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Bye-Bye Big Boys? The SEC Turns its Enforcement Focus to Private Deals

On April 4, 2023, the U.S. Securities and Exchange Commission ("SEC") filed suit against Charlie Javice, the 31-year-old founder of Frank,[1] a student loan and financial aid assistance company.[2] That same day, the U.S. Attorney's Office for the Southern District of New York ("DOJ") unsealed a criminal complaint against Javice.[3] On May 18, 2023, a federal grand jury indicted Javice on four counts: one count of wire fraud, one count of bank fraud, one count of securities fraud, and one count of conspiracy to commit wire fraud and bank fraud.[4]

The essence of the SEC and DOJ actions against Javice allege that Frank defrauded a large financial institution in connection with the sale of her company by providing false information regarding its number of users. According to the SEC, Javice engineered a scheme to create a fraudulent data set that misrepresented Frank's customer base as consisting of 4.25 million students – when the actual number was less than 300,000. The SEC further alleged the number of students was a material data point for the $175 million transaction.

The SEC's decision to charge a company or an individual with fraud relating to a significant securities transaction is certainly not a noteworthy story. What is noteworthy is that this was a ***private*** transaction involving two sophisticated parties.

The SEC's jurisdictional predicate to charge fraud-based violations under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") hinges upon the offer, purchase, or sale of securities, but not upon the presence of ***publicly traded** securities*. The Director of the SEC's Division of Enforcement, Gurbir Grewal, emphasized this point in the SEC's press release announcing the action against Javice when he stated: "Even ***non-public,*** *early-stage companies* must be truthful in their representations, and when they fall short we will hold them accountable as in this case."[5]

The SEC's charging fraud in connection with an equity transaction essentially involving only two private parties is relatively uncommon territory for the SEC to plant its enforcement flag. The SEC's Division of Enforcement has limited resources that it can devote to investigations. In evaluating its enforcement priorities, the SEC has historically considered investor harm a significant factor – with a particular focus on retail investors.[6] In the words of former SEC Chair Jay Clayton, the SEC best serves the public by protecting the interests of "Mr. and Ms. 401(k)."[7]

When it comes to dedicating these limited enforcement resources to matters involving only more sophisticated parties or larger market participants, the SEC has often internally concluded that such parties can adequately protect their own interests. While there certainly have been instances of the SEC pursuing alleged fraud in connection with transactions involving more sophisticated market participants, those examples generally involve what the SEC perceives as a more systemic risk and not a stand-alone transaction such as the Frank acquisition.[8]

Expanding the universe of market participants subject to enforcement actions, though, is consistent with Director Grewal's public messaging of more cases, in more areas, with more sanctions.[9] Director Grewal has also underscored the need to seek greater penalties and pursue enforcement in cases that deter misconduct and restore public trust in the financial markets. High-profile private M&A activity, in the nature of the Frank acquisition, provides exactly this opportunity for SEC Staff eager to follow through on these priorities.[10]

The SEC's allegations in its complaint against Javice show a fact pattern that it is reasonable to expect the SEC to investigate in other transactions. According to the SEC, following the signing of a non-disclosure agreement, Frank opened a shared data room. An allegedly fraudulent spreadsheet identifying 4.25 million customers was uploaded and made available to the acquirer. To the SEC, it was a case of "an old school fraud" where "fake information" was used to deceive the purchaser.[11] Even if not part of an intentional scheme to "fabricate data" as the SEC alleged with Javice, sellers including imprecise, estimated, or somewhat aggressive projections in a data room should be on notice.[12] Although sellers may consider these practices to be a somewhat routine negotiation tactic, the Javice case signals that such behavior may be subject to more exacting scrutiny from the SEC going forward. Not dissimilar to the approach employed by the SEC (at times unsuccessfully) in bond market cases, the SEC may consider those practices as sufficiently reckless or loose with the facts to merit anti-fraud charges under the Securities Act and the Exchange Act.[13]

