

# Privately-Held Companies

## Legislation, Regulation, and Limited Dissemination of Financial Information

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*Publicly-traded companies have reporting and disclosure requirements set by the U.S. Securities and Exchange Commission (SEC), which includes the public disclosure of financial statements and an annual 10-K report. In contrast, privately-held companies most often do not meet the SEC filing requirements, and therefore, are not required to disclose financial information. For investors and business researchers, this can provide clear challenges for researching privately-held companies. This paper first highlights a sample of the significant legislation and rules affecting disclosure requirements of public and private companies. Then, it offers other government sources for company and industry financial information. Finally, it suggests further resources to educate business owners, investors, and business researchers.*

Company research can be an arduous task for business researchers and investors alike. The elusiveness of financial information from privately-held firms can make company research even more challenging, especially when compared to their publicly-traded counterparts. Privately-held firms do not trade company securities on the public market, and are generally exempt from the public reporting obligations, which are set by the Securities and Exchange Commission (SEC).<sup>1</sup> In contrast, publicly-traded companies are required to disclose comprehensive statements through the SEC, which include, but are not limited to, audited financial information within an annual 10-K report, executive compensation summary, and annual statement of beneficial ownership of securities.<sup>2</sup>

In 2015, there were over 6,000,000 companies in the United States, and only 4,381 companies were publicly-traded.<sup>3</sup> The number of publicly-traded companies has also dramatically decreased in the last two decades. At its peak in 1996, there were 8,090 publicly-traded companies, which by 2017 fell to 4,336.<sup>4</sup> There is speculation that regulatory pressures, such as reporting standards required by the Sarbanes Oxley Act, create an incentive for companies to remain privately-held or to go from a public to private status.<sup>5</sup>

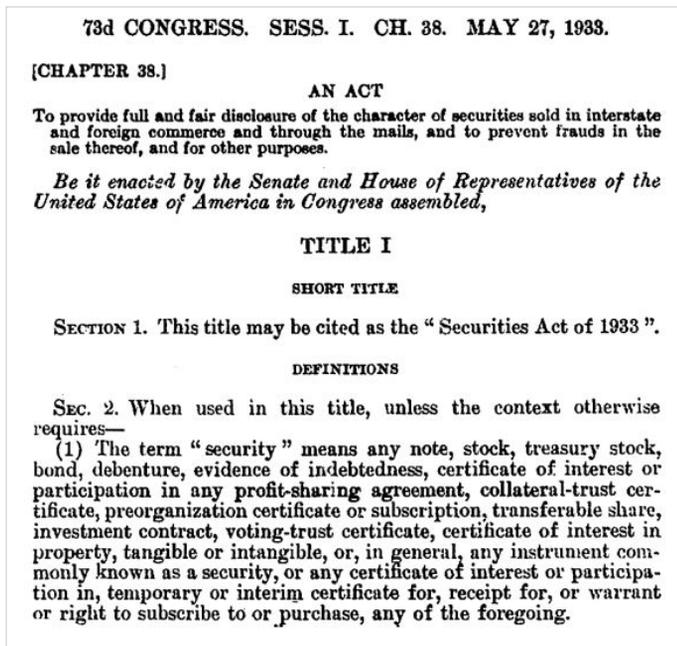
Because the vast majority of U.S. companies are private, it is often challenging to find financial information about these businesses. Under most conditions, private companies are exempt from registration requirements put forth by the SEC and are instead regulated by the Secretary of State.<sup>6</sup> Registration and disclosure requirements through the Secretary of State vary by state, but the company information made available to the public is often minimal and may include articles of incorporation and general company information.<sup>7</sup> In order to supplement this limited information, business researchers should also consider whether a particular private company belongs to “an industry subject to special regulations and reporting.”<sup>8</sup> Regulated industries, such as utilities, health, and transportation, can be required to disclose company data, which are sometimes published on federal and state agency websites. Private companies might also share confidential financial information with the United States Census Bureau (Census) and the Bureau of Economic Analysis (BEA) for aggregated industry and economic statistics.

