MarketWatch

Progressive hopes for a radical SEC agenda face a unicorn problem

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The left flank of the Democratic Party cheered when President Joe Biden nominated Gary Gensler to be the next chairman of the Securities Exchange Commission, given his record of taking on Wall Street and progressives' ambition for new financial regulations that can advance their goals on issues ranging from climate change to economic inequality to diversity at U.S. corporations.

Those hopes, however, will have to contend with the growing importance of private companies that are not subject to most reporting requirements, and experts say for new financial regulations to have the widest impact, the SEC will have to move to greatly expand the universe of firms under its oversight.

Lee Reiners, executive director of Duke Global Financial Markets Center, published a report Tuesday that recommended the SEC require U.S. companies to disclose risks to their businesses from climate change, information on political spending and information on how they treat their workforces, to name a few issues. This information, Reiners argued, is essential for the public to make informed decisions about which companies to invest in.

"But if the SEC were to follow these recommendations, it would increase the burden on public companies and create a further incentive to stay private longer," Reiners told MarketWatch, adding that this incentive must be blunted through rule changes that make it more difficult for companies to raise capital privately.

There is strong evidence to suggest that young companies find it relatively easy to raise sufficient capital without going public, with data showing that the number of private companies worth more than $1 billion rising to 527 in January 2021, according to CBinsights. That's up from 39 in 2013, when venture capitalist Aileen Lee coined the term "unicorn" to describe such firms because they were so rare. Meanwhile, roughly 70% of all capital raised from securities sales in 2019 was exempt from SEC registration and reporting requirements, according to the agency.

Renee Jones, a professor at Boston College Law School, said in an interview that the growing clout of companies shielded from SEC regulations has been the product of deregulatory trends dating back 40 years, culminating in the 2012 JOBS Act that significantly expanded companies' ability to raise capital from investors without going public.

"There are about half as many public companies today as there were in 1996, and more importantly, the path to the IPO has slowed significantly," she told MarketWatch. "Companies can stay private for as long as they want."

To reverse this trend, Reiners proposed the SEC take steps including amending its definition of a “shareholder of record,” which he said allows private companies to appear to have fewer than 2,000 shareholders — the threshold beyond which a company must become public — through arrangements with banks that pool investor funds into omnibus stockholding accounts.

He also suggested the SEC revise its definition of an “accredited investor,” or individuals to whom private companies can sell an unlimited number of shares to without needing to publicly register. Currently, accredited investors are anyone with annual income exceeding $200,000 per year or a net worth of $1 million, figures that have remained unrevised since they were first introduced in the early 1980s.

“The SEC should consider revising the accredited investor definition to be based on a combination of sophistication, income, wealth, and access to the kind of information which registration would disclose,” Reiners wrote.

Republicans are likely to fiercely oppose attempts to broaden disclosure requirements or to force a larger share of U.S. companies to fall under full SEC oversight. During a House Financial Services subcommittee hearing Thursday, Republicans pushed back on proposals to require public companies to disclose risks related to climate change and practices around worker pay and diversity.

Rep. Bill Huizenga of Michigan, the ranking Republican on the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee, argued that the disclosures being proposed were not aimed at helping inform investors, but arming activists who wish to “name and shame” companies they “perceive as corporate villains.” He added that “these types of mandatory disclosures only waste private-sector resources” that could be better used to invest in new technology or raise worker wages.

Meanwhile, the 2012 JOBS Act that ushered in changes that have enabled the proliferation of unicorn companies won near-universal support from the GOP, which has long criticized the burdens imposed on companies by mandatory disclosures.

“By bringing additional companies under the reporting umbrella, you’re imposing disclosure obligations on them which can be burdensome,’ said Jennifer Schulp, director of financial regulation studies at the libertarian Cato Institute. “We should be asking why companies are looking to stay private longer, and if it’s to avoid the costs of being public, we should be asking why the costs of being public are so high, rather than talking about imposing high costs on more companies.”

Assuming that Gensler is confirmed by the Senate, he will have a 3-2 Democratic majority on the SEC. As chairman of the Commodity Futures Trading Commission, he enacted tough new regulations in the face of fierce industry opposition.

Gensler’s nomination hearing, in the Senate Banking Committee, is scheduled for Tuesday.

The most important constraint on the SEC, therefore, is time and labor needed to successfully enact controversial new rules that are sure to be challenged in court. “This means regulators are going to have to move methodically,” Reiners said.

“I’m plugged into some of the advocacy community and I think some of their expectations about what gets done and how quickly it gets done are completely unrealistic,” he added. “The goal is getting it right for the long run, not appeasing some base.”