

Are Unicorns a Myth?

Unicorns are not just the stuff of fairy tales; some financial unicorns exist today. Retail investors looking to bet on a unicorn may be able to do so indirectly through a mutual fund, exchange-traded fund or business development company. But beware; investing in unicorns is risky.

What Does it Mean to be a Financial Unicorn?

In the area of financing businesses and start-up companies, the term “unicorn” has come to refer to a privately held company with a supposed valuation on paper of more than \$1 billion. A privately held company is one that generally cannot sell shares to the public and is owned by a limited number of investors. Private companies can raise capital to fund their businesses in a variety of ways, and recent changes in federal and state securities laws have expanded these options.

Investors in unicorns typically are private funds (such as venture-capital, private-equity or hedge funds), wealthy individuals, and direct owners or employees of the unicorn itself. SEC-registered mutual funds, exchange-traded funds (ETFs) and business development companies (BDCs) also may invest in unicorns.

Generally, retail investors cannot purchase shares of unicorns directly. Retail investors interested in betting on a particular unicorn could, however, search for a mutual fund, ETF or BDC with exposure to the company.

Investing in unicorns carries very real risks, particularly when investing directly into a unicorn. As privately held companies, there is no public market to trade the securities of unicorns. This means that the securities are illiquid, or not easily sold or exchanged for cash. The market valuations of unicorns therefore may not reflect the intrinsic value of these businesses. Unicorns also are unlikely to have the same level of robust public disclosures required of publicly-traded companies.

Historically, investors in start-ups had limited opportunities to sell shares before the company held an initial public offering (IPO) and a secondary trading market opened. As a result, start-ups' securities were highly illiquid. Federal legislation that came into effect on December 4, 2015 eased the way for early investors to resell shares. This enabled unicorns to expand their investor base and develop market awareness prior to making a public offering, although unicorns should still be considered illiquid. In addition, regulatory changes enacted in 2012 raised the ceiling on the number of investors a private company could have before the company would be required to register its securities and become publicly-traded. This regulatory change has helped unicorns stay private for longer periods of time.

What are Some Risks of Investing in pre-IPO Shares?

- **Fraud:** weak internal controls and corporate governance infrastructure may lead to fraudulent practices by a unicorn. For example, a company could create false sales and shipping documents to artificially increase sales numbers.
- **Disclosure:** since the securities of unicorns will not be registered at the state or federal level, investors may lack important information to make an investment decision.
- **Liquidity:** there is no guarantee shares can be resold after purchase.
- **Valuation:** the valuation on a unicorn pre-IPO may not reflect the intrinsic value of the enterprise. In addition, even if the unicorn eventually holds an IPO, there is no guarantee the stock price will rise. Some IPOs are unsuccessful and shares fall after the company goes public.

The Bottom Line

Before making any financial decisions, ask questions, do your homework and contact the Nebraska Department of Banking and Finance at 402-471-3445.

The Nebraska Department of Banking and Finance is a member of the North American Securities Administrators Association (NASAA). NASAA has provided this information as a service to investors. It is neither a legal interpretation nor an indication of a policy position by NASAA or any of its members, the state and provincial securities regulators. If you have questions concerning the meaning or application of a particular state law or rule or regulation, or a NASAA model rule, statement of policy or other materials, please consult with an attorney who specializes in securities law.