### Background

Privately-held companies vary in size and structure and can be wholly owned by a corporation and its members, or its shares can be privately sold to a limited number of investors. While private companies do not trade securities to the general public, there are options under the SEC regulations to sell unregistered offerings, which are also commonly referred to as private placements.<sup>9</sup> Private placements are security offerings that are sold to private investors, and thus are exempt from registration requirements through the SEC. However, private placements are not exempt from “antifraud, civil liability, and other provisions of federal securities law,” which have accumulated over decades of legislative action.<sup>10</sup>

### Legislation Highlights, 1933–2002

The laws that govern the securities industry are grounded in the notion that companies and individuals that sell or trade

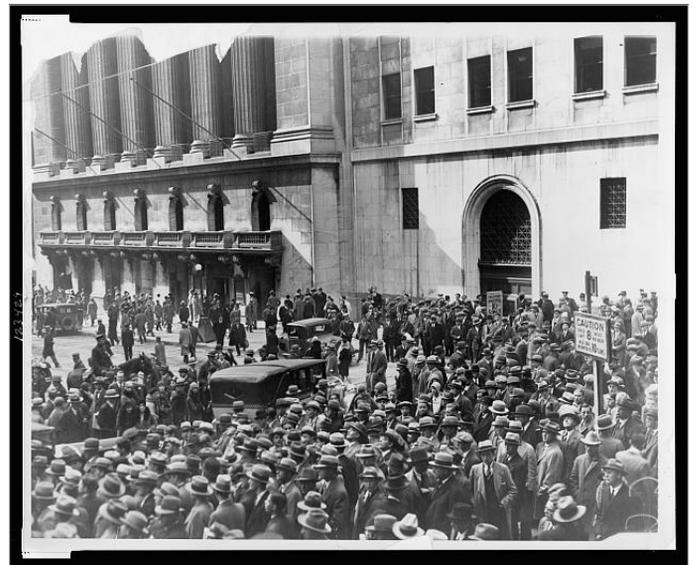


**Figure 1.** Securities Act of 1933, P.L. No. 73-22, § 48 Stat. 74 (1933). <https://www.loc.gov/law/help/statutes-at-large/73rd-congress/session-1/c73s1ch38.pdf>.

securities on the public market should be honest and fair to promote consumer confidence and market stability.<sup>11</sup> Between 1933 and 2002, many securities laws were passed to support these goals. This includes the Securities Act of 1933 (figure 1), the Securities Exchange Act of 1934, Investment Company Act of 1940, Investment Advisers Act of 1940, and the Sarbanes-Oxley Act of 2002.<sup>12</sup> What follows are brief summaries of these essential laws.

*Securities Act of 1933.* In a response to risky investments that contributed to the stock market crash of 1929 (figure 2), the Securities Act of 1933 was enacted on May 27, 1933, with the purpose of regulating sales of securities and providing fair and full disclosure of financial information to protect the public and investors from reckless and fraudulent sellers of securities.<sup>13</sup> Securities and transactions that are exempt include securities that are "not necessary in the public interest" because of the "small amount involved or limited character of the public offering."<sup>14</sup> However, if the aggregated amount offered to the public exceeded \$100,000 in 1933, then a public disclosure was required.<sup>15</sup> In 2016, this value was increased to \$5,000,000 in the amended Securities Act.<sup>16</sup>

*Securities Exchange Act of 1934.* Next, the Securities Exchange Act of 1934 was enacted on June 6, 1934. Section 4(a) established and authorized the Securities and Exchange Commission to promulgate securities law and regulations.<sup>17</sup> Registration requirements for publicly-traded securities were originally outlined in Section 12. The registration application



