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SEC PENALIZES COMPANY FOR "UNSUPPORTED HYPE"

FAULTS ITS INABILITY TO BACK-UP IPO CLAIMS

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WHAT HAPPENED

The SEC announced settled charges against Zymergen Inc. in connection with its IPO based on misleading statements about its market potential, revenue prospects and customer pipeline. After raising $530 million in the 2021 IPO, the company filed for bankruptcy in October 2023 and its plan of liquidation was approved in early 2024. The company agreed to pay a $30 million civil penalty, to cease-and-desist from future violations and to cooperate in other SEC proceedings. It neither admitted nor denied the SEC's findings.

TAKEAWAYS

The SEC criticized the company for misleading investors "with what amounted to unsupported hype." For example, the SEC Order noted that the finance team developed forecasts and estimates for the IPO without consulting with the sales team and, in one case, jawboning the sales team to increase its internal estimates.

Although primarily tied to IPO-related disclosures, the case provides lessons for public companies with their routine SEC filings and investor communications. It illustrates the importance of establishing and following effective disclosure controls and procedures, such as:

- Developing a systematic approach for collecting and reviewing relevant information.
- Circulating questionnaires or inquiries to various business units and having them confirm material statements within their areas of responsibility.
- Instituting appropriate procedures to confirm the absence of any material changes following the inquiry process but before filing the report.
- Assembling back-up and supporting documentation in an appropriate file or binder for each of the various statements made in the report.

- Reviewing press releases, board materials and other sources of information for relevance and consistency.
- Documenting a reasonable basis, with adequate underlying support, for any forward-looking statements.

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Background

The SEC Order relates to the April 2021 IPO by Zymergen, a biotechnology company founded for the purpose of replacing petroleum-based products with biobased materials. Forbes described the "moonshot vision" in The Inside Story Of How Zymergen Imploded Four Months After Its $3 Billion IPO (Oct. 2021 - paywall) as "crafting products normally made of petrochemicals, from optic film for smartphone screens to mosquito [repellent], in a way that's better for the environment."

After raising over $800 million in private offerings, by 2020 it had developed one commercially available product: Hyaline — a film designed for electronic companies to use for display touch sensors in personal and other devices. Based on its cash burn rate, in early 2021 the company decided to accelerate IPO planning even though still pre-revenue.

Market potential inflated in IPO prospectus

In its IPO prospectus, Zymergen claimed that it estimated "the display market alone for Hyaline was over $1 billion in 2020." However, according to the SEC, this estimate was based on flawed and unreasonable assumptions:

- The finance team estimated the size of Hyaline's display market opportunities and prices — but had no role in marketing or sales or first-hand knowledge or expertise.
- The $1 billion figure included product markets that the sales team was not targeting and/or that were poor fits for Hyaline's technical characteristics.
  - The estimate included two key markets — rigid-touch-sensors and fingerprint-on-display — that comprised over 99% of the total. No member of the sales team reviewed this assumption, nor did the information provided by them support the inclusion of those markets. In fact, the sales team knew past attempts to sell Hyaline there had failed after customers found Hyaline was either too expensive, unnecessary or both.
- The $1 billion figure relied on product pricing assumptions that were unreasonable and at odds with the company's own internal sales analyses.
  - The finance team assumed pricing that was 3-5x higher than for similar products. For example, the finance team assumed that Hyaline could be sold at a price of $100 per square

meter in the two key markets even though the sales team knew the dominant films were priced at approximately $20 per square meter in those markets. The price assumed by the finance team was a premium price that the sales team believed customers might pay for Hyaline in smaller specialty markets with less competition.

- By contrast, using product prices that reflected actual pricing and excluding the two key markets that were deemed unlikely, the sales team separately prepared internal analyses showing the total display market opportunity in 2021 was approximately $42 million to $100 million — or 5 to 10% of the $1 billion estimate presented in the IPO.

Revenue forecasts boosted for analysts

Leading up to the IPO, Zymergen distributed revenue projections to research analysts so they could create financial models that would be communicated to investors.

- To create their internal model, the finance team asked the sales team to provide its highest-confidence revenue projections. In response, the sales team provided projections showing revenues for 2021, 2022 and 2023 were approximately 60–70% lower than management's prior projections in September 2020.
- In response, the finance team reduced by approximately half their internal 2021 estimate but asked the sales team to target significantly higher revenue projections for 2022 and 2023 and therefore more in line with the prior projections. In turn, the sales team significantly increased — in some instances, more than doubled — its previous highest-confidence projections for 2022 through 2025, increasing total revenues for those years by approximately $740 million. The finance team subsequently increased these figures even further.
- The company described these projections to analysts as "conservative" and suggested that there were multiple ways the company could exceed the projections. It did not disclose that the revenue projections for 2022 through 2025 were materially higher — sometimes double or more — than the highest-confidence projections originally provided by the sales team.
- Analysts subsequently published and provided models to investors that substantially mirrored the higher projections provided by the company.

Customer pipeline warning signs ignored in earnings call

In May 2021, Zymergen misled investors during its first public earnings call by misrepresenting the strength of Hyaline's customer pipeline and future sales while omitting significant technical and commercial problems facing the product.

- During the call, research analysts asked about the current status of the customer pipeline and requested an "update on the number of customers evaluating" Hyaline and "where your customers are in evaluation process."

- The company responded by noting that "customer market feedback during the product qualification process has been positive," and customer qualification was "progressing in line with expectations." It also stated that it "continue[d] to strengthen the pipeline" of customers.

- These statements omitted adverse facts known to the sales team:
  - The late-stage customer pipeline experienced significant technical and commercial challenges over the first half of 2021.

  - Multiple significant customers were either delayed in their qualification process, had dropped out of the pipeline, or indicated that they were likely to do so.

  - Rising concern within the company over the weeks and days preceding the earnings call about whether any of Hyaline's late-stage customers would purchase significant amounts of Hyaline in 2021.

  - The company's internal customer tracking documents indicated that the then-current display market for Hyaline was very small and internal projections for revenue continued to decline significantly.

Aftermath of IPO

Less than four months after the closing the IPO, the company issued a press release announcing:

- The CEO left the company and resigned as a director.

- Product revenue would be zero in 2021 and immaterial in 2022.

- Key Hyaline customers had faced technical issues and the product's commercial rollout was being delayed.

- "Emerging data" indicated a "smaller near-term market opportunity that is growing less rapidly than anticipated."

- The board of directors formed committees, including a Strategic Oversight Committee, to work "with outside experts to conduct an in-depth review of the Company's operational, financial, product, and commercialization efforts to facilitate the development of an updated strategic plan for Zymergen."

Findings of violations; terms of settlement

The SEC Order found that the company violated Section 17(a), an antifraud provision that does not require scienter and can be based on mere negligence.

Without admitting or denying the SEC's findings, and subject to bankruptcy court approval, the company agreed to cease-and-desist from future violations of Section 17(a) and to pay a civil penalty of $30 million.

Until the termination of the liquidating trust, the company agreed to cooperate with the SEC in any related judicial or administrative proceeding or investigation by the SEC or to which it is a party with respect to disclosing documents and other information, as well as employee depositions and testimony.

RELATED CAPABILITIES

- Securities & Corporate Governance

MEET THE TEAM

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