The Theranos Securities Fraud Settlement...an easily avoidable financial and career train wreck for the founder

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Dynamic entrepreneurship energizes our economy, creates wealth for founders and investors, and ushers in societal benefits of new products, jobs, and technologies. Nowhere do we see this more than in the accelerated world of tech startups.

The blood-testing company Theranos Inc. and its founder and CEO, Elizabeth Holmes, garnered considerable media interest with the alleged ability to test for conditions ranging from diabetes to cancer using just a few drops of blood from a finger. Media attention followed and magnified the subsequent events and discoveries leading to the company's disintegration. Theranos' securities fraud saga concluded in March of 2018, with the settlement of SEC charges of fraud leveled at the founder. It's a sobering reminder of the bad things that can happen when the necessary precautions aren't taken, and appropriate professionals are not engaged to ensure correct execution of capital raising.

Theranos struggled through several investigations and lawsuits from multiple parties, but it was the securities fraud charges that ultimately crashed the company. While other flawed consumer and business actions by the company are serious, it was defrauding investors that resulted in the most severe punishment. The SEC ordered Theranos to return over $750 million to investors, while Holmes is personally liable for $500,000 in fines and banned from serving as a public company officer or director for the next ten years. Holmes also has to return millions of shares and relinquish voting control of the company that she dropped out of Stanford to found.

The ultimate lesson of the Theranos saga?

For entrepreneurs looking to take their business to the next stage of growth, the case of Theranos offers a hard lesson in what happens when raising capital is not done through the

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appropriate channels – namely, engaging licensed investment bankers to manage the raise. The one thing which the company and founder were most severely punished for – securities fraud – was something that could have been avoided if appropriate professional advice had been taken when raising funds.

While Theranos had a strong legal team, there was little the lawyers could do to prevent securities fraud from being committed in the first place. Legal counsel is responsible for providing advice and defending clients' best interests, but they are not licensed to underwrite and oversee capital raises. That is the domain of investment banking professionals. To bypass engaging bankers in later-stage capital raises is to risk violating securities regulations and being charged with investment fraud. For Theranos, that risk turned into a very real and irreversible outcome.

So how can issuers protect themselves from the potential pitfalls of raising capital incorrectly?

In today's highly regulated financial environment, it's imperative for issuers to engage licensed brokers who structure a raise where the responsibility – and risks – of compliant investor communication on the sale of securities are limited to those same professionals. There is no such thing as "securities fraud insurance," but the act of hiring licensed bankers to manage your raise is essentially that.

By engaging a banker, issuers effectively transfer the responsibilities and risks associated with securities sales to a professional who is fully equipped to handle them. It's in your banker's interests, as much as your own, to ensure your raise is fully compliant and all investor sales communication is compliant. Then you, as the issuer, can be secure in the knowledge that your raise is in line with regulations and you remain protected in the event any issues occur.

For very early-stage companies, with limited resources, that are raising capital from friends and family as well as angel investors, the upfront cost of engaging investment bankers may not be justified. However, at the "scale up" or "growth stage" of raising more significant amounts of capital from strangers, the cost of not hiring the appropriate professionals can far outweigh the fees of those professionals. For Theranos Inc., valued at $9 billion at its peak, the financial and existential cost of failing to engage professional bankers was devastating. This oversight all but destroyed the company, the careers of the individuals involved, investor value, and hundreds of jobs once held by employees.

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And what about the investors? Are they protected?
The use of banking professionals not only protects issuers from their oftentimes inadvertent fraudulent communication and mistakes, but provides a similar "insurance" to investors. The laws are written so that it's not up to the investor to do appropriate diligence to uncover misrepresentation. The issuer's responsibility is to make sure what is represented to investors is factual. The bankers take regulatory responsibility for these representations made in the offering and ensure that all communications to investors are factual and free of hyperbole.

The bankers do the investigative work (due diligence) in order to make sure that the representations they make to investors are true and accurate, to the best of their ability. There are severe fines and career-ending sanctions for misrepresenting the facts. Under penalty of law, representations to investors must be factual and the assumption by investors can be "what's said to me by the bankers is true."

So the engagement of bankers in a deal ensures investor protection as well, but this also reduces the likelihood of wronged parties taking advantage of compromising circumstances to personally pursue actions against the issuer, and stage a hostile takeover – another threat that became true for Theranos.

We are confident that the company could have avoided the final straw of being charged with massive securities fraud, if it had simply taken out "securities fraud insurance" – by hiring licensed investment bankers to manage the sale of its securities. Ultimately, it's always advisable to do things properly from the beginning. When it comes to acquiring capital to grow your business, the investment banking industry is mandated to support issuers and protect investor interests.

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