**Figure 2.** Crowd of people gather outside the New York Stock Exchange following the Crash of 1929. New York, 1929. Photograph. <https://www.loc.gov/item/99471695/>.

required information about the financial structure of the business, balance sheets of three preceding fiscal years (certified by independent public accountants), profit and loss statements, and further required financial statements for the protection of investors.<sup>18</sup>

*Investment Acts of 1940.* Another primary activity for the SEC is the regulation of investment companies and advisers, which was authorized under the Investment Company Act of 1940 and Investment Advisers Act of 1940.<sup>19</sup> Investment advisers are defined as persons who advise on the value of securities, and the advisability of investing, purchasing, and selling securities.<sup>20</sup> Similar to public companies, investment advisers must register with the SEC and comply with registration requirements. However, there are exemptions for certain private fund advisers, including those that act solely as an advisor to private funds, where assets under management are less than \$150,000,000.<sup>21</sup>

*Sarbanes-Oxley Act.* As a result of the Enron scandal, the Sarbanes-Oxley Act was signed into law by President Bush on July 30, 2002, to improve the accuracy and reliability of corporate disclosures.<sup>22</sup> In an investigation by the 107th Senate on the role of the board of directors in Enron's collapse, the subcommittee found that Enron's board of directors failed to safeguard their shareholders, knowingly allowed high-risk accounting practices, engaged in extensive undisclosed off-the-books activities, approved excessive compensation for company executives, and failed to ensure the independence of the company's auditor.<sup>23</sup> The Sarbanes-Oxley Act reformed business practices to promote corporate responsibility and enhance financial

disclosures. The Sarbanes-Oxley Act also established the Public Company Accounting Oversight Board (PCAOB), a third-party non-profit entity that would oversee company audits.<sup>24</sup>

The increase in insurance, legal, and compliance costs associated with the Sarbanes-Oxley Act have resulted in some public companies deciding to go private, which can be accomplished by having the company or investor group acquire all publicly-held shares.<sup>25</sup> Going private can be appealing because private companies are not required to comply with the mandated business practices promulgated by the Sarbanes-Oxley Act. However, there are provisions of the Sarbanes-Oxley Act that apply to both private and public companies, especially as it relates to corporate and criminal fraud accountability.<sup>26</sup> For example, violations of federal and state securities law with private securities are nondischargeable in a bankruptcy, and fabricating or destroying evidence during a federal agency investigation is a crime under the Sarbanes-Oxley Act.<sup>27</sup>

The Securities Act of 1933, the Securities Exchange Act of 1934, Investment Company Act of 1940, Investment Advisers Act of 1940, and the Sarbanes-Oxley Act have thus been foundational in defining and enforcing registered and unregistered requirements for financial information disclosures. I now turn to the provisions of these acts that govern private companies, many of which are currently exempted from the reporting requirements detailed above.

## Laws and Regulations Affecting Private Company Financial Information

Under the Securities Act of 1933, the general rules and regulations of the SEC were codified under Title 17, Part 230 of the *Code of Federal Regulations* (CFR). In 1982, Regulation D was added to Title 17 (§§ 230.500–230.508), addressing rules governing the limited offerings and sales of securities without registration.<sup>28</sup> Rules 504 and 506 specifically reference private securities. Rule 504 states that issuers may offer and sell up to \$1,000,000 of securities within twelve months without being subject to disclosure requirements.<sup>29</sup> Rule 506 stipulates that private companies can have an unlimited number of accredited investors, and can decide what information to give to an investor, so long as it does not “violate antifraud prohibitions of the federal securities laws.”<sup>30</sup>

On December 12, 2011, an issued report was submitted through the House of Representatives on the suggested Private Company Flexibility and Growth Act.<sup>31</sup> If enacted, the law would raise the “threshold for mandatory registration under the SEC from 500 shareholders to 1000 shareholders,”<sup>32</sup> which would amend section 12(g) of the Exchange Act that had not been updated since 1964. By increasing the threshold, the

report argued that small companies would have the opportunity to grow capital and create jobs, but the bill was rejected.<sup>33</sup> However, the Jumpstart Our Business Startups (JOBS) Act of 2012 included Title 5, which addressed private company flexibility and growth, and through section 501 officially amended the Securities Exchange Act of 1934 to increase the statutory threshold from 500 to 2000 shareholders.<sup>34</sup> With new laws and rules amending the shareholder threshold, private companies are more likely to be exempt from registration requirements and financial disclosures.

