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SEC Evaluates Changes to Its Investor Counting Rules Potentially Forcing Large Private Companies into the Public Reporting Regime

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BACKGROUND

In 2012, the Jumpstart Our Business Startups Act (the JOBS Act) became law. Among other things, the JOBS Act sought to democratize access to the private markets, including raising the total assets threshold under Section 12(g) of the Securities and Exchange Act of 1934, as amended (the Exchange Act), from US$1 million to US$10 million as well as permitting private companies to raise equity through crowdfunding and by raising the shareholder “of record” limit for private companies from 500 to either (a) 2,000 persons or (b) 500 persons who are not accredited investors. The U.S. Securities and Exchange Commission (SEC) has now signaled a potential reversal in this democratization of the private markets, at least with respect to the largest private companies.

POTENTIAL NEW RULES TARGETING UNICORN COMPANIES WOULD CHANGE THE WAY “INVESTORS OF RECORD” ARE COUNTED

The SEC is currently evaluating potential new rules intended to increase transparency by “unicorns”—private companies valued in excess of US$1 billion. The burdens of registering securities with the SEC and complying with ongoing reporting requirements under the Exchange Act have deterred many private companies from going public. As a result of choosing to remain private, such companies avoid strict public disclosure requirements that investors in the public markets use to make investment decisions. The SEC is now seeking to draw many of those private companies into the public markets and increase the disclosure such companies provide to the public. SEC Commissioner Allison Lee told the Wall Street Journal, “When they’re big firms, they can have a huge impact on thousands of people’s lives with absolutely no visibility for investors, employees and their unions, regulators, or the public.” CB Insights reports that there are nearly 1,000 so-called unicorns raising capital today. Indeed, according to PitchBook and Dealogic, in 2021, venture capital investments reached US$330 billion, surpassing the total amount raised in initial public offerings (IPOs) for the year. However, questions remain as to whether such regulatory changes are desirable and whether the SEC would be willing to implement rules that run contrary to the JOBS Act's goal of increasing access to private markets.

One potential area in which rules changes could draw private companies into the public markets and into becoming public reporting companies would be rulemaking around who is counted as a shareholder "of record" for purposes of the investor limit. Currently, Section 12(g) of the Exchange Act provides that registration is required if the company's securities are "held of record" by either 2,000 persons or 500 persons who are not accredited investors. Although the threshold itself is set by statute and is not subject to change through SEC rulemaking, the SEC may seek to change how the number of persons for purposes of the threshold are calculated. For example, currently, feeder funds are counted as one shareholder of record for purposes of the investor limit, but the SEC could determine that each investor in a feeder fund should be individually counted, thereby increasing the number of shareholders of record counted toward the limit. Similarly, the SEC could also determine that venture capital funds no longer constitute a single shareholder of record for purposes of the shareholder limit, but rather, each of their individual limited partners would count as a holder of record.

POSSIBLE IMPACTS AND CONSIDERATIONS FOR PRIVATE COMPANIES AND INVESTORS

These potential changes have drawn predictable opposition from private companies and from the venture capital industry. Opponents of these changes argue that they would impose the burdens of public reporting on companies that will not enjoy the benefits of being publicly traded companies and that they have the potential of reversing the trend of increased access to private markets for investors and issuers alike. One potential reaction from companies seeking to avoid inadvertently crossing over threshold of becoming a reporting company may be to limit the pool of their investors by excluding investors other than those capable of writing the biggest checks to fund their working capital. In such cases, the potential new approach from the SEC could result in only a marginal increase to the number of public companies while simultaneously closing off access for certain investors to private equity markets. In addition, later-stage investors may seek representations and warranties targeting the number and nature of beneficial owners of feeder and venture capital funds owning equity in a company, and conversely, companies who are approaching the investor limit may seek to conduct counter diligence on potential fund investors to ensure that such investors do not result in the company inadvertently exceeding the limit.

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