). The company resolved the matter, consenting to the entry of permanent injunctions based on the Sections cited in the complaint. The Commission instituted a separate action against the former CEO, *SEC v. Lachwani*, Civil Action No. 3:21 Civ. 6554 (N.D. Cal.).

Comment

The press release announcing the case states that the Commission settled with HeadSpin "without a penalty" because it made "significant remedial efforts" in the wake of an internal investigation into misconduct by its now former CEO. There is no doubt that the company took every remedial step available to it.

While it is true that the Commission did not impose a penalty in this case, it did charge the company under two fraud statutes. It did insist that the company consent to the entry of two fraud injunctions despite the fact that the fraud was apparently conducted by the CEO and that the investors were repaid.

The real question here is does HeadSpin encourage others to self-report, permitting the Commission to leverage cooperation? Probably not. There is little here to encourage a firm to step forward. Here a start-up that did everything possible to correct a one-man fraud will for years have to disclose that the SEC branded it with two fraud charges -- a brand that may well impede its development. If cooperation means anything, it should not be this.