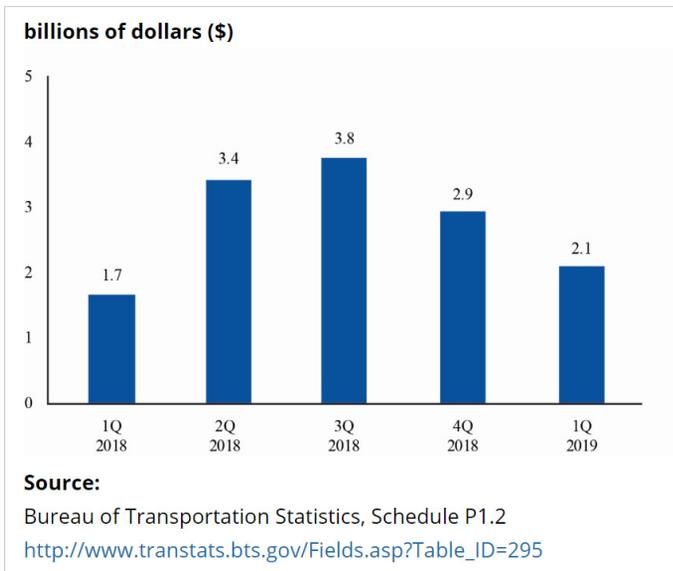
## Regulations through the Secretary of State

In addition to federal requirements for financial reporting, public and private companies are required to file general business disclosures with the Secretary of State in the state where it was incorporated. Depending on the business structure, companies may need to submit an article of incorporation, certificate of formation, or a certificate of limited partnership.<sup>35</sup> In Washington State, the filing requirements are outlined through the Revised Code of Washington (RCW) 23B.01 under the Washington Business Corporation Act.<sup>36</sup> RCW 23.95.255 details the initial and annual reports, which include entity name and jurisdiction, address, a brief description of the nature of the business, and other necessary information. The annual report does not include financial information for its disclosure. However, through RCW 23B.16.200, financial statements are required for shareholders that show a reasonably detailed look at the financial condition of the corporation and include recent balance sheets and income statements prepared using generally accepted accounting principles. Financial statements are only required for shareholders, and not available to the general public through the Secretary of State Business search.

## Private Companies in Regulated Industries

Regulated industries, such as utilities, health, and transportation, may provide additional financial reports by company or by industry. The Bureau of Transportation Statistics, for example, offers quarterly data for the airline industry that includes net income (figure 3), operating revenue, and operating expenses.<sup>37</sup>

Another example is the Washington Utilities and Transportation Commission (WUTC), which provides financial data by company for specific industries. For the electric industry, annual statistics of the three major electric utility companies from 1978 to 2017 are publicly available through the WUTC website. The financial information included are balance sheets, net income statements, unappropriated retained earnings, unappropriated undistributed subsidiary earnings



**Figure 3. Systemwide U.S. Scheduled Service Passenger Airlines Quarterly After Tax Net Profit, 1Q 2019.** Bureau of Transportation Statistics, Schedule P1.2. <https://www.bts.gov/newsroom/first-quarter-2019-us-airline-financial-data>

statement, and more.<sup>38</sup> Disclosure of financial records and reporting rules is promulgated by the Washington Administrative Code (WAC) chapter 480-100, sections 203-248.<sup>39</sup>