The SEC's approach contrasts with the potential relief available to aggrieved private parties in a private M&A transaction. Sophisticated parties typically include in relevant purchase agreements a non-reliance clause, which the Delaware Chancery and other courts have held prevents a buyer from being able to assert a fraud claim against a seller for false statements made outside the face of the purchase agreement itself.[14] Similarly, so-called "Big Boy" letters acknowledging the information asymmetry between sophisticated parties to complex transactions are rarely invalidated.[15] And although reliance is generally a required element in private civil suits alleging securities fraud, actions by the SEC have no such reliance requirement.[16] Moreover, as the SEC continues to promote its whistleblower program, an aggrieved counterparty may consider reporting to the SEC as a newly available option.[17] Ultimately, a party that may have successfully insulated itself from civil liability against its counterparty, may now instead find itself subject to a civil or criminal prosecution backed by the full weight of the United States government.

For an SEC looking for the next big thing, they may have found it. We do not ultimately mean to suggest that the SEC intends to lurk in the shadows of every coming deal between private parties. But in an environment of rising economic pressures, the SEC has likely further increased the risk, cost, and diligence necessary for private transactions. Parties who may have traditionally offloaded some aspect of these risks through contract terms and "Big Boy" letters will likely need to assess with counsel what additional steps may be necessary to best protect their interests – with respect to both counterparties and the SEC.

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[1] TAPD, Inc. was the legal name for Frank, with "Frank" being the entity's doing-business-as name.
[2] https://www.sec.gov/news/press-release/2023-74
[3] https://www.justice.gov/usao-sdny/pr/former-start-ceo-charged-175-million-fraud
[4] *U.S. v. Javice*, 1:23-CR-00251-AKH (S.D.N.Y. 2023).
[5] https://www.sec.gov/news/press-release/2023-74 (emphasis added).
[6] *See, e.g.*, *Protecting the Retail Investor*, https://www.sec.gov/news/speech/mjw-speech-032114-protecting-retail-investor.
[7] https://www.sec.gov/news/speech/remarks-economic-club-new-york
[8] *See, e.g.*, asset-backed securities actions related to the 2008 financial crisis, https://www.sec.gov/spotlight/enf-actions-fc.shtml
[9] https://www.sec.gov/news/speech/grewal-speech-securities-enforcement-forum-111522
[10] The SEC appears focused on multiple other private company securities exemptions and initial public offering matters as well. *See, e.g.*, the SEC's proposed rule updates for Special Purpose Acquisition Companies, Shell Companies, and Projections, https://www.sec.gov/rules/proposed/2022/33-11048.pdf, and Commissioner Caroline Crenshaw's comments regarding "unicorns," https://www.sec.gov/news/speech/crenshaw-remarks-securities-regulation-institute-013023.
[11] https://www.sec.gov/news/press-release/2023-74
[12] https://www.sec.gov/litigation/complaints/2023/comp-pr2023-74.pdf.
[13] https://www.sec.gov/news/press-release/2017-102. *But see* subsequent jury verdict finding trader not liable https://www.bloomberg.com/news/articles/2022-05-06/ex-nomura-trader-not-liable-for-lying-to-clients-about-prices#xj4y7vzkg.
[14] *See Online HealthNow, Inc. v. CIP OCL Invs., LLC*, Del. Ch. 2021, 2021 WL 3557857, at *11-*17 (explaining that non-reliance clauses in a stock purchase agreement can prevent a plaintiff from asserting fraud claims where one party knowingly made false statements to the other party that were relied on as part of the transaction, but the false statements where not within the agreement itself).
[15] *Cf. Harborview Master Fund, LP v. Lightpath Tech., Inc., et al.*, 601 F. Supp. 2d 537, 546-47 & n.8 (S.D.N.Y. 2009).
[16] *See, e.g.*, *SEC v. Lemelson*, 57 F.4th 17, 28 (1st Cir. 2023).
[17] *See, e.g.*, *SEC Issues Largest-Ever Whistleblower Award*, https://www.sec.gov/news/press-release/2023-89.