## Economic Statistics through Government Resources

*Economic Census.* The Economic Census collects aggregated data and reports from both private and public companies by industry or geographic area.<sup>40</sup> The Economic Census tries to avoid possible disclosure issues where users may infer that data values are connected to an individual business. Two methods are used to prevent disclosure and protect participant confidentiality: cell suppression and noise infusion.<sup>41</sup> Cell suppression involves withholding data and replacing the value with a “D.” Noise infusion camouflages data by marginally adjusting each respondent’s data to lightly distort the total amount. Disclosure limitations are bound by Title 13 and Title 26 of the *United States Code*, which protects information collected by individuals and businesses. While the Economic Census provides aggregated data by industry, opposed to company-specific data, it offers useful insights on estimated sales and annual payroll expenses.

*Statistics of U.S. Businesses (SUSB).* The SUSB is a data series that concentrates on small business statistics.<sup>42</sup> The data is extracted from the Business Register (BR), which the census considers to be “the most complete, current, and consistent data for U.S. business establishments.”<sup>43</sup> The BR compiles information from the Economic Census, current business surveys, federal tax records, and other federal statistics. Though

not as focused on financial data, the SUSB provides an alternative source for small business statistics.

*U.S. Bureau of Economic Statistics (BEA).* The BEA (bea.gov) provides economic statistics and analysis to enhance public understanding of the U.S. economy. Notable data collections from the BEA include the corporate profits by industry estimates and private fixed investments. Corporate profits are income before income tax deductions and are an important U.S. economic indicator that measures corporate financial health and economic performance, as well as measure the relationship between earning and equity valuation.<sup>44</sup> Corporate profits data are collected from federal, state, and local taxes and are received on a tax-accounting basis when available to ensure consistent accounting definitions.<sup>45</sup> Private fixed investments (PFI) measures spending by private businesses, which serves as an indicator to whether private companies are willing to expand their production capacity.<sup>46</sup> Similar to corporate profits, data is collected using business-tax-accounting practices. The BEA industry financial statistics and ratios provide rich data from private companies, as well as critical economic indicators when evaluating business industries.

## Information Dissemination

*Private Company Financial Information.* Lenient regulations have allowed exemptions and increased shareholder thresholds of privately-held companies that as a result limit the dissemination of private company financial information. Private companies that exceed a shareholder threshold of 2000 persons and have more than \$10,000,000 in total assets must register with the SEC, and would, therefore, be searchable in the EDGAR Company Filing Database. Some private company information may be available through the Secretary of State Business database, such as an article of incorporation or annual reports. Financial information may also be available for companies within regulated industries depending on the state legal codes and regulations. Users can also supplement financial information with industry statistics and reports through the economic census and the BEA. Non-government subscription databases, such as PrivCo, estimate financial data for private companies, and thus could fill in information gaps for users who have database access.

*Business, and Investor Resources.* Through the SEC Office of Investor Education and Advocacy, Investor.gov is a resource that can help users make informed investment decisions and avoid fraud. The site provides instructional materials on investment research and assessing risk tolerance, as well as strategies to protect investments. Another useful resource is the U.S. Small Business Administration (sba.gov), which assists small business

owners with launching and managing their businesses. SBA offers online courses and helps connect business owners with funders from the Small Business Investment Company (SBIC).

## Conclusion

Legislative and regulatory exclusions to private companies limit public access to financial information. Public access to audited financial information can protect investors from risky unregistered offerings and provide data for company research and valuation. However, registration requirements can be costly, and expose unwanted details to competitors. For business researchers, libraries can fill the information gap by subscribing to databases like PrivCo and Dun & Bradstreet to provide estimated financial data for available private companies. Though the future of publicly-traded companies is unclear, increased shareholder thresholds through the JOBS Act and enhanced disclosures through the Sarbanes-Oxley Act have made the privately-held status attractive to moderate and large-sized firms. Thus, more companies may remain unregistered and keep their information private